Portfolio Management, LLC

Building Wealth Wisely

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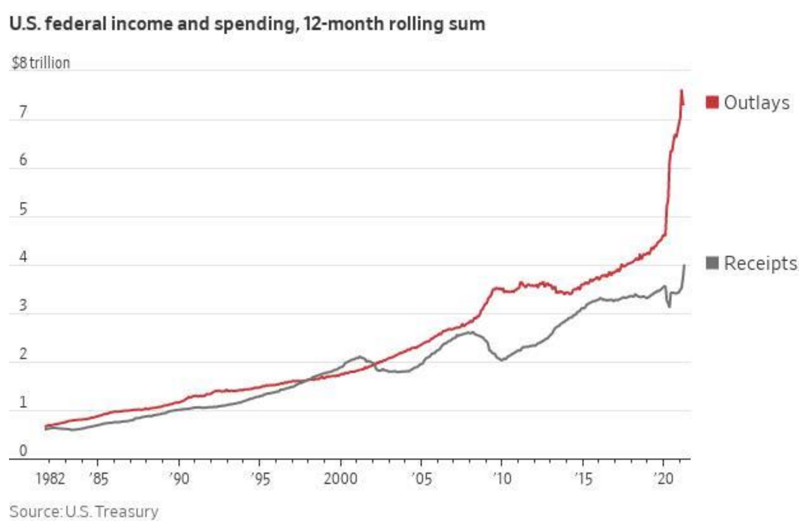
2022 - A Year of Transition

Americans returned to more typical lifestyles during the second year of the pandemic, helping the economy and U.S. stocks achieve a year of outsized gains. The S&P 500 Index hit 70 all-time highs in 2021. Bonds, on the other hand, dipped in price last year in the face of rising interest rates. Inflation just reached a 39-year high, rising perilously close to the 7.4% annualized inflation rate of the 1970s.

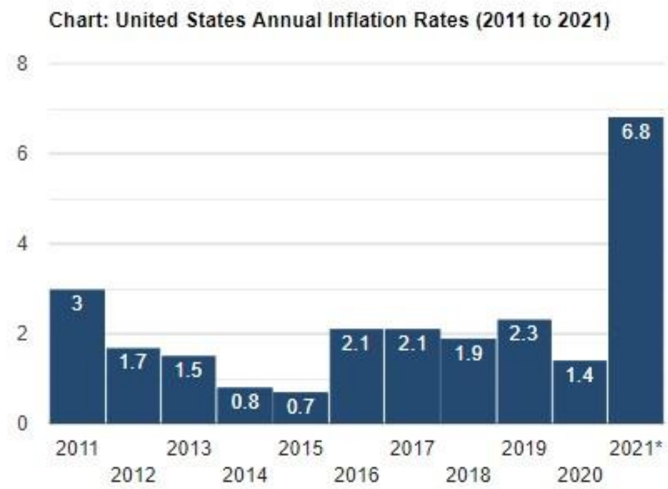
Valuations are elevated across the board, from stocks to bonds to real estate. Home prices were up over 20% in 2021 versus the long term average of 3.5% per year. Whether you're in the market for steaks or stocks, today everything seems to be expensive.

Looking into the new year, government stimulus is waning, and central bankers have become more hawkish. The Federal Reserve has already started a gradual reduction in monetary stimulus measures. The stage is set for 2022 to be a year of transition as policies and economies normalize.

Interest rates will probably continue to move higher but not to levels that could seriously damage the economy or the markets in the near term. Due to economic uncertainty and massive government debt levels, the Federal Reserve may not have as much scope to raise interest rates as currently expected. Federal government debt now exceeds 100% of GDP.



Higher prices for goods and services will linger into 2022. The path of inflation later in the year will largely depend on whether Covid-related bottlenecks and labor shortages ease or expand. Inflation is likely to remain higher than average for an extended period of time due to the increasing cost of labor and unrestrained government deficit spending. The primary reason for the current high rate of inflation is too many government-printed dollars chasing too few goods; the primary driver of prolonged inflation is usually spiraling labor costs.



Although it will be hard to put the inflation genie back into the bottle, it would be out of the ordinary for inflation to stay excessively elevated if economic growth slows as expected. Economic growth is usually weak when debt-to-GDP levels are high. Economies have already started decelerating in the U.S. and around the globe, even in China.

