VWG WEALTH MANAGEMENT
A Hightower Company

VWG Wealth Management 2021 4th Quarter and Year-End Review

Executive Summary

- The global Omicron surge pushed cases to record highs in 20 countries on 4 continents, dampening year-end holiday gatherings and travel. Despite this gloomy backdrop, financial markets remained resilient. Fears surrounding spiking inflation and slowing Chinese growth were contained, and other concerns facing markets faded. Proposed increased individual and corporate taxes fizzled, energy prices pulled back, and the U.S debt ceiling was raised.
- The S&P 500 was the equity standout in the quarter, increasing 11.0%. It gained 28.7% for the year. The Russell 2000 index, a measure of U.S. small stocks,

edged 2.0% higher in the quarter. Its 2021 full year return was 14.5%. Developed international stocks were flat for the quarter. The MSCI EAFE index of developed international stocks gained 2.8% for the quarter and 11.4% for the year.

- Despite the Federal Reserve becoming more reactive to inflation and removing their ‘transitory’ stance, bonds were stable. The 10-year U.S. Treasury ended 2021 yielding 1.51%. Early in the year many had predicted ending levels of 2.25-2.75%. The Fed is accelerating tapering and has signaled that they expect to begin raising short-term interest rates.
- The U.S. economy and corporate profits are expected to be solid in 2022 but will slow from 2021’s robust levels. Global goods and manufacturing outputs are still running above longer-term trends. U.S. housing completions are rising above trend. Various measures point to the tightest U.S. labor market in over 30 years. U.S. household balance sheets are very healthy.
- The global pandemic, digitization, connectivity, and increased computing power have fused to accelerate great behavioral and technological disruption. The promise of transformative advancement is real. VWG recommends that long-term investors remain committed to the ownership of dominant businesses implementing these technologies to maintain competitive advantages. Diversified investors may consider seeking out exposure to idiosyncratic strategies and managers investing in niche public and private

assets. Patience and discipline will be required. Thorough and thoughtful financial planning is mandated.

Review of the Markets

Large U.S. stocks, as measured by the S&P 500 Index, increased 11.0% in the quarter. 2021's full year gain was a surprising 28.7%.   Small U.S. stocks, perceived to be less economically resilient, lagged large stocks in the face of spiking inflation and the Omicron outbreak. The Russell 2000 Index returned 14.5% for the year.

International stocks turned in a solid year, but also lagged U.S. large stocks. The MSCI EAFE Index added 2.8% in the quarter and earned 11.4% for the year. Slowing China economic growth, Chinese corporate and banking reforms, and the rapid spread of the Omicron virus weighed on emerging markets. The MSCI Emerging Markets Index fell 1.6% for the quarter and lost 3.6% for the year

In stark contrast to sharp increases in consumer and producer prices, bonds were relatively flat. The Barclays Aggregate Bond Index slipped 0.1% in the quarter and lost 1.8% for the full year.   Despite waning fears of personal tax increases that failed to materialize, tax-exempt bonds were firm in comparison. The S&P National Municipal Bond Index improved 0.7% in the quarter, gaining 1.0% in 2021. Encouragingly, there were no signs of stress or decaying credit conditions in the high yield bond market. The

Bloomberg Barclays High Yield Bond Index edged 0.7% higher in the quarter and gained 4.0% this year.

2021's rise in oil prices stabilized in the fourth quarter, in part due to Omicron concerns and the Federal Reserve's increased attention to inflation. The NYMEX West Texas Intermediate Crude Oil continuous futures contract added 1.6% in the quarter and rose 56.2% for the year. Natural gas corrected sharply in the quarter. The NYMEX Henry Hub Natural Gas continuous futures contract fell 39.5%, but still increased 40.3% for the year.

The NYMEX Gold continuous futures contract improved 5.5% in the quarter, but still lost 3.5% for the year. As William Bernstein states in his book Deep Risk, "historically gold returns have correlated poorly with inflation (on a specific country and currency basis). It has protected superbly against *deflation*."

Looking Back at 2021, and Looking Forward to 2022

At the beginning of 2021, we observed a complicated, almost incomprehensible investment landscape:

- The global pandemic was still in full force. U.S. COVID-related hospitalizations had not peaked. Much of the world economy was still in lockdown. Revolutionary mRNA vaccines were being approved but had not been rolled out.

