COLORADO
FINANCIAL
MANAGEMENT®

Economic & Market Review

Written by Brad Bickham, CFA, CFP®
Partner & Chief Investment Officer

January 2022

As Of 12/31/2021	2021	Last 3 Years	Last 5 Years
50/50 Balanced World Index (AGG & ACWI)	8.3%	13.0%	9.4%
World Equity Index (ACWI)	18.2%	20.2%	14.1%
U.S. Large Cap Equities (S&P 500)	28.2%	25.4%	17.8%
U.S. Large Caps (Dow Jones Industrials)	18.7%	15.9%	13.0%
U.S. Small/Mid Cap Equities (Wilshire 4500)	16.0%	25.2%	15.9%
Foreign Equities (ACWI-ex U.S.)	8.5%	13.6%	9.8%
U.S. Bonds (AGG)	-1.5%	4.8%	3.6%
Global Bond Index (BNDW)	-2.1%	4.1%	n/a
Cash & Equivalents (VMFXX)	0.0%	0.9%	1.0%

Dear Clients and Friends,

There are several details about last year's performance we would like to bring to your attention:

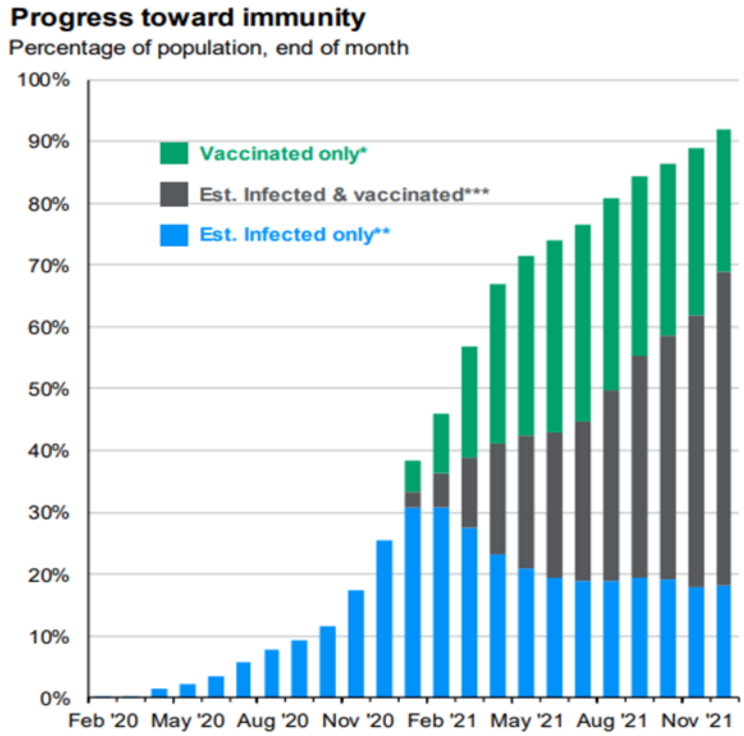
1. Bonds had a rare negative return year last year both in the U.S. and abroad.
2. The ACWI had a spectacular year with a 18.2% return. Therefore, a balanced portfolio of global equities and fixed income had a good return of 8.3%. Investors often make the mistake of comparing a diversified portfolio return against a stock index. There is always one index or another that stands out both positive and negative.
3. U.S. large cap stocks had another year of significant outperformance compared to U.S. small caps and foreign equities, but as shown there was a wide discrepancy even between large cap indexes. The S&P 500 was up significantly more than the Dow Jones Industrial Average.

As we look forward into 2022, we'll come back to each of these topics in greater detail but first let us review the economy and other fundamentals both from last year and what we expect for this year.

