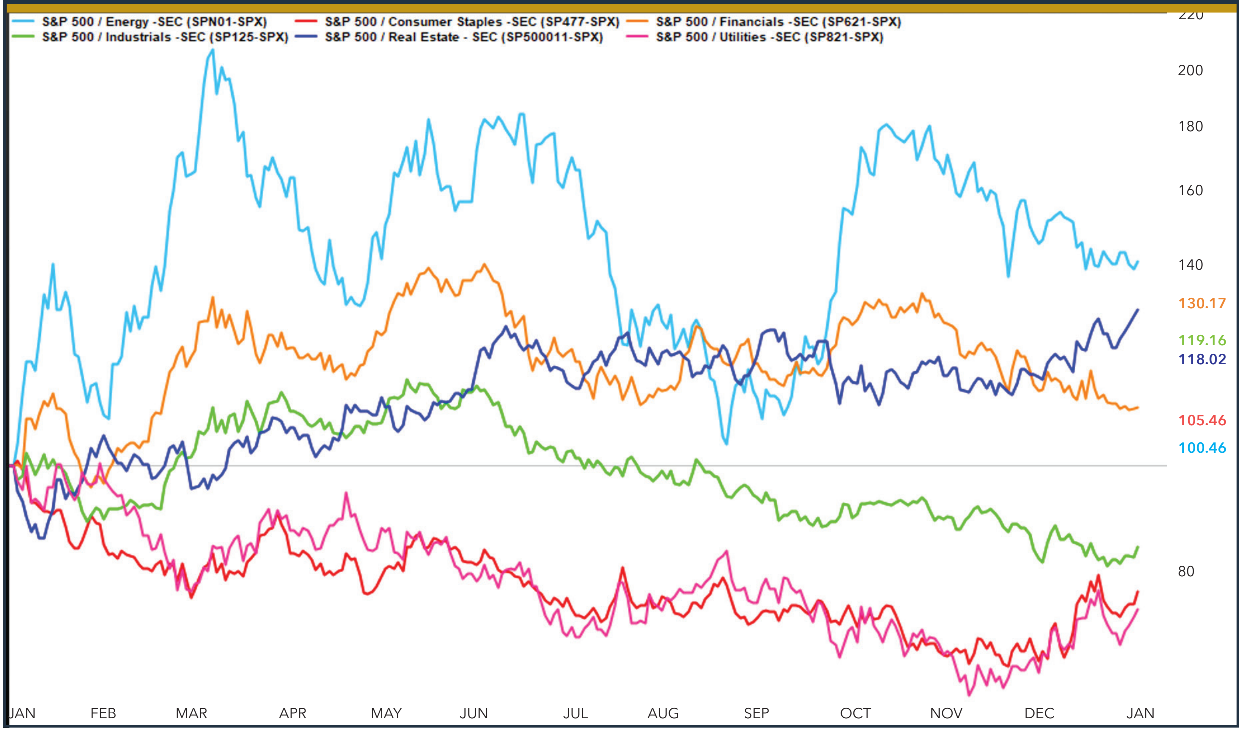
Winter 2022 Market Commentary

To the casual observer it might seem incongruous that in 2021 the S&P 500 stock index, the widely used proxy for the US stock market, scored another stellar year of performance in a year challenged by extreme uncertainty, and always under the sobering overhang of the COVID pandemic. By looking closer at the drivers of performance, we find that the rally in the index was actually quite narrow and was skewed favorably to the upside by significant gains in just a handful of the largest stocks by market capitalization, namely Apple, Alphabet (Google), Microsoft, Tesla and Nvidia.

RELATIVE STRENGTH VS S&P 500 (12/31/20 – 12/31/2021)



Source: FactSet as of December 31, 2021

In fact, while these five stocks make up 21% of the S&P 500 index, they accounted for 41% (11.2%) of the 27% index price appreciation in 2021. The price performance for the other 495 index constituents was still positive but less so at +15.7%, with the larger companies outperforming the smaller and more economically sensitive names. Further, of the 500 companies in the index, only 33% of the stocks made new highs while most index constituents made new annual lows, an anomaly last seen in the year 1999.

