PrivateWealth Partners, LLC

FOURTH QUARTER 2021 REVIEW

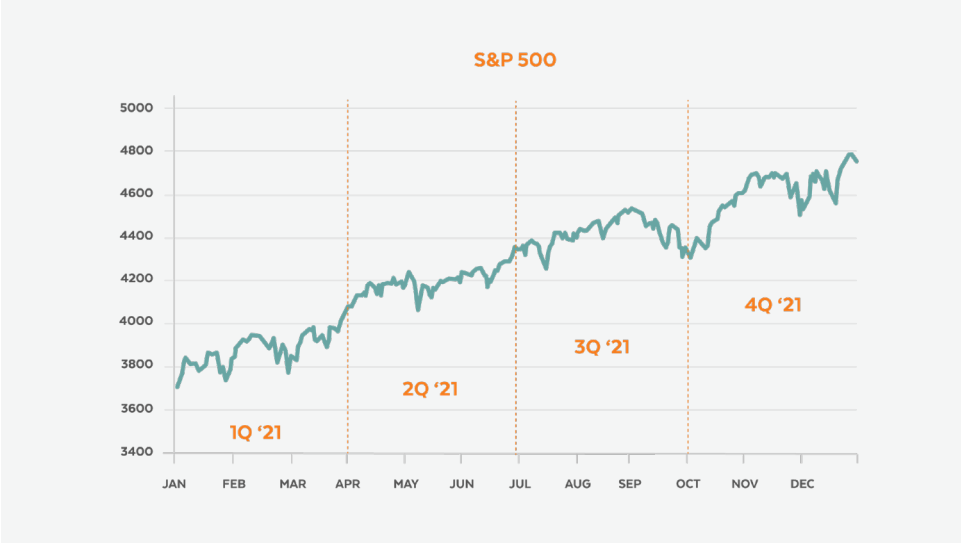
Dear Friend, January 18, 2022

2021 was a year that brought a unique mix of events for investors. The year featured a political crisis, an economic boom in the first half, a Delta-induced drag over the summer, snarled supply chains, elevated inflation, a dovish Fed, then a hawkish Fed, and finally an Omicron wave in time for the holidays. Just to name a few.

For investors, however, one story mattered most: U.S. companies reported some of their best financial results ever. According to Strategas, S&P 500 operating earnings are on track to have increased by 49% in 2021, with a revenue jump of 15.8% and a profit margin surge to highs well in excess of pre-pandemic levels. Financial data firm Refinitiv said total 2021 sales from S&P small-, mid-, and large-cap companies were higher in aggregate than pre-pandemic, and profit growth was even stronger.

Investors who focused on these fundamentals and tuned out everything else likely had a good year. Private Wealth Partners has been effective at capturing these gains during this unique period. Our focus on the 'digital economy' theme in 2020 played out in our favor, and in 2021 we stayed focused on our higher profit large-cap U.S. company theme—which proved to be strategically advantageous.The broad U.S. market as measured by the S&P 500 finished the year up +28.7%.

THE S&P 500 REACHED 70 NEW DAILY HIGHS IN 2021

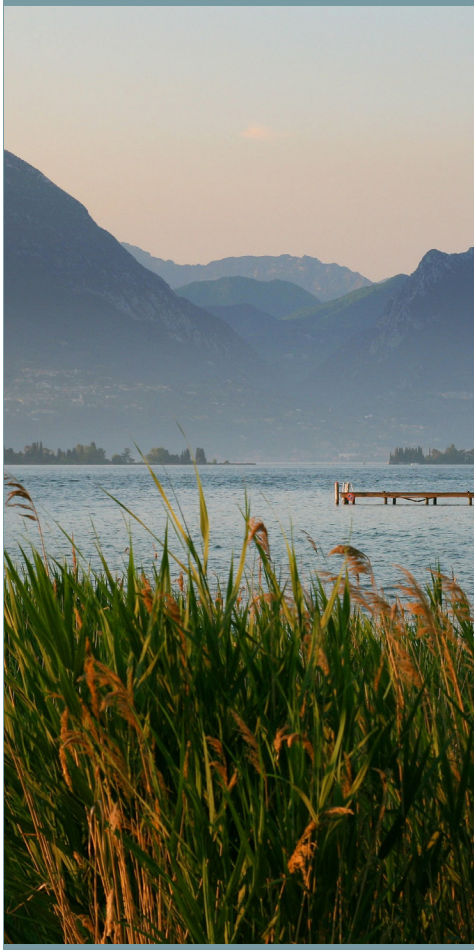


Source: Strategas Research

In remembrance of our long-time colleague,

Peter K. Maier

Rest in Peace.
(1928 – 2021)



