Produced by our Portfolio Management Team, Affinity Investment Advisors, LLC

Q4 2021 Market Commentary

Top of Mind

- **The rise of Omicron (and future variants) and its impact on business conditions**
- **Fiscal and monetary policy in 2022**
- **Inflation and interest rate trends**
- **Equity and fixed income valuations**
- **Sustainable investing and its impact on industries and companies**

Equity Market Review

The U.S. equity bull market moved ahead full steam in the 4th quarter of 2021. The S&P 500 Index advanced 11.0% higher during the quarter, marking the end of a very impressive year. The index rose 28.7% in 2021, nearly three times the index's annual average since 1926. Both growth and value stocks performed well during the quarter and full year. The Russell 1000 Growth Index rose 11.6% during the quarter and 27.6% for the year. In the 4th quarter, the Russell 1000 Value Index climbed 7.8% and 25.2% for the year.

However, as the table below shows, growth stocks still hold a significant advantage over value stocks over the trailing 3-, 5-, and 10-year periods.

	1 Year	3 Years	5 Years	10 Years
Russell 1000 Growth Index	27.60	34.08	25.32	19.79
Russell 1000 Value Index	25.16	17.64	11.16	12.97

All data as of 12-31-2021; Source: FTSE Russell

While growth has dominated in the large cap universe, a more significant reversal of the relationship has occurred in the small cap space. During the fourth quarter, the Russell 2000 Growth Index delivered a return of essentially 0%, while the Russell 2000 Value Index rose 4.4%. For the calendar year 2021, the difference was striking: small cap growth stocks returned a paltry 2.8% while small cap value stocks jumped 28.3% higher. Small cap value's strong outperformance in 2021 has meaningfully closed the gap over longer periods. Over the trailing 10-year period, small cap growth stocks lead small cap value stocks by about 200 basis points annualized (14.1% vs. 12.0%, respectively) – a much different picture than in large cap. This is not surprising to us because we have observed that the change in equity risk factors has led in small cap. For example, valuation as a factor has been strongly in favor in small cap stocks during the past year, while it has been more mixed in the large cap space.

U.S. stocks continued to perform better than non-U.S. equities. The MSCI EAFE Index moved 2.7% higher in the 4th quarter and 11.3% for the year. Emerging market equities did not fare well, as the MSCI Emerging Markets Index fell -1.3% for the quarter and -2.5% for the year. Within emerging markets, stocks in Asia and Latin America were particularly weak during the year.

