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MARKET REVIEW

› 4th QUARTER 2021

EXECUTIVE SUMMARY

- All equity classes were positive for the quarter with global REITs posting the strongest returns with +12%.
- Annual inflation ending November 2021 has accelerated to 6.8%. A majority of this increased inflation is expected to be transitory.
- Federal Reserve is expected to start raising rates in 2022 and into 2023.

Quarterly Market Review

Fourth Quarter 2021

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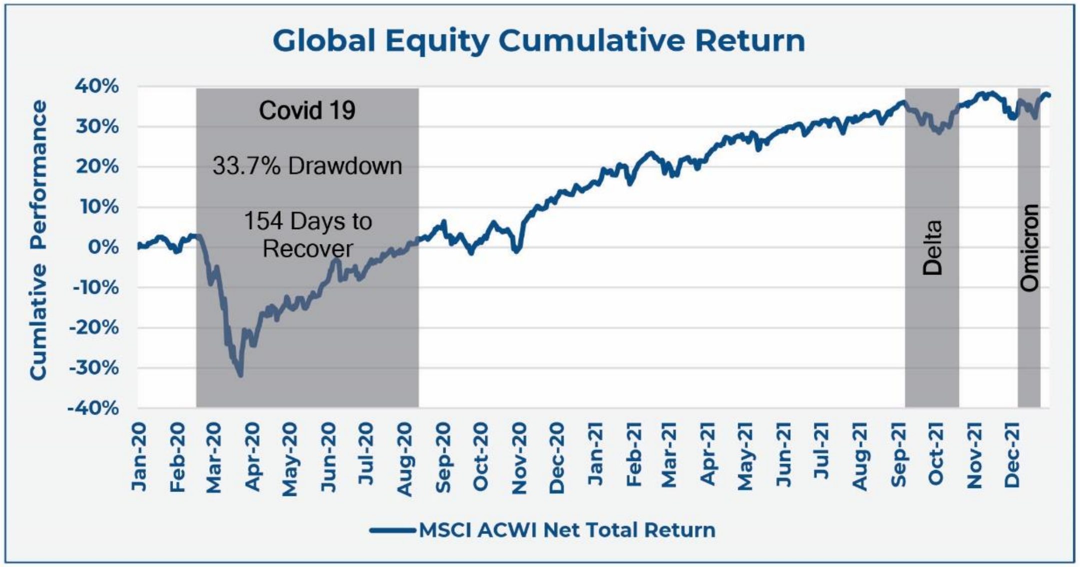
"Economists have successfully predicted nine out of the last five recessions." - Paul Samuelson, Noble Prize Economist

2021 ended with COVID continuing to occupy the headlines with a seemingly endless type of variant. However, similar to 2020, if you just observed news headlines, the prospect of a strong return for the market would seem to be very slim. In reality, people are adjusting their behavior, attaining increased immunity, and overall getting back to their normal lives. Correspondingly, businesses have adapted the way they do business, and the Federal Reserve has been exceptionally encouraging – all supporting another year of strong returns for the market.



Source: www.gsisus.com

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Market Performance:
The global market has proven again to be resilient by rebounding from new COVID variants, increased inflation, and continued political dysfunction – posting a global stock market quarterly return of 6% and 19% for the year. The markets were led by the continued strong performance by the United States with a quarterly return of 9%, and 26% for 2021. The heavier tilt a client's portfolio was allocated towards US small value companies, the greater returns they experienced for the year. The standard US small value benchmark is the Russell 2000 Value, which returned 28% for the year. However, the small value fund we typically utilize posted an outsized return of 38%, driven by the stronger weighting to the small company and value factor. Emerging markets trailed the other asset classes with a slightly negative return for the year, primarily driven by the poor performance of the BRIC countries (Brazil, Russia, India, and China).