PRIVATE WEALTH PARTNERS, LLC

591 Redwood Highway
Suite 3210
Mill Valley, CA 94941
Tel: 415. 461. 3850
http://www.pwpart.com

Though the equity markets were strong in 2021, the rising tide of stock prices did not lift all boats. Strategic positioning and tactical decision-making mattered.

Small and mid-cap stocks performed well in 2021, for instance, with the S&P 400 Mid-Cap Index rising +24.8% and the Russell 2000 Index up +14.8% for the year. But this area of the market was very challenging to navigate, as many of the fast-growing 'pandemic stocks' that surged in 2020 fell far out of favor in 2021.

There was also a significant leadership shift in mid-May, when value stocks' countertrend rally lost steam and growth stocks started to outperform again. Through May 14, global growth stocks were up only +3.7% compared to value's +16.1% return, but from mid-May to the end of the year growth rose approximately +18% to value's +5%—leaving the two styles basically even for 2021. This rotation caught many investors off guard, and under the surface of a flat index over the summer months, there was some very choppy stock price action. The Delta wave of the pandemic generated volatility in many individual stocks and sectors.

A marketplace awash in liquidity also led many investors into risky, unproven categories. The "meme stock" and SPAC craze early in the year basically blew out by mid-summer. An index tracking SPACs was down -33.1% from its mid-February peak and -15.3% for the year. In the traditional IPO world, of the 384 companies that went public in 2021, 255 ended the year trading below their offer price. Cryptocurrencies were boom-bust, and an entirely new—and highly speculative—market for selling digital art via non-fungible tokens (NFTs) emerged. We are following these stories but are inclined to steer clear.

Defensive assets such as investment-grade bonds, U.S. Treasuries, and gold were all negative in 2021. The takeaway: any blind diversification into these segments that have neither yield nor growth was not a worthwhile exposure to maintain.

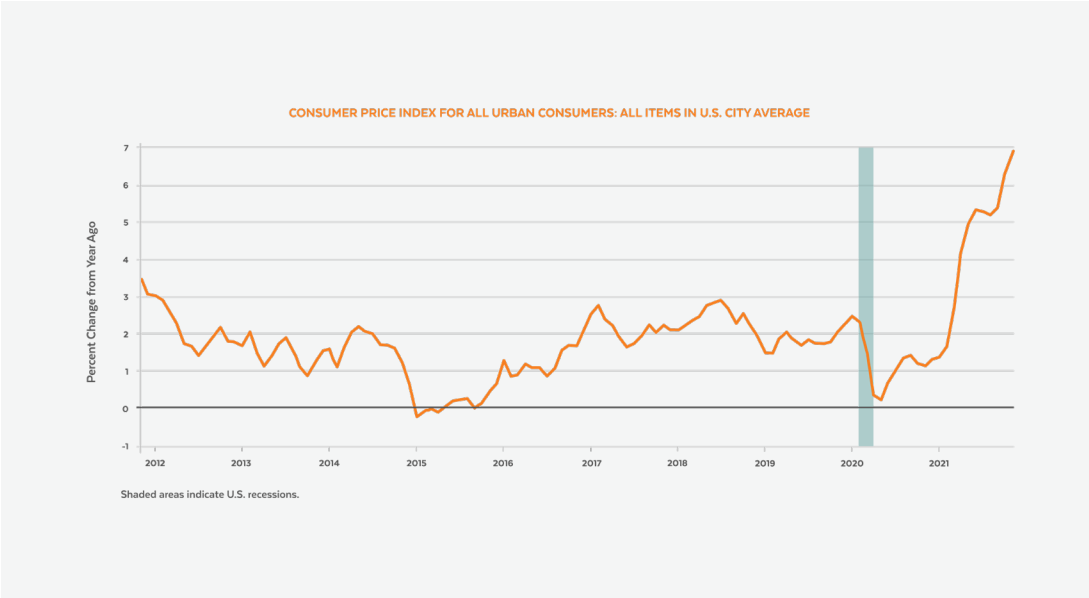
Finally, the 10-year U.S. Treasury bond finished the year yielding 1.52%. Compared to the roughly 3.4% earnings yield on the S&P 500 as of December 31, 2021, stocks remained the most attractive asset class to start the new year, in our view. Our expectation for continued economic and earnings growth in 2022 supports a continued overweight to equities. But as we will discuss in the next section, bond yields are on the move and the Fed is turning more hawkish, which could create headwinds for some categories of stocks and could result in heightened volatility in the coming quarters.

