The final quarter of 2021 certainly did not lack for excitement, as the Omicron variant served to upend the global order and cast aside any notions that we are looking in the rearview mirror at this pandemic. Despite the never-ending stream of COVID-related setbacks, the markets continued to give a collective shrug, with the S&P 500 returning an eye-popping 27.8% for the year. This has been somewhat of a trend throughout, with financial markets willing to take the 'glass half full' viewpoint, happy to relinquish the more pessimistic narrative to the rest of us.

The emergence of Omicron has been a bit of a double-edged sword; whilst case numbers are at record highs, schools and businesses are struggling to stay open and hospitals are being inundated with the sheer number of patients, by all accounts, this new strain has proven to be milder with much lower mortality rates than before. Similarly, with vaccination rates close to 80% in many developed countries, coupled with the natural immunity conferred from infections, we may well be looking at a shift to an endemic disease, rather than a pandemic event. The contagiousness of Omicron may actually work in our favor and to hasten the end of the global disruptions, lockdowns and uncertainty that we've all been living with for the past two years.

Nonetheless, Omicron has injected a measure of volatility and unpredictability into the global economic picture, especially as it relates to inflation. 2021 saw central banks living with inflation, despite levels not seen for 40 years. Their greater tolerance for price pressures and hewing to goals of employment mandates, buoyed equities and risk assets and limited drastic rises in bond yields. 2022 will definitely see some changes to this approach, though exactly how they respond and with what level of hawkishness may well be *the* story for the year ahead. The Fed has already signaled three rate increases for 2022, ahead of what many prognosticated just months ago, yet still a rather muted response in historical context. However, questions and risks remain; should the full economic restart be delayed further due to rising cases and especially how China squares their zero-COVID policy with the virulence of Omicron will be especially in focus.

Recently, markets seem keen to paint rising inflation and changing central bank policies as a negative for equities, a view we do not necessarily share. Corporate profits are at record highs and many companies have taken advantage of consistently low rates to either de-lever, or strategically deploy capital to strengthen their balance sheets. While inflation may crimp profitability, those companies with pricing power and demand inelasticity should continue to thrive and expand their margins. Undoubtedly, we will be living with higher inflation for some time and rates will rise to reflect this, however the benchmark 10-year Treasury is still shy of 2% and assuming three rate hikes by the Fed in 2022, the Fed Funds Rate will still be at, or around, 1%. In historical and real (inflation-adjusted) terms, this is ridiculously low and coupled with the solid economic growth that we expect, should persist in supporting high-quality equities.

When approaching investments and portfolio construction we tend to think in likely outcomes; the proverbial bear, base, and bull-case scenarios. Currently, we are solidly in the base-case camp, expecting higher inflation, some of which will be transitory, some structural, and it will be met by a subdued response from central banks. Global equities should continue to benefit, but bonds will almost assuredly be a laggard. We maintain our fixed income position as portfolio ballast, mitigating volatility and providing a higher-yielding cash alternative, but will not be looking to it as a source of excess return. Our preference and bias towards quality domestic stocks remains unchanged, a stance that has rewarded us in the past. We are cautiously optimistic that 2022 will engender positive portfolio returns and hopefully (fingers crossed) some return to normalcy. Please do not hesitate to reach out, we look forward to hearing from you!

Prepared by Flagship Capital Management, Inc.
Flagship Corporate Center | 2. W. Baltimore Ave. | Suite 200 | Media, PA 19063
T 610.565.9580 | flagshipcap.com