Market Commentary – Fourth Quarter 2021

Malcolm Polley, CFA, President and Chief Investment Officer

As usually happens, we got some things wrong (but in the right direction) and several things right. While we got strong double-digit returns in equities for 2021, bond returns ended about as expected. We thought that value stocks would outperform growth stocks, and value made a strong comeback in small and mid-cap equities, while they lagged in large-cap equities. We also thought that full-year GDP growth would be around 2%. This prediction turned out to be farthest from the truth. In all fairness, we did revise our expectations upward later in the year.

While returns ran the gamut from blah to pretty exciting, the year-over-year changes belie the realities of the year – namely that 2021 saw quite a bit of turmoil. Whether we focus on presidential transition shenanigans, continuing waves of COVID creating market concerns or year-end anxieties over inflation turning from transitory to problematic, how we got to where we are was a fairly exciting ride.

The Economy

The biggest argument in the economy today has to do with the return of inflation: is it transitory or not?

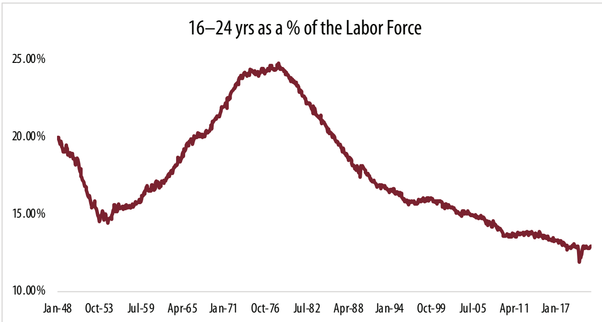
While we had been in the transitory camp, we have also been arguing that transitory does not mean, as some would think, a return to pre-pandemic levels.

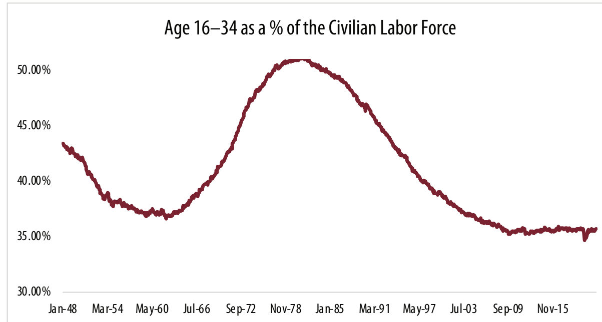
Indeed, our statement at the beginning of 2021 that we weren't concerned about inflation was due primarily to the fact that the inflation we have been experiencing is of a different flavor than the inflation of the 1970s and '80s.

We have been fairly vocal in our belief that the inflation we are currently experiencing is not the same kind of inflation that worries the market – namely the hyperinflation of the 1970s and early 1980s. This is because the inflation of the 1970s and '80s was caused by increasing demand, whereas the current flare-up is supply-driven (limited supplies due to pandemic-driven shutdowns and supply chain issues). Further, the underlying demographics are different, and nowhere do we see the difference better than if we look at the youngest portion of the labor force (ages 16–24 and 25–34).

We have often focused on the 16–24 demographic, as it is the source of *new labor* to the labor force and have stated publicly that without growth in this demographic within the labor force, GDP growth stalls and inflation can't get a lasting foothold. In his January 3rd edition of *Morning Briefs*, Dr. Ed Yardeni echoed our thoughts regarding the correlation of what he terms the *Age Wave* and inflation. That is, because the youngest portion of the labor force represents a smaller and (relatively) declining percentage of the labor force, inflation should remain relatively contained. (See charts on the following page. Source: US Bureau of Labor Statistics.) This is because the youngest portion of the labor force experiences the biggest increase in both earnings and spending as they earn money and desire stuff, while we older generations (i.e., Boomers) see earnings stagnate and decline.

That does not mean, however, that inflation will return to pre-pandemic levels. Far from it.