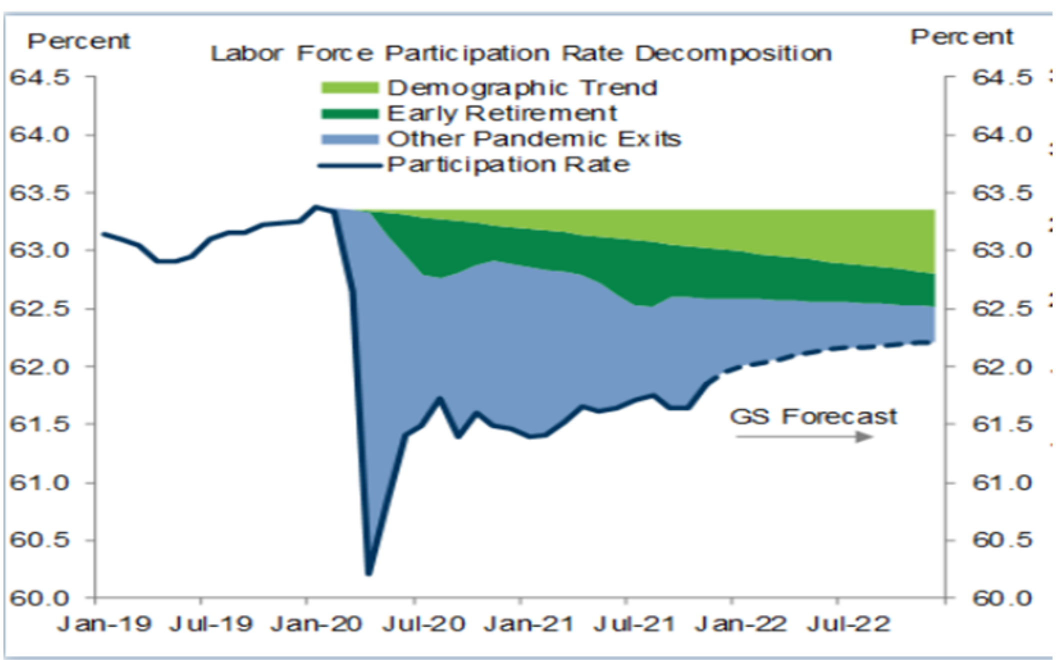
The economy had a spectacular year in 2021 with GDP growth of nearly 6%. That is 3x the 20 year average of 2%. This was due to two things: first was the ongoing recovery from the short but significant recession of 2020 induced by the Covid pandemic. Second, and related, was the significant level of government stimulus both fiscally and monetarily. As we look forward to 2022, we expect the economy to continue to grow above the 2% trend, but not as spectacularly… probably in the 3% range. We believe the chances of recession are low. There is still some fiscal stimulus coming, and due to Omicron there may be even more. There is also government infrastructure spending to come. And, the private sectors of the economy are strong: employment growth, small businesses, housing and auto sales. Additionally, inventories will be built up as the supply chain issues gradually subside.

Covid will continue to be a wildcard that could derail the economy, but after 2 years and backlashes from many directions, the government has no appetite for locking down the economy again. People appear to be ready to move forward and live with Covid. As evidenced by the reaction to school closings in Chicago, people are no longer tolerant of shut-downs.

A large percentage of the population has either been vaccinated, or infected, or both as shown in this chart. We do not know yet how long immunity from infection lasts, or even vaccinations, but scientists are learning more all the time. There are indeed disruptions to the labor market due to people having to stay home after they test positive, or stay home with children, but all in all, 2022 is probably the year that Covid as we know it now becomes only a small threat to the economy.