Investment Portfolio Update:
Our investment portfolios continue to be tilted towards more attractively priced companies (ie: Value) across the globe. For example, the average Price/Earnings ratio (the higher the number the more "expensive" the investment is) of an HFG Trust investment portfolio is 16, compared to growth companies in the United States having an average ratio of 33. This does not mean value companies will outperform growth this year, but intuitively it should give investors comfort that their investments aren't over-allocated to companies and regions that are valued at historical highs.

Fixed income performed how it should, uneventful. We continue to tilt towards shorter-term bonds while staying high in quality. Generally, fixed income was slightly negative for 2021 due to interest rates rising modestly. In addition to having a preference towards short-term, high-quality bonds, we continue to incorporate inflation protection on a portion of our bond portfolio, which provided an impressive +6% outperformance compared to bonds without inflation protection in 2021. We're not in the business of predicting inflation rates but incorporating this insurance (hedging) at the right price has been prudent for investors.

Overall, fixed income continues to be an important pillar for most investors' portfolios. Even though we may be tempted to reduce one's fixed income allocations due to the current rate environment, it continues to perform an important role in dampening overall portfolio volatility, offering liquidity for distributions and rebalancing, and providing income to investors.

Economy:
Increased inflation was and continues to be felt across the economy with inflation clocking in at 6.8% from November 2020 to November 2021. In spring of last year, inflation became top of mind as the prices to purchase goods and services surged, resulting from a culmination of increased labor costs, money supply, and continued supply chain issues. A majority of this increase is still expected to be transitory, including the energy and supply chain issues.

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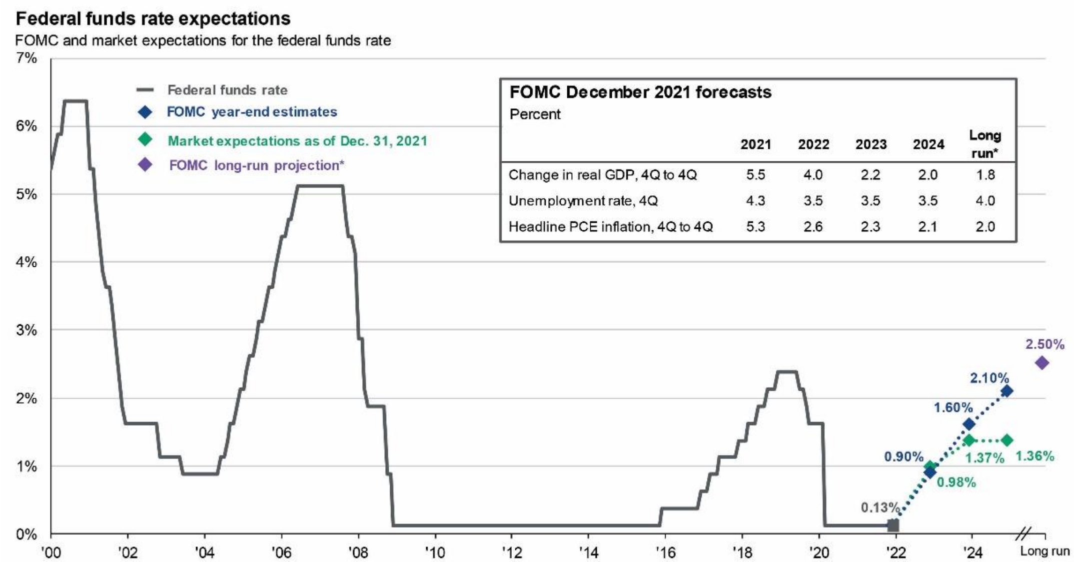
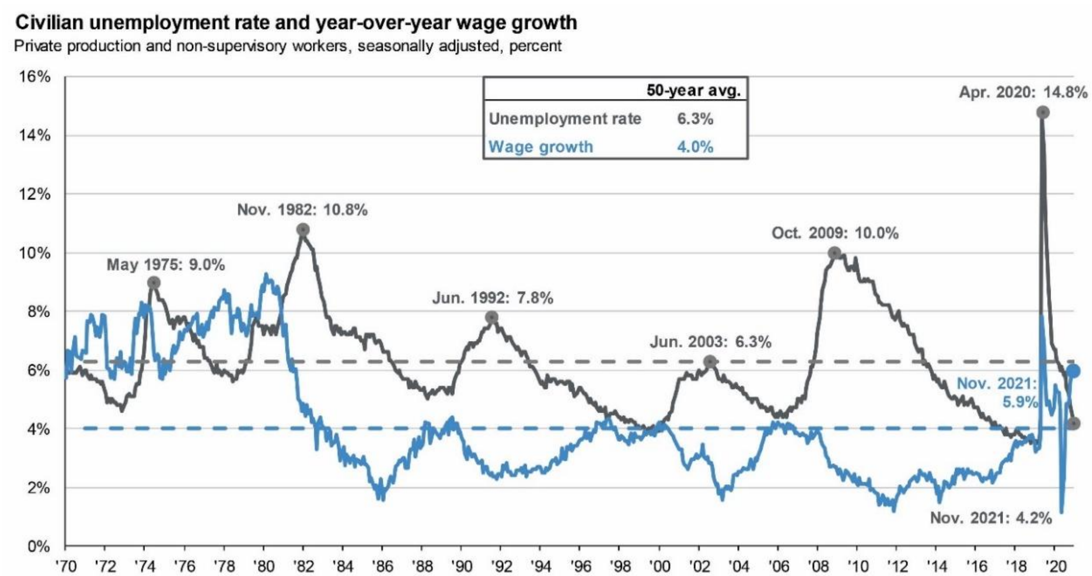