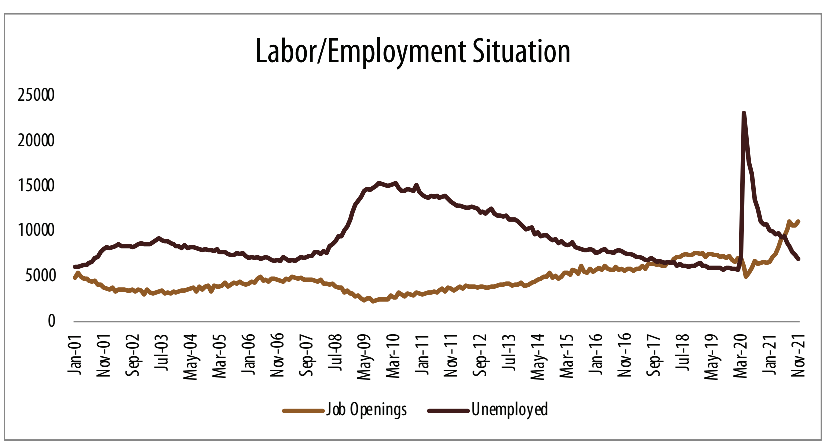




We have also been pretty vocal in our belief that while inflation will likely subside from the current levels north of 6%, it will likely only decline to between 3% and 4% – higher than the Federal Reserve (Fed) would like and higher than the last decade or more of experience.

Employment has also bounced back rather nicely, with the unemployment rate declining to 3.9%. While that is still higher than the pre-pandemic lows, it is also in-line with what is largely believed to be full employment.

Of greater interest (and concern) is the widening gap between the numbers of available jobs and the unemployed people available to fill those jobs. The JOLTS data (Job Openings and Labor Turnover Survey) for November, released the first week of January 2022, shows unemployed people at approximately one-third of pre-pandemic highs. Job openings also remain very strong, crossing over the total number of unemployed persons in May of 2021 and now standing at approximately 10.5 million jobs. (Down from approximately 11.1 million in October 2021, see chart below. Source: US Bureau of Labor Statistics, JOLTS.) Strength in job formations, coupled with a shortage of available workers, has created a situation where unemployed people now have the luxury of waiting for the job they want on terms they want, and where employed people are increasingly willing to leave their existing job – even if it means they don't have one with which to replace it. This has caused wage pressures – particularly at the lower end of the compensation and experience range. Wage inflation (something about which we have been concerned) is real, and it seems as if it is here to stay – at least for a while.



Interest Rates

We were at zero on Fed Funds a year ago and are still there today. As the fourth quarter of 2021 started, we expected the Fed to announce it was beginning its tapering program (announced the beginning of November 2021). However, because Fed chairman Jerome Powell faced the likelihood of not being re-appointed, he had been quite dovish about the interest rate environment. . .and then the Biden administration announced that it would reappoint him to lead the Federal Reserve for another term. Almost immediately Powell did an about-face, indicating that the Fed would speed up its tapering, ending the program in the second quarter, and would likely hike rates both sooner than expected and more frequently. The Fed is now widely expected to increase short-term rates three times in 2022 for a total of 0.75%.

Our initial outlook for how rates would end the year was spot on. We had predicted that the 10-year Treasury Note would end at 1.50%, and it ended the year at 1.51%. We had further predicted that the 30-year Treasury Bond would finish the year close to 2%, and we ended the year at 1.90%.

What you don't see, however, was the rather volatile year interest rates (and by extension, bonds) had. Rates rose so aggressively early in the year that we revised our outlook for both the 10-year and 30-year treasuries to 2% and 2.5%, respectively. While during the first quarter and early second quarter it certainly seemed as if rates were headed sharply higher, the climb stalled as renewed COVID concerns, international buyers competing with the Federal Reserve for bonds as well as dovish comments from the Federal Reserve helped to push rates back down – somewhat.

We were also right to warn about the impact the ultra-low interest rate environment would have on bond returns.

We were hard pressed to find a scenario where bond indices would provide more than very modestly positive returns and believed it a very real likelihood that we could see negative returns from bonds for the full year.

Other than the Fed Funds rate, interest rates ended the year modestly higher across the yield spectrum, causing bond returns to turn negative for all but the shortest duration offerings and municipal bonds. We aren't expecting much different results for 2022.

Market Overview

Equity markets had a monster year. Even though the market did not go straight up (though we are sure that it seemed to do so for some), every major non-Russell domestic equity index, except for the S&P MidCap 400 Growth Index, saw greater than 20% returns and value outperformed growth everywhere except in large-cap equities. This is on top of double-digit returns in 2020. Even international equities (MSCI EAFE Index) had a decent year, albeit much lower than domestic equities, returning more than 11%. Yes, we had some volatility with six downturns of more than 3% and yes, the yield curve worked higher, but all is well! Or is it?

