GM ADVISORY GROUP
WEALTH MANAGEMENT

Monthly Market Review

December 2021

What happened in December?

The MSCI All Country World Index gained **+4.0%** in December whereas the Barclays US Aggregate Bond Index declined **-0.3%**. Broad commodities rebounded **+7.6%** after falling **-10.8%** in November, and gold appreciated **+0.1%**.

Increased hedging into December helped fuel a Santa Claus rally later in the month. Although the Fed will begin tightening monetary conditions, our outlook remains constructive as strong momentum in the labor market persists.

Equity market volatility rose in early December in part because market participants increased hedges (by buying put options) to protect equity portfolios against risks related to the Omicron variant and the December FOMC Meeting out of fear that the Fed may deliver a more hawkish tone than expected. In our communication last month, we maintained the view that these risks were likely overblown, and if we were correct, these hedges would have to be unwound, which should provide fuel for higher equity prices. In hindsight, this appears to be what happened.

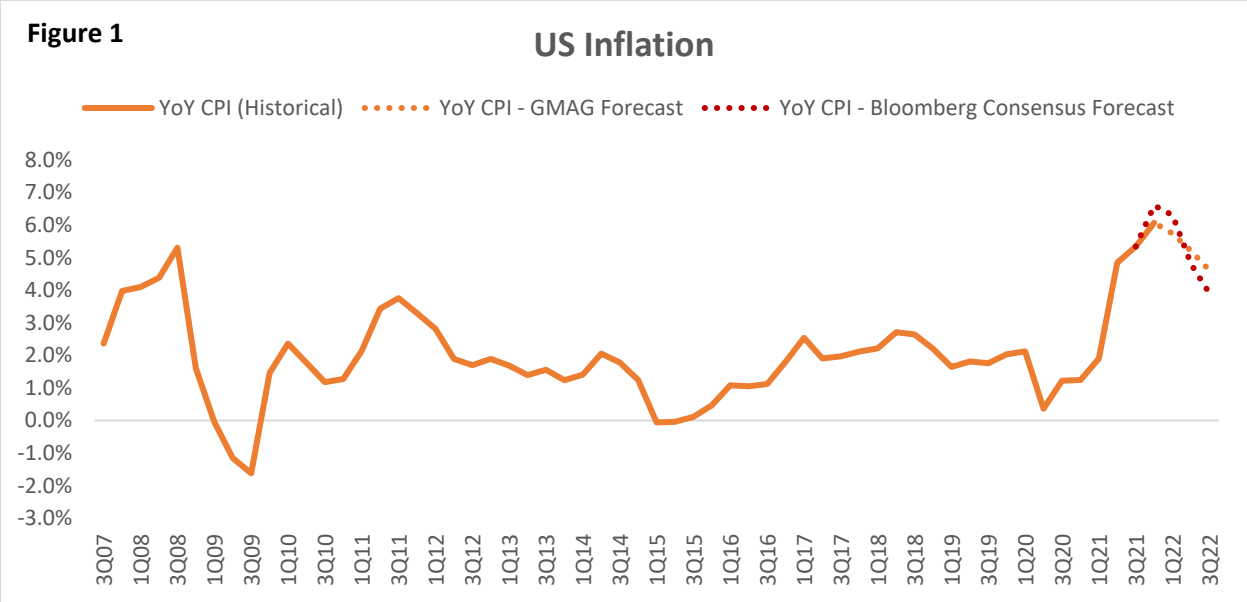
Although Omicron has proven to be highly contagious, the severity of COVID-19 continues to decline (see Charts of the Month), and we are optimistic that this will bring us one step closer to some form of herd immunity. With respect to the risks related to Fed tightening, minutes from the December FOMC released yesterday indicate that economic strength coupled with higher inflation could cause the Fed to cease asset purchases by March and begin increasing interest rates by June, which represents a faster tightening path than what it had previously communicated. That said, the market is already pricing in more than three rate hikes in 2022, which we believe provides the Fed with room to tighten monetary conditions without making a policy error.

To the Fed's point about economic strength, yesterday's ADP report revealed that momentum in the labor market remains strong, as US private sector employment increased by 807,000 in December, nearly doubling the expectation of 410,000. So long as the economy continues to add jobs, the path of least resistance for equity prices is likely higher. That said, we expect choppier conditions in 2022 as the Fed removes its support.

We expect inflation to moderate from here.

