THE PRIVATE CLIENT GROUP

BALANCING LIFE & WEALTH

ECONOMIC & MARKET INSIGHTS

Year-End 2021

EXECUTIVE SUMMARY

U.S. stocks once again dominated global investment markets in 2021, far surpassing other asset classes. It was a good year for risk-assets with equities, commodities, credit-sensitive bonds, and hedge funds posting strong gains. As the recovery from the coronavirus pandemic gained momentum, shortages in labor and materials created supply bottlenecks that drove inflation to the highest level in 40 years. Startled investors piled into inflation-sensitive assets such as real estate and high-yielding sectors with the potential to generate positive returns net of inflation. Energy-related assets, including stocks, and commodity futures, made a stunning comeback and were top performers in 2021 after experiencing substantial losses the prior year. On the other hand, safe-haven assets, including government bonds and gold, were weighed down by rising interest rates. Emerging markets also had a difficult year, reflecting the regulatory crackdown in China and greater challenges fighting COVID-19 compared to developed countries.

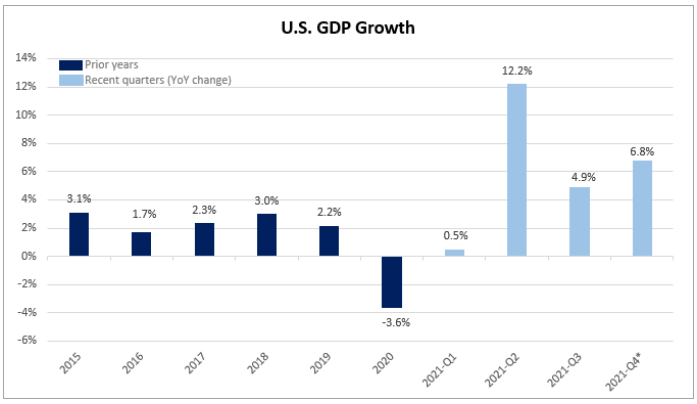
The economy has been growing at a rapid pace, but momentum is showing signs of slowing. The Federal Reserve has clearly signaled that monetary stimulus will be pulled back over the coming year. The sharp spike in the inflation rate and the unanticipated persistence and breadth of higher prices is likely to force the Fed to stay the course. Similar actions from other central banks are expected to drive global rates higher which could dampen business activity. In the U.S., the massive fiscal stimulus enacted at the start of the pandemic is ending, and spending from the current administration to fund policy initiatives is likely to fall below expectations. High inflation, negative real wage gains and a smaller labor force may be a drag on consumer spending. Heightened geopolitical tensions are also a concern. Although the economy and corporate earnings are expected to grow in the coming year, many forecasters are downgrading expectations.

After recent price gains, valuations are elevated across many asset classes, notably the U.S. stock market. While the rebound from COVID-19 is expected to continue, investment returns could be modest going forward. However, investors have tools at their disposal to improve financial outcomes. Tax strategies such as tax-loss harvesting and tax location can help maximize after-tax performance. There is also an unusually wide valuation dispersion within markets, providing opportunities to enhance returns through active management and thematic strategies. For investors that can tolerate less liquidity, alternative investment can provide levels of income and/or price return not available from stocks and bonds, sometimes with lower volatility. Finally, rising interest rates will eventually generate higher fixed income returns, although falling prices will initially be a headwind. High-quality fixed income remains an essential component of a diversified investment portfolio.

