Market Commentary

Fourth Quarter 2021

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Michael Jackson's "Thriller" was setting sales records, Herschel Walker won college football's Heisman Trophy, ET was the top grossing film of the year, and Disney opened the EPCOT resort in Florida. The year was 1982. In July of that year, inflation declined to 6.4% on an annual basis, a level that would not be surpassed until this past November when it reached 6.8%. After more than a decade of inflation running below the Federal Reserve's stated 2% target level, the trifecta of rising wages, supply-chain disruptions for many goods and trillions of dollars of government largesse combined to push inflation steadily higher as the year progressed. As 2021 concluded, financial markets saw a wave of increased volatility, spurred by the spreading of the Omicron variant, the above-mentioned inflation spike, and a rapidly pivoting Federal Reserve that was caught flat-footed by the persistently high inflation reports. Investors found themselves struggling to interpret the cross currents of continued positive economic data along with the potential headwinds from another potential COVID wave and inflationary pressures. Despite the volatility, US equity markets as measured by the benchmark S&P 500 rose 11.0% during the fourth quarter of 2021. This brought the benchmark's total return for the full year to 28.7%. Stepping back from the volatility of the past few weeks, we note the S&P 500 has risen an eye-popping 120.6% on a total return basis from the March 2020 lows after registering 70 new all-time highs during the past 12 months.

Fixed income yields also gyrated during the quarter as investors sought to interpret the changes in the Fed's statements along with exogenous factors such as the Omicron variant which was announced over Thanksgiving weekend. We had been hoping the Fed would move even earlier than it did to remove its crisis-level monetary policy. Nonetheless, we believe if it follows through on its currently stated policy - despite short-term market hiccups that may occur - inflation could subside to the 2-3% level at some point in 2022. The 10-year note ended the quarter at 1.51%, virtually unchanged from the 1.52% yield on September 30 but still well above the 0.92% yield at year-end 2020. With the Fed looking to end its asset purchases by March 2022, we believe rates will drift higher along the entire yield curve as both economic growth and inflation should see slower growth rates over the coming quarters. The challenge facing the Fed is to slow inflation growth while not disrupting the job market which still has millions less people employed than before the pandemic.

The price for benchmark West Texas Intermediate began the quarter at $75.03 and moved to a multi-year high of $85.00 per barrel in late October. After drifting lower for a few weeks, oil prices took a sharp dive when Omicron was discovered and did not fully recover pre-Omicron levels by year-end. As with other waves of COVID infection, fears of decreased demand due to declining travel weighed on oil prices. Oil prices ended 2021 at $75.44, a gain of less than 1% for the quarter, but well above the $48.52 at year-end 2020. Supply/demand issues, tied to forecasts of economic growth in 2022 will drive oil prices in the coming months. We have long used a fair value range of $50-70 a barrel for oil but may move this range higher if Omicron fears fade and global economic growth continues to rebound. Inflation also puts upward pressure on commodity pricing which factors into our calculations.

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Economic and Market Outlook

Inflation has been at or near the top of most investors' minds over the past several months. To better understand why we believe inflation has risen so dramatically, and why it should (hopefully) decline in the coming months, it is important to look at the prodigious change in the amount of money in the US economic system. We do not often include charts in our market commentary, but we believe a couple of charts will assist in explaining our thoughts.

Some economists have likened the US economic system to a bathtub with currency as the water coming from the faucet. [1] Normally, a steady amount of water (government spending) flows into the economy each year. The amount tends to increase in a regular fashion, and we usually know ahead of time how much the government plans to spend due to budgeting issues. However, during the past two years, the amount of fiscal stimulus has been unprecedented as the Federal Government pushed approximately $6 trillion of grants, loans, etc. into the economy. This can be seen in the chart nearby which displays the annualized level of government expenditures during the past ten years on a quarterly basis.

In a normally operating bathtub, if the water level (money in the system) gets too high, the overflow drain (Federal Reserve) will siphon off the excess to prevent the tub from overflowing. However, several Federal Reserve programs that cut short-term rates to near zero, quantitative easing, and highly expanded repo operations combined to effectively close the overflow drain. This resulted in the water (money in the system) overflowing the tub and splashing out as inflation. The huge increase in money supply is shown in this chart which plots M2, used as a broad measure of the amount of money in the US economy. After rising in linear fashion for many years, the chart goes almost vertical beginning in 2020.