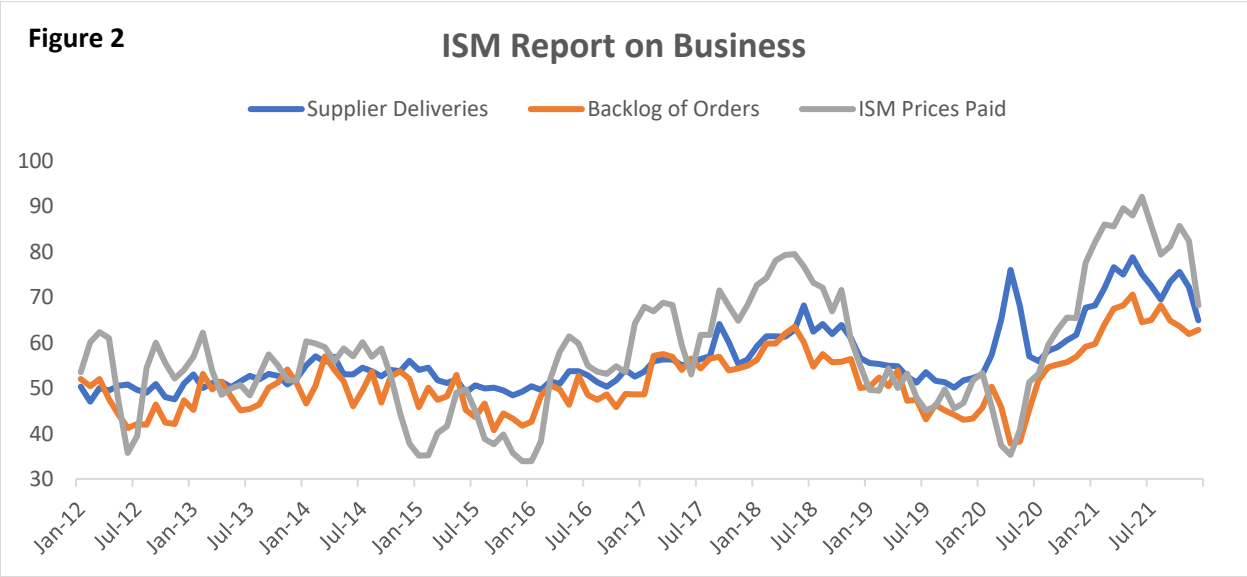
Incessant demand combined with lingering supply chain disruptions and a shift in consumer preferences from services to goods have contributed to higher levels of inflation that have not been experienced in the US since 2008 (see **Figure 1**).

Although the risk that inflation persists at these levels or accelerates higher is not immaterial, we believe that inflation likely peaked from a rate of change perspective in 4Q21. Tightening monetary conditions, steepening base effects, rising employment, and easing government restrictions—notwithstanding China's zero tolerance policy—are the basis for this assessment.



Source: Bloomberg, GMAG Research

To that point, the December ISM report released on Tuesday illustrated that supply chain pressures may be starting to ease on the margin (see **Figure 2**).



Source: Bloomberg

Positioning Highlights

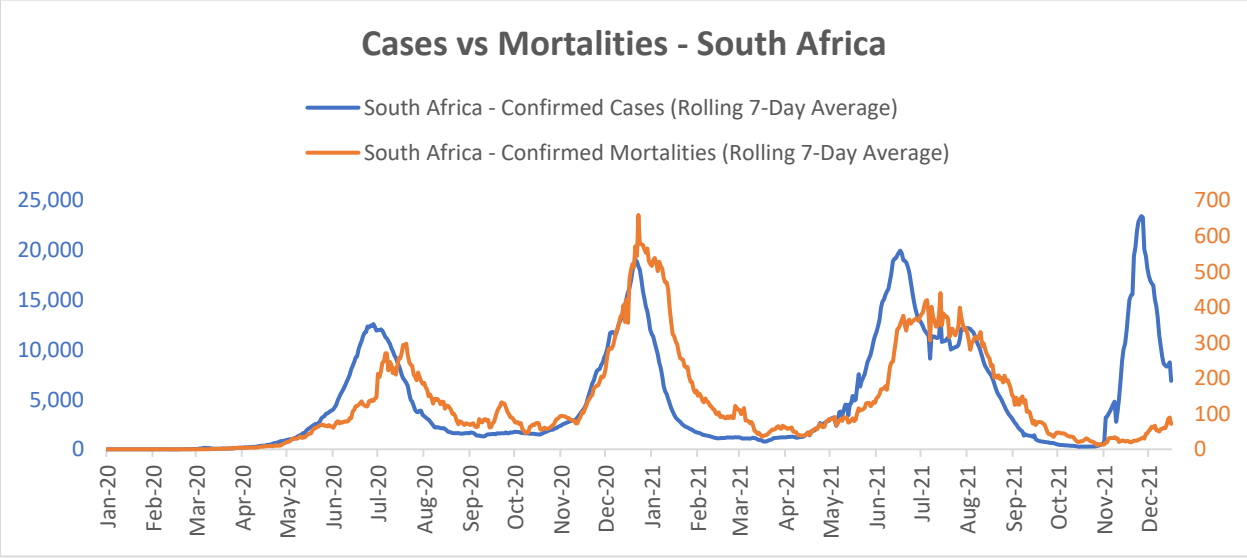
Although equity valuations are elevated, our economic outlook remains constructive, and thus, we favor remaining overweight risk assets.