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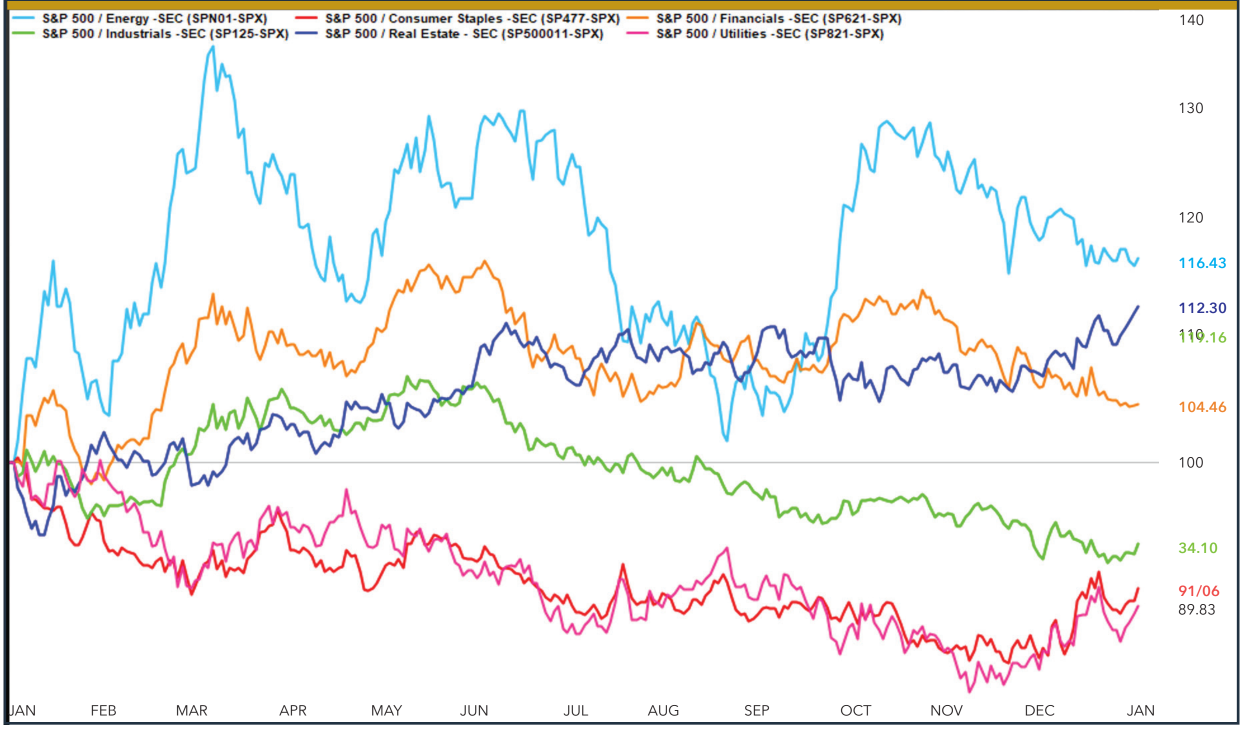


