Q4 MARKET INSIGHTS

Winter 2021

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On behalf of the entire team at Beaumont Financial Partners, we hope you had a wonderful holiday season and wish you a Happy New Year! U.S. stocks also enjoyed the holiday season, rolling higher through December, capping off another quarter of gains and culminating in what turned out to be an excellent run of performance in 2021. Over the course of the year, the S&P 500 Index returned 28.68% without a meaningful correction. The strong results can be attributed to a number of factors, including the distribution of vaccines, continued expansion of central bank balance sheets and accommodative monetary policy, fiscal stimulus, as well as strong corporate earnings. Economic growth in the U.S. remained robust despite a number of high-profile headwinds including the emergence of new COVID variants, supply chain constraints, and persistent inflationary pressures. In addition, the U.S. equity markets shook off prospects for changes to Fed policy and possible tax increases, helping the S&P 500 finish the year near its all-time high. After a stellar year, the index has now delivered returns of greater than 25% for the second time in three years. Internationally, foreign markets saw modest gains in the fourth quarter as declines in emerging markets partially offset gains in foreign developed markets. Emerging markets dropped in the fourth quarter in reaction to a stronger U.S. dollar while the Omicron variant also weighed on global economic growth estimates. For the full year 2021, foreign markets registered positive returns but, again, handily underperformed the S&P 500 as only moderate gains in developed markets were offset by a modest annual decline in emerging markets. China, in particular, underperformed sharply as government crackdowns on the real estate sector continued to inhibit economic growth. For the year, the Chinese equity market (as represented by the MSCI China Index) fell by over 21%. Overall, emerging markets, represented by the MSCI Emerging Markets Index, posted a return of negative 2.47% for the year, while foreign developed markets, as represented by the MSCI EAFE Index, were up 11.86%. Switching to fixed income markets, the leading benchmark for bonds (Bloomberg Barclays US Aggregate Bond Index) experienced a fractionally positive return for the fourth quarter but declined 1.54% for 2021, as the potential for sooner-than-expected Fed rate hikes and persistent inflation weighed on most bond classes.

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WHAT WE’RE WATCHING FOR IN 2022

Markets have exhibited very impressive resilience since the pandemic began and that remained the case throughout the fourth quarter and all of 2021, as the strength of the U.S. economy and corporate America helped produce another year of substantially positive returns in stocks. That resilient nature is expected to support markets and the economy as we begin a new year. Like all years, however, 2022 presents numerous potential challenges to economic growth, and market returns, including a reduction in global stimulus, stubbornly high inflation pressures, political uncertainty, and the ongoing pandemic. Here is what we are watching for in 2022.

TAXES AND THE BUILD BACK BETTER ACT

In our last quarterly update, we highlighted the prospects for additional taxes as Congress worked to pass President Biden’s Build Back Better Act. Our concerns were about the impact that higher individual and corporate tax rates may have on the financial markets. In November, the House approved a $1.7 trillion (scaled back from $3.5 trillion originally) version of the bill that focused its spending on health care, education, family support, and climate change initiatives. This version

of the bill did not propose any major increases in corporate or individual marginal tax rates. Some of the proposed tax changes included a 15% minimum tax on large corporations, 1% tax on corporate buybacks, a 5% surtax on individuals earning annual income over $10 million plus an additional 3% surtax on annual income over $25 million, as well as forced distributions from IRA accounts over $10 million (to start in tax year 2029), and some additional limitations on Roth conversions. None of these proposed tax changes should have a meaningful impact on corporate earnings or individual spending habits. However, as the House-approved version of the bill was passed to the Senate, Democratic Party Senator Joe Manchin declined to vote for the bill. Given that the Senate is split 50-50 Democrat/Republican, the Democrats really need Mr. Manchin's vote to get this bill to pass. It appears that Mr. Manchin is willing to work with the President and other members of the Senate to craft a version of the bill that he would find acceptable, yet, we believe the likelihood of any major policy initiative passing through Congress, particularly during a mid-term election year is negligible. Even if a version of the Build Back Better Act is passed, we believe the odds for any significant tax increases have declined.