- **Maintain overweight exposure to equities.** We favor remaining overweight equities as the economic recovery progresses.

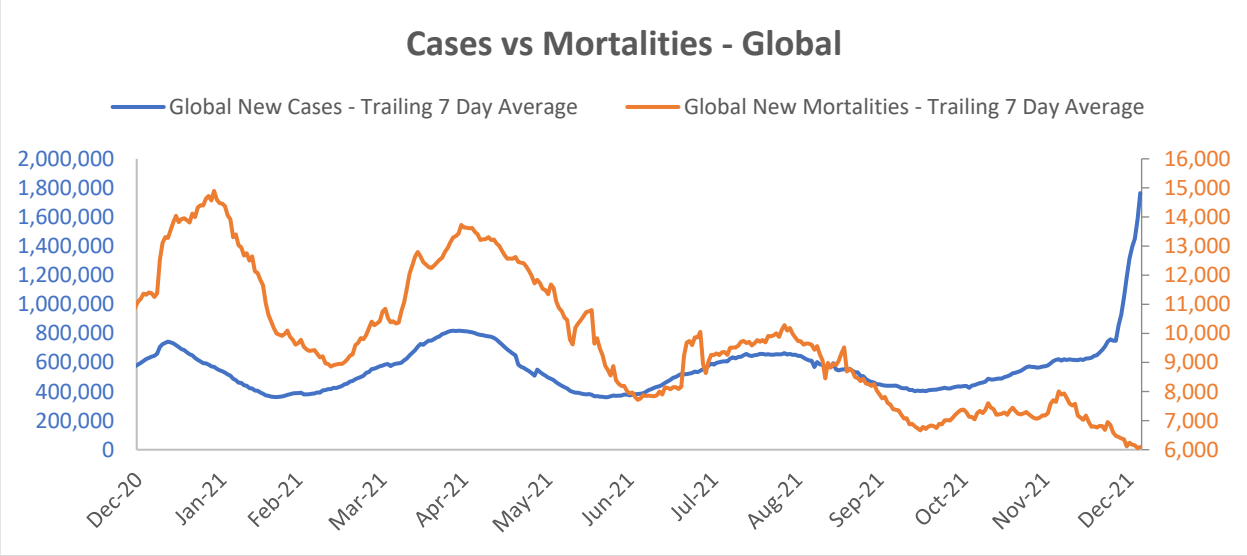
- **Increase exposure to growth stocks within equities.** We favor increasing exposure to growth stocks, given our expectation that high economic growth will persist while inflation remains under control. In contrast, we favor reducing exposure to cyclical stocks because of evidence that the reflation/recovery trade may be nearing its end.
- **Maintain underweight exposure to defensive assets but less so than before.** We favor maintaining an underweight posture in defensive asset classes (e.g., fixed income) because we expect defensive assets to underperform while economic growth remains elevated. However, we tactically favor increasing exposure to long-term treasuries and defensive equity sectors in the near term because decelerating growth and inflation (from a rate-of-change perspective) could provide opportunities for defensive assets to outperform in the coming months and quarters.

Charts of the Month

Although the world is experiencing the greatest surge in COVID-19 cases since the onset of the pandemic, the severity of the virus (as measured by COVID-19 mortalities) continues to decline.



Source: Bloomberg, GMAG Research



Source: Bloomberg, GMAG Research

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