Canandaigua National Trust Company

QUARTERLY PERSPECTIVE

WINTER 2022

2021 Year in Review

The year 2021 saw a significant rebound in economic growth propelling real GDP above its pre-pandemic level. Equity markets followed along, making new highs throughout the year as corporate earnings continued their recovery. While the final numbers aren't in yet, the expectation is that U.S. GDP grew at roughly 5.6%[1] in 2021 and will likely carry that momentum into the first half of 2022 before slowing down later in the year. Not surprisingly, the primary driver of economic growth was the U.S. consumer who unleashed a wave of spending fueled by government stimulus payments, increased savings rates, and pent-up demand following 2020's lockdowns.

Aiding the recovery was a significant uptick in labor demand. Businesses rehired workers and added new jobs to meet increased demand, bringing the unemployment rate from 6.7% at the start of the year down to roughly 4.2% by year-end. As a sign of the ongoing labor market's strength, most recent data showed more than 11 million unfilled job openings,[2] an all time record. This strength has led to meaningful wage increases as businesses competed for workers to fill positions.

The flip side of this unprecedented recovery has been one of the most substantial increases in inflation that we've seen in decades. Unsurprisingly, when significantly elevated cash levels from government stimulus payments and Federal Reserve balance sheet expansion met a wave of demand that couldn't be filled due to supply chain issues, prices rose. As it stands, the U.S. Consumer Price Index ended November at 6.9% (annualized) and has been far more robust, in both its level and duration, than the Fed anticipated. By year-end, this prompted the Fed to begin a more aggressive tapering of its bond purchase program, which it will now likely wind down by March. This sets up the potential for a Fed Funds rate increase by spring, with others later in the year.

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Brian is a member of CNB Wealth Management's Investment Committee, where he is responsible for providing the research and analysis necessary to oversee the firm's investment portfolios. Additionally, Brian coordinates the firm's due diligence process, which monitors and evaluates all existing and prospective investment managers.

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2021 Index Returns	
S&P 500	28.71%
Russell 1000 Growth	27.60%
Russell 1000 Value	25.16%
Russell 2000 Value	28.27%
Dow Jones US Real Estate	38.99%
MSCI EAFE (net)	11.26%
MSCI Emerging Markets (net)	-2.54%
Bloomberg US Aggregate Bond	-1.54%
Bloomberg Municipal Bond	1.52%
Bloomberg High Yield Bond	5.28%

Source: Zephyr/Informa Investment Solutions

Markets

U.S. equities had another outstanding year, with the S&P 500 up 28.7% on back of strong earnings growth. Both revenues and profits continually exceeded expectations over the course of the year as companies fought to keep up with consumer demand. By year-end, even with the sharp increase in the S&P level (price), overall valuations had moderated, with the forward price-to-earnings ratio falling from 22.4x to 21.4x.[3] While still well above historical averages, this level continues to be supported by low interest rates, a strong consumer, and increased government spending. The question moving into 2022 is whether the likely increase in rates, along with moderating GDP growth, unsettles equity investors.

The rising tide lifted all boats, and equities fared well across the style and market capitalization spectrum with most U.S. asset classes up over 20%. Generally, small cap stocks lagged large caps, but small cap value stocks did very well with the Russell 2000 Value Index up over 28%. Also of note, real estate did exceptionally well, returning over 39% as measured by the Dow

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Jones U.S. Real Estate Index as the asset class continued its recovery and investors sought yield and potential inflation hedges.

Internationally, developed market equities fared well but lagged U.S. returns with the MSCI EAFE Net Index up 11.2%. Conversely, emerging markets struggled on weakness in China, and the MSCI Emerging Market Net Index was down 2.6% for the year.

