

Q4 2021 Newsletter

Economy & Market Valuation

The US stock market as measured by the S&P 500 went up by ~27% in 2021. The stock market looked very calm at the surface but there was a lot of hidden turbulence under the surface. Many of the high growth names dropped by up to 50% in Q4 2021. The reason for the turbulence in Q4 2021 was the Fed announcement of end of QE and expectations of increase in interest rates in 2022. The Fed has decided that interest rates have to go up to bring the inflation down. We expect interest rates to start increasing in the first half of 2022. The market debate is how fast will the Fed increase the rates and what would be the terminal interest rate once Fed has finished interest rate hikes. Our view is that the trajectory of inflation in 2022 will decide the rate of increase of interest rates. If inflation remains high, Fed will increase interest rates at a faster pace. If inflation starts dropping in 2022, Fed can afford to go slow on interest rate hikes. Due to uncertainty with the inflation and interest rate hikes, we expect the US stock market to remain very volatile in 2022. We do not expect repeat of 2021 stocks market returns in 2022. We do not expect US economy to enter recession in 2022 either. But there is a risk that a Fed mistake can take US economy towards recession.

2021 performance and 2022 investment strategy:

Alpha fund of OCA underperformed S&P 500 in 2021. It may sound weird, but the reason for underperformance in 2021 was a huge outperformance in 2020. In 2020 and 2021 growth stocks constituted a big %age of the portfolio. When the US economy was coming out of the pandemic lock down, we anticipated that growth stocks will outperform the market and they did outperform the stock market by a huge margin. But the same stocks underperformed the market when Fed announced tightening of easy monetary policy. We have since moved the portfolio away from growth stocks and increased focus towards high quality secular growth names. We have increased exposure to the segments of the market that do well in high inflation environment. Some examples are financials, energy and companies that have pricing power. We have increased cash in the portfolio with a view that we will see higher volatility in 2022. The cash is to take advantage of market opportunities that higher volatility is expected to offer. We have **a substantial cash position** in the portfolio. We are keeping an eye on opportunities including growth stocks. If we find the right prices, we will buy the beaten up stocks again.