Source: Bloomberg, FactSet, Federal Reserve, J.P. Morgan Asset Management. *Guide to the Markets – U.S.* Data are as of 12/31/2021.



Source: BLS, FactSet, J.P. Morgan Asset Management. *Guide to the Markets – U.S.* Data are as of 12/31/2021.

However, the impacts of wage growth, rising rents, and generally higher inflation expectations may linger and push the average expected inflation rate above 2% for the remainder of this economic expansion.
As mentioned above, the United States has experienced strong economic expansion and higher inflation; this has prompted an acceleration in the pace of the Federal Reserve tapering its bond purchases. During the December 2021 meeting, the Fed communicated it will terminate the asset purchase program in the first half of 2022 and intends to raise the Fed funds rate.

The surge in the economy has corresponded with a rebound in the employment market. After shedding 22.4 million jobs from February to April of 2020, the economy has recovered 18.4 million jobs, or 82% of those jobs lost. The job recovery isn't quite complete, sitting at 4.2% unemployment rate versus the pre-pandemic rate of 3.5%. One may think this means there is still unemployment slack; wage growth tells a different story. Wage growth has been increasing and is at levels not seen since the 1980s. Putting this together with increased labor demand, this suggests the labor shortfall is primarily due to labor supply, which has been slow to recover as the economy continues to reopen.