Fixed income returns, outside of high yield credit, were generally negative for the year as prices dropped with rising rates. Yields, which continue to be extremely low, were not enough to offset the weakness in prices, leading the Bloomberg U.S. Aggregate Bond Index to post a -1.5% return for the year. For bond investors, the only areas of the market that provided meaningful returns were in high yield (below investment grade) and inflation protected securities (TIPS).

The fixed income outlook for next year doesn't look much better, as the Fed will likely begin raising rates to combat inflation. This will lead to more weakness in bond prices as the yield curve adjusts to higher rates. For the near-term, bond investors will need to focus on the diversification benefits of owning fixed income, understanding their role in dampening volatility in portfolios that own equities.

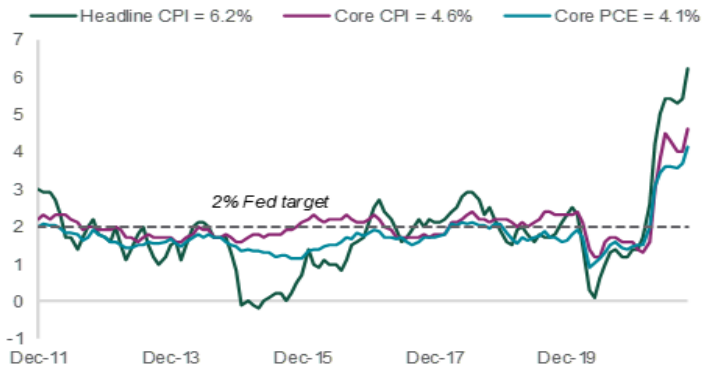
The Keys to 2022

Inflation would seem to be the lynchpin in 2022. Is it short-lived and likely to fade as we go through the year, or does it become embedded in the economy? Right now, the camps seem split, with arguments being made to support either argument. But one thing is almost certain: Its trajectory will play a significant role in how 2022 unfolds from a market and economic perspective.

Asset prices have been buoyed by easy monetary policy for over a decade, and if the punch bowl is removed by a Fed that is forced to be more aggressive with rates, then equity markets may bear the brunt of investor angst. Either way, given current U.S. equity valuations, it's likely that returns moderate over the next few years as they take a breather from their recent pace.

Of course, the virus will also play a substantial part in 2022. Covid-19 has taken a horrible toll on us as a country, with over 800,000 people having died from the disease and its complications. Yet many have decided to return to a more normal lifestyle, and there is little appetite for additional restrictions on schools and businesses. At the same time,

Inflation Readings – Percentage Changes Year-over-Year



CPI: Consumer Price Index, PCE: Personal Consumption Expenditures
Source: Northern Trust, information as of 10/31/21

hospital systems and workers can only endure so much, and the government will need to do what it can to protect them and their ability to function and provide vital services. Any restrictions, whether in the U.S. or internationally, could limit economic growth through lost revenues and the exacerbation of supply chain issues. Equity markets will continue to factor in the virus news flow as they attempt to ascertain the likely winners and losers, and the Fed will also need to weigh its policy decisions carefully in a very uncertain environment.

Conclusion

Our expectation is that the global economic recovery will continue in 2022 with GDP growth and inflation beginning to moderate toward more normal levels as we go through the second half of the year. Challenges will be posed by the uncertain path of the virus, and the Fed will have its hands full balancing the desire to fight inflation while not undermining asset prices, but for long-term investors the path ahead remains the same. A diversified portfolio of equities, with allocations across various capitalizations, styles, and geographic regions, remains the best way to grow wealth over the long-term, and while bonds may be handicapped in the short-term, they still provide stability in difficult periods.

Our investment committee will continue to actively discuss all of these factors and make adjustments in light of new opportunities or to help mitigate risks based on market conditions. As always, we are here to help keep your financial plan on track to meet your life goals. Please contact your advisor if you have any questions or concerns, and we wish you and your family all the best in the New Year.

Sources: [1]The Conference Board December forecast, [2]Bureau of Labor Statistics JOLTS report, and [3]FactSet as of 12/31/21.