SIERRA MUTUAL FUNDS | OCEAN PARK ASSET MANAGEMENT

2021 Market and Economic Review

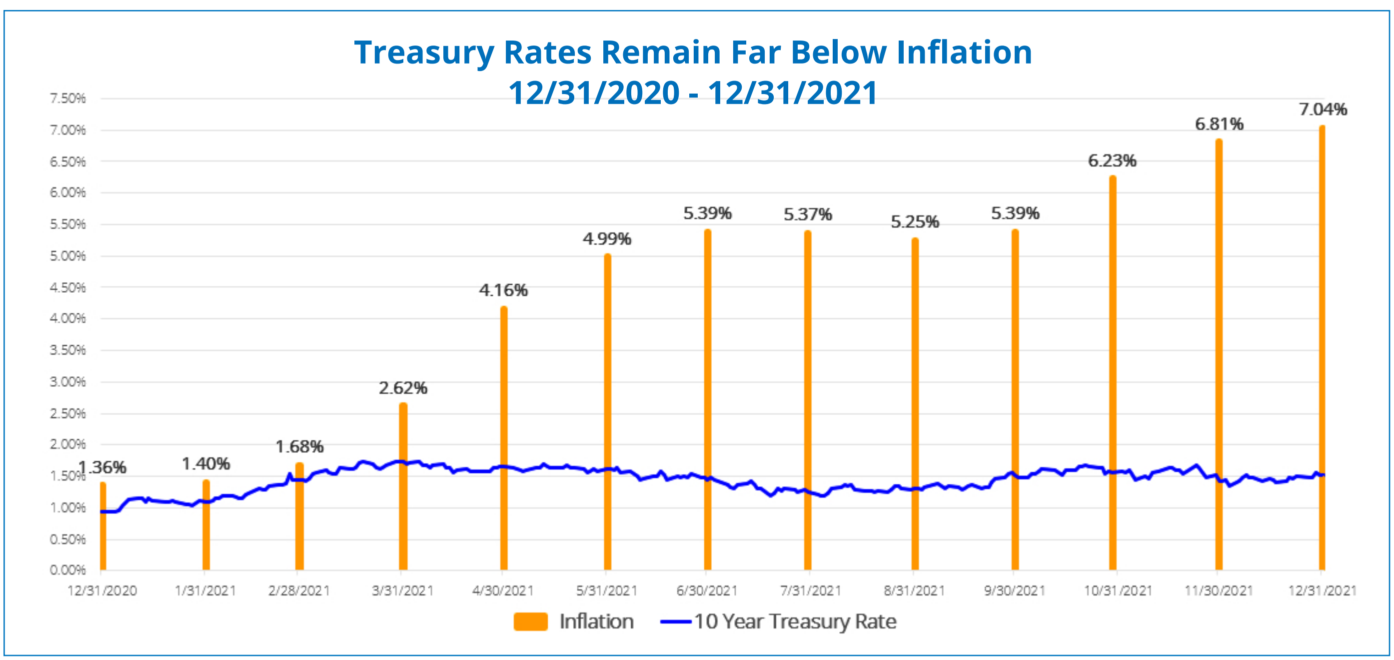
Overview

The U.S. Economy moved forward in 2021 fueled by fiscal and monetary stimulus as the economy more than fully recovered from last year's sharp but short recession. Over 6 million new jobs were gained during the year as the unemployment fell below 4%. Financial markets favored equities during the year, but the market focus shifted frequently from month-to-month. Rising inflation in the second half of the year and the U.S. Federal Reserve's move to a tightening stance in the second half of the year were two of the strongest concerns at year-end.

We recognize that markets anticipate the impact of these factors so that current prices incorporate all that is known and can be known. The issues and factors described below are therefore not what we use in managing portfolios. But they did impact the market returns seen in 2021.