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OMICRON'S IMPACT

New variants of COVID-19 continue to make headlines and cause investor anxiety. The Omicron variant has become the dominant strain of COVID-19 circulating across the globe. While this variant appears to be extremely contagious and resistant to vaccines, initial analysis shows that it does not result in nearly as many severe cases as previous COVID variants. While daily cases are spiking to new all-time highs, hospitalizations and deaths are lower than previous levels. Overall, this is good news for the markets as the chances of the government imposing economically crippling lockdowns here in the U.S. remains low. We are hopeful that we are closer to the end of this pandemic. While we do not claim to be epidemiologists, there are historic examples of viruses which gradually became less dangerous over time, such as the H1N1 influenza viruses responsible for the 1918 "Spanish flu" and 2009 "swine flu" pandemics, and the myxoma virus that causes myxomatosis in rabbits (this was introduced in Australia in 1950 in an effort to control the rabbit population). OC43, a human coronavirus that causes the common cold, is also believed to have started out as a more deadly coronavirus; it was suspected to have been responsible for a pandemic that began in 1890, which killed more than a million people worldwide. There is a commonly held belief among some scientists that a virus's goal is to survive, replicate and spread. If a virus kills its host, it dies with the host, so viruses tend to evolve toward being more infectious and less deadly. Of course, these scientists also maintain that there are exceptions and other factors that come into play, but let's hope that this is not the case for COVID-19 and it continues to become more benign.

Unfortunately, COVID-19 is not going to disappear tomorrow. Therefore, we will continue to watch for new variants and for any sustainably negative impacts from COVID-19 on the economy or the financial markets. While the Omicron variant is not likely to lead to any lockdowns here in the U.S., we still need to be cognizant of any supply chain disruptions due to worker shortages as people miss work due to illness and any associated inflationary pressures.

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SUPPLY CHAINS, INFLATION, AND THE FED

As we learned during the pandemic, the global supply chain is fragile and very interdependent. Interruptions to manufacturing or services in one area can have a ripple effect throughout the entire system. The rapid spread of the virus prompted shutdowns of industries around the world; at the same time fiscal stimulus (via direct payments to individuals, PPP loans, extended unemployment benefits, etc.) created consumer demand for goods. As lockdowns

