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INVESTMENT ADVISORS

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INVESTMENT REVIEW AND OUTLOOK

A Silver Lining Quarter

On the surface, the fourth quarter appeared to be filled with disconcerting news. The Delta and Omicron variants of COVID-19 spread at seemingly exponential rates. In Washington, the signature initiative of the administration, the Build Back Better (BBB) legislation, failed to pass the US Senate. Inflation, as measured by the Consumer Price Index, showed a year-to-year increase of 7% in the month of December, which, according to the Bureau of Labor Statistics, is the fastest rate of gain since 1982. The price of oil, as measured by the WTI benchmark, reached $82 per barrel during the fourth quarter - its highest level since 2014.

However, the US stock market, as measured by the S&P 500, had a total return of 11% in the fourth quarter. Growth stocks performed strongly, and the Citigroup Index of growth stocks gained 13.4%. US stocks continued their pattern of outperformance versus foreign markets; the FTSE All World ex-US Index gained 1.8% during the same quarter. Interest rates were little changed, and the yield on the 10-year US Treasury was 1.44% at year-end.

To say that the strength of the stock market was at odds with the news headlines during the fourth quarter would be an understatement. However, it is worth bearing in mind that economic and interest rate conditions remained broadly supportive of stock prices. It is also possible that there is a "silver lining" to some of the disappointing developments cited above. COVID-19 remains a significant public health threat, and hospital capacity is once again being taxed in many regions of the country. With the rapid spread of Omicron, it is becoming increasingly clear that we may be passing from the pandemic phase of COVID-19 to the endemic phase. Put simply, rather than defeating the virus, we will learn to adapt to and live with it. Rapid progress in the development of vaccines and therapeutics has been essential to managing COVID-19 and reducing mortality. Despite the significant increase in global COVID-19 infections, according to data compiled by the World Health Organization (WHO), mortality rates for the current wave are a fraction of those from previous waves of infections.

The collapse of the BBB legislation coincided with the release of inflation readings not seen in over three decades, and this was a prominent talking point by senators on both sides of the aisle. The debate over the cost of the legislation, estimated at $1.5–$1.8 trillion, occurred at a time when the ratio of US federal debt to GDP was approaching 130%, a level not seen since World War II. It is not known whether the BBB legislation will be introduced in some form during the next session of Congress. However, it would appear that forces of fiscal restraint may be taking hold.

The increase in inflation during 2021 is perhaps the most enduring concern emerging from the fourth quarter, and it is more difficult to find a silver lining for the current inflation situation. As we have written in recent letters, the price paid for a cross-section of both goods and services has risen sharply over the last 12 months. Many categories of goods have been affected by supply chain and/or labor disruptions. In the energy sector, higher prices are primarily due to underinvestment by the energy industry combined with a rebound in demand; exploration and production capital budgets for the industry are 30–50% below 2018 levels. If history is any guide, higher energy prices should serve as an incentive to increase capital spending in the sector. Similarly, product shortages related to supply chains should also begin to benefit from increased capital investment and higher wages. It is the wage component of inflation that is perhaps most challenging and faces multiple headwinds due to aging demographics and a shortage of skilled labor in a variety of fields, including health care, manufacturing, and transportation. The increase in inflation caught the attention of elected officials and the Federal Reserve, which announced its intention to "taper" open market bond purchases in 2022. Only time will tell if a combination of increased investment in the labor force and tempered fiscal and monetary policy will moderate wage growth in the months and years ahead.

Our Silent Partner

Last quarter, we wrote about the strong stock market gains over the last decade. For the ten-year period ended December 31, 2021, the S&P 500 has had an annualized return of 16.6%, in contrast to the 10% long-term average annual return of US stocks since 1927. Many factors have contributed to this decade's strong stock market returns, including a vibrant innovation economy, consistent economic growth, low inflation, and generally low interest rates. In particular, the impact of the faster-growing innovation sector on the US economy has been dramatic. For example, Amazon.com had a total market value of $81 billion in 2010, but by year-end 2021, that value had risen to over $1.6 trillion, which is a gain of over 1,800%.

One additional factor has been critical to strong stock market returns in recent years: global monetary policies have been quite accommodative for much of the last decade. These policies began with the financial crisis of 2008–2009 and continued with the European sovereign debt crisis of 2012–2015. However, starting in early 2020, the COVID-19 pandemic triggered a response from central banks that had never before been witnessed. In the US alone, the Federal Reserve has made open market purchases of US Treasury and mortgage-backed securities of over $3.5 trillion. These purchases have effectively kept short-term interest rates at historically low levels. From early 2020 through the end of 2021, the 2-year US Treasury note had an average yield of 0.18%, in contrast to a yield of 2.5% in early 2019.

Because the stock market is ultimately a discounting mechanism for underlying earnings and cash flow, the level of interest rates has an overwhelming influence on the valuation of stock prices. In general, the lower the level of interest rates, the higher the valuation multiple for company earnings, as expressed by the price/earnings ratio (P/E). By way of illustration, the S&P 500 P/E ratio was 16x trailing earnings in the mid-2000s, which coincided with a 10-year US Treasury Bond yield of 5%. Conversely, in 2021, amid abundant monetary stimulus, the 10-year US Treasury yielded 1.2%, and the P/E ratio for the S&P 500 was 23x trailing earnings. While many variables have contributed to the strong performance of equities since the COVID-19 market bottom in March 2020, it is evident that the rise in stock prices has been, in part, supported by the "silent partner" of accommodative monetary policy.

Taking Stock

Over the last 12 months, we have written about a variety of concerns regarding speculative excesses in the stock market. During the second half of 2021, some of these excesses began to correct. The IPOX SPAC Index, a measure of Special Purpose Acquisition Companies (SPACs, also known as "blank check companies"), declined by more than 36% between January 2021 and January 2022. Many prominent "meme" stocks also came back to Earth. In an earlier letter, we wrote about AMC Entertainment, which rose dramatically in the first half of last year; however, between May 2021 and January 2022, AMC's share price declined by 60%. In contrast to the performance of these speculative sectors, the broad market for established companies enjoyed a robust year, and the Dow Jones Industrial Average had a total return of 21% in 2021.

A more rational investment environment is a welcome development. However, there continues to be a number of considerations that may weigh on stock valuations in the near term. With inflation front and center, the Federal Reserve has been proactive in communicating its commitment to ending open market bond purchases and likely instituting interest rate hikes in the months ahead. To that end, short-term interest rates have begun to reflect the Fed's anticipated move: the yield on the 2-year Treasury Note has risen from 0.2% in late September 2021 to 1.02% in mid-January 2022. Inflation is another wild card. Although supply chain bottlenecks are expected to be at least partially alleviated in the year ahead, it is less clear how the challenge of labor inflation is to be remedied. Labor markets have tightened, and the unemployment rate reached 3.9% in December 2021. Heightened geopolitical tensions, which have been a concern for several years, have increased with recent developments in Ukraine and sharp rhetoric over Taiwan. Finally, the after-effects of a prolonged period of easy monetary policy are an ongoing concern. While the speculative fever of early 2021 may have cooled, both public and private debt levels are high. It is likely that we will witness additional fallout from higher financial leverage in the months ahead.

As has been the case for over a year, we are emphasizing "anchors to windward" in our portfolios: dividend-paying equities of well-established companies trading at attractive valuations with conservative balance sheets, consistent earnings growth, and a record of free cash flow generation. In general, our weightings of stocks vs. bonds are above the midpoint, owing to the attractiveness of dividend-paying equities. For clients with meaningful fixed-income exposure, credit quality remains high, and maturities are below the benchmark.

As always, we welcome your comments and questions.