Interest Rates and Interest Rates

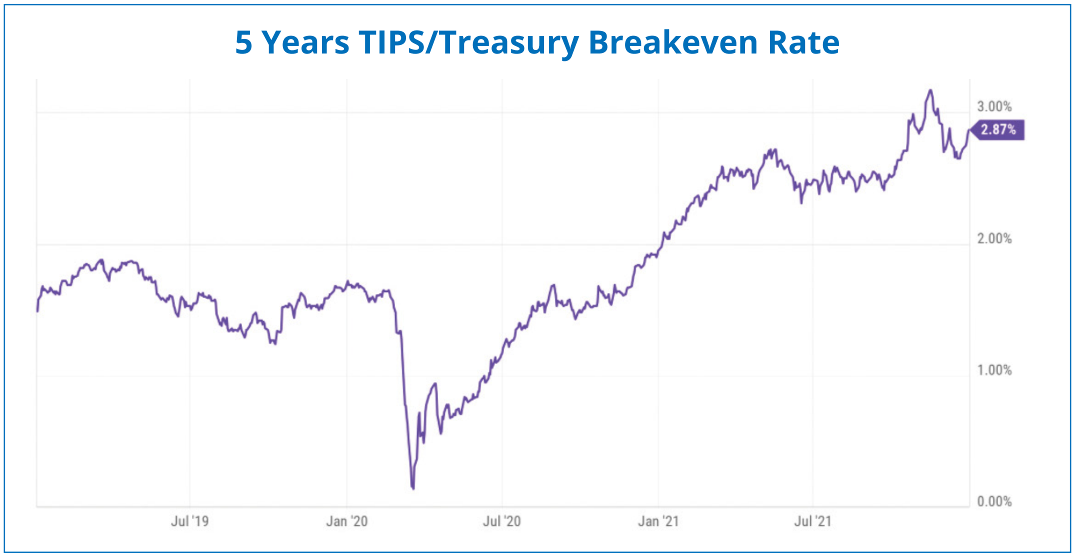
Interest rates started off 2021 by moving sharply higher at the beginning of the year. The 10-year Treasury rate hit its highest level of 2021 at the end of the first quarter, despite very low levels of inflation at this time. Inflation rose significantly in the second half of the year, reaching 6.8% year-over-year in November. This represents an increase of over 5.6% from the inflation rate in November 2020. The last time inflation increased this much in a 12-month period was in 1974, when the government's slogan was "Whip Inflation Now".



Source: Bureau of Labor Statistics, as of 12/31/21

Normally, interest rates move up when inflation increases as investors demand higher interest rates to protect their purchasing power. This has not happened. At least not so far.

Many economists and the Federal Reserve viewed the increase in inflation as primarily due to global supply chain disruptions which were thought to be 'transitory.' However, data from the Federal Reserve shows that the market's view of inflation over the next five years spiked up from 2% at the beginning of 2021 to almost 3% at the end of the year. 5 year-forward inflation in the fourth quarter hit levels not seen since 2004.