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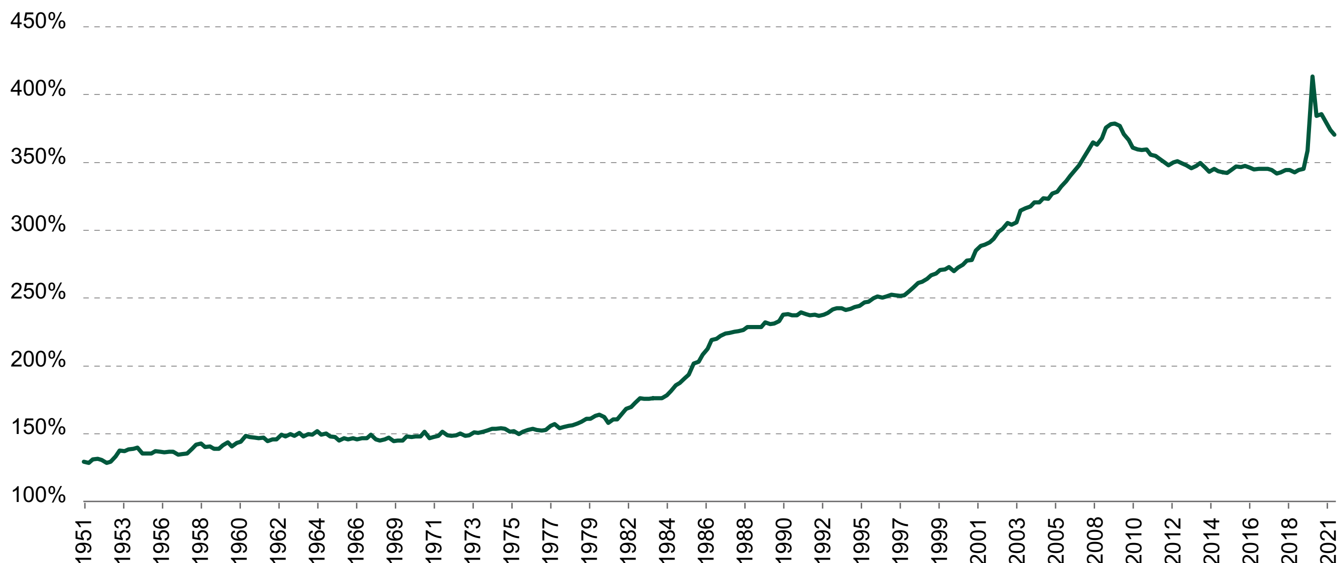
were lifted, consumer demand skyrocketed even higher, and the supply chains that were disrupted during the health crisis continue to face huge challenges to this day. This has led to chaos for the manufacturers and distributors of goods who cannot produce or supply as much as they did pre-pandemic due to worker shortages and/or a lack of key components and necessary raw materials. As a result, prices for goods, as measured by the Consumer Price Index ("CPI") reached their highest levels since 1982 (reported CPI for November was 6.8%). These inflationary pressures are expected to subside somewhat in the coming year, but are still going to be elevated, with analyst consensus (according to estimates on Bloomberg) expecting CPI of 4.4% for 2022. These developments will have a crucial impact on Fed policy going forward. The Fed is tasked by Congress with a "dual mandate" to support a healthy economy. This mandate directs the Fed to use its available tools to promote 1) maximum employment and 2) stable prices. During the quarter, the Fed announced that it will begin to taper its quantitative easing ("QE") program, which was put in place to help the economy in response to the COVID-19 crisis. In addition, the Fed has signaled that it intends to begin raising interest rates during 2022, in an attempt to reduce inflation. Current expectations are for three rate hikes in the upcoming year. However, the Fed is in a precarious position. The risk is not in the number of times the Fed increases rates; it is the point where the increase in rates causes something to break in the economy or credit markets. Total U.S. credit market debt outstanding (which includes household debt, corporate debt, local and state government debt, as well as federal government debt) currently stands at 370% of GDP (see chart below for perspective). Given the historically high level of outstanding debt in the economy, the Fed cannot allow rates to increase meaningfully or it risks causing a recession. So the Fed must walk a tightrope where it will try to raise rates in an effort to slow the inflationary pressures, while at the same time try not to cause a recession (and harm its goal of achieving maximum employment). With an overleveraged U.S. economy, we find it hard to believe that the Fed will raise rates too much and risk causing a recession. If the Fed does make a policy mistake, then we believe they will pivot quickly and cut rates and likely introduce additional QE, which will ultimately benefit equity markets. We will closely monitor the future inflation numbers, as well as Fed communications and what impact they may have on financial markets, as we move through 2022.