As we stated last year, as is often the case, markets tend to take the future to extremes in terms of its assumptions.

We believe that the stickier than expected inflation and the likelihood of higher interest rates coupled with slowing growth will act to put pressure on indicis overweighted with growth names due to their market cap weightings.

Growth may have done well in a zero-rate environment where the cost of capital doesn't matter and far-future earnings receive nary a discount, but in a rising rate environment, earnings and stability of earnings matter. Cost of capital matters. Far-future earnings are not worth nearly as much as current and near-term earnings.

Outlook

We have been in an ultra-low interest rate environment for so long that people had forgotten what it means to actually have a cost to debt capital. That is changing. We believe that this year will kick off the beginning of a secular upward move in interest rates that will reach its zenith sometime after your author is no longer in the business. (Typical secular interest rate cycles last 20–40 years.) That does not mean, however, that interest rates will march upward in a straight line for the next couple of decades. As is typically the case, there are numerous cyclical rate cycles within a longer secular cycle. As is also typically the case, the Federal Reserve does not lead rates higher, they follow. The current cycle will be no different.

Based on the yield curve, it is apparent that the market believes we will get at least three 0.25% Fed Funds rate hikes during 2022, probably beginning sooner rather than later. Indeed, if you follow the dot-plot of rate expectations by the members of the Federal Reserve Open Market Committee (FOMC), they are also expecting the Fed Funds rate to be at 0.75% by year-end. What we find interesting is that the dot-plot (which measures FOMC members' expectations for interest rates, the economy and inflation) sees rates potentially rising an additional 0.75%–1% in 2023 to between 1.5%–2% before levelling off at roughly 2.5% in 2024. Why is that?

In order to understand the FOMC's reasoning, you also need to understand their outlook for growth and inflation, as well as the real rate environment over that same time period. (Real rates are the nominal or headline rate less the inflation rate.) With a current Fed Funds rate of 0%–0.25%, the current real rate is roughly -6% – very easy money. Looking into out years and using FOMC expectations indicate a real Fed Funds rate of between -1.25% to -2.5% (assumes inflation of between 2%–3.25%) in 2022, a real Fed Funds rate of -0.75% to -0.25% (assumes inflation of between 2%–2.5%) in 2023 and a real Fed Funds rate of 0% to 0.75% for 2024. A pretty benign interest rate environment that hinges on inflation coming back to pre-pandemic levels. And yet, as easy as monetary policy looks to stay, the reality is that the Fed is walking a tight rope.

It is clear that the Fed can't simply stand by and do nothing. The economy is doing well, and inflation is running hotter than nearly anyone would like and yet, they are also fighting a natural fiscal tightening. This is because the $5 trillion spending orgy that the federal government underwent to save us from the pandemic-induced shutdowns won't be repeated. Even had the $2–$3 trillion Build Back Better legislation passed, that only amounted to roughly $300 billion in annual spending – still a $4.7 trillion reduction from the previous year.

So, the Fed walks a tight rope between the fiscal tightening currently taking place and the monetary tightening they must do to keep the economy from inflating any more than it has.

Will they be successful? Our expectation is that the Fed will stay behind the (yield) curve, and the markets will likely dictate where Fed policy ends.

We believe that the Fed Funds rate will rise by at least 0.75% with the Fed Funds rate ending in a range of 0.75 – 1.00%. The yield curve will remain upward sloping with its long end reflecting how well or poorly the Fed does in walking its tight rope. For now, we see the ten-year Treasury note ending the year at 2.25% and the thirty-year bond ending at 2.6%. Could we have some volatility around those numbers? Certainly, with the likely volatility being higher rather than lower.

This rate outlook also implies expectations for negative returns from bonds (as rates rise, prices fall). As we expect a difficult return year for bonds, our focus will be on preservation of capital in the fixed income sector. We believe that it is prudent to take steps to reduce the volatility in our fixed portfolios by focusing on one-year corporate bonds that will give us a little added yield relative to government securities and will give us the flexibility to reallocate those dollars a year hence at higher rates; and by looking to more non-traditional means of protecting principal.