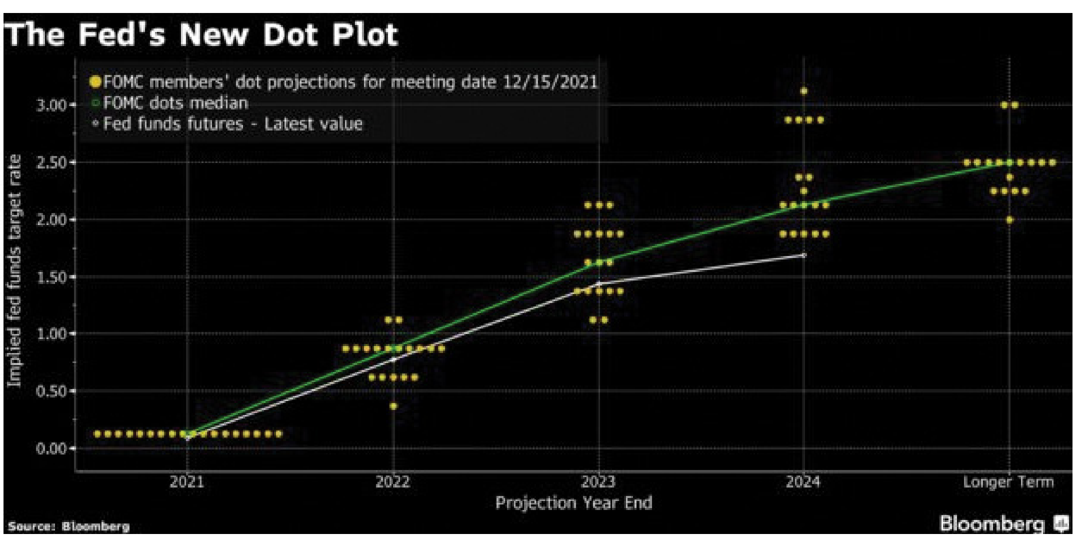


Source: U.S. Treasury. YCharts

The Fed Takes a Hawkish Turn in the Fourth Quarter

The Fed capitulated in the fourth quarter on its view that high inflation would be "transitory." As a result, the Fed moved up its timeframe to stop purchasing U.S. Treasuries and mortgage bonds, while also signaling multiple Fed Funds rate hikes in 2022. Immediate market reaction to this change was relatively mild. It remains to be seen whether or not financial markets in 2022 will be rattled by the Fed's sharp U-turn. The Fed had little choice in the matter since inflationary expectations for the next 5 years have risen from about 1.5% pre-COVID to 2.9% at year-end 2021. According to Invesco, if inflation expectations continue to rise the Fed may have to take additional action to slow the economy.

Treasury markets are now pricing in at least three 0.25% increases in the Fed Funds rate in 2022, with the prospect for more hikes in later years. Goldman Sachs has increased its view on the number of Fed Fund rate hikes in 2022 to four from three, one rate hike in each quarter.



Stubbornly flat 10-year Treasury rates and expectations for short-term rate increases have reduced the extra interest investors receive by owning long bonds. In fact, 10-year Treasury yields after inflation are very negative.

Fed Tightening May Be the Catalyst for Real Treasury Yields to Move Closer to Zero

The Fed has consistently held long-term U.S. rates low by buying trillions of dollars in U.S. Treasuries. The Fed now expects to completely stop buying Treasuries at the end of March and it may soon start to reduce its balance sheet by selling Treasuries. Short-term rates are almost certain to rise in 2022, based on the latest guidance from the Fed in their "Dot Plot". The chart on page 2 shows that every single Federal Open Market Committee ("FOMC") member expects to raise Fed Fund rates in 2022. And a large majority of FOMC members expect three or four rate hikes in 2022, with consensus looking for a 1.5% Fed Funds rate in 2023.

Global Economies Recovered in 2021 but Took a Turn for the Worst at the End of the Year

U.S. and global economies continued to recover in 2021 from the devastating COVID-19-related economic shutdowns last year. In the U.S. one can even say that we have more than recovered from the 2020 downturn, since U.S. GDP, corporate earnings, and stock markets all hit record high levels in 2021. JPMorgan has noted that credit card usage is higher now than before March 2020, while other metrics are such as hotel occupancy, indoor dining, and TSA traveler traffic have yet to reach their 2020 highs.

The strong recovery has been fueled by multiple rounds of fiscal stimulus amounting to over $5 trillion as well as the Federal Reserve's near-zero Federal Funds Rate and purchases of more than $4 trillion in Treasuries and Mortgages.

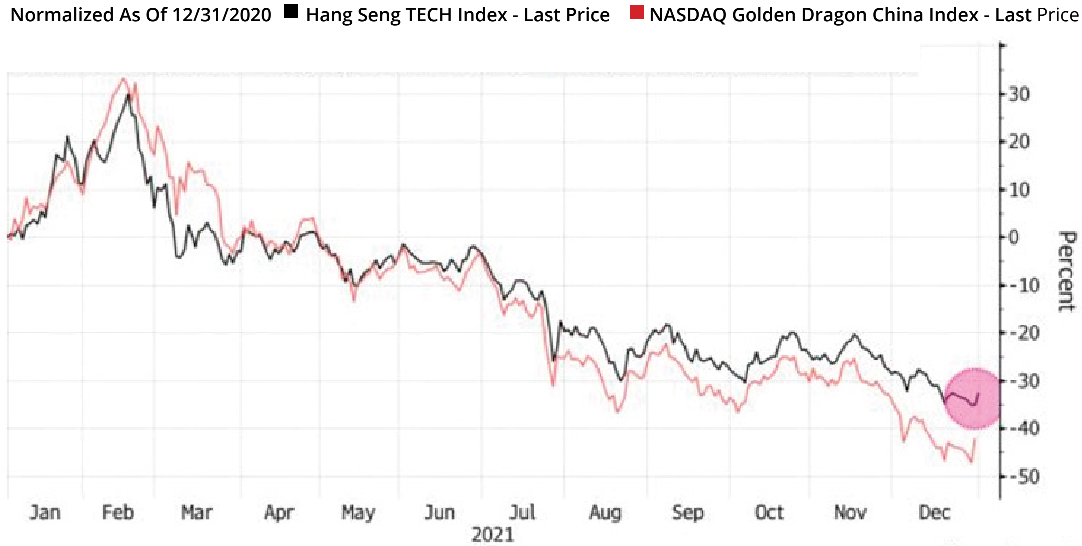
Unfortunately, we are not just still living with COVID-19 as we enter 2022, but are seeing the highest number of daily infections ever. Fortunately, it appears that the Omicron variant is not as deadly as previous strains, but this is a setback. Even so, the high infection rates, not just in the U.S. but globally, have the potential to poke new holes in global supply chains, while also creating damage to industries like hotels and restaurants.