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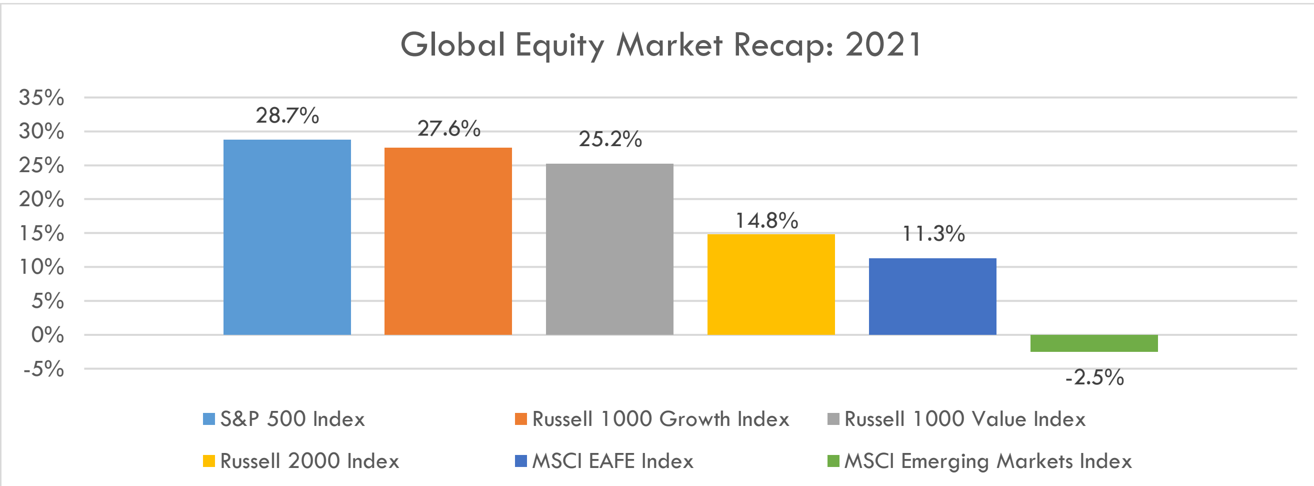
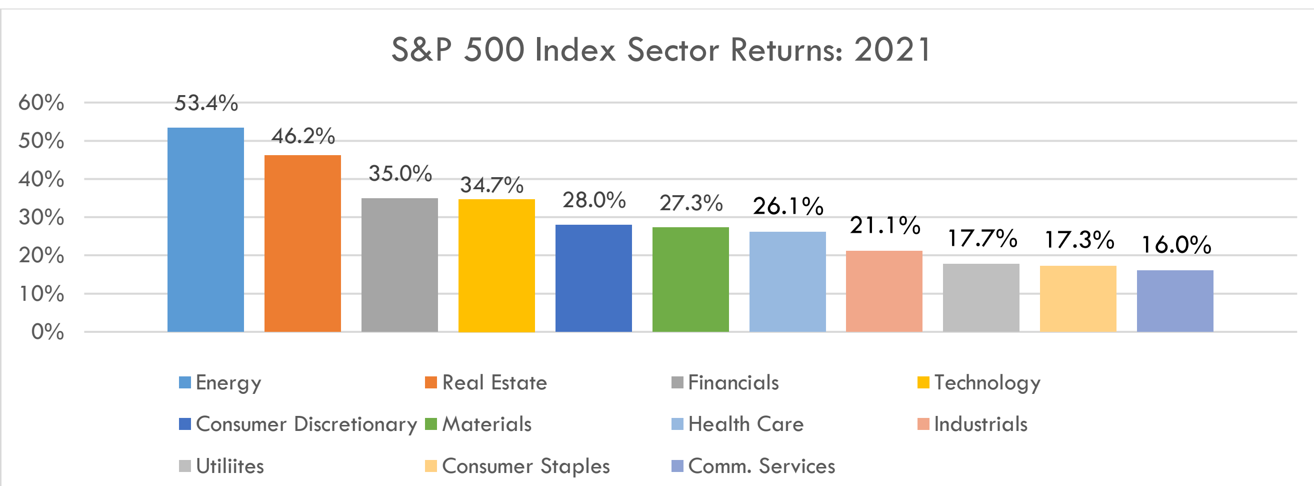


During 2021, all S&P 500 sectors generated solid returns, as noted in the chart below. The largest sector by weight in the large cap growth index is Technology; in the large cap value index, Financials represent the largest weight. Technology and Financial stocks were the third and fourth best performing S&P 500 sectors, respectively. This helps explain the strong performance from both styles during the year.



Fixed Income Markets Review

Interest rates rose during 2021. As the chart below shows, the yield on the 10-Year U.S. Treasury began the year at just under 1% and ended the year above 1.5%. Consequently, the prices of government and corporate fixed income securities declined during the period. Longer duration bonds – which are more vulnerable to rising interest rates vs. shorter term bonds, fared worse, with the Bloomberg Long Government & Credit Index falling -4.6% for the year. Corporate bonds, which hold a yield advantage