We expect that GDP will slow in 2022, largely because of the fiscal tightening that is occurring. Less extra spending means less extra liquidity sloshing around, meaning slower growth. Although, in this case, slower is a relative term. We expect full-year GDP to come in around 4%, with faster growth in the first half of the year than the back half.

Equity markets are also facing a shift. With ultra-low interest rates, the cost of capital was extremely low, and nearly any project could be justified. Similarly, the discount rates used to value future cash flows have also been quite low. In fact, we have argued for nearly a decade that the discount rate assumptions used have been wrong because the base rate was too low. (Can you really justify discounting future earnings by nearly zero forever?) Ultimately, as interest rates rise, all else equal, values fall. There are, however, some potential offsets because, of course, not all companies are equal.

Over at least the last decade of ultra-low interest rates, companies with more volatile or more future-dated earnings did not receive the valuation discount a more normal rate environment would have imposed. This meant that higher-growth companies were more highly valued because their future earnings would grow more rapidly, and those future earnings would not be heavily discounted. Relatively more stable, lower-growth companies that had more bond-like earning streams did not get the benefit of more stable earnings and saw relative values falter. Therefore, value stocks have underperformed growth stocks for the last decade or more.

In fact, as various market capitalization weighted indices saw growth stocks become a greater percentage of those indices, due to better stock price performance in a low-rate environment, the indices saw outperformance relative to value stocks accelerate. We believe that scenario is in the process of changing.

As we noted at the beginning of this commentary, value stocks outperformed growth stocks across the market capitalization spectrum in all but large-cap equities. We believe that outperformance will continue in 2022. We don't, however, expect that equities will have nearly as strong a year as they did in 2021.

According to Yardeni.com, IBES consensus estimates are for 2022 S&P 500 EPS of $223.04. This is a growth rate of just a little over 8% above the $205.79 expected for calendar 2021, and a substantial slowdown versus the 24%+ growth rate of 2021 versus 2020.

Further, if interest rates do rise along the curve, then PE ratios should decline as the inverse of the PE ratio (the E/P ratio or Earnings Yield) has had a fairly good correlation to the 10-year note since 1960. Given the S&P 500's 2021 year-end PE ratio of 23.16, its earnings yield would then be 4.32%. Assuming a 0.75% rise in rates from current levels would imply an earnings yield of 5.07% and a PE of 19.72. If we are able to simply maintain the current PE, then the implied growth rate for the index would also be roughly 8.4%. PE contraction, particularly to the level indicated above, would result in losses on the order of 7.7%. We think that reality lies somewhere in between those two numbers.

We believe that assumptions for earnings in 2022 are pretty much on course. However, because of the market cap weighting of the benchmarks that have tended to favor growth-oriented and technology stocks, and because we believe that interest rates will rise over the course of the year, we are expecting some contractions.

We believe that the earnings multiple will likely remain around 20 times earnings. As such, we are pegging expectations for the S&P 500 at about 4,500. When coupled with its 1.29% dividend yield, it would indicate a year-end loss of approximately 5%.

Value names, however, will probably have a better year-earning reasonably positive (albeit below normal) returns in the range of 7%–9%.

Strategy Overview

Given expectations for rising rates, higher inflation and slowing earnings growth, we believe that downside risks outweigh the upside potential. As such, it is even more important to be cognizant of the relationship between risk and return. Taking a little extra time to fully understand potential risks can help avoid bad surprises and can, potentially, identify situations where risks have either been overpriced or underpriced, or find situations where the potential downside may be relatively limited.

Gauging appropriate valuation and purchase prices relative to risks has always been, and will always be, our primary focus. Linking investment decisions to something tangible like the cash generating capabilities of a business or investment, and assuming a minimum acceptable rate of return for each decision, should add value. Elevated risks should translate into higher return requirements and lower valuations, all else equal.

Looking at investments, as would any rational person, helps us focus on those things that are most important: return of and return on capital invested.

Regardless of the environment or level of market uncertainty, when we see investment opportunities that allow us to earn returns in excess of our requirements, we jump. Over time, this should allow us to be well compensated for the decisions made. In our mind, the real risks are those not taken.

Stewart Capital Advisors, LLC • 800 Philadelphia Street • Indiana, PA 15701 • 855.783.9227