ECONOMIC INSIGHTS

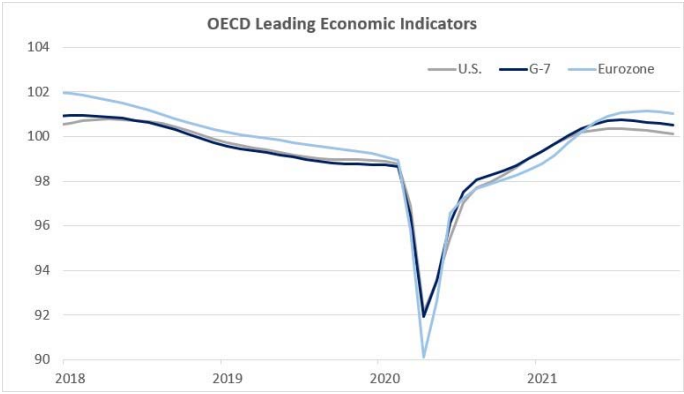
The global economy took large strides in its recovery during 2021. While the pandemic is still present, it has become more manageable through the extensive deployment of vaccines, a high level of natural immunity, and adaptations in lifestyles and how business is conducted. Although cases are currently surging due to the rapid spread of the Omicron variant, the pace of infection and lower severity could result in a higher peak but quicker surge. Last year's economic activity and growth levels reflected robust demand from the world reopening paired with a restocking of inventories. The economy is likely to continue its growth trajectory into 2022 as it evolves to the "new normal". Higher inflation and subsequent Fed hiking could also contribute to volatility in both the path of the recovery and risk asset markets.

U.S. real output is on pace to exceed pre-pandemic levels within the next year, indicating a full recovery from the pandemic-induced recession. The fourth quarter represented a strong pick-up in growth following a slowdown over the summer, caused by the Delta variant. While the pace of the snapback was impressive, it can be viewed as a double-edged sword. Unprecedented levels of government intervention, supply chain disruptions, and a shortage of workers have awoken inflationary pressures not seen in decades. These factors are likely to serve as near- and medium-term headwinds, offsetting the heightened levels of growth to a degree. Looking out further, the economy should reach a more normalized level of growth closer to historical averages of around 2%. This will incorporate reduced monetary and fiscal policy, more stable supply chains, and a (hopefully) even more subdued impact from the pandemic.



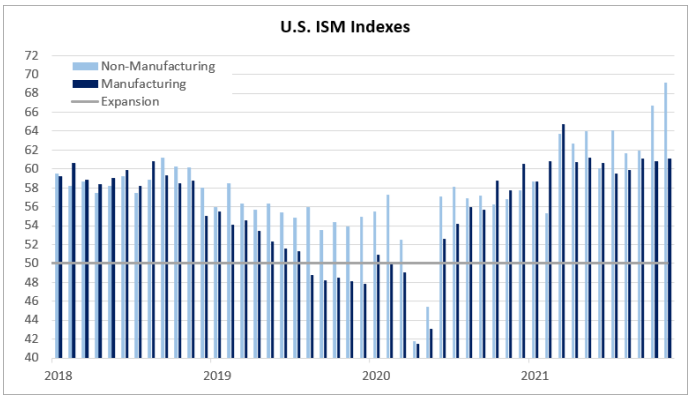
*U.S. Department of Commerce, *Atlanta Fed GDP Now Estimate SAAR*

Following GDP's decline in 2020 due to the pandemic, growth roared back in 2021 reflecting a rapid economic recovery partially fueled by massive levels of government assistance. Full-year 2021 GDP growth is likely to be in the mid-single-digit range before falling to more normal levels going forward.



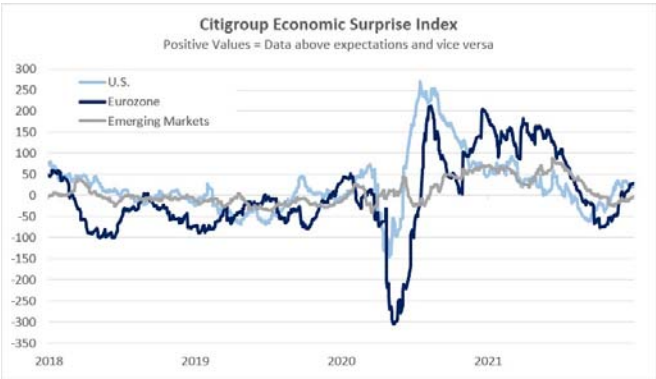
Organization for Economic Cooperation and Development

Leading economic indicators rose to pre-pandemic levels over much of 2021 following a swift bounce back from the depths of the recession. Recently, the slope has leveled off suggesting less growth momentum in the future.