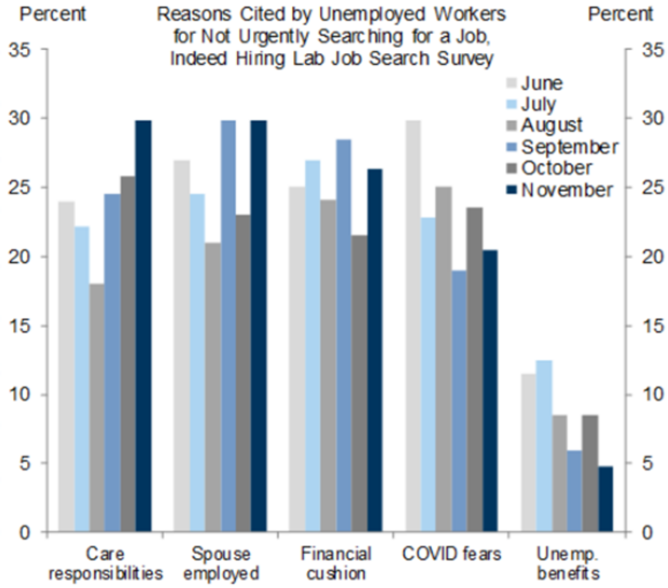


The labor market is undergoing a very interesting change. The unemployment rate is already below 4% and likely to reach its pre-pandemic level of 3.5% in 2022. What is different is that the participation rate is still about 1.5% below where it was in 2019. Part of this is due to the pandemic, but another part is demographics. The baby boomers have been in retirement age for several years, but their rate of retirement has accelerated as shown in this chart. Additionally, because of recent policies immigration is significantly lower than in prior years. The result is a smaller work force, which has a knock on effect to GDP growth in the longer term.



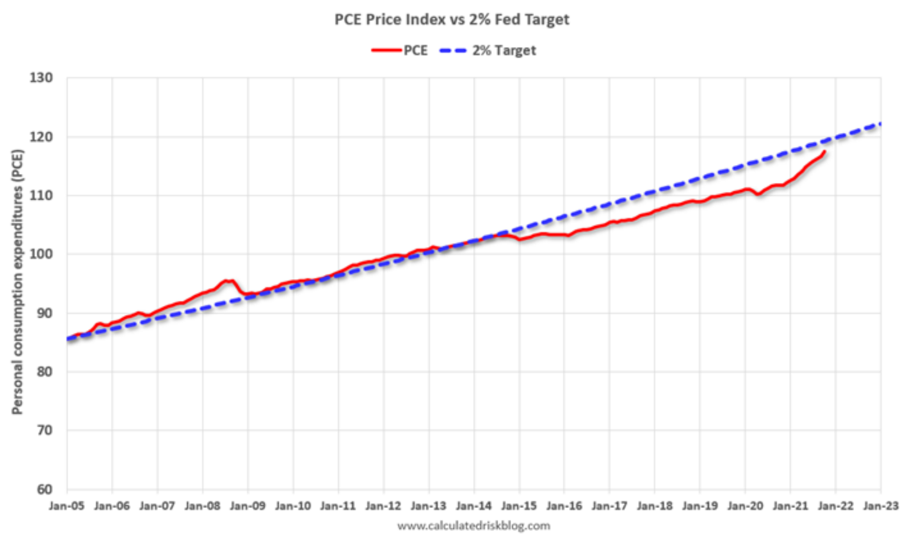
Source: Goldman Sachs Global Investment Research, Indeed Hiring Lab

The final observation about employment is that the causal relationship between enhanced unemployment benefits and lower workforce participation has either diminished or never was as significant as had been thought. As shown below, unemployment benefits are reported to be the least important reason for not returning to work. If we are right about Covid fading as the year goes on, then many people will return to the workforce (but not the retired baby boomers).



As the calendar turned and financial markets began trading in 2022, the focus shifted to inflation and for good reason. Inflation has risen to about 7% and even the core (ex-energy and food) rate has risen to ~ 5%. We haven't seen levels this high for four decades. The Fed has stopped using the word 'transitory' to describe it, but that still remains the critical question… Will it return to the Fed's desired rate of 2%, and if so how long will it take? A related important question is when will the inflection point be. Where interest rates settle, and the performance of various types and maturities of bonds will be determined by these two questions.