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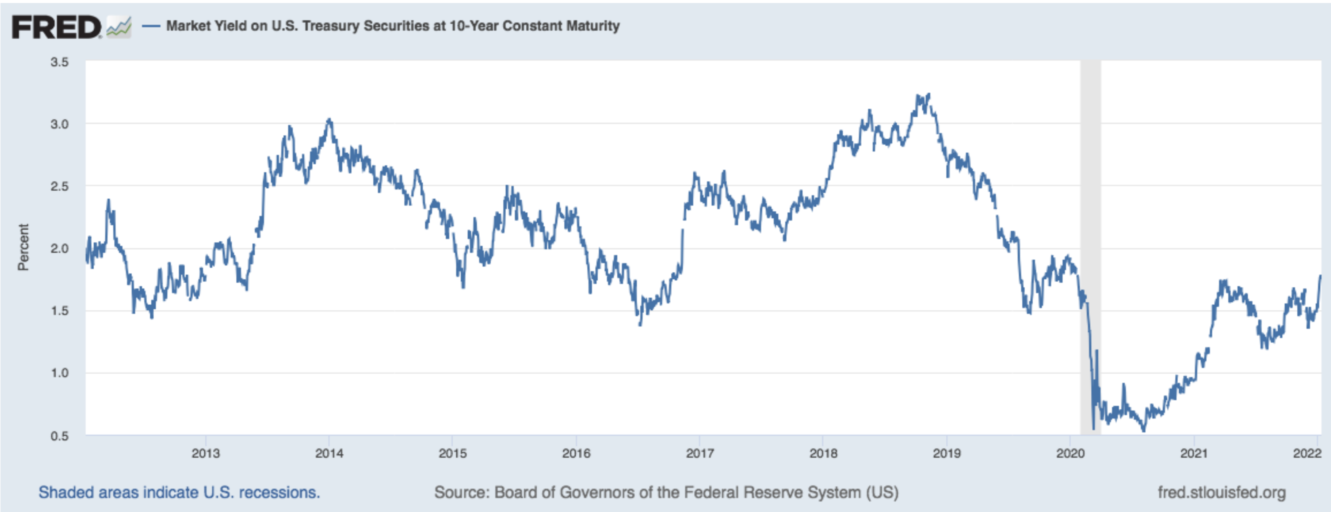
over government securities, performed better as the Bloomberg U.S. Credit Index declined -1.3% for the year.



Meanwhile high yield bonds (based on the ICE BofA High Yield Index) performed the best, rising 4.7% in 2021. This is not surprising as high yield bond returns are often more highly correlated with equity returns than with corporate fixed income. Credit spreads, a primary determinant of the strength of high yield bonds, remained incredibly tight during 2021.

Capital Markets Outlook

Covid-19 remains a challenge – an obvious statement that probably does not need to be articulated. But the future is unclear, and it is debatable as to its impact on growth and employment. In Los Angeles County new Covid-19 cases are approximately 35k to 40k daily (early January). There are 2 million confirmed cases since the pandemic began in a county with a population of 10 million. On a percentage basis, U.S. statistics are similar. These numbers may be understated since tests are hard to acquire, many individuals are asymptomatic, and others may have mild conditions and will not attempt to test. In any case, it seems that the world may be shifting from pandemic to epidemic. It also seems increasingly unlikely that broad shutdowns will occur, particularly since a meaningful number of Covid-19 hospitalizations are due to other factors. While the impact of Covid-19 is very difficult to predict, it appears to us that at this time it will have a diminishing impact on the economy as time passes.

Fiscal policy will likely impact the capital markets in the coming year. Congressional approval, rejection, or modification of the Build Back Better bill is perhaps the most profound measure potentially affecting the investing landscape. Successful passage will inject a significant new amount of stimulus into the market. In our view this is likely positive for asset prices in the short term, but likely negative over the intermediate to longer term. It is worth noting that the $1T+ infrastructure bill has yet to be fully deployed and will provide additional stimulus. The equity market has generally befitted from an expanding Federal Reserve balance sheet (see the chart below). A tertiary but related topic is the mid-term elections. Historically, stocks have underperformed in the first part of the year when mid-term elections occur, but often recover as the year

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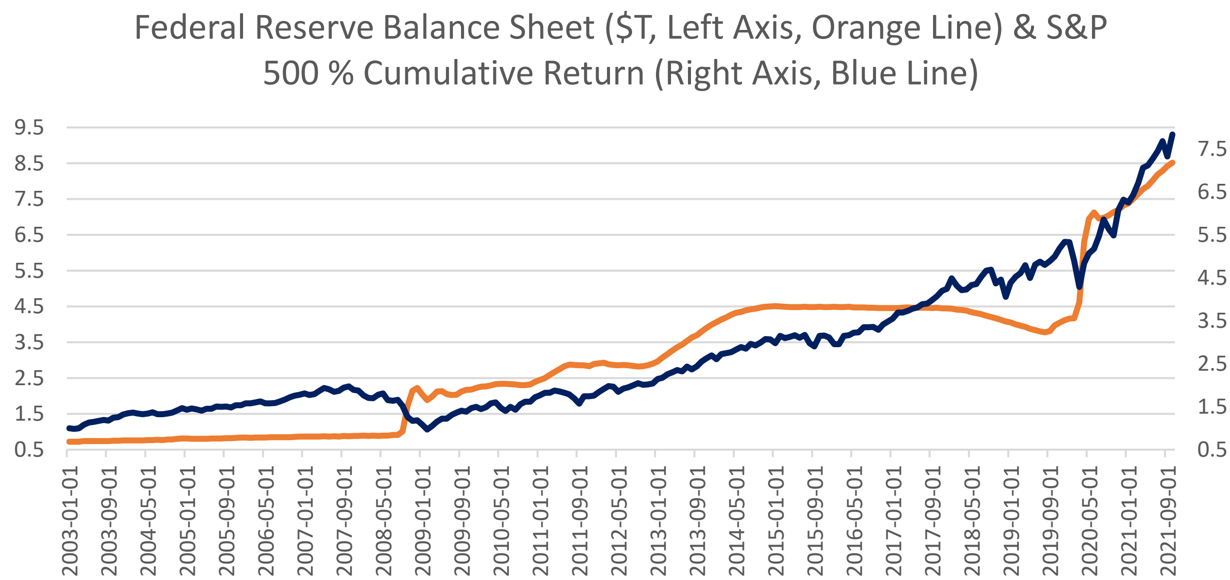