Institute for Supply Management

Over 2021, the manufacturing ISM index was first to peak, and rose to levels last seen in the 1980s. Over the fourth quarter, the non-manufacturing ISM Index soared to record levels, representing extensive pent-up demand for services and experiences. Although the manufacturing PMI has fallen in recent months, both indexes continue to be well into expansionary territory (above 50).



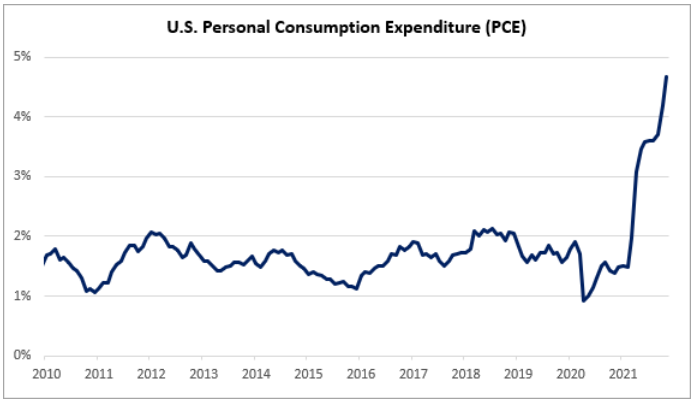
Citigroup

After declining during the third quarter, economic surprise indexes rose over Q4. These indexes, which are designed to measure the degree to which data is beating or missing expectations, show that U.S. and Eurozone data has largely come in ahead of consensus. Emerging Markets data has been less encouraging, reflecting a slowdown in China and a strong U.S. Dollar.

EMPLOYMENT AND THE CONSUMER

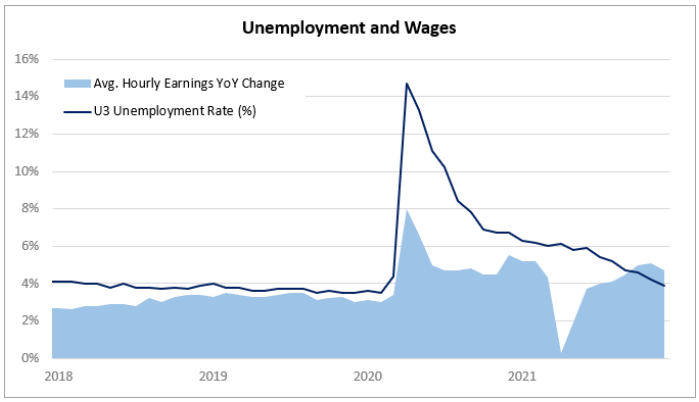
2021 was generally a good time to be a consumer. After a pandemic-induced spike in unemployment over 2020, the labor market came back with a vengeance. The U.S. unemployment rate started the year near 7% and ended just under 4%. While the economy has so far recovered around 80% of the jobs lost during the pandemic, labor market slack and wage growth paint a drastically different picture. A variety of factors including additional unemployment benefits, expensive and complicated childcare arrangements, and lingering health concerns have kept many from reentering the workforce, constraining supply. The shortage in labor has started to cause a rare shift in the balance of power between employee and employer. This has so far translated to higher wages and in many cases, concessions to employees such as promotions and increased flexibility. Even with these added benefits, many employers are still struggling to find adequate staffing to maintain pre-pandemic levels of operation. Staffing shortages could translate to reduced economic output for the early months of 2022, although things should normalize further into the year.

Higher wages, paired with government subsidies, have fueled a large appetite for goods and services. This elevated demand has been met with supply constraints, pushing prices higher and leading to inflation that might not be as transitory as initially thought. Despite large-scale price increases, consumer confidence steadily increased over the year, although there was some volatility mid-year reflecting the impact of the delta variant.
Americans felt optimistic about the economy heading into the holiday season and there were early indicators that supply chain disruptions were easing before the impact of the Omicron variant was felt. In the near-term, COVID-19's impact is likely to continue being felt by businesses and consumers as millions of Americans have called out sick over the past several weeks.