Financial Markets in 2021

Financial markets also continued to recover, but it has not been smooth or similar to prior recoveries. As an example, small-cap and cyclical companies typically benefit the most in economic recoveries. So, one would have expected small-caps and value-oriented equities to lead the way. This has not been the case, as large-cap stocks trumped small-caps for the second year in a row while the same was true for growth stocks versus value stocks. The Russell 1000 Index's 2021 gain of 26.5% was well ahead of the Russell 2000's gain of 16.5%. And the Russell 1000 Growth Index's return of 27.6% was above the Russell 1000 Value's return of 25.2%.

U.S. equities were in favor in 2021 as they significantly outperformed non-U.S. markets. The S&P 500's 28.7% return was almost three times higher than the MSCI EAFE Index, a measure of developed countries, which returned only 9.8%. Emerging Market stocks actually lost value in US dollar terms last year, falling 5.3%. China accounted for much of the Emerging Market equity decline, as it fell more than 20% last year due to investor concerns about the property sector and the government's increased oversight of foreign-listed Chinese companies.

Tough Year
Offshore China stocks were hammered by regulations 2021



Source: Bloomberg

Equity returns were boosted in 2021 as investors poured $250 billion into equity funds and ETFs in the first 11 months, according to data from ICI. This was a 180 degree turn from 2020, when investors pulled out almost $400 billion from equities.

Investors piled into fixed income funds and ETFs for the second year in a row, with more than half a trillion dollars of inflows each year. These strong inflows have helped keep bond interest rates low.

Fixed income returns significantly trailed equity returns in 2021. In fact, the Bloomberg Barclays U.S. Aggregate Bond Index, a commonly used benchmark, fell 1.54% last year. The Bloomberg Treasury Index also declined last year. This was only the fourth annual loss in its history. High yield corporate bond and inflation-protected securities rose more than 5% during the year while Emerging Market bonds fell.

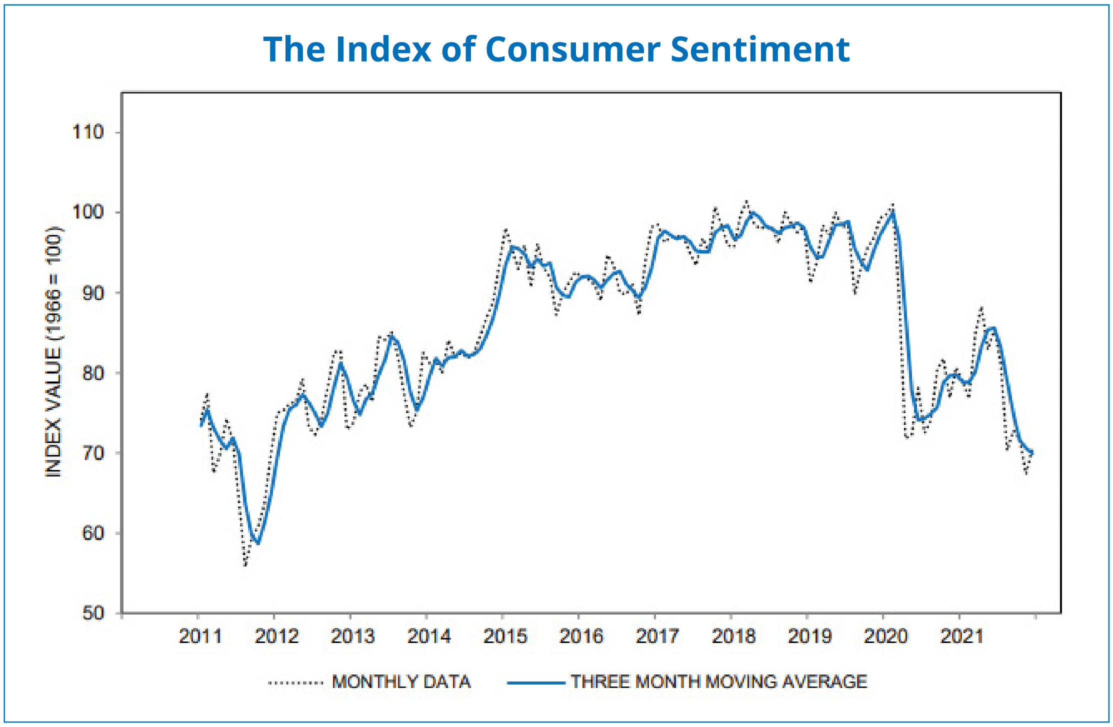
Commodities and Real Estate continued to benefit from increased demand, and in some cases limited supply, as economies recovered. They gained 38.5% and 32.5%, respectively.