INFLATION, INTEREST RATES, AND THE FEDERAL RESERVE

Inflation was probably the most-discussed topic at Thanksgiving dinners around the country last year. And for good reason—in Q4, prices in the U.S. rose at their highest year-over-year rate in over 30 years.

[1] - *Does not constitute an investment recommendation.*

INFLATION JUMPED CONSIDERABLY IN 2021



Source: Federal Reserve Bank of St. Louis

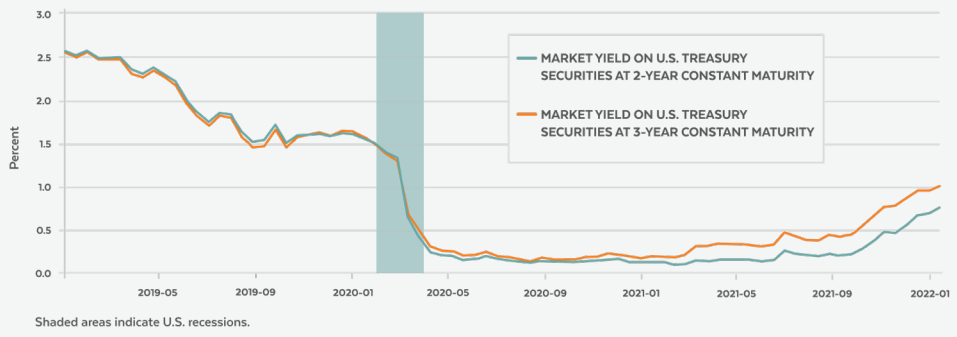
Price pressures largely stemmed from supply chain problems and labor shortages—what we might classify as a good, resolvable problem given some time. Goldman Sachs forecasted core CPI inflation to peak in Q1 2022 and then to drop back to 3.5% by December 2022, which would place it higher than the Fed's target range. We think it is important to look past the inflation conditions of the current month and stay focused on what will be happening 6-12 months from now. While current inflation data is indeed running hot, some inflation components will be hard pressed to continue moving upward so quickly. Thus, high inflation now only modestly affects the longer-term inflation rate forecast upward. While current inflation is above the Fed's target and will be addressed with more restrictive policy, if done well we think it will prolong the current economic expansion and allow companies an extended environment for continued compounded growth.

Minutes from the Fed's December 14-15 meeting, published on January 5, 2022, make it clear the Fed is more urgently addressing price pressures: "*participants generally noted that…it may become warranted to increase the federal funds rate sooner or at a faster pace than participants had earlier anticipated." The minutes also noted that some participants see it as "appropriate to begin to reduce the size of the Federal Reserve's balance sheet relatively soon after beginning to raise the federal funds rate.*" During the previous rate hike cycle in the 2010s, the Fed waited about two years before reducing its balance sheet.

Stocks sold off sharply on January 5 when the Fed minutes were released, with the tech-heavy Nasdaq posting its worst single-day loss since February 2021. Indeed, if interest rates move sharply higher, then this would likely create volatility. But the stock market has also historically tolerated rate increases that move at a reasonable rate. After all, stocks have a positive long-term bias. The real villains are either recession and/or hyperinflation, which we do not see. Instead, an outcome of 3% to 4% inflation, with near full-employment, is not an outright bearish set-up.