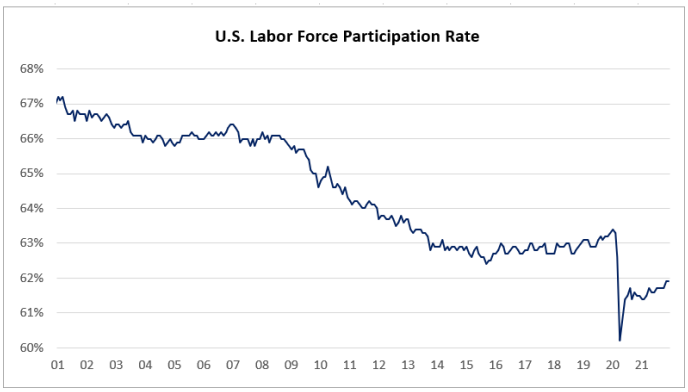
Bureau of Economic Analysis

The PCE Index represents the change in the prices of goods and services purchased by U.S. consumers. The Fed seeks a 2% annual increase in this index, but it has recently been averaging closer to 5% indicating much higher price inflation than the Fed targets.



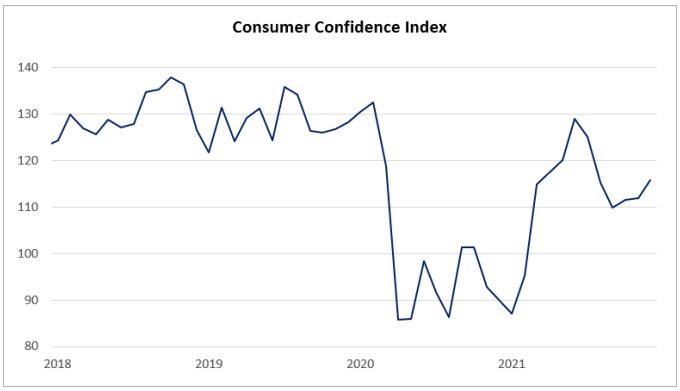
Bureau of Labor Statistics

The unemployment rate has made a miraculous recovery from pandemic highs near 15% to now being below 4%. While current levels are still above pre-pandemic readings, it doesn't fully represent the limited slack in the workforce which is possibly better portrayed by the level of robust wage growth.



Bureau of Labor Statistics

Referred to as the "Great Resignation" or the "Big Quit", Americans have been leaving their jobs at a historic pace. Although caused by a variety of factors, the result is a meaningful decline in the labor force participation rate and the dearth of labor supply forcing businesses to adapt how they operate.



Conference Board

Consumer confidence rose throughout the year, although it settled below levels reached in early summer. The increase is representative of the robust economic recovery, although it has the potential to be delayed or derailed by emerging coronavirus variants, most recently Omicron.

