Managing the Peaks

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Dear Clients and Friends: January 19, 2022

As 2021 started, we had high hopes, but were quickly disappointed. We anticipated calm and cooperation making its way back to Washington. We envisioned holidays and vacations with loved ones and our favorite sports would go uninterrupted. The newly introduced vaccines were supposed to stop COVID in its tracks. Mostly, we were expecting a return to normalcy.

We got none of that. Instead, we got more hyper-partisan politics and political dysfunction, a breakdown in global supply chains, a surge in prices for just about everything, and two new variants of COVID, each more contagious than the last. 2021 seemed more like a continuation of 2020, not a new beginning.

Not all was bad, however. We moved closer to some form of herd immunity as billions of people around the world got vaccinated and millions more got Delta and Omicron infections. Economies around the world continued their recovery. We've also seen the human race become surprisingly resilient and adaptive to the odd landscape in which we find ourselves living. All progress… at some level.

The fourth quarter opened with the passage of the bipartisan Infrastructure and Jobs Act and the Fed's effective communication around tapering their balance sheet and starting to raise interest rates. These events calmed and buoyed markets for most of the quarter. There was volatility around Omicron's appearance and as inflation numbers continued to spike. However, markets ended the quarter with a rally, netting an 11% gain for the large-cap S&P. Other markets did not fair quite as well; domestic small-cap stocks and developed international markets finished up 2.5%. Emerging markets were negative -1.3% and bonds finished flat.

For the year, we saw a similar picture. Lifted by strength in energy, financials, and of course, technology stocks, the S&P was up a remarkable 28%. Small-cap stocks, as represented by the Russell 2000, were up about 14%. International stocks lagged, up 8%. Emerging markets were down -2%. Finally, it was a tough year for bonds as the rise in interest rates led the Aggregate index to a decline of -1.2%.

Pumping the Brakes

That odd landscape we find ourselves living in continues to change. While the last two years have been like no other, the immediate future is looking quite different as well. As COVID has rolled through, we've seen record amounts of government involvement. Citizens saw stimulus checks and more stimulus checks. Businesses saw tax breaks, loan forgiveness, and payroll help. Investors saw the Fed supporting markets by buying even more bonds and pegging interest rates back at zero.

All this money sloshing around affected the economy. Its most easily seen in prices we pay for things. Whether at the pump, the grocery store, or the value of our homes and cars, when too many dollars chase too few goods, prices move up. The time has come to pump the brakes and pull those excess dollars out of the system, hopefully reversing some trends, while not causing too much damage to others.

Getting the excess dollars out of the system is the responsibility of Congress and the Federal Reserve. As a result, we are now being asked to manage through some unfamiliar peaks. We believe peak stimulus has run its course. A deeply divided Congress means existing programs are expiring and unlikely to be renewed. This stimulus will naturally taper off and additional spending appears to be extremely unlikely. The Fed will be tasked with removing its exceptionally accommodative, crisis era monetary policies by reducing both bond purchases and balance sheet size. They ultimately must raise interest rates. Their ability to do this in an effectual manner will determine much of how 2022 plays out.

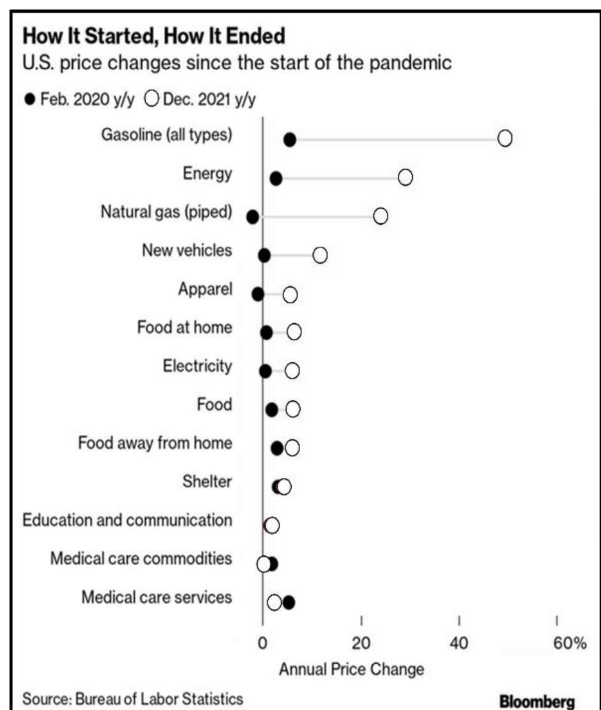
Also, we've likely reached peak economic growth for this cycle. We do not expect a recession, but as peak stimulus and the Fed's peak monetary policies wind down, we do expect growth to slow. Consumers have been spending excess savings created during the lockdowns and are starting to fulfill many of their pent-up demands. As excess savings diminish, spending will slow and the economy will settle back down to trend growth.