Overleveraged Economy



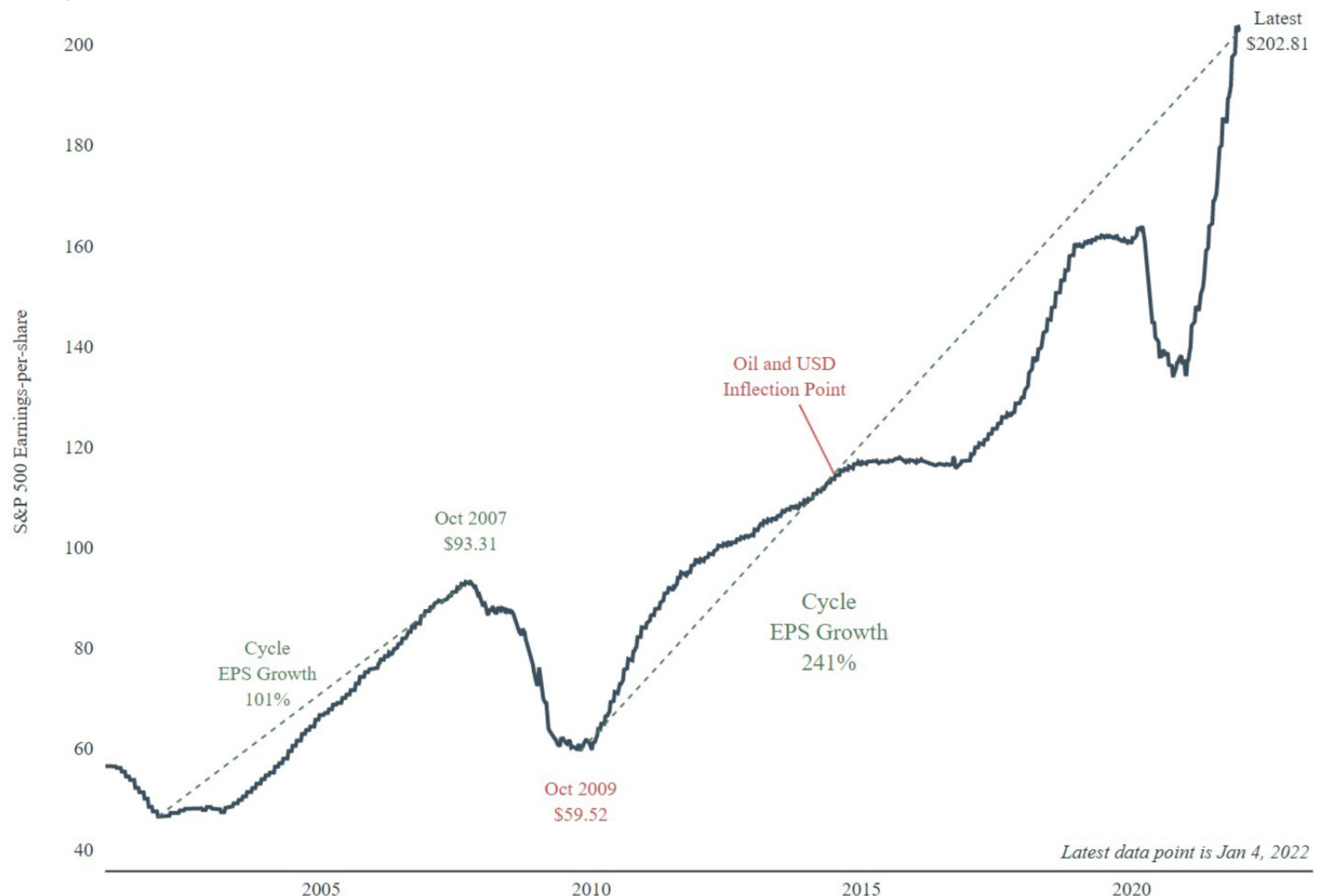
Source: Federal Reserve Bank of St. Louis