Bond yields have risen to their highest levels since early April 2021 continuing a trend we identified late last year. In the chart below, you can see the 2- and 3-year U.S. Treasury bond yields have already bounced off lows and are moving in a noticeable uptrend. Short duration Treasury bond yields tend to rise when investors anticipate tighter central bank policies.

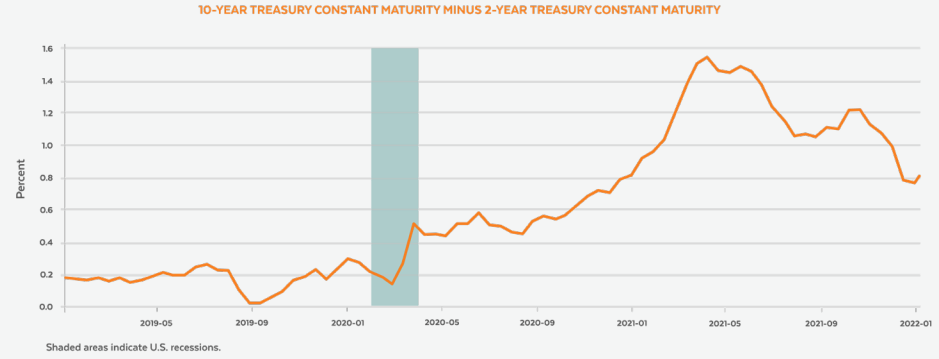
SHORT-TERM TREASURY BOND YIELDS HAVE BEEN MOVING HIGHER



Source: Federal Reserve Bank of St. Louis

Historically, the yield curve has been a good forward-looking indicator for the economy, which is why rapidly rising short duration U.S. Treasury bond yields are worth watching closely. In the chart below, the yield curve is presented as the 10-year U.S. Treasury bond yield minus the 2-year U.S. Treasury bond yield. A declining line means the yield curve is flattening, and if the line falls below 0%, it means the yield curve is inverted. As seen below, the yield curve is clearly in a flattening pattern, making it a key indicator to watch in 2022. We do not see the Fed allowing this measure to invert but will remain alert should conditions continue in this direction.

THE YIELD CURVE HAS BEEN IN A FLATTENING PATTERN



Source: Federal Reserve Bank of St. Louis

THE U.S. ECONOMY POISED FOR MORE GROWTH IN 2022

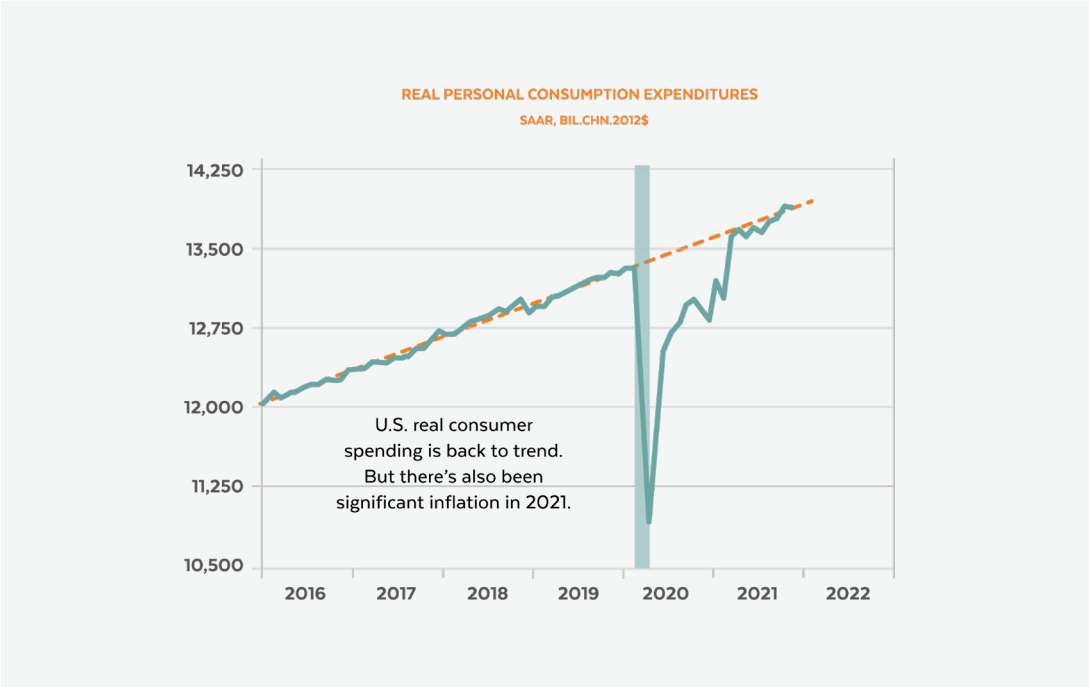
Rising inflation and interest rates, a hawkish Fed, and a flattening yield curve are all key factors to watch in the new year. But a balanced view should also consider the positive backdrop of durable economic growth, record profits, a very tight U.S. labor market, rising wages, record household net worth, and an undeterred U.S. consumer. For 2022, we see these tailwinds as stronger than the headwinds detailed in the previous section.

