FIRST NEBRASKA Trust COMPANY

Fourth Quarter 2021
Quarterly Letter to Clients
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For investors, 2021 was a year like no other! Stocks soared, real-estate prices boomed, commodities skyrocketed, bonds slumped, and non-fungible tokens (NFTs) became a head-scratching asset class. Day-trading investors, driven by a social-media frenzy, disrupted the power dynamic between professional and retail investors. This caused "meme" stocks (like GameStop Corp) to soar to nose-bleed levels. More money than ever was raised in the IPO market, as startups and early investors cashed in on sky-high valuations.

Economies around the globe enjoyed notable recoveries. Several rounds of stimulus payments lined consumers' pockets, which led to surging demand for goods and services. However, that caused supply-chain issues, which brought about inflation levels that we haven't seen in four decades. As a result, the Fed pivoted and announced plans to tap the breaks on their easy-money policies as the year came to an end.

Economic Overview

The nation's economic steward finally backed off using the word "transitory" to describe inflation, as Federal Reserve policymakers acknowledged the increased risk of more persistent pricing pressure. The central bank used the "T"-word since the beginning of 2021. The hope was that higher than expected inflation readings would fade in late 2021 as supply-chain bottlenecks and labor shortages eased. Instead, inflation accelerated during the fourth quarter with 6.2%, 6.8%, and 7.0% readings in October, November, and December, respectively. The inflation readings notched a nearly 40-year high, as pandemic-related supply constraints stunted growing consumer demand juiced by government stimulus payments.

In December, Fed Chairman Jerome Powell announced that the U.S. Central Bank would accelerate the taper of its stimulus spending in a bid to combat inflation. Beginning in January 2022, the Central Bank will reduce its asset purchase program by $30 billion per month, unless adjustments are warranted. The hawkish turn should also pave the way for an increase in interest rates – for the first time in nearly four years. The most recent dot plot, which shows the median of Fed leaders' interest rate forecasts, puts the federal funds rate between 0.75% and 1.0% by the end of 2022. To get there, the Fed will need to hike rates three times this year. However, it should be noted that these forecasts can change with the wind, much like a weather reporter's predictions. It wasn't too long ago that the first interest rate hike wasn't expected until 2024.

Hiring slowed in December, signifying the economic recovery was moderating ahead of disruptions from the Omicron variant of COVID-19. According to the Labor Department, employers added 199,000 jobs in December, cooling from 249,000 new jobs in November and 648,000 in October. The gains left the U.S. economy with about 6.4 million more jobs than at the end of 2020, but the nation remains 3.6 million jobs short of pre-pandemic levels. The tight labor market spurred wage gains with average hourly earnings increasing 4.7% in December from a year earlier.

In December, the unemployment rate fell to 3.9%, down from 4.2% in November and 4.6% in October. Nearly 170,000 people joined the workforce, but at 61.9%, labor-force participation remained below its 63.4% level in February 2020 before the pandemic hit. As we head into 2022, declining unemployment and strong wage growth point to further improvements in the jobs market as employers look to fill openings.

While the economy accelerated in the third quarter, it did not keep pace with the rate of growth in the previous quarter. GDP increased at 2.3% (annualized), up slightly from the pace expected, but significantly less than the 6.7% expansion in the second quarter. The deceleration in the third quarter reflected the continued economic impact of the COVID-19 pandemic. A resurgence of COVID-19 cases resulted in restrictions and delays in parts of the country, and government assistance payments decreased across the board. However, according to the Federal Reserve Bank of Atlanta, real GDP growth in the fourth quarter of 2021 is expected to rebound, increasing to 5.0% growth. For the full year, the economy remains on track to record its best growth rate since 1984.

As measured by the personal consumption expenditures index (PCE), consumer spending also decelerated last quarter, rising by 0.6% in November after climbing 1.4% in October. Holiday shoppers snatched up gifts earlier this year in anticipation of product shortages, helping boost spending in October while contributing to a November sales slowdown. According to Adobe Analytics, online sales rose nearly 9% to a record $204.5 billion during the holiday season. The uptick was driven, in part, by higher prices. Online prices increased 3.1% in December compared to the prior year. That marked the 20th consecutive month of online inflation on a year-over-year basis.

Waning fiscal stimulus combined with higher prices will be a headwind to consumer spending in 2022. Americans are running through the large piles of extra cash they accumulated due to government stimulus. Consumers were saving at an annualized rate of $1.3T in October, compared to $5.7T in March when the last round of stimulus checks hit American bank accounts. As consumers deplete their savings, wage growth will become a more critical source of spending power in the coming months.

Energy prices are putting a dent in disposable incomes. Crude oil fetched more than $80.00 per barrel in October – a price not seen since 2014 – but ultimately ended the fourth quarter at about $75 per barrel. Prices at the pump responded accordingly. The national average retail price for a gallon of regular gasoline hit a high of $3.41 in early November. It then trended marginally lower for the remainder of the fourth quarter, closing out the year at $3.28 per gallon. This compares to $2.25 to begin 2021, a 45% increase year-over-year. The higher energy prices may be foreshadowing further inflationary pressures across the economy in the New Year.