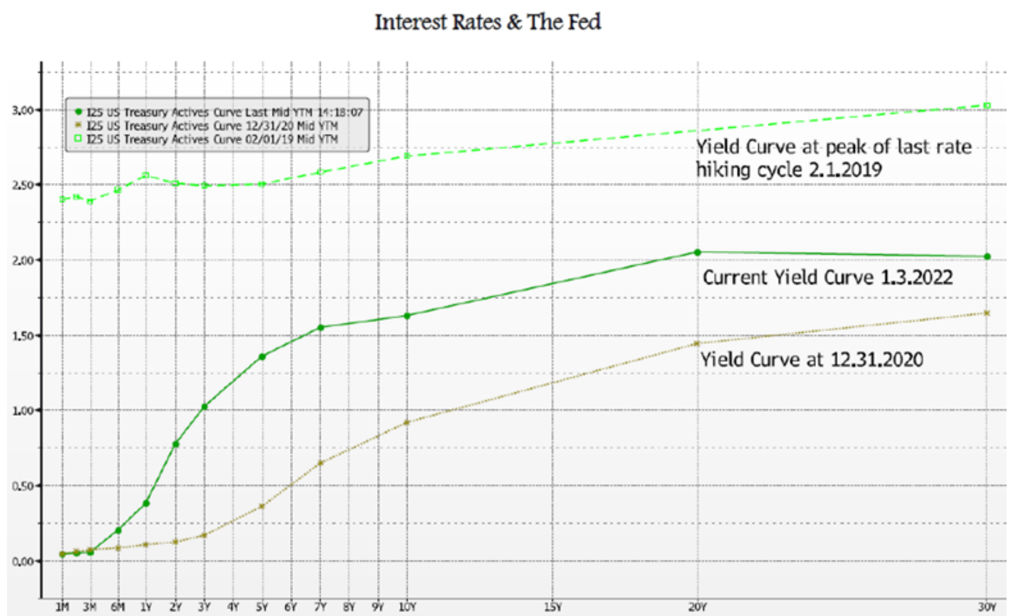
For all the hand wringing, this chart is interesting. For the last five or more years, inflation has undershot the Fed's 2% target. Just last year, the Fed said they would allow inflation to run higher than 2% in order for the 'average' rate to be 2%. They got what they were after and a little more, although it is not only due to Fed policy. And, while the government stimulus certainly had something to do with increasing demand, the inflation surge had more to do with supply disruption.



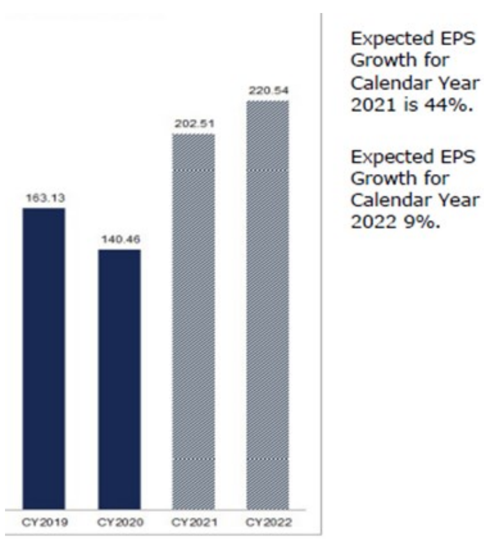
The Fed controls inflation by increasing interest rates, which in turn slows demand and reduces inflationary pressures. What is different now is that inflation is being driven by disruptions in supply due to Covid related bottlenecks. The Fed can't do anything about supply.

We believe inflation will moderate for a few reasons. One is simple math. Oil prices, for example, were up from $48 at the beginning of last year to $75 at the end. That is a 55% increase, which is one big reason the Consumer Price Index is up 7%. From here, oil would have to rise to over $116 to have the same impact. That's unlikely since the demand and supply of oil are projected to come into balance early this year. Similarly, other supply chain issues should resolve themselves this year.

For example, a shortage of computer chips has led to reduced output of new cars, which led to significant price increases for both new and used cars.