- The U.S. was pumping out staggering amounts of monetary and fiscal stimulus in response to the negative economic effects of the pandemic. Major central banks worldwide enacted similar policies.
- The U.S. economy was healing from its 2020 2nd quarter shock. 2021's prospects for gradual re-opening, increased activity and improved profits were positive.
- Mismatches between the supply and demand for goods, and disruptions in supply chains, were readily visible but were expected to be 'transitory.' Early signs of rising prices were percolating. Oil and gasoline prices were already very close to their pre-pandemic levels.
- The S&P 500 Index was trading at record highs despite S&P5 500 earnings having fallen -33% in 2020. Over 90% of stocks were trading above their 200-day moving averages.

<u>From this backdrop a remarkable, unexpected series of events ensued, including:</u>

- Mass global rollouts of vaccines, and then boosters, providing unprecedented efficacy.
- Strong economic and profit growth that was undeterred by Delta and (to date) Omicron variants.

- Strong industrial and consumer demand confronted widespread supply shortages, leading to a 6.2% increase in the U.S. consumer price index. U.S. Bureau of Labor Statistics JOLTs job openings soared to record highs.
- The S&P 500 rising another 28.7%, with U.S. small stocks and many developed international stock markets enjoying a solid year.

<u>2021's most surprising outcome was the direction and level of long-term interest rates.</u> The yield of the 10-year U.S. Treasury note ended the year yielding 1.51%. The 30-year bond yield, which had never in history prior to COVID traded below 2%, ended the year yielding 1.90%.

The review and contemplation of this extremely complex set of inputs only further reinforces that we are not economists, and our job is not in making market predictions.

<u>As we look forward</u>, risks and potential negatives are interwoven with opportunities and potential positives. Federal Reserve and global central bank stimulus is being removed. Interest rate increases are expected. Pundits question whether efforts to rein in and reverse unprecedented mountains of monetary stimulus could ultimately result in a policy error. Dean Curnutt of Macro Risk Advisors reminds us that "we have not had a significant Federal Reserve action that <u>was not</u> market friendly since 1994." U.S. inflation is rising at its fastest pace in almost 40 years.