The housing market continues to be on solid footing. In November, sales of existing homes increased 1.9%, marking the third consecutive monthly increase. The median existing-home price was $353,900, the same as in October. New single-family homes also advanced in November, climbing 12.4% after falling 9.2% in October, with a median sales price of $416,900. Housing starts and building permits have remained near their best levels since 2007, despite building material shortages and ongoing labor challenges. Historically low mortgage rates and the "work from home" trend have supported the housing market. Still, those tailwinds seem to be ebbing, and deteriorating affordability is becoming a hurdle for more buyers. Homebuilder confidence remains very optimistic. However, homebuyer confidence dropped to historically low levels. In conjunction with higher mortgage rates, that could put a damper on housing activity in 2022.

The ISM Manufacturing index moderated in December. The index fell to 58.7% from 61.1% - its lowest level since January 2021. However, the sector is still expanding and is near the high end of its 38-year history. The latest reading marked the 19th consecutive month of expansion. Prices paid declined by 14.2% to 68.2%, compared to the September reading of 82.4%. That was the lowest level in more than a year. According to the ISM, "the U.S. manufacturing sector remains in a demand-driven, supply chain-constrained environment, with indications of improvements in labor resources and supplier deliveries." That should bode well for the start of 2022, but the Omicron variant may cause disruptions given the increasing cases we've seen to start the year.

Stocks

U.S. stocks capped off the fourth quarter with strong returns, resulting in a third consecutive year of big gains. The solid returns marked the second time since 1928 that the S&P 500 recorded three successive years of 15%+ price increases. The S&P 500 advanced 26.9% on the year, hitting 70 record highs along the way, despite mounting COVID-19 cases, increasing inflation, labor shortages, and supply-chain disruptions. Strong corporate earnings, a low-interest-rate environment, government support, strong jobs, and vaccine distribution contributed to the strong market performance.

The tech-heavy NASDAQ Composite underperformed the S&P 500 for the first time since 2016, as investors shunned the high-flying stay-at-home, play-at-home, and work-from-home stocks that soared to nose-bleed levels during the pandemic. Yet, the index still climbed by 21.3% on the year. The Dow Jones Industrial Average gained about 19.0%, the Global Dow advanced 18.6%, and the small-cap Russell 2000 index climbed 13.7%. Each of the market’s 11 sectors closed the year well above their prior year's levels. Energy ended 2021 48.0% higher, followed by real estate (43.0%), information technology (33.5%), and financials (33.0%).

The fourth quarter contributed significantly towards the strong annual returns despite a weak November, during which fears of rising cases of the Omicron variant of COVID-19 and the speed of the Federal Reserve’s asset tapering weighed on the market. However, by year-end, those worries largely subsided. The S&P 500 climbed 10.7% in the fourth quarter alone, the Dow Jones Industrial Average advanced 7.4%, and the NASDAQ Composite increased by 8.3%.

Earnings for the fourth quarter are expected to remain strong. According to FactSet, analysts project earnings growth of 21.7% and revenue growth of 12.9%. For the full year of 2021, earnings are expected to increase by 45.2%, with revenue growth of 15.9%. However, earnings are expected to moderate in the year ahead as fiscal and monetary tailwinds begin to fade. Looking ahead to Q1 2022, earnings and revenue growth are expected to slow to 6.3% and 9.7%, respectively. Higher revenue growth relative to earnings growth implies that corporate profit margins are also expected to dip as companies find it harder to pass along higher costs.

With the Fed pinning short rates to zero and pressuring long bond yields lower, stock market valuations continue to trade at a historically high level – about 21x earnings estimates for 2022. However, that could change as the Fed implements its plan to tighten monetary policies. Higher yields could lure some investors out of stocks and into bonds – putting downward pressure on valuations.

Bonds

The bond markets had to contend with rising inflation and the start of tighter monetary policy during the fourth quarter. Yet, the US 10-year Treasury yield was little changed for the quarter, moving from 1.49% to 1.51%. However, there was some volatility at points during the quarter. In October, the benchmark yield climbed to 1.7% amid elevated inflation and policy tightening expectations but then reversed course, hitting a low of 1.36% in early December amid fears over the Omicron Covid-19 variant. Over the full three months, the short-end of the curve moved up, with the U.S. 2-year yield increasing from 0.28% to 0.73%.

The 10-year Treasury note moved higher by 58 basis points in 2021, which notched the largest annual rise since 2013. The increase in yields was enough headwind to push investment-grade bond returns into negative territory for the year. The Morningstar U.S. Core Bond Index, a proxy for typical U.S. bond exposure, fell 1.6% for the year, posting its worst calendar-year return since the taper tantrum that roiled fixed income markets in 2013. High-yield municipal funds led the way, with an average return of 5.7%.

Hopefully 2022 will bring the end the COVID-19 pandemic and the world will inch closer to normalcy. Current forecasts predict the economy will continue to recover, albeit at a more moderate pace. Inflationary pressures are likely to continue, prompting adjustments to the Fed's monetary policies, which in turn could push interest rates higher. As a result, volatility is to be expected. While we can't forecast the twist and turns we are likely to see, we can and will plan for a range of outcomes by following our investment discipline of constructing portfolios designed to meet your long term objectives.

May 2022 bring you much peace and prosperity. Thank you for your ongoing confidence and trust. If you have questions or comments, please don't hesitate to contact us.