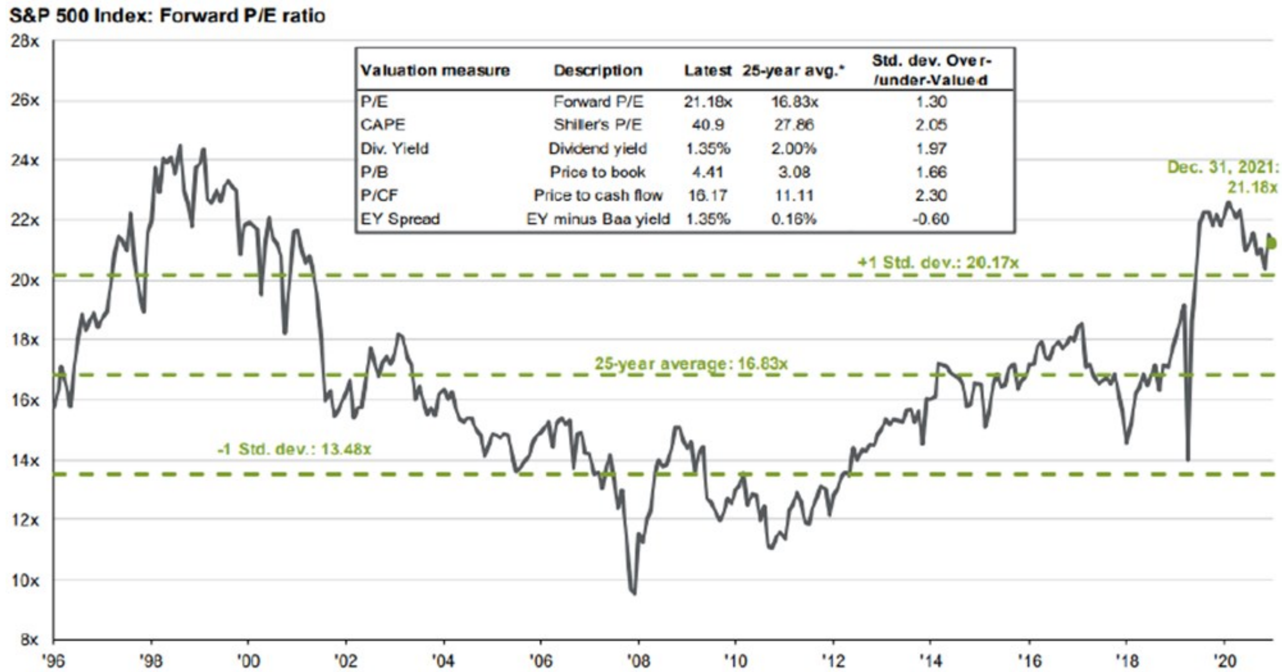
Therefore, we believe that inflation pressures will subside as we go through the year. It may still be higher than in the past, but heading lower. What then will happen to interest rates? The Fed is expected to increase rates by 0.25% either three or four times this year. The curve is likely to 'flatten' over the course of the next couple of years similar to what it looked like in 2019. For argument's sake, let us assume we go back to the same yield curve we had in 2019. What happens to bond returns? Last year the 10 year yield rose from 0.9% to 1.6% - an increase of 0.7%. As shown on page 1, the total return of the bond index was -1.5%. If the yield on the 10 year increases to the 2019 level of ~ 2.6% that would be an increase of 1% and the return on bonds would be a little worse than last year's return. However, that might take a couple of years. If the Fed increases rates only 0.25% per quarter, it would take two years to get up to the 2% level. The bottom line is that total returns (yield and price change) on bonds is not likely to be good over the next year, but probably not as bad as some expect. The good news is that yields are rising so we will get more attractive returns from bonds once we get through the next year or two.



Turning to equities, which had returns well above average over the last 3 years. There are reasons to believe equity returns will be below average this year (but we could have said the same thing last year). Stocks are driven by earnings and changes in valuation. For example, if a company has $10 of earnings and trades at a P/E of 10 its price is $100 (10 x 10 = 100). If the earnings grow by 10% and the P/E multiple stays the same, it will be priced at $110 (11 x 10 = 110) and the return on the stock is 10%. On the other hand, if the P/E ratio increases to 12 then the price grows to $132 (11 x 12 = 132), and the return increases to 32%. You can see the change in the P/E ratio is even more important than the earnings growth.