OUTLOOK FOR 2022

Our view is that 2022 will be an important transition year for a global growth cycle largely shaped by the pandemic. Economic growth in the U.S. (according to the Conference Board Economic Forecast) is expected to slow down from 5.6% in 2021 to 3.5% in 2022 on waning fiscal stimulus and inflationary headwinds. Even with that downshift, the U.S. economy should easily outpace the 1.9% annual average growth rate it had achieved from 2000 to 2020, barring any unforeseen events. Outside the U.S. the transition in economic growth should be less synchronized. In as much as we are encouraged that the COVID risks to the economy are diminishing in the U.S., it does not appear to be the case overseas, where many governments continue to enforce lockdowns and limit personal and economic activities to combat outbreaks. Beyond COVID, it is the impact of higher fuel costs that have hit Europe and Asia the hardest. Following a sharp slowdown, the Chinese economy is likely to stabilize (albeit at a slow pace) as the central government tries to closely manage its real estate sector. Broadening vaccination coverage across the globe should help international economies later in 2022, but the U.S. is likely to be the main source of global economic growth. As such, we would expect the value of the U.S. Dollar to remain strong through most of the upcoming year, especially if interest rates rise (putting pressure on emerging market equity valuations and currencies).

Given this backdrop we believe the case for owning U.S. equities remains strong. Corporate America has executed extraordinarily well in the wake of COVID, with productivity enhancements leading to all-time high profit margins and exceptional earnings growth (see chart below). While the threat of inflation can be unsettling to investors, as it can erode profits, we believe that the corporations that make up a large portion of the S&P 500 can offset any inflationary pressures due to pricing power. According to Refinitiv, the trailing four quarter operating profit margin for the S&P 500 is currently 13.1% (an all-time high). We feel that the reason why the companies in the S&P 500 are able to maintain such a high margin in the current environment is partly due to

S&P 500 Earnings-Per-Share



Source: Refinitiv

their ability to pass along any rising costs to their customers. The largest U.S. public companies are basically oligopolies, as most industries are now dominated by a few big firms that enjoy substantial market share, high barriers to entry, and very little competition. This construct gives companies the ability to raise prices without much risk of losing business to a competitor. This is especially true of companies with strong brand recognition, companies that provide essential services, or those which provide products with favorable supply and demand dynamics. In fact, some Wall Street firms are projecting operating margins for the S&P 500 to increase in 2022. Given this increase in corporate profits, valuation multiples are now lower than they were at the start of 2021.

Speaking of valuation multiples, there are concerns that higher interest rates will put downward pressure on P/E (price/earnings) multiples due to future earnings being worth less (as they are discounted at a higher rate). However, given the current low level of interest rates, the U.S. equity market should continue to be supported by a scarcity of compelling asset allocation alternatives. In particular, from a relative value standpoint, low interest rates continue to make stocks look attractive when compared to other asset classes, especially bonds. We have drawn attention to this point in previous letters, where we compared the free cashflow yield of the S&P 500 relative to the yields of other fixed income options. See table below for yields updated as of December 31st, 2021.

	Yield at 12/31/2021*
10-Yr US Treasury Note	1.51%
30-Yr US Treasury Bond	1.90%
IG Corporate Bonds	2.60%
S&P 500	3.32%
High Yield Corp Bonds	4.35%

*Yield quoted for S&P 500 is free cashflow yield; see definitions for additional information on IG Corporate Bond yields and High Yield Corporate Bond yields

Source: Bloomberg, Federal Reserve Bank of St. Louis

As you can see, the free cashflow yield on the S&P 500 is much higher than the yields of the 10-year U.S. Treasury note, the 30-year U.S. Treasury bond, as well as investment grade corporate bonds (the yield on high yield corporate bonds is higher, however, high yield bond investors are subject to elevated levels of default risk). Even if the Fed were to raise rates by 1.25% (five rate hikes), equities will still be cheap relative to bonds. We believe this is why stocks will continue to outperform relative to fixed income as investors, especially those looking for yield, will prefer to own equities. Which would you rather own: a 30-year U.S. Treasury bond paying you 1.90%, or would you rather own a stock that

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is generating 3.32% in free cash that can be used to pay dividends and has the potential to increase in value over 30 years?

With bond yields at historic lows, increased levels of inflation, and the prospect of the Fed raising rates, we believe investors are not currently being compensated for the risks of owning fixed income. While fixed income does offer diversification and correlation benefits relative to equities, especially during equity market corrections, we would prefer to see the yield on the 10-year U.S. Treasury Note above 2% before we believe the risk/reward tradeoff of increasing allocations to fixed income is more appropriate.