Record high levels of fiscal stimulus may have been the largest driver of economic recovery as more than $5 trillion of Federal aid was approved to offset the effects of the 2020 economic shutdown. But we may have seen the last major fiscal stimulus package, since both chambers of Congress appear to be stalemated in new legislation, and this is not likely to change prior to the elections later this year.

Consumer Wealth Has Soared, but Their View of the Future Has Fallen

U.S. consumers saw employment, income and wealth grow rapidly in 2021. The unemployment rate fell from 6.7% at the end of 2020 to only 4.2% as of November 2021. More than 5 million new jobs were created during this period. Hourly wages rose almost 5% in 2021 while aggregate earnings rose over 9% due to job growth. U.S. households' wealth rose by more than $13 trillion in the first three quarter of 2021, driven primarily by stock market gains, but also by the largest gains from real estate in at least fifty years. JPMorgan has noted that consumers are in great shape overall because net worth soared in 2021 and household debt to service ratio is near its historic lows.

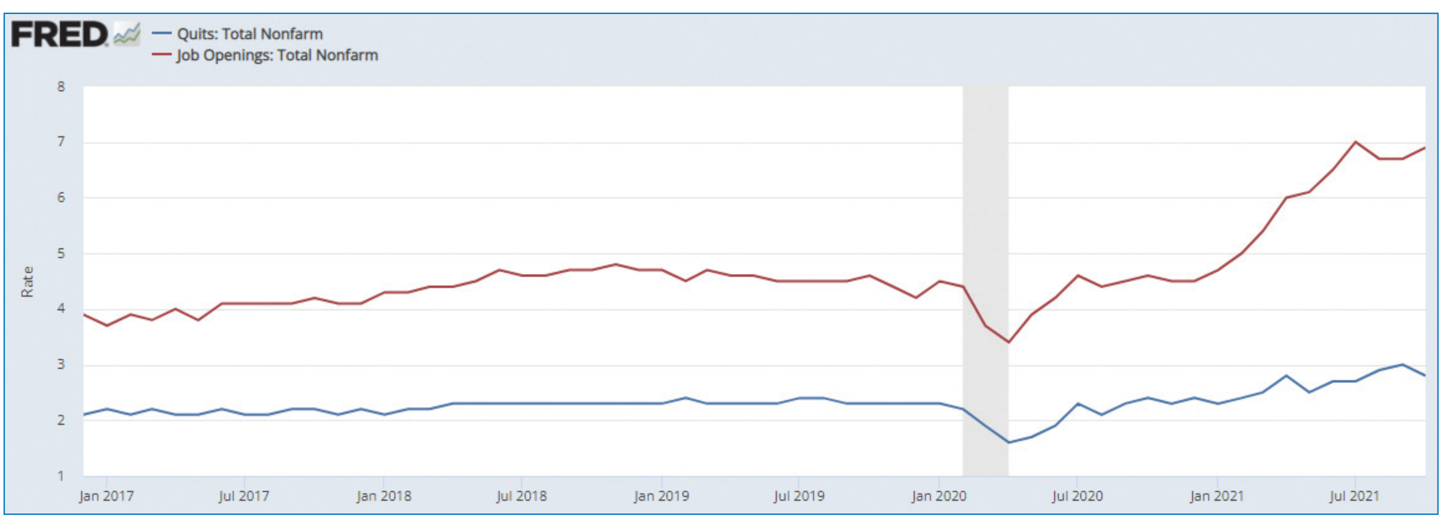
Given this background one would think that U.S. consumers would be rejoicing. But according to data from the University of Michigan, consumers' view of the future has not just fallen, but it is actually lower than any reading seen last year during the COVID-19 shutdown.