World Stock Market Performance

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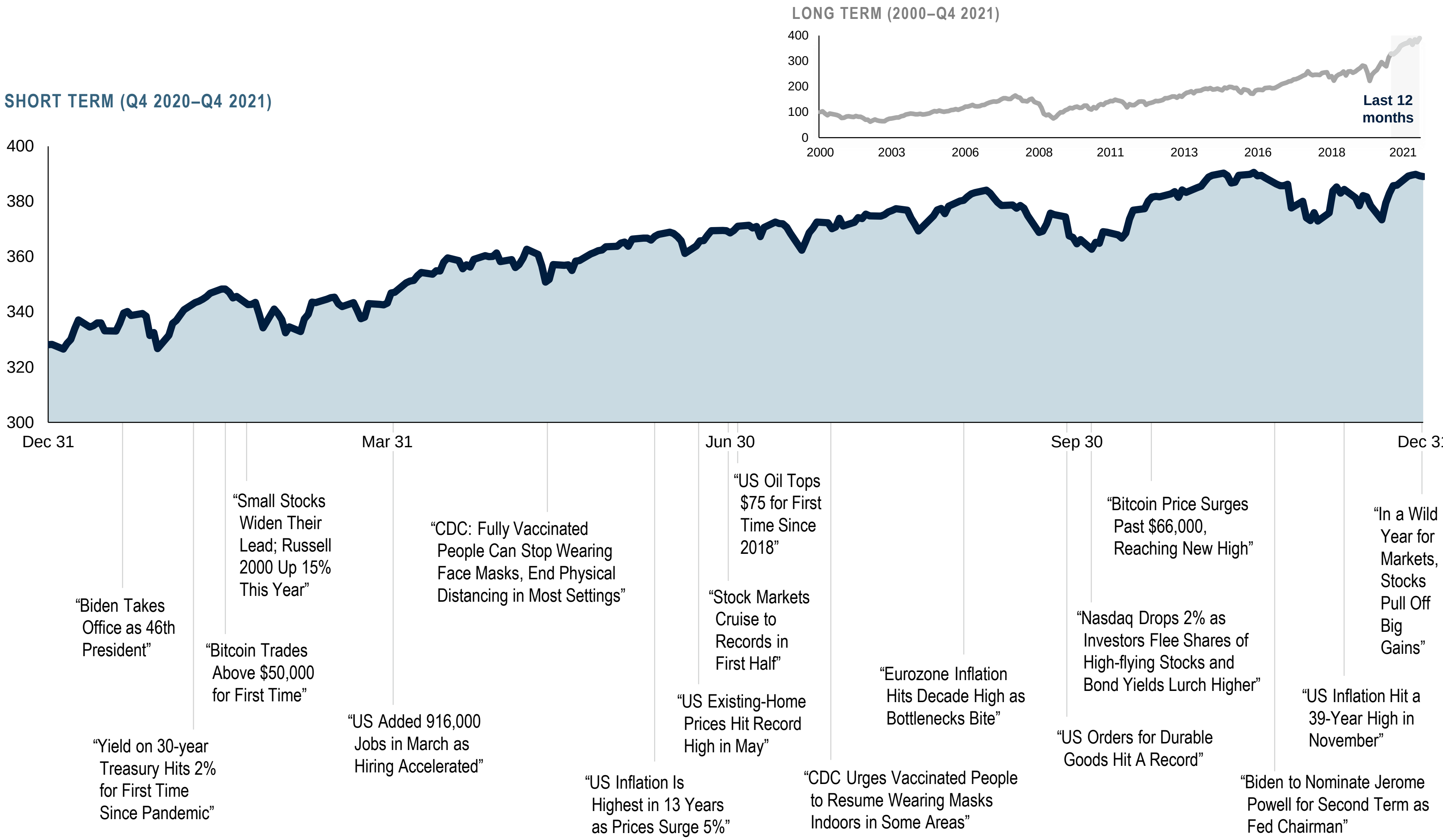
MSCI All Country World Index with selected headlines from past 12 months



These headlines are not offered to explain market returns. Instead, they serve as a reminder that investors should view daily events from a long-term perspective and avoid making investment decisions based solely on the news.

Graph Source: MSCI ACWI Index [net dividends]. MSCI data © MSCI 2022, all rights reserved.
It is not possible to invest directly in an index. Performance does not reflect the expenses associated with management of an actual portfolio. **Past performance is not a guarantee of future results.**

Global Valuations

What is the Investment Climate?