Allocations to alternative investments (where appropriate) may also serve an important role in a client's portfolio. Investments in real estate, private credit, real assets, bitcoin or other alternatives may not only help protect the risks associated with higher inflation, but they can also offer uncorrelated exposure to traditional asset classes and reduce overall portfolio volatility.

Finally, one last thing to keep in mind as we look ahead to 2022. Given our outlook for slowing growth, and the Fed's tightening cycle, we would expect to see increased volatility in the year ahead. Given the strong performance over the past three years, it would not surprise us to see an equity market correction of 10% to occur at some point. Since 1928, a correction of at least 10% has occurred about once every 19 months. The S&P 500 has currently gone since June 29, 2020 without a correction of 10% or more. However, we must keep in mind that if a correction is to take place, the best thing to do is not panic. The key to withstanding bouts of market volatility is to have an appropriate asset allocation. This is why we work with you to establish an investment plan based on your financial position, risk tolerance, and investment timeline in an effort to meet your long-term financial goals, despite market gyrations. Short-term market "noise" should not derail the long-term investment approach that we created together.

We thank you for your ongoing confidence and trust. Please rest assured that our entire team will remain dedicated to helping you successfully navigate these financial markets.

Best wishes for a healthy and prosperous 2022!

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The material may contain forward or backward-looking statements regarding intent, beliefs regarding current or past expectations. The views expressed are also subject to change based on market and other conditions.

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All performance data is as of 12/31/2021 unless otherwise stated. Diversification does not ensure a profit or guarantee against loss. An investment cannot be made directly in an index. As with all investments, there are associated inherent risks, including loss of principal. Sector investments concentrate in a particular industry and the investments' performance could depend heavily on the performance of that industry and be more volatile than the performance of less concentrated investment options and the market as a whole. Foreign markets, particularly emerging markets, can be more volatile than U.S. markets due to increased political, regulatory, social or economic uncertainties. Fixed Income investments include risks such as exposure to interest rate fluctuation, credit changes and inflation. Positions held in cash are subject to inflation risk.

Past performance is no indication of future results

Definitions:

S&P 500® Index is a registered trademark of Standard & Poor's Financial Services LLC, a division of S&P Global ("S&P"). S&P 500 Index is an unmanaged index used as a measurement of change in U.S. equity markets. Performance numbers for the index are total return with dividends reinvested in the index.

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The MSCI EAFE Index is a stock market index that is designed to measure the equity market performance of developed markets (Europe, Australasia, Far East), excluding the US & Canada. The MSCI EAFE Index is an equity index which captures large and mid-cap representation across Developed Markets countries around the world, excluding the US and Canada. With 913 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. Indices are not managed and do not incur fees or expenses. Performance numbers for the index are total return with dividends reinvested in the index.

The MSCI Emerging Markets Index captures large and mid-cap representation across 24 Emerging Markets (EM) countries*. With 838 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. Performance numbers for the index are total return with dividends reinvested in the index.

The Bloomberg Barclays US Aggregate Bond Index provides a measure of the total return performance of the U.S. dollar denominated investment grade bond market, which includes investment grade government bonds, investment grade corporate bonds, mortgage pass through securities, commercial mortgage backed securities and asset backed securities that are publicly for sale in the United States.

Quantitative easing (QE) is defined as large scale purchases of securities, typically fixed income, by a monetary authority such as the Federal Reserve. In theory, the result is an increase in demand for those securities, putting upward pressure on their prices and pushing yields down. Quantitative easing allows a monetary authority the ability to influence longer duration securities, while traditional monetary tools can only directly influence shorter duration securities.

The price-to-earnings ratio (P/E ratio) is the ratio for valuing a company that measures its current share price relative to its earnings per share. The price-to-earnings ratio is also sometimes known as the price multiple or the earnings multiple.