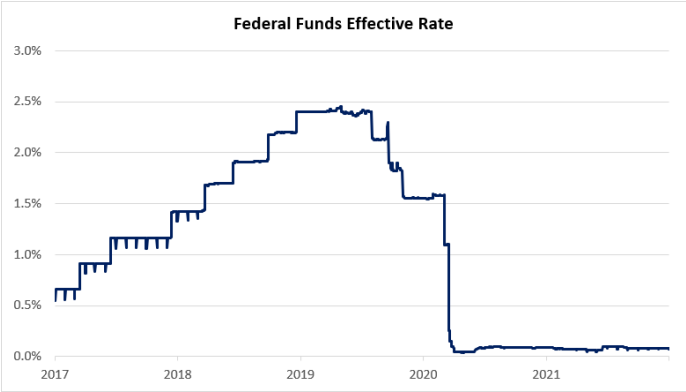
GOVERNMENT POLICY

Government and central bank intervention have been a significant factor in the path of the post-pandemic recovery. Legislation passed over the past two years has added over $5 trillion to the economy and, in some cases, vastly expanded the size and scope of the government. While the level of spending is likely to drop going forward, it has added considerable borrowing to the federal budget. The substantial injection of money and aid into the economy has also awoken long-tamed inflationary forces that pushed up consumer prices across the board. While supply chain disruptions and unusual demand activity are likely partially to blame, multi-decade high CPI readings have forced the Fed's hand to take faster action to readjust its policy stance relative to the level of economic growth.

The fourth quarter marked a notable shift in this transition. The Fed messaged its intent to both accelerate the pace of bond purchase tapering paired with the potential for three or more rate increases over 2022. The Fed also put forth the notion of reducing its balance sheet – another sign that the Fed is likely to be less dovish in the future. Notably, messaging is an important tool at the Fed's disposal as it retains the ability to pivot its path of policy adjustments based on how the economic recovery progresses. As it stands, less dovish messaging has already had meaningful ramifications across currency and asset markets. The expectation of higher rates has given the U.S. Dollar a significant advantage relative to other global currencies. This has translated to significant U.S. Dollar strength late into the year, pushing it to the strongest levels since mid-2020. Additionally, select U.S. Treasury yields reached their highest level since pre-pandemic which has reined in valuations of some of the most expensive areas of the stock and bond market.

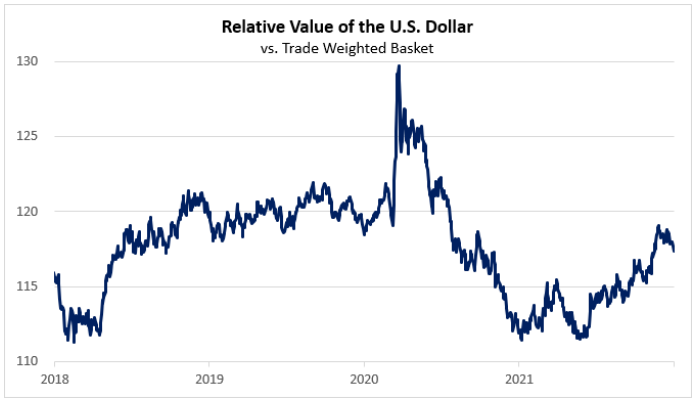
Bloomberg

The Fed's balance sheet reached record highs in 2021, reflecting extensive monetary aid to bolster the economic recovery from the pandemic. These figures could represent the peak as the Fed started tapering in November and messaged the potential to shrink the size of its balance sheet in the future.



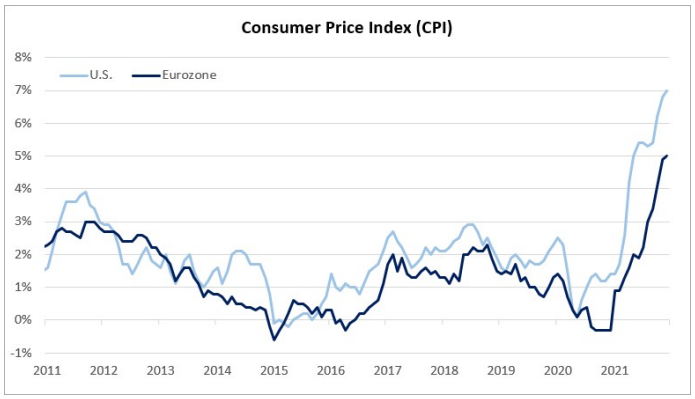
Board of Governors of the Federal Reserve System

Short-term rates have hovered near-0 for nearly the past two years, after they were initially dropped at the start of the pandemic. Recently, Fed Chair Powell has indicated that aggressive monetary stimulus is no longer necessary and it's time for rates to return to more normal levels.