Source: University of Michigan, 12/31/21

The consumer wealth and employment data shown are averages. Homeowners have benefited strongly from rising demand for existing homes, which boosted their wealth. Renters, on the other hand, do not benefit from rising home prices, and pay more out of pocket when rents rise.

While employment data has been very strong there are also some weak points in the data. Job openings, the number of open positions available for workers, has more than doubled since the lows of 2020. But the number of people quitting is also rising. This has meant that many employers have not been able to grow as much as they want due to a shortage of applicants.



Source: Bureau of Labor, 12/31/21

U.S. Small Business Confidence Has Fallen

According to the WSJ/Visage Small Business CEO Confidence index, CEO's confidence has fallen for six consecutive months. Almost 50% of CEOs feel that the national economy has improved over the past 12 months. But high wage increases, inflation, and difficulty finding workers have led many CEOs to lower their outlook for the future. Over one-third of Small Business CEOs see the future economy as negative, versus only 25% that see it improving. Small businesses are important to the economy, as they have provided almost one-fourth of the new jobs in 2021, according to ADP.

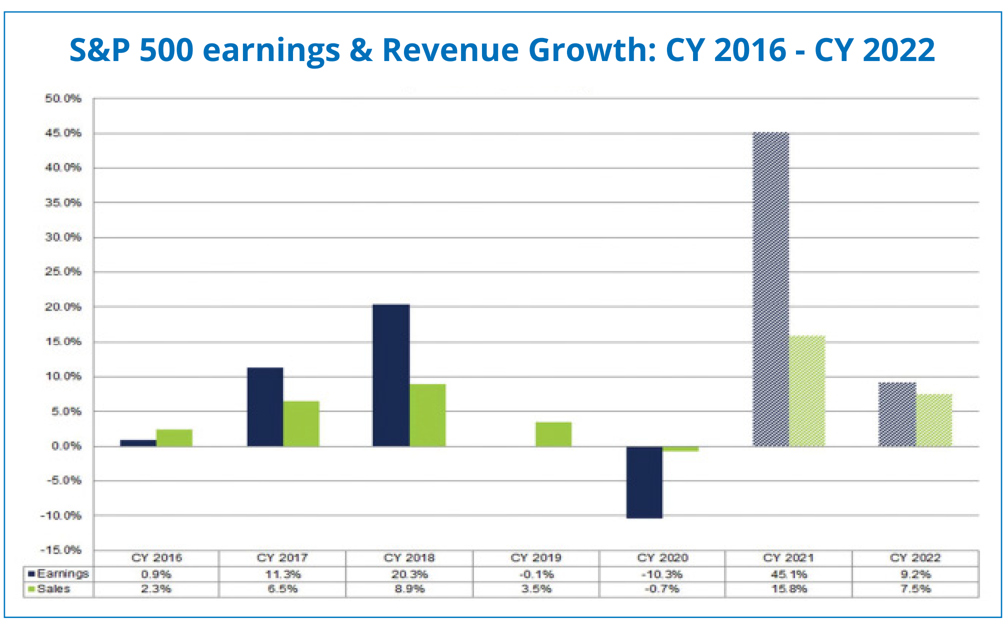
The WSJ/Vistage Small Business CEO Confidence Index dropped to 99.5 in November, the sixth consecutive month of decline.

WSJ/Vistage, 12/31/21

Strong Corporate Earnings Growth Drove Strong Returns in 2021

Corporate earnings soared in 2021 after weakness in 2019 and 2020. But S&P 500 earnings growth is expected to fall back to single digits in 2022. The current high S&P 500 valuations — more than 20 times next years forecasted earnings — may be more difficult to support if earnings growth falls to single-digits.