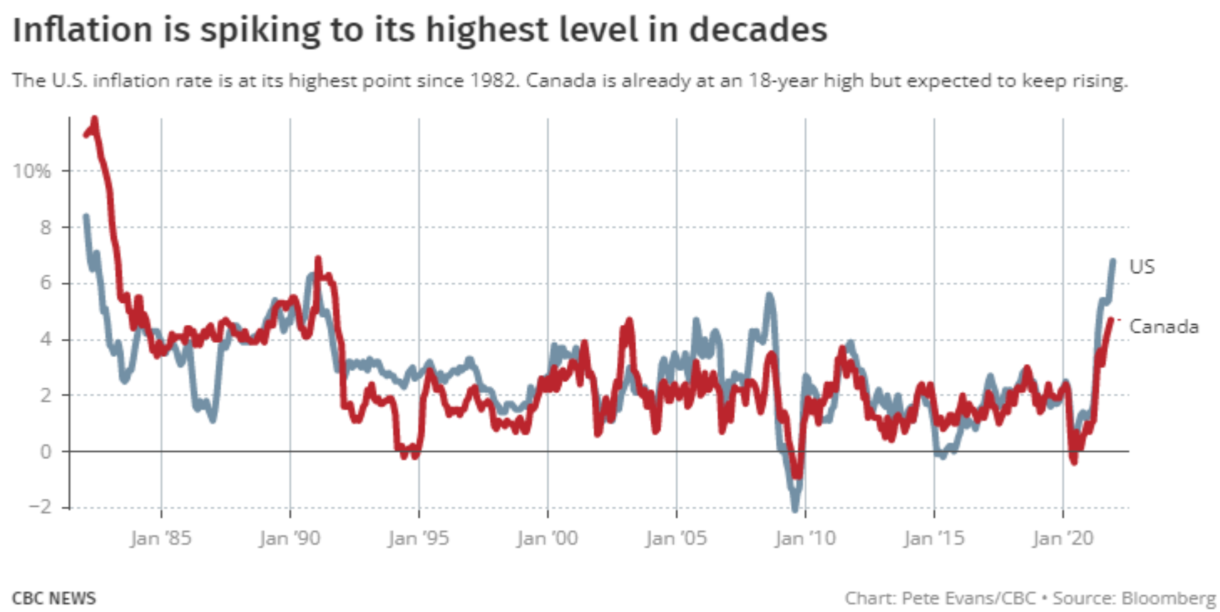

Chart courtesy of CBC News / Bloomberg

There are other risks to markets and the global economy. The course and character of the COVID pandemic remains at the top of this list. The health crisis has inflicted outsized damage on small businesses, who are still struggling mightily to combat a difficult hiring market, material shortages, and spiking prices. China's economy has slowed and is not expected to reaccelerate, pressured by aging demographics and necessary deleveraging. This curtails a tailwind that has pushed global growth for the past forty years. Many foreign governments, health systems and food supply chains have become more fragile in the wake of the pandemic. The geopolitical situations in the Ukraine and the South China Sea threaten stability. Volatility is always possible. For 2022, rising rates and U.S. midterm elections are potential catalysts.

Despite these risks we remain optimistic. U.S. economic output and corporate profits are expected to slow, but from 2021's robust levels. U.S. housing starts continue to rise. They have been in secular increase for the past nine years, only briefly interrupted at the onset of the pandemic. As shown in the following chart, the U.S. economy has not gone into recession (gray bars) anytime in the past 70 years when housing starts were rising.

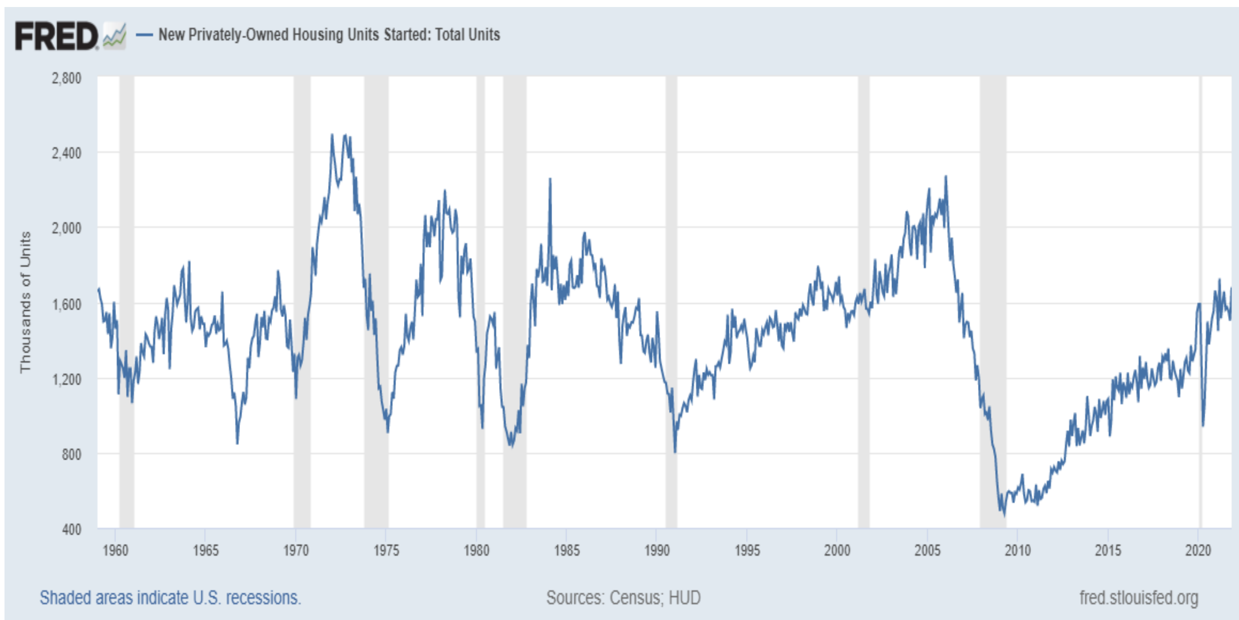

Chart courtesy of Federal Reserve Bank of St. Louis Research Department

Inflation is of concern but should not be entirely unexpected. GaveKal's Anatole Kaletsy puts it into perspective: *"Once we recall that the world has just lived through a period of unprecedented economic dislocation with extraordinary swings in consumer demand and supply capacity, why should we be surprised that price movements have been bigger than at any time since 1990? Rather than extrapolating these extreme price changes into the long-term future, it seems more reasonable to expect prices to stop moving wildly as the effects of Covid distortions (hopefully) dissipate."* Cornerstone Macro's Nancy Lazar sees signs of supply chain stresses easing. These include ocean freight and trucking rates coming off their highs, manufacturing PMIs coming increasingly in line with new orders, and retail inventory levels remaining healthy.