Bloomberg

After initially surging during a flight to core reserve currencies at the start of the pandemic, the U.S. Dollar subsequently underwent a period of weakness through the remainder of 2020. Since then, expectations of rate increases have supported the dollar which is nearing pre-pandemic levels.



Bureau of Labor Statistics

U.S. inflation is at multi-decade highs, reflecting substantial supply and demand imbalances across many areas of the economy. The notion that inflation is transitory has come into question as the impact of the pandemic could be continuing in some cases.

MARKET INSIGHTS

EQUITY MARKETS

Relative to the volatility in the pandemic recovery, major U.S. large-cap indexes had a surprisingly calm and positive year. The S&P 500 Index rose again in 2021, marking the third year in a row of positive performance. While mega-cap tech platform companies (Apple, Microsoft, Facebook, etc.) mostly had a strong year, index gains were more broad-based relative to 2020. This is reflected in the top-performing areas of the market which included energy, real estate, and financial stocks versus technology and consumer discretionary names. There was also less variance between the results of investment styles (growth, value, and core). An impressive earnings recovery was a key driver of stock performance and S&P earnings reached a fresh all-time high over the year. Powerful consumer demand and some productivity gains were both important contributors to higher earnings. In 2022, several of the powerful drivers of the recovery could contribute to negative overhangs for future growth. Hawkish Fed actions, inflationary pressures, and the potential for higher corporate taxes all have the potential to hamper positive momentum.

While headline U.S. large-cap index returns were impressive, they disguised a wider dispersion of returns in other areas of the market. This was seen even within the U.S. – where areas of the market such as small-cap growth stocks rose a meager amount over the year. International equities logged another year of relative underperformance. While developed international equities rose, emerging market equities were negative. A stronger U.S. dollar and Chinese growth/regulatory concerns were key headwinds for emerging market equity performance. In many cases, earnings growth was still robust in 2021 for many non-U.S. markets, contributing to a more compelling valuation landscape relative to most portions of the U.S. equity market.

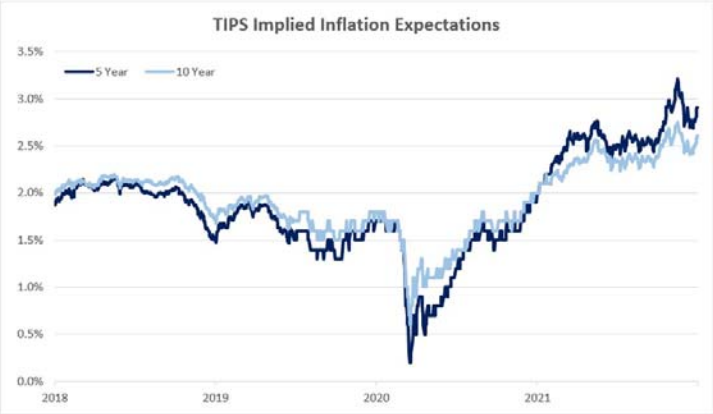
Bloomberg

Much of the strong equity market performance last year was driven by earnings growth. In the U.S., multiples compressed contributing to a slightly more encouraging valuation environment, although U.S. stocks are still expensive relative to history. The valuation environment today tends to be more encouraging internationally.

