LEEWARD
FINANCIAL PARTNERS

Q4

2021

MARKET REVIEW

Outsized growth in 2021 leads to choppy markets in early 2022.

4Q Review and 2022 Outlook

LEEWARD FINANCIAL PARTNERS, LLC

Slowing but still growing

Last year was, yet again, another great year. Unfortunately, the pandemic was still front and center, driven by the emergence of new variants, the most potent being Delta and Omicron. While parts of the economy remained entirely shut down or constrained with supply chain issues, other parts of the economy and the stock market performed exceptionally well. The results speak for themselves. The U.S. economy produced real GDP growth of 6.9% in the fourth quarter and is expected to increase 5.6% for all of 2021. Equities across all asset classes posted positive returns, with the most substantial returns produced by large U.S. companies.

In the fourth quarter, U.S. equities shook off September's -5.2% pullback and quickly recovered to hit new highs, with the S&P 500 Index gaining 28.7% for the year. The S&P 500's performance was remarkable in 2022, beating all other asset classes by margins not seen since 1998. Yet, scratching below the surface, there was sharper volatility in the quarter that has continued into the new year. Particularly variable were highly valued technology companies and small-cap stocks, as rising interest rates and high valuations caused investors to flee and seek diversification. Small-capitalization stocks were up 14.8% for the year, and international markets appreciated 11.3%, significantly less than large U.S. companies. While growth was strong, so was inflation. The Consumer Price Index (CPI) soared to 7.0% for 2021, far higher than expected, spiking to its highest rate in 40 years. For context, the consensus this time last year called for inflation in 2021 to be just above 2.2%. In 2022, inflation is expected to stay elevated but decrease throughout the year. The latest estimate for 2022 is now 3.8%, more than double the ten-year average of 1.8%. The surge in prices has been a function of fiscal stimulus and COVID closures, providing consumers plenty of cash in an environment limited by supply-chain constraints.

We have started to see some price softening in December, particularly in the ISM Manufacturing Prices Paid Index. Still, we don't expect inflation to plateau until the middle of the year. We do expect the components driving

inflation to shift. In 2021 much of CPI's increase was driven by energy prices (+29.3%), new vehicles (+11.8%), and used cars and trucks (+37.3%). These sub-categories are components of the Goods and Energy categories in the CPI and account for about 30% of the total household consumption. These categories have started to slow, a trend we expect to continue through the spring. Contrary to Goods and Energy categories; however, the Services category (almost 60% of Household Consumption) will remain high. Notable subcategories in this group include shelter, travel, and entertainment. We expect these areas to stay elevated due to worker wage growth and increased travel.

The Fed is ready to raise interest rates.

In reaction to recent inflation data, the Federal Reserve Bank has (Fed) has shown signs it is preparing steps to combat inflation. Only a few months ago, the Fed announced that it would gradually taper its quantitative easing (QE) bond purchases. Now, based on the Fed's December meeting minutes, participants forecast three rate hikes of .25% each in 2022, another three rate hikes of .25% each in 2023, and two additional rate hikes of .25% each in 2024, totaling +2.0% over three years. Clearly, we are entering a rising rate environment.

The initial impact of the Fed's shift in policy has been for short-term interest rates to rise, but medium to long-term rates to remain essentially unchanged. The rising short-term rates have flattened the yield curve (a line that plots bond yields with different maturities.) The rate movements are not overly surprising because structural constraints in the U.S. economy (slowing growth, limited labor supply, ample liquidity, negative rates internationally) have created a ceiling on long-term interest rates. This has concerned some investors because a flat-to-inverse yield curve has historically signaled increased recessionary risk.

We do not believe these rate hikes alone will spark a recession because the absolute level of interest rates remains low. Recessions triggered by rate moves are typically caused by tighter lending standards and higher borrowing costs limiting capital access. Right now, the fed funds rate (the rate at which the Fed lends overnight funds to banks) is 0 - .25%. After three years of potential rate hikes, the Fed funds rate will only be marginally above 2%. This is low by historical standards and makes tighter lending improbable. We would become more concerned if projections called for rates to increase and stay above 3%, a level where

corporations and municipalities might become capital constrained. For now, there is plenty of room for rates to rise before recessionary fears become material.