The second year of a presidential cycle traditionally incurs the largest drawdowns, averaging -19% from 1962-2020. Even this has a potential silver lining. Strategas' Dan Clifton observes, "the good news is that these corrections have historically turned out to be good buying opportunities, with stocks up twelve months from the low every year since 1962."

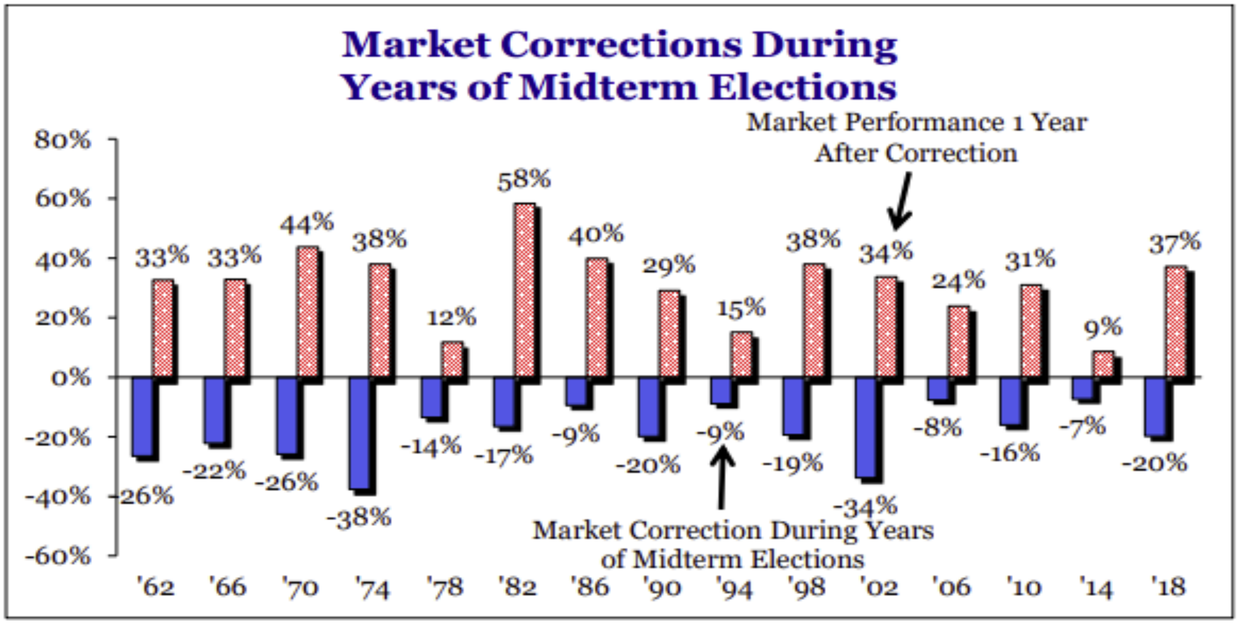

Chart courtesy of Strategas Research Partners

Great change, but also great opportunity confronts households, businesses, entrepreneurs, and investors. The dizzying combination - of the pandemic, lockdowns, digitization and connectivity, abrupt behavioral changes, technological advancements, and disruptive innovation - have spurred and accelerated remarkable change. A recent Accenture global survey found that since the COVID-19 outbreak, 95% of consumers have made at least one change to their lifestyle that they expect to be permanent. Economic growth could be strengthened and extended by this rapid change and adoption.

Multi-disciplinary advancement is exploding - in artificial intelligence, robotics, digitization, genomics, clean technologies, next generation materials, blockchain and distributed ledgers, 5G and future connectivity, cloud, edge- and zero-trust networks, decentralized finance, and space. Cornerstone Macro believes that robotics and digitization are the backbone for the case of improved productivity and GDP growth in the U.S. 2021 is on track for the biggest year ever in purchases of robotics, in both the number and the total value of transactions.