FIXED INCOME AND ALTERNATIVES MARKETS

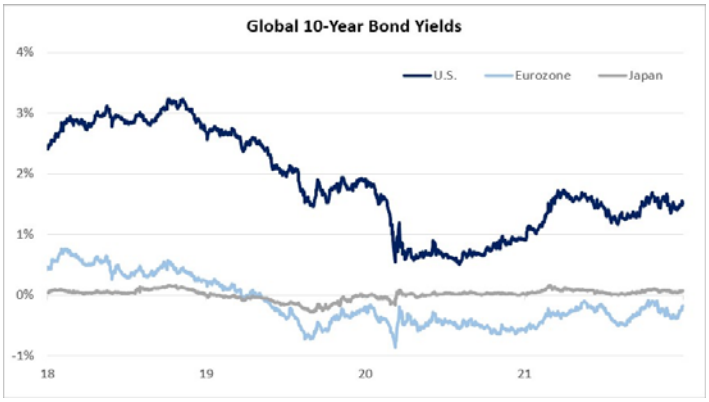
Given the expected interest rate hikes by the Fed over the next couple of years, in tandem with the planned asset purchase tapering, a meager outlook awaits fixed income returns in the short-term while long-term performance seems more compelling. The benchmark U.S. Treasury 10-Year yield had an upward trajectory over the year, climbing from around 0.92% at the start to end at around 1.51% at year-end, after experiencing some volatility along the way. Despite the higher shift in Treasury yields on what will likely be the strongest pace of economic growth and inflation since the 1980s, interest rates remain near their lowest level in 60 years of recorded data since 1962. The overall yield curve flattened and shifted higher during the year given the strong growth forecasts as COVID-19 vaccines were rolled out to begin 2021. Additionally, a record amount of money flowed into taxable fixed-income funds and ETFs during the year, to the tune of $583 billion, which far surpassed the previous record of $459 billion set in 2019.
This also clearly demonstrates the resiliency of the asset class. After tightening throughout most of the year, investment-grade corporate credit spreads widened in the fourth quarter as the Omicron variant reduced investors' appetite for risk. According to Bloomberg indices, high yield spreads tightened in 2021 thanks to a strong economy and solid underlying fundamentals. On the contrary, emerging market corporate credit spreads widened a bit, positioning their bonds to arguably be considered attractive relative to developed market bonds, albeit flush with added risk.

Municipal bonds saw record amounts of inflows, driven by expectations of higher tax rates and support from investors seeking safety and income. The AAA-rated municipal yield curve also shifted higher and flattened on expectations of strong growth and inflation. Like taxable funds, muni-funds also saw 51 out of 52 weeks with positive net inflows resulting in more than $100 billion of new capital allocated to the asset class. Congress also passed the $1.2 trillion Infrastructure Investment and Jobs Act in the fourth quarter, which included $550 billion of new infrastructure spending that will be spread out for use over several years, likely impacting municipal bonds.



Bloomberg

Medium- and long-term implied inflation expectations rose in 2021 as investors slowly accepted the fact that high inflation may be less transitory than originally thought. Regardless, the normalization of economic supply and demand should put a lid on rising inflation.



Bloomberg

The 10-Year U.S. Treasury yield rose around 60 bps, a large single-year move. Other developed markets yields remained in negative or near-zero territory. Because of this, U.S. debt appears quite attractive to foreign investors, namely Japan, given near-zero yields.

Barclays Capital

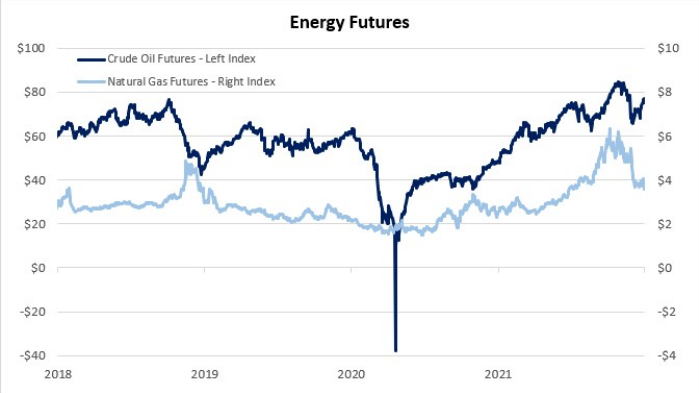
High-yield corporate bond spreads tightened over the full year despite a brief lapse in the fourth quarter following uncertainty brought on by Omicron. The broad tightening led to strong outperformance from the sector as the world sought to look past the pandemic.