1. Greenwood J. and Hanke S. (2021, October 21). The Monetary Bathtub is Overflowing. Wall Street Journal

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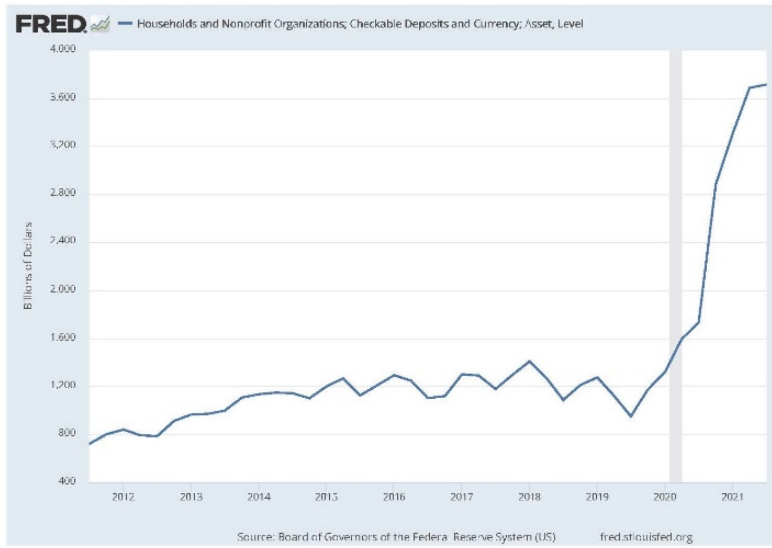
We believe the Fed's recent moves to rapidly taper its asset purchases could result in a rate hike as early as the second quarter of 2022. Continuing with our analogy, these moves will re-open the overflow drain, putting downward pressure on inflation. The caveat to this is, of course, increased headwinds to economic growth from higher interest rates and tighter monetary and fiscal policy. In fact, with the recent demise (at least for now) of Democrats' Build Back Better plan, Federal spending should decline meaningfully from 2021's pandemic fueled levels. As is our discipline, we step back from the headlines and posit that the fiscal tapering may not be as detrimental to consumer spending as many fear. The nearby chart shows the level of checking deposits and currency held in the US by individuals. It is obvious a significant part of peoples' incomes over the past two years has been saved, rather than spent. Consumers have accumulated more than $2 trillion in additional savings during the pandemic, saving much of their government payouts. This excess savings could provide a boost to spending and counter much of the decline in Federal spending during 2022 and 2023.



At the December Fed meeting, the FOMC voted to double the speed of its asset purchase tapering along with a clear message of higher interest rates at some point in 2022. This is a rapid reversal from its comments earlier this year to keep rates near zero through 2023. After focusing more on the employment side of its dual mandate, significant inflationary pressures forced the Fed to tighten monetary policy much earlier than they had anticipated.

Current estimates for US GDP growth in 2021 are in the 5.5%-6.0% range. This is lower than the 6.6% estimate at mid-year as the third quarter showed slower than expected growth and the fourth quarter is being buffeted by the strong uptick in COVID cases. 2022 growth has several variables that could move GDP higher or lower from the current estimate of 3.5%. Among these are the fate of the Build Back Better Plan (passage would put upward pressure on both GDP growth and inflation), changes to tax rates, and the vagaries with the Omicron variant. Earnings estimates for the S&P 500 have remained steady over the past few months with higher expectations for technology, healthcare, and financials offsetting declining estimates in consumer-related areas. Earnings in 2022 are expected to show a further increase of approximately 10% from this year's level. Despite the Fed signaling it will be moving short-term rates higher in the coming months and the 40-year highs in inflation, Treasury yields remain stubbornly low. We have often written of our disdain for lending the government money for 10 years at an interest rate significantly below the current inflation level, guaranteeing a decline in purchasing power to an investor who does so. With interest rates so low, equities continue to look attractive on a relative basis, despite the elevated P/E multiples. At year-end, investors assigned a 21.3x multiple to forward (2022 estimates) earnings on the S&P 500. While that is higher than historical averages, it is down meaningfully from levels earlier this year.

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Portfolio Positioning

Portfolios saw little change during the recent quarter, aside from asset allocation rebalancing when necessary. We have long believed that asset allocation is more important than individual security selection to allow client portfolios to grow on a long-term basis without excess volatility. While equities are not inexpensive on an absolute basis, they remain far more attractive than intermediate- and long-term fixed income holdings in our opinion. Investors need to not only earn solid risk-adjusted returns, but to also stay ahead of inflation. Equities are far better inflation hedges than fixed income, particularly with interest rates currently so low. It would not take a large increase in interest rates to wipe out a year or two of long-term bonds' coupon payments. Although we do not see a catalyst for a sharp pullback in equities, with US stocks more than double their level of March 2020, a decline of 5-10% is not only possible, but probable. This would give us an opportunity to review portfolio holdings and pick up securities that are currently too expensive for our discipline.

Conclusion

As we end 2021, we note that many investors (us included) were surprised by the strength and speed of inflationary pressures. We understood the supply chain problems but did not fully appreciate the consumer demand for goods as they postponed spending on services such as travel, restaurants, etc. In fact, when compared to just before the pandemic began, consumer spending on services is still slightly down, while spending on goods has risen approximately 20%. As pandemic era programs end, government spending should decline, which will help relieve upward pressure on costs. COVID appears to have become more endemic, and we are learning to live with it in our lives. We are heartened that there is little talk of shutdowns despite the large number of new cases over the past month. We are no longer sure what "normal" means, and it may be quite some time before people return to the office five days a week. We are watching employment levels, wage growth, and corporate earnings along with inflation as we move into 2022. During times of volatility, it is emotionally challenging to hold firm, but this is often the best course of action. The volatility and extreme price movements of the past two years gave us many challenges but staying true to our discipline benefitted us and our clients. It has helped portfolio returns in the past and we expect it will do so in the future. As always, we enjoy hearing from our clients and encourage you to contact us if you have any comments or questions about your investments or any changes in your financial situation. We close by wishing a heartfelt Happy and Healthy New Year to each one of you!

December 31, 2021

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