As mentioned in the introduction of this letter, U.S. corporate earnings posted a sharp year-over-year jump in 2021. U.S. GDP also recovered nicely, even with the Delta-induced drag in Q3. Strong growth rates last year will mean tougher comparisons in 2022, but we still expect modestly positive earnings and GDP growth in the new year.

EARNINGS AND GDP GROWTH RATES LIKELY TO MODERATE IN 2022

U.S. consumers also remain in good shape—buoyed in 2021 by accumulated savings and the largest wage increases in 20 years, consumer spending returned to record highs and is back to its pre-pandemic trend.

U.S. CONSUMERS CONTINUE TO SPEND



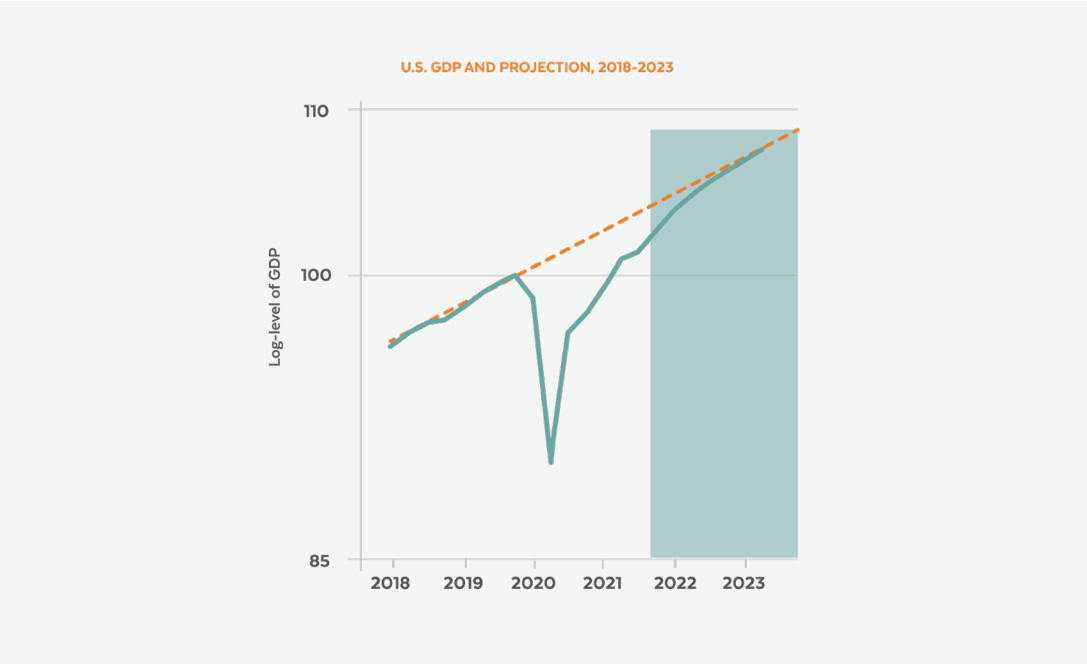
Source: Strategas Research

For private sector workers in aggregate, wages grew at a 4.6% year-over-year pace in Q3 2021, with the biggest increases landing in service sector occupations like retail and hospitality. For higher skilled workers in management, business, and financial occupations, wages rose by a lesser 3.9% over the same period, but this increase still marks the fastest pace of rising wages since 2003 for this group. According to the Conference Board, employers are setting aside an average of 3.9% of total payroll for wage increases in the new year, the most since 2008.