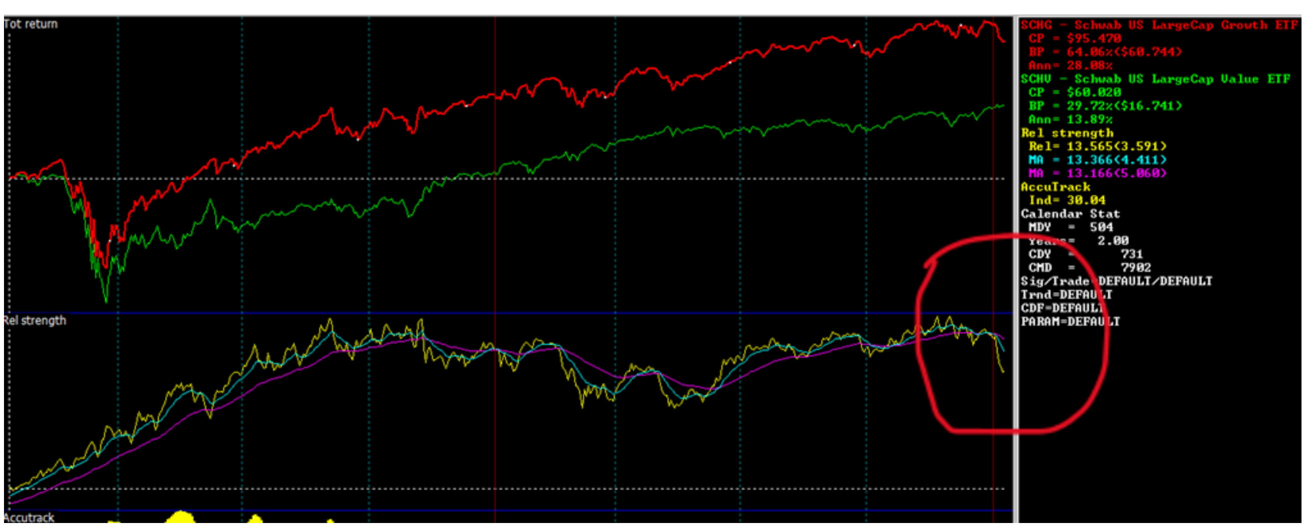
This year earnings are expected to grow about 9% to 10%. The problem is that the valuation level is already above average. The P/E on 2022 estimated earnings is about 21x. That compares to a 25 year average of about 17x. Let's assume that earnings grow 10% in 2022 and in 2023. If the forward P/E ratio on the market fell to 20x, still above the long term average, then the return for 2022 would be about 4%. Add 1.5% from dividends and you get total return of 5.5%. That's not a prediction, just math. The P/E could go higher or lower.

Market Valuation



So let's pull it together and think about what kind of strategy we need for 2022. The economy is unlikely to go into recession in 2022. That means corrections, or drawdowns in the stock market are likely to be in the 10% variety rather than the 20% or more that comes with recessions. Earnings are likely to rise. Interest rates are likely to rise by maybe 1% on the short maturities, maybe a little less on longer term bonds. The broad based large cap indexes, especially the S&P 500, is likely to have a below average year. Where can we invest to do better?

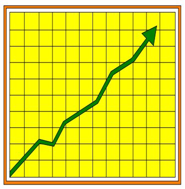
On the fixed income side of the portfolio, we had success last year with our alternative strategies. On average, this group returned about 8% for our clients. This includes high yield bonds, lower volatility equity funds including an infrastructure fund, and a mutual fund that hedges using options. This strategy should continue to outperform. On the equity side, maybe this is finally the year where value and small caps outperform. It is too early to say these trends have changed, but large cap growth and technology have outperformed for so long the valuation disparity has grown very wide. The fundamentals point in the direction of a change. And, the technicals are also showing early signs of reversal. Shown below is a relative strength chart showing large cap growth vs. large cap value. The line circled shows how large cap value has started outperforming growth since late December.



Two weeks does not a trend make, and we continue to be believers in large cap technology; but this is our process… study the fundamentals and also watch for changes in trends. We have yet to see any change in relative strength trends in international or small caps, but we'll be watching. We are currently overweight to large cap growth, but likely to make incremental adjustments toward these other sectors as we go through this year.

As always we appreciate the confidence you place in us. 2022 will be our 34th year in business and my 40th year anniversary in the industry. It's a far different world than 1982, but the principles learned over those years remain the same… the economy, earnings, inflation, interest rates, and valuation. These are the drivers of returns. The rest are inputs and tools for understanding.