COVID is the wildcard.

COVID continues to be the most significant unknown to the global economic outlook. Omicron's emergence in the fourth quarter reminds us that the pandemic remains unpredictable. The economy, supported by solid corporate balance sheets, healthy consumer savings, and robust demand for labor, is in good shape, albeit slowing from last year's break-neck growth. In this slowing growth environment, the withdrawal of central bank support will result in pockets of weakness. In January, we've already had our first period, where we experienced multiple intraday 1000-point price swings in the Dow Jones Industrial Average (DJIA) and most indices declining over 10% before recovering. Such periods will, as they have historically, represent investment opportunities. We focus on high-quality companies with durable earnings when this occurs.

Mid-Cycle phase

Slowing GDP growth and rising interest rates in 2022 have signaled the beginning of a mid-cycle phase in the economy. Profitable earnings and valuation are more critical than high-octane revenue expansion in this environment. Quality earnings become a significant swing factor in stock performance, with the best opportunities in companies that set beatable expectations and have good underlying growth. Execution is paramount. Companies that can perform and capitalize on the earnings power of their business models will produce the best returns. With some exceptions, now is not the time to look at low-quality concept stocks.

Valuations will matter more this year than in the recent past. Growth will be at a premium because multiples aren't expected to expand due to rising interest rates and reduced support from the Federal Reserve. Tough earnings comparisons from last year will need to be absorbed. In 2021 the S&P 500 Index had total earnings growth of 45%. This year's estimates are for high-single-digit growth. These factors suggest positive earnings surprises will be more difficult to achieve, and thus, rewarded handsomely. Conversely, earnings misses will be punished because it will be harder for companies to recover from weakness. We've already started to see this trend over the last few weeks, with companies like Amazon

<AMZN> and Met Life <MET> performing well post-earnings, and companies such as Ford <F> and Clorox <CLX> more challenged after disappointing reports.

Portfolio Positions

In client portfolios, we remain structurally tilted to equities (stocks) at the expense of fixed income (bonds). We continue to favor domestic stocks but have increased positioning in some international areas where valuations are compelling. Emerging markets look more attractive but offer more tactical trading opportunities than actual long-term allocations. Real estate continues to be appealing as an inflation hedge but admittedly may see some headwinds due to rising interest rates.

We continue to own short-term bonds for fixed-income allocations but may be close to increasing duration by purchasing intermediate-term bond exchange-traded funds. Intermediate rates have increased slightly but should remain range-bound, making mid-duration bonds more attractive. We continue to like the high-yield bond market as default risk remains low.

In equities, we have moved away from some speculative positions in favor of investments with high-quality cash flows. In high-risk-tolerance portfolios, we have made tactical adjustments to take advantage of volatility. Higher trading activity is a trend that should continue in aggressive portfolios throughout 2022 due to the mid-cycle characteristics of the U.S. economy.

We emphasize companies with excellent cash flows and earnings for portfolios with moderate risk tolerances. Enterprise software, industrial and communication companies exposed to infrastructure building, digital commerce, and consumer discretionary firms appear attractive. Traditional financial services, healthcare, and consumer staples are not as compelling at this point.

The slowing but still-growing mantra of the U.S. economy in 2022 will make markets more volatile than last year. Overall, we expect positive returns, but moderate compared to the above-average returns of 2020 and 2021. Inflation should start to fall by early summer but remain elevated for the year. Mid-term elections are not on the radar screen of many investors yet but should become a topic of

conversation in the second half of the year. The dips and turns of the pandemic remain as unpredictable as always. If the global economy reopens smoothly and supply chains heal faster than expected, there will be an upside to our expectations. Conversely, if a more strident COVID strain emerges, political acrimony in D.C., or international conflicts erupt, our expectations for total returns may be overly optimistic.

We hope your family remains healthy and happy. We appreciate the opportunity to work with you and look forward to speaking with many of you over the next several weeks.

Sincerely,

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