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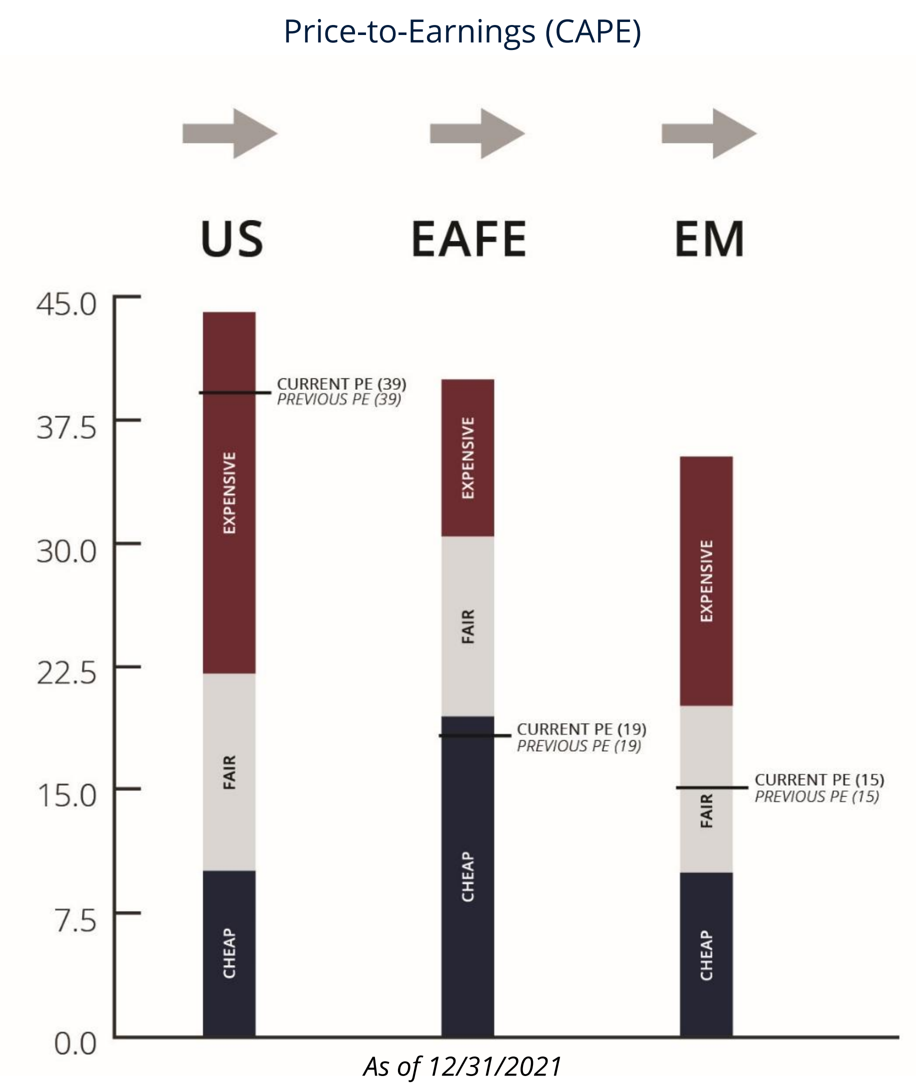