The jobs market also remains historically tight. The number of people filing for unemployment registered at 207,000 for the week ending January 1, which is near levels last seen in 1969. Job openings in the U.S. also continue to reach record highs, with an estimated 12 million available jobs by the end of last year. 1 million new jobs were added in Q4 2021, which underscores the desperation of companies to bring on new workers to meet robust demand.

The Omicron variant is likely to factor in Q1 2022, but each new wave of the pandemic has had a diminishing impact on economic growth. As Blackrock points out, "the big picture is unchanged: less growth now is more later.

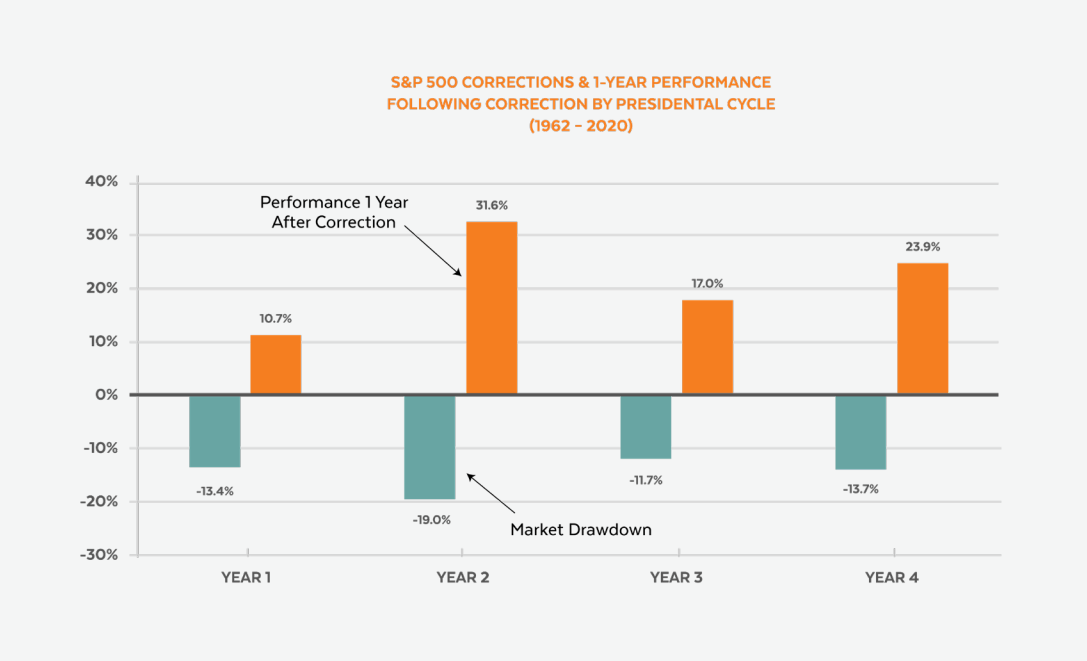
MORE U.S. GDP GROWTH EXPECTED IN 2022



Source: Blackrock

One final note regarding the outlook for 2022 involves the midterm elections. We already anticipate more volatility in 2022 due to Fed tightening and the absence of a market correction in 2021. But history shows that midterm election years (year 2 of a presidential cycle) also tend to feature bigger market pullbacks:

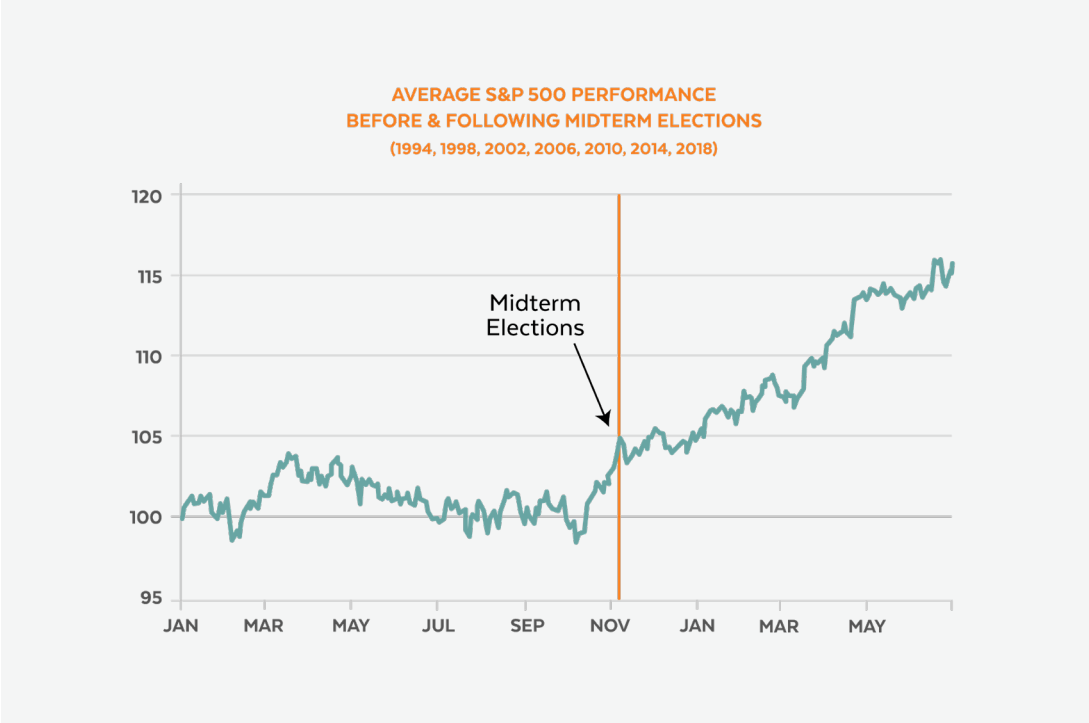
MIDTERM ELECTION YEARS TEND TO FEATURE MARKET CORRECTIONS



Source: Strategas Research

The upshot is that any downside volatility has historically been accompanied by strong rallies—the S&P 500 has not declined in the 12 months following a midterm election since 1946.

THE GOOD NEWS: EQUITIES OFTEN RALLY AFTER THE MIDTERMS



Source: Strategas Research

CONCLUSION

Over the past three years, the price return on the S&P 500 was a robust +90%. Staying the course amidst rising uncertainty has paid off.

Inflation, rising rates, and a hawkish Fed all present headwinds to equity markets in the year ahead. But it is also important to acknowledge that the Federal Reserve is moving off a position of extraordinary accommodation. If the Fed follows through with ending QE, raising rates a few times, and shrinking its $8.76 trillion balance sheet, it will still likely finish 2022 looking accommodative by historical standards—a point many miss.

The shift in policy is likely to result in heightened volatility, but we continue to see economic growth and rising corporate earnings as bigger forces for the markets in 2022. We do not believe all areas of the market will do well—navigating higher input costs and inflation requires strong balance sheets and pricing power, and rising rates are likely to result in multiple

compression in certain areas of the market. Stock selection will be key in the new year, and we think it is important to favor quality, liquidity, and companies with strong cash flows and attractive profit margins. We will continue to remain vigilant, disciplined and patient.

If you have any questions about this review or your portfolio, please do not hesitate to reach out to us. We wish you a Happy New Year, and hope you stay safe and healthy in these winter months.

Kenneth F. Siebel | William F. Dagley | Chris Greene

David P. Wong | Elyse Gottschalk | Richard G. Kuchen

Katrina Sutherland | Jason M. Saxon | James Lenczowski

Vickie Marinovich | Matt Kalabokes

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