Monetary policy will likely gravitate from highly accommodative to incrementally more restrictive. According to the Atlanta Fed there is a greater than 80% probability of a quarter point rate hike in early 2022 and current expectations are for the Fed Funds Rate to reach 100 basis points by the end of 2022; at the margin, this is negative for stocks. However, given the still very low base rate, the impact seems unlikely to dramatically shock the stock market.

Treasury yields are likely to rise, particularly given the inflation data. However, yields are still extremely low. The 10-year U.S. Treasury yield exceeded 3% in 2018, and it did not derail the market. We expect there will be winners and losers in a rising rate environment with perhaps a secular tailwind behind value stocks. A rising rate environment has historically benefitted banks and other financial institutions, companies which generally comprise a much larger percentage of value benchmarks. Important factors impacting interest rates are the Federal Reserve's resolve to begin tapering the purchase of government bonds (and recall that tapering is not ending the purchases, but rather reducing) as well as inflation. Inflationary pressures are likely the result of both supply constraints (supply chain interruptions) and demand (stimulus and higher wages). Looking closer at the greatest contributors to CPI, it is housing (42%), transportation/gas (15.3%), and food (15.0%). Clearly inflation has been increasing and problematic. That said, we believe inflation will moderate in the ensuing quarters. First, the Federal Reserve will begin raising rates in 2022 – albeit gradually and modestly. Second, in our view wage inflation remains somewhat contained by globalization. Third, as supply chain disruptions subside, some components of CPI will moderate. Finally, housing, the largest component of CPI, may also experience some weakness as interest rates rise.

Regarding valuations, the P/E Ratio for the S&P 500 Index was close to 30 times trailing twelve months earnings at the end of the 4th quarter. This level is about twice the historical average. The market's

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ability to support this high valuation reflects a generally optimistic outlook on the part of market participants. Corporate profits rose an estimated 12% to 13% in 2021, and they are expected to rise another 5% to 10% in 2022. Real economic growth in 2021 is estimated to have been 5% to 6%, and the consensus expectation is for 3% to 4% real growth in 2022. Forward P/E ratios generally look more attractive, but of course are dependent on the realization of earnings growth, a metric which is never a certainty. However, if earnings growth meets expectations this year or surprises to the upside, it will help mitigate some concerns over valuations.

A secular trend worth mentioning is sustainable investing. Search activity and mandates awarded in the institutional space have risen over the past several years. Opportunities likely exist for industries and companies who proactively address sustainability and diversity. The flow of institutional capital into publicly traded equities which meet certain criteria regarding sustainability may have an increasing impact on the returns of individual companies and industries in the coming quarters and years.

The net result is increased volatility in the equity markets with weaker returns, at least in the first half of the year. Non-US stocks may very well outperform due to more attractive valuations and economies that have mostly lagged the U.S. in the post pandemic recovery. The Federal Funds Rate and Treasury yields will likely trend higher, but relative to historical levels will appear modest. There are many factors that will impact capital market returns in 2022, which creates a wide range of investment return possibilities across asset classes. We remain constructive on the global capital markets, but certainly recognize that risks are present and must be monitored on an ongoing basis.

Sources: Federal Reserve Bank of St. Louis; FTSE Russell; MSCI; S&P Dow Jones; Bureau of Labor Statistics; and Refinitiv.

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