The Consumer Price Index (CPI) is issued by the U.S. Bureau of Labor Statistics and is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Indexes are available for the U.S. and various geographic areas.

The Conference Board, Inc. is a 501(c) (3) non-profit business membership and research group organization that was founded in 1916. It counts over 1,000 public and private corporations and other organizations as members, encompassing 60 countries. The Conference Board convenes conferences and peer-learning groups, conducts economic and business management research, and publishes several widely tracked economic indicators.

Investment Grade Corporate Bond Yields- This data represents the effective yield of the ICE BofA BBB US Corporate Index, a subset of the ICE BofA US Corporate Master Index tracking the performance of US dollar denominated investment grade rated corporate debt publicly issued in the US domestic market. This subset includes all securities with a given investment grade rating BBB. When the last calendar day of the month takes place on the weekend, weekend observations will occur as a result of month ending accrued interest adjustments. The ICE BofA US Corporate Master Index tracks the performance of US dollar denominated investment grade rated corporate debt publicly issued in the US domestic market. To qualify for inclusion in the index, securities must have an investment grade rating (based on an average of Moody's, S&P, and Fitch) and an investment grade rated country of risk (based on an average of Moody's, S&P, and Fitch foreign currency long term sovereign debt ratings). Each security must have greater than 1 year of remaining maturity, a fixed coupon schedule, and a minimum amount outstanding of $250 million. Original issue zero coupon bonds, "global" securities (debt issued simultaneously in the eurobond and US domestic bond markets), 144a securities and pay-in-kind securities, including toggle notes, qualify for inclusion in the Index. Callable perpetual securities qualify provided they are at least one year from the first call date. Fixed-to-floating rate securities also qualify provided they are callable within the fixed rate period and are at least one year from the last call prior to the date the bond transitions from a fixed to a floating rate security. DRD-eligible and defaulted securities are excluded from the Index.

High Yield Corporate Bond Yields- This data represents the effective yield of the ICE BofA US High Yield Index, which tracks the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the US domestic market. To qualify for inclusion in the index, securities must have a below investment grade rating (based on an average of Moody's, S&P, and Fitch) and an investment grade rated country of risk (based on an average of Moody's, S&P, and Fitch foreign currency long term sovereign debt ratings). Each security must have greater than 1 year of remaining maturity, a fixed coupon schedule, and a minimum amount outstanding of $100 million. Original issue zero coupon bonds, "global" securities (debt issued simultaneously in the eurobond and US domestic bond markets), 144a securities and pay-in-kind securities, including toggle notes, qualify for inclusion in the Index. Callable perpetual securities qualify provided they are at least one year from the first call date. Fixed-to-floating rate securities also qualify provided they are callable within the fixed rate period and are at least one year from the last call prior to the date the bond transitions from a fixed to a floating rate security. DRD-eligible and defaulted securities are excluded from the Index.

ICE BofA Explains the Construction Methodology of this series as:
Index constituents are capitalization-weighted based on their current amount outstanding. With the exception of U.S. mortgage pass-throughs and U.S. structured products (ABS, CMBS and CMOs), accrued interest is calculated assuming next-day settlement. Accrued interest for U.S. mortgage pass-through and U.S. structured products is calculated assuming same-day settlement. Cash flows from bond payments that are received during the month are retained in the index until the end of the month and then are removed as part of the rebalancing. Cash does not earn any reinvestment income while it is held in the Index. The Index is rebalanced on the last calendar day of the month, based on information available up to and including the third business day before the last business day of the month. Issues that meet the qualifying criteria are included in the Index for the following month. Issues that no longer meet the criteria during the course of the month remain in the Index until the next month-end rebalancing at which point they are removed from the Index.

Refinitiv (formerly known as Thomson Reuters) is an American-British global provider of financial market data and infrastructure.

Please contact us at 781-400-2800 for more information on how we can assist you with your financial needs.

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