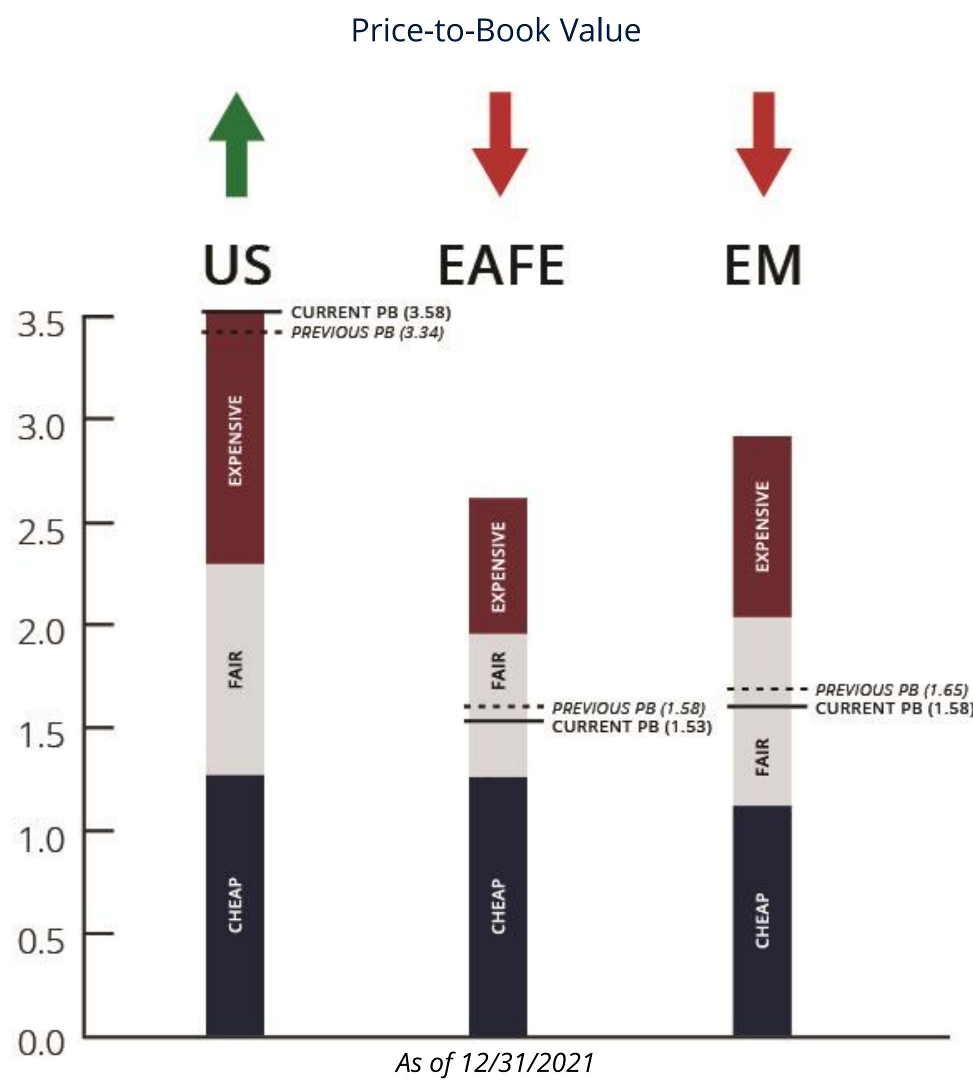

Cyclically Adjusted Price-to-Earnings or "CAPE" is a valuation metric, where the current market price is divided by the last ten years of average earnings (adjusted for inflation). The price you pay is what you get, and by utilizing average earnings over a longer period (10 years), we can put into perspective whether the current market price is trending toward expensive, undervalued, or fairly valued historically.

Quarterly Market Summary

Index Returns

4Q 2021	US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate	US Bond Market	Global Bond Market ex US
	STOCKS				BONDS	
	9.28%	3.14%	-1.31%	12.35%	0.01%	0.07%

Since Jan. 2001	US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate	US Bond Market	Global Bond Market ex US
Average Quarterly Return	2.5%	1.7%	2.9%	2.7%	1.1%	1.1%
Best Quarter	22.0%	25.9%	34.7%	32.3%	4.6%	4.6%
	2020 Q2	**2009 Q2**	**2009 Q2**	**2009 Q3**	**2001 Q3**	**2008 Q4**
Worst Quarter	-22.8%	-23.3%	-27.6%	-36.1%	-3.4%	-2.7%
	2008 Q4	**2020 Q1**	**2008 Q4**	**2008 Q4**	**2021 Q1**	**2015 Q2**

Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio.
Market segment (index representation) as follows: US Stock Market (Russell 3000 Index), International Developed Stocks (MSCI World ex USA Index [net dividends]), Emerging Markets (MSCI Emerging Markets Index [net dividends]), Global Real Estate (S&P Global REIT Index [net dividends]), US Bond Market (Bloomberg US Aggregate Bond Index), and Global Bond Market ex US (Bloomberg Global Aggregate ex-USD Bond Index [hedged to USD]). S&P data © 2022 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved. Frank Russell Company is the source and owner of the trademarks, service marks, and copyrights related to the Russell Indexes. MSCI data © MSCI 2022, all rights reserved. Bloomberg data provided by Bloomberg.