S&P 500 CY 2021 Earnings Preview: Record-High Earnings and Sales Growth in CY2021



	CY 2016	CY 2017	CY 2018	CY 2019	CY 2020	CY 2021	CY 2022
Earnings	0.9%	11.3%	20.3%	-0.1%	-10.3%	45.1%	9.2%
Sales	2.3%	6.5%	8.9%	3.5%	-0.7%	15.8%	7.5%

Source: FactSet, 12/31/21

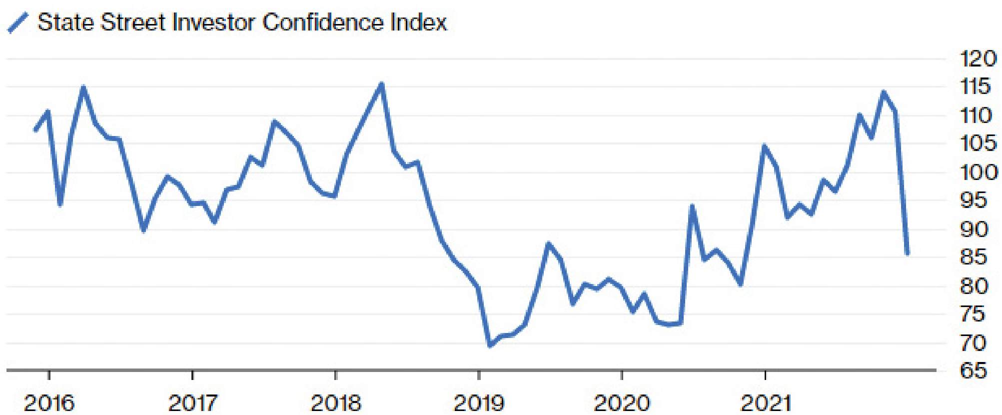
Institutional Investors' Confidence Plummeted at Year-End

State Street's Global Investor Confidence Index plummeted in December by far the largest amount in the survey's 10 year history. European sentiment fell the most while the U.S. and Asia investors also falling significantly. State Street stated their view that even though the Omicron variant is less virulent than previous variants they believe that investor sentiment in 2022 will be challenged by "tightening financial conditions, high inflation and fiscal headwinds."

European investors' investment sentiment fell the most in State Street's Investor Confidence survey and this may be because COVID cases in Europe spiked up ahead of the U.S. and other regions. Expectations for fourth quarter GDP growth in Europe have also fallen significantly in recent months.

Historic Drop

State Street's investor confidence index fell the most on record in December



Sources: State Street, Bloomberg as of 12/31/21
A reading of 100 indicates investors are neither increasing nor decreasing their long-term allocations to risky assets.

Risks to Financial Markets in 2021 Have Increased

- Signs of speculation in equity markets:
  - Record levels of margin debt, investments in leveraged ETFS, and IPOs, most of which were unprofitable are just a few of the risks raised by the Elliott Wave Theorist.
- Slowing economic growth:
  - Goldman Sachs notes slowing growth in the next 3 years globally, with a large decline in the US, a small drop in Europe, and an increase (from low levels) in Japan. They are still optimistic on financial markets.
- Financial markets are addicted to Fed support:
  - But the Fed's purchases of Treasuries and mortgages will stop in March, and they may start selling some of their bonds. All Fed Board members support raising the Fed Funds rate in 2022. And if inflation continues to be high they may need to turbocharge the number of rate hikes.
- Schroders sees the risk that Omicron makes it less likely that we will have a strong, synchronized global economic recovery

Wall Street Is Sending Mixed Messages on the Outlook for Investments

- Bank of America:
  - Bearish on markets. “Rate shock” in 2022 to follow “inflation shock” of 2021. Capital preservation will grow as a theme in the year ahead.
- Goldman Sachs:
  - Expects less impressive returns for risky asset in line with a more mature cycle.
- JPMorgan:
  - Sees plenty of opportunities for investors. They have an optimistic outlook given low return expectations in markets and above-trend growth.
- Morgan Stanley Wealth:
  - Sees a positive scenario with a robust global recovery; a moderation of U.S. growth and inflation: and more balanced monetary and fiscal policies.
- PIMCO:
  - Expects positive global economic growth and inflation that moderates over time. They remain overweight overall risk.

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