Despite low bond yields and high stock valuations, we start the current year with a number of positives. The worst of Covid may be gone by the spring. Economic growth should slow but remain healthy this year. Labor markets are robust, with room for labor participation rates to expand further. Consumer disposable income is solid.

There is still a lot of government stimulus in the pipeline. None of the funds allocated for infrastructure have yet been spent. The vast and expanded federal and state social safety net – food stamps, unemployment insurance, Medicaid, housing subsidies, school lunches, Head Start, child-care assistance, and much more – remains in place.

Strong corporate profits and easy monetary policy helped fuel last year’s run in stocks, but don’t expect a repeat in 2022. Some of the factors that have supported equities will fade next year. Stock gains were bolstered by central bank interventions that kept short-term interest rates near zero.

Profits at large U.S. companies are expected to grow this year, though at a slower pace than last year’s surge. Rising interest rates are likely to keep a lid on valuations in 2022, limiting stocks to more modest gains. Higher inflation will be healthy for some companies. It allows them to raise prices and enhance profitability in ways not available during periods of low inflation.

Given today's low yields, finding opportunities for value in the bond markets won't be easy this year. For most bonds, rising interest rates translate into lower prices. Investors holding riskier or longer-term bonds could end up with a permanent loss of capital in an inflationary (or recessionary) period.

Our portfolios are heavy on high quality bonds with low to intermediate durations (duration is a measure of sensitivity to interest rate risk). We are also overweight in fixed-income instruments that potentially benefit from rising rates, such as Treasury Inflation Protected bonds, floating rate bonds, and variable rate preferred stocks.

At year-end, the S&P 500 traded at about 21 times its projected earnings over the next 12 months, a rich valuation versus history. The trailing price-to-earnings ratio of the S&P 500's top 10 constituents in November was 68% above their average multiple over the past quarter-century, which includes the tech bubble years. Moreover, 75% of companies going public in 2021 were unprofitable. Speculative investors often learn the hard way that euphoria is not a wise investment strategy. In the long run, earnings – not speculation – drive equity markets.

Microsoft Corp., Nvidia Corp., Apple Inc., Alphabet Inc. and Tesla Inc. accounted for about one-third of the benchmark's gains last year. Consequently, index investors are increasingly invested in just a handful of high-priced stocks that could be vulnerable to a dud product or regulatory setback. Apple and the other nine largest constituents of the S&P 500 currently comprise nearly 30% of its market value, well above the previous concentration peak seen at the height of the tech bubble before a brutal bear market.

Thinking of this in terms of buying an entire business is helpful: Would you rather own only Apple or own all of McDonald's, Walmart, AT&T, Philip Morris, Berkshire Hathaway, Procter & Gamble, JPMorgan Chase, Starbucks, Boeing, Deere and American Express combined? A lot would have to go wrong to sink that diversified group of blue-chip stocks.

It may be difficult to imagine a company as dominant as Apple stumbling, but that has usually been the case with past market leaders. The top companies in the index in recent decades were Exxon Mobil, General Electric, and AT&T. All have shrunk in size and stature.

Looking beyond this year, the enlargement of government debt during the pandemic along with weakening demographic trends might pose a challenge for future economic growth and stock returns. In 2021, our country's population grew at the slowest rate since the founding of our nation. Given lofty valuations and heavy debt loads, the next bear market could be a severe one – and deliver an outsized hit to consumer confidence and economic growth – as was the case in 2001.

Our firm has taken the above factors into consideration when allocating client portfolios this past year. We are overweight in equities that should do well during an inflationary period (real estate, energy, natural resources, materials, and metals). We also remain committed to value stocks, small cap equities, and international equities. While large U.S. growth stocks have outperformed and pushed their future return expectations lower, other less popular equity categories have lagged and offer higher expectations of future returns.

While slower growth could lead to uneven and modest investment results in the coming decade, we are still confident in the benefits of long-term investing. Financial markets have ultimately proven to be resilient to all challenges throughout history. The discipline of diversification – across and within asset classes – and periodic rebalancing should deliver for long-term investors. What ultimately matters to savvy investors is not what we think we know about the future; it's what we do along the way.