Happy returns,



Brad Bickham, CFA, CFP®
Partner | Chief Investment Officer

And Your Entire Colorado Financial Mgmt. Team

Index Definitions & Disclosures:

Standard and Poor's Index

- **S&P 500:** The S&P 500® is an unmanaged index that is widely regarded as the best single gauge of large-cap U.S. equities. The index includes 500 leading companies and captures approximately 80% coverage of available U.S. market capitalization.

Morgan Stanley Capital International (MSCI)

- **MSCI All Country World Index:** The MSCI ACWI Index is designed to represent performance of the full opportunity set of large- and mid-cap stocks across 23 developed and 24 emerging markets. As of September 2018, it covers more than 2,700 constituents across 11 sectors and approximately 85% of the free float-adjusted market capitalization in each market. The index is often used as a benchmark for global equity portfolios. Investments in international and emerging markets include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability.
- **MSCI All Country World Index Ex U.S.:** The All Country World Index Ex-U.S. (MSCI ACWI Ex-U.S.) is a market-capitalization-weighted. It is designed to provide a broad measure of stock performance throughout the world, apart from U.S.-based companies. The MSCI All Country World Index Ex-U.S. includes both developed and emerging markets. For investors who benchmark their U.S. and international stocks separately, this index provides a way to monitor international exposure apart from U.S. investments.

Bloomberg Barclays Indices

- **Bloomberg Barclays Global-Aggregate Total Return Index (Hedged):** The Bloomberg Barclays Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.
- **Bloomberg U.S. Aggregate Bond Index:** The Bloomberg U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency).
- **Barclays Capital 1-3 Month U.S. Treasury Bill Index:** The Barclays Capital 1-3 Month U.S. Treasury Bill Index includes all publicly issued zero-coupon U.S. Treasury Bills that have a remaining maturity of less than 3 months and more than 1 month, are rated investment grade, and have $250 million or more of outstanding face value. In addition, the securities must be denominated in U.S. dollars and must be fixed rate and nonconvertible.

Other Indices

- **Dow Jones Industrial Average® (The Dow®):** The Dow is a price-weighted measure of 30 U.S. blue-chip companies. The index covers all industries except transportation and utilities.
- **iShares Core U.S. Aggregate Bond ETF:** seeks to track the investment results of an index composed of the total U.S. investment-grade bond market. The underlying index the ETF is designed to track is the Bloomberg US Aggregate Bond Index.
- **Schwab US Large-Cap Growth ETF:** Is a ETF where the fund's goal is to track as closely as possible, before fees and expenses, the total return of the Dow Jones U.S. Large-Cap Growth Total Stock Market Index.
- **Schwab US Large-Cap Value ETF:** Is a ETF where the fund's goal is to track as closely as possible, before fees and expenses, the total return of the Dow Jones U.S. Large-Cap Value Total Stock Market Index.
- **Wilshire 5000:** The Wilshire 5000 Total Market Index is widely accepted as the definitive benchmark for the U.S. equity market, and measures performance of all U.S. equity securities with readily available price data.
- **Vanguard Federal Money Market Fund** invests at least 99.5% of its total assets in cash, government securities, and/or repurchase agreements that are collateralized solely by government securities or cash (collectively, government securities). As government agency securities, the fund's holdings have very high credit quality, although most are not backed by the full faith and credit of the U.S. government. The average maturity typically ranges from 30–60 days, and the fund maintains a dollar-weighted average maturity of 60 days or less, and a dollar-weighted average life of 120 days or less.
- **Vanguard Total World Bond ETF** seeks to track the performance of a broad, market-weighted index that measures the investment return of investment-grade U.S. bonds and investment-grade non-U.S. dollar-denominated bonds.

Performance Calculation Disclosures: a) Time weighted returns are used; b) Cash and equivalents are included in the balanced composite, but not in the equity or fixed income composite; c) Gross figures do not reflect the deduction of investment advisory fees for all clients. Therefore the return would be reduced by the advisory fees in some cases. d) Returns are not GIPS compliant; e) Total return includes the reinvestment of dividends and capital gains.

Past performance is not to be construed as a guarantee of future performance. Returns are presented for the period shown and may differ for future time periods. Composite is a broad reflection of performance. Prospective clients should recognize that each client's account is customized and performance can vary widely.

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