Long-Term Market Summary

Index Returns as of December 31, 2021

	US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate	US Bond Market	Global Bond Market ex US
	STOCKS				BONDS	
1 Year	25.66%	12.62%	-2.54%	31.38%	-1.54%	-1.40%
5 Years	17.97%	9.63%	9.87%	8.25%	3.57%	3.11%
10 Years	16.30%	7.84%	5.49%	9.01%	2.90%	3.80%

Quarterly Topic: All-Time-High Anxiety

Fourth Quarter 2021

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Investors are often conflicted about record-high stock prices. They are pleased to see their existing equity holdings gain in value but apprehensive that higher prices somehow foreshadow a dramatic downturn in the future. And they may be reluctant to make new purchases since the traditional "buy low, sell high" mantra suggests committing funds to stocks at an all-time high is a surefire recipe for disappointment.

Financial journalists periodically stoke investors' record-high anxiety by suggesting the laws of physics apply to financial markets—that what goes up must come down. "Stocks Head Back to Earth," read a headline in the *Wall Street Journal* in 2012.[1] "Weird Science: Wall Street Repeals Law of Gravity," *Barron's* put it in 2017.[2] And a *Los Angeles Times* reporter had a similar take last year, noting that low interest rates have "helped stock and bond markets defy gravity."[3]

Those who find such observations alarming will likely shy away from purchasing stocks at record highs. But shares are not heavy objects kept aloft through strenuous effort. They are perpetual claim tickets on companies' earnings and dividends. Thousands of business managers go to work every day seeking projects that appear to offer profitable returns on capital while providing goods and services people desire. Although some new ideas and the firms behind them end in failure, history offers abundant evidence that investors around the world can be rewarded for the capital they provide.

Whether at a new high or a new low, today's share price reflects investors' collective judgment of what tomorrow's earnings and dividends are likely to be—and those of all the tomorrows to come. And every day, stocks must be priced to deliver a positive expected return for the buyer. Otherwise, no trade would take place. It's difficult to imagine a scenario where investors freely invest in stocks with the expectation of losing money.

Investors should treat record high prices with neither excitement nor alarm, but rather indifference. If stocks have a positive expected return, reaching record highs with some frequency is exactly the outcome we would expect. Using month-end data over the 94-year period ending in 2020, the S&P 500 Index produced a new high in ending wealth in more than 30% of those monthly observations. Moreover, purchasing shares at all-time records has, on average, generated similar returns over subsequent one-, three-, and five-year periods to those of a strategy that purchases stocks following a sharp decline, as **Exhibit 1** shows.

EXHIBIT 1

All Rise

Average annualized returns for S&P 500 Index after market highs and declines

	1 year later	3 years later	5 years later
After new market high	13.9%	10.5%	9.9%
After 20% market decline	11.6%	9.9%	9.6%

Humans are conditioned to think that after the rise must come the fall, tempting us to fiddle with our portfolios. But the data suggest such signals only exist in our imagination and that our efforts to improve results will just as likely penalize them.

Investors should take comfort knowing that share prices are not fighting the forces of gravity when they move higher and have confidence that record highs only tell us the system is working just as we would expect—nothing more.

1. Jonathan Cheng and Christian Berthelsen, "Stocks Head Back to Earth," *Wall Street Journal,* February 11, 2012.
2. Kopin Tan, "Weird Science: Wall Street Repeals Law of Gravity," *Barron's,* August 7, 2017.
3. Russ Mitchell, "Tesla's Insane Stock Price Makes Sense in a Market Gone Mad," *Los Angeles Times,* July 22, 2020.