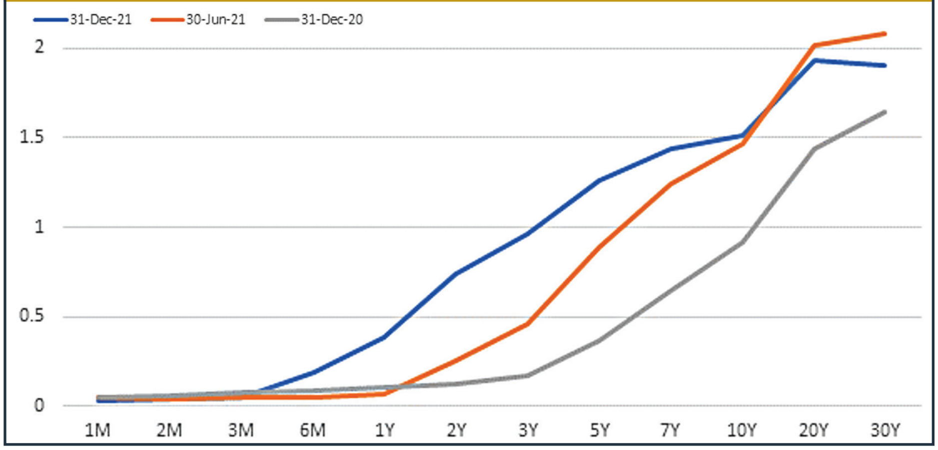
Source: FactSet as of December 31, 2021

Corporate profitability in 2021 was robust and once the Q4 numbers are reported, likely experienced a +50% growth rate versus the profit slump witnessed in 2020. Throughout 2021, corporate earnings consistently exceeded analyst expectations to the upside and fueled investment money flows into the equity markets. Given the anemic yields offered in the fixed income market, the popular catchphrase “there is no alternative to stocks” encouraged investor speculation in popular “meme” stocks such as Gamestop, new IPO offerings (70% of which were for unprofitable enterprises), and various cryptocurrencies such as “Dogecoin.”

The American Rescue Plan’s $1.9 trillion in direct fiscal stimulus payments to households and the continual support of the financial markets by the Federal Reserve, which added a whopping $3.9 trillion in securities to its massive $9 trillion balance sheet since the start of the pandemic, likely contributed to investor exuberance and the commensurate rise in financial and real assets as exemplified by skyrocketing home prices.

The US bond market was more responsive to the periodic pandemic-related economic slowdowns and reopening growth spurts experienced throughout the year. The benchmark 10-year interest rate began the year below 1%, rose to 1.75% mid-year as Covid vaccination programs were rolled out nationwide and service related businesses reopened to customers, then dipped again below 1.20% when the Delta variant swept across the country. On a total return basis, lower-rated, high-yield securities posted positive performance of close to +4.0% as the credit spread required by investors over risk-free Treasuries continued to decline, reflecting investor expectations that the Fed would continue to support the economy which in turn, would limit credit defaults. Conversely, risk-free fixed-income investments lost ground with the 7-10 year maturity US Treasury notes losing -3.0% for the year as interest rates rose and bond prices declined at year end.

TREASURY YIELDS



Source: Bloomberg as of December 31, 2021

Today's high inflation rates are worrying policymakers. Inflation, or the loss of US dollar purchasing power, is effectively a repressive tax on consumers, hurting lower income families to a much larger degree than those individuals with investments in real and financial assets that stand to benefit from any increase in prices. To mitigate further increases in inflation, which has now reached a level not seen in four decades, the Federal Reserve has indicated its plan to effectively remove liquidity from the financial system by tightening the monetary policy it controls. This policy shift will likely cause interest rates across the yield curve to increase with the intended goal of slowing borrowing and consumer demand for goods and services. Fed officials will be tasked with the job of tamping down inflationary demand impulses by just enough without risking a recession. This is akin to walking the length of a tightrope without teetering off to one side or the other. The Fed has pledged to be data dependent and flexible in its policy implementation but this operation will most certainly be as difficult to successfully execute as it sounds. The Fed has limited to no control over global supply chains, individual country pandemic policies (e.g. China's zero-Covid policy), the availability of energy resources, and the labor market's desire to work or return to the office.

Interest rates may continue to trend higher, but will most likely remain lower than historical levels as the Fed attempts to quell inflationary pressures without destabilizing the financial system. Corporate profits are unlikely to repeat the strong performance of 2021 for the simple fact that the annual comparison will be considerably more difficult and given the likelihood that higher wages and input costs will weigh heavily on profit margins. For this reason, we favor investing in resilient companies with strong balance sheets, competitive pricing power and formidable business moats. We continue to advocate that the best way to grow and preserve capital in today's uncertain environment is to properly diversify investment portfolios with assets of varying risk and return profiles. Fixed income instruments may not presently generate much in the way of income, but they are expected to continue to provide support to a portfolio in times of equity market distress.

Reference: The Leuthold Group

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