Real assets had a mostly positive 2021. Crude oil had a banner year due to higher global demand than supply. On the demand side, consumers resumed travel after some pandemic-related restrictions were loosened, which boosted demand for energy. However, on the supply side, constraints in production were mostly attributable to OPEC+ which had started cutting its oil production in mid-2020. Also, after a brief spike in February during a winter storm that strained natural gas production, prices subsided, but still increased throughout the year overall. As a result, the prices of energy-oriented products rose.

Similarly, cryptocurrencies had a record year, which briefly surpassed $3 trillion in value in November, but has since retreated proving the volatile nature of these types of investments. Bitcoin and Ether reached all-time highs while other coins surged in popularity. The jury is still out as to whether the asset class should be considered as part of some wealthy clients' overall asset allocation, but the proposition has gained traction.

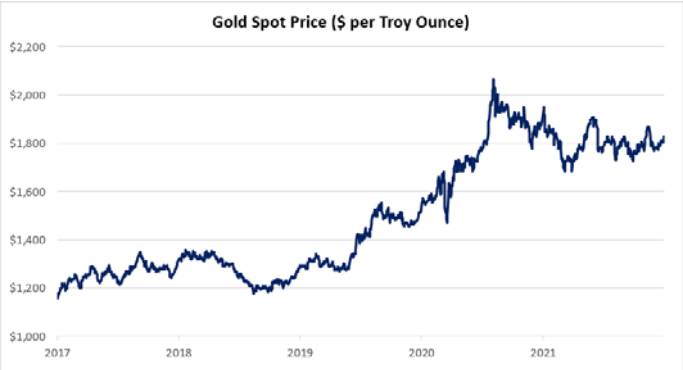
Real estate mortgage rates rose since their lows at the start of the year while residential real estate prices were pushed higher in 2021 following strong demand. Supply chain issues and labor shortages limited the number of new homes that could be built as demand soared. In commercial real estate, cities are seeing signs of improved rental growth given an expected increase in employment levels. Flexible working arrangements and demand for enhanced technological skills will help to determine the outlook as people return to work amidst the pandemic.

An area that was under pressure in 2021 was precious metals. Most gold-oriented products declined as the accelerated pace of monetary tightening implied increased competition from yield-bearing assets. Because of this, gold did not hedge against higher inflation very well over the year.



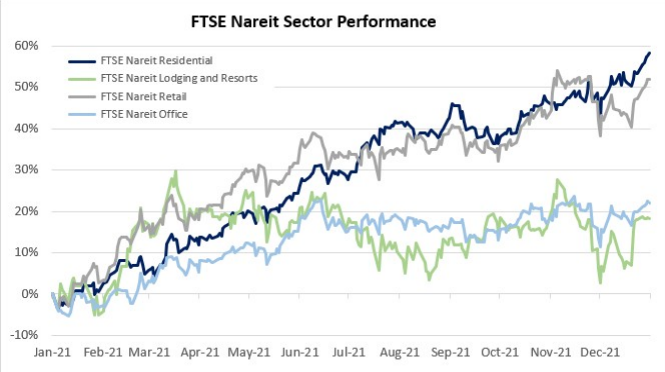
Bloomberg

Crude oil and natural gas futures' prices rose over the year but hit a speed bump in the fourth quarter as Omicron cases increased. The renewed consumer demand for travel and leisure drove oil prices higher while extreme weather events and demand for natural gas internationally caused its price to increase.



Bloomberg

The price of gold declined last year as future demand for the precious metal was cloudy. Investors view the Federal Reserve's pledge to accelerate monetary tightening as likely detracting from the demand for gold.



Nareit

Residential and retail real estate prices boomed for a few reasons, including low mortgage interest rates and insatiable levels of demand. On the other hand, office and hospitality rose, but to a lesser extent.

Steven W. Lieberman is the President and CEO of The Private Client Group Wealth Management, LLC. Investment advisory and financial planning services are offered through Summit Financial, LLC, an SEC Registered Investment Adviser ("Summit"), doing business as The Private Client Group (4 Campus Drive, Parsippany, NJ 07054. Tel. 973-285-3637). 01182022-0040