THE YEAR AHEAD

The S&P 500 had a phenomenal year in 2021, ending a three-year run where it averaged an almost 24% annualized return. The last time consecutive annual returns were this strong was during the late 1990s. After periods, especially extended ones, of very strong performance, it is usually wise to lower one's expectations coming into the new year. It is unnatural to sustain such high levels of investment returns without periodic and healthy pullbacks. Progress in all aspects of life does not occur in an upward sloping straight line, and no one should expect investing to be any different.

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Part of the reason for these spectacular returns was the unprecedented influx of capital into the economy and markets we experienced during the past few years. This additional money and ensuing momentum chased returns which led to a rising market and high valuations. This was evidenced by the tremendous activity experienced in IPOs, SPACs, cryptocurrencies, and meme stocks. This behavior, usually present during the late stages of a bull market, occurs when investors shed their regard for risk and focus exclusively on the upside. This momentum is unlikely to continue indefinitely as the markets need to eventually correct themselves to function properly. Volatility should be expected as investors grapple with the unknowns surrounding the change in interest rates and inflation's effect on the economy.

This past year, the market returns were driven by many poor-quality companies that happened to have their day in the sun. Many investors took big bets on cyclical industries hoping that an economic recovery would benefit those companies and cause them to significantly outperform the broader market. We are entering the new year with muted expectations for the broader market, but optimistic that there will be continued prosperity throughout the economy.

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