In addition, we are hopeful peak supply chain problems, while still present, will soon be behind us. As detailed in last quarter's letter, the world's supply chains have been hit with a myriad of difficulties resulting in empty shelves and delayed deliveries. The two biggest culprits have been COVID disruptions and consumers' buying patterns. Now, as consumers enter the much less frantic post-holiday season, both manufacture and logistic companies should have time to catch up and relieve some of the stress on the system.

Lastly, we hope to see COVID infections peak and move lower, permanently. While the vaccines/boosters seem to reduce the severity of most COVID infections, they are not completely preventing them. Omicron could do that job and move the world more quickly towards herd immunity. Regardless of your stance on vaccines, the reality is that every new infection gives the virus a chance to mutate into a more dangerous variant. To move on from COVID, we must reduce the virus's prospect set.

Inflation

About those rising prices, we also hope we are reaching peak inflation. Those excess dollars boosted economic growth and propelled financial markets to record levels. As demand for goods and services eclipsed the available supply, inflationary pressures built. In December, the Consumer Price Index hit 7%, the largest increase since 1982. It was also the third straight month above 6%. We think current inflation rates will fall but remain elevated above the Fed's 2% target for quite some time. Some inflationary factors are temporary and should pass while others will be more persistent.



The chart to the right, produced by Bloomberg with data from the Bureau of Labor Statistics, shows the change in prices for many of the things we buy. It measures

the year-over-year change for two periods, before COVID hit and for 2021. The results are exactly what your pocketbook is feeling. Inflation is up across the board, but most significantly in the energy sector and in headline grabbing new and used cars. Energy prices may remain higher for longer. Over the last decade, there has been chronic underinvestment in fossil fuel production as the developed world embraced cleaner energy initiatives. Elevated prices everywhere else can be partially explained by supply/demand imbalances and supply chain issues that will likely be worked out over the coming year.

Not on the chart, but also an issue, is wages. Continuing wage pressure is also likely more enduring with the ongoing labor shortage in the U.S. Several million workers left the labor force since the beginning of COVID and have not returned. Immigration has also been largely shut down. With so many jobs available relative to jobs being sought, employees find themselves with a lot of bargaining power. This is leading to rising wages and higher labor costs throughout the economy. Finally, there is similarly high demand for real estate, especially single and multi-family homes, and anything related to infrastructure and logistics. Rent increases tend to be persistent.

Outlook

As for markets going forward? COVID is no longer the major focus. Attention has shifted to the Fed and their agenda for addressing inflation. Major markets have thus far been resilient to inflation fears, but the Fed needs to avoid any policy errors. The concern is they are being too cautious, and inflation holds stubbornly above 3% into year-end. In that case, price pressures may be too ingrained in the economic psyche, and the Fed would need to respond even more aggressively. The opposite risk exists as well. The current plan could already be too aggressive if inflation is predominantly a result of supply chain issues. Overtightening could slow economic growth too much and be bearish for equity markets.

There has already been a good amount of volatility to start 2022, especially under the surface of the major indices. Much of this can be attributed to the Fed pivoting towards fire-fighting mode and turning off the spigot sooner than anticipated. The more speculative areas of the stock market, which zoomed with zero rates, have been left drowning.

We expect continued volatility as markets absorb the economy's reaction to all the changing influences. We still have the tailwinds of solid corporate earnings growth and GDP growth near 4% in 2022. History also shows that stock prices generally make progress during a rate hiking cycle; the fear is often worse than reality. International markets still offer tremendous relative value and opportunity for future returns. Conservative fixed income will continue to be a challenge, as bond prices move in the opposite direction of interest rates. Bonds are a necessary but unattractive asset. We are doing our best to find yield while still protecting principal in a rising rate world.

Thank you again for your continued confidence and trust as we work through these extraordinary times. We welcome your comments, questions, and referrals. Please don't hesitate to contact us. Please stay safe and well.

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