Low-cost tools and computing power - plus network effects - plus capital, are coalescing into a revolutionary change in the speed of business creation and growth. David Sacks of Craft Ventures (formerly founding COO of PayPal, founding CEO of Yammer) recently stated that “the start-up environment has never been better. It has never been easier to start a company (other than hiring), and for a founder to raise money.” Yes, some ‘bubble-like’ valuations witnessed during the past year, such as early-stage private businesses and start-ups, SPACs, meme stocks, and NFTs. Counterintuitively, some of today’s extreme business valuations could be precursors of the application of disruptive new technologies and asset-light business models that we cannot fully grasp or envision. In the highly competitive environment of securing scarce talent, rising stock prices and private valuations are an essential ‘currency’ for companies seeking continued growth.

We suspect that some stock and asset-specific valuations are already pricing the brightest of all possible outcomes. Many speculators will lose. But as long-term investors in businesses attempting to grow shareholder value, VWG needs to participate in secular and potentially transformational change. In most cases, we do not recommend making investments into individual emerging businesses and technologies that have no past records of success, positive cash flows, or palatable valuations. VWG attempts to find and employ entrepreneurs and strategies seeking measured, diversified exposure, ever mindful of the many risks involved. We also point out that some of the greatest beneficiaries of new technologies and disruption may be today's visionary businesses that implement them.

Portfolio Strategy and Asset Positioning

With consideration to each client's specific planning and cash flow requirements, tax sensitivity and risk tolerance, VWG Wealth Management's core investment portfolios consist of diversified public equities, liquid short-term bonds and cash, and assets and strategies seeking alternative sources of return and diversification.

We currently recommend that public equities be allocated moderately. Many stock portfolios that have enjoyed strong performance over the past three years should be trimmed and rebalanced. Although we remain constructive, we concede that the historically strong returns earned by large U.S. equities over the past three years may not persist. VWG's core philosophy is allocating capital to portfolio managers of businesses focused on the long-term compounding of shareholder value. Particularly at this juncture of expected rate increases and slowing profit growth, core businesses with strong fundamentals should be favored. Specifically, the businesses should feature solid balance sheets, organic revenue growth, abundant free cash flow, stable or improving margins, and wide protective 'moats.'

Appropriate levels of quality, liquid short-term bonds and cash should be maintained and in some situations be increased. Regardless of inflationary spikes and the current level of interest rates, safe liquidity provides for expected and unexpected future needs, and a pool of capital to deploy when future opportunities arise. Just as important, the right level of cash and short-term bonds allow us to endure uncertainty and volatility without succumbing to rash action.

With private and alternative investments, VWG seeks to commit capital to experienced entrepreneurial operators and strategies attempting idiosyncratic sources of returns, both in capital appreciation and in cash flows. Subject to each unique client's situation, these alternative assets can include private businesses, real estate, public and private debt, hard assets, and positively skewed note structures issued by U.S. Federal Bank holding companies. Ideally, VWG prefers niche, asset-constrained managers, and strategies. We generally underweight or avoid exposure to mass asset-gathering vehicles and providers.

In the extremely complicated set of conditions and variables the world is currently facing, it is our mandate to remain on watch for both risks and opportunities. We will work hard to do so with patience and discipline.

VWG will communicate to you if our views change. Please reach out to us with your questions and your engaging dialogue. Let us know if anything significant in your financial situation has or is expected to change.

As the huge Omicron variant wave surges across the U.S. and the globe, VWG Wealth Management is thinking of you. We hope you and your family remain physically and mentally safe. We are optimistic that epidemiologist projections, and the arsenal of effective vaccines, antivirals, and mitigation tactics, will soon prove to put this episode of the pandemic behind us. Please accept our wishes for a 2022 filled with time spent with family and friends, good health, love, and laughter. We look forward to speaking with you in the New Year!

Regards,

VWG Wealth Management

Suzanne, Ashley, Rashmi, Kay, Brandi, Lynette, Ona, Michelle, Ryan, Ryan, Susan, Marnie, Justin, Elana, Patricia, John, Rick and Jeff

Who we are

** Index Data and Charts Sourced from FactSet Research, Morningstar, CBC News, Bloomberg, Strategas Research Partners, Federal Reserve Bank of St.Louis.*

Please reach out to us if you have any questions or comments.

VWG Wealth Management

(571) 406-4700
vwg@hightoweradvisors.com

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VWG Wealth Management, A Hightower Company

1919 Gallows Road, Suite 330, Vienna, VA 22182
(571) 406-4700
Visit Our Website