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Market Commentary

Bubbles, bright as ever Hope
Drew from fancy – or from soap;
Bright as e'er the South Sea sent
From its frothy element
...
See!—But hark my time is out —
Now, like some great water-spout,
Scaterr'd by the cannon's thunder,
Burst, ye bubbles, burst asunder!– An Incantation: Sung by the Bubble Spirit by Irish Poet Thomas Moore, alluding to the South Sea Bubble of the early 18th century

The news of the omicron variant roiled financial markets during the fourth quarter, resulting in losses for energy and other cyclical sectors that had rallied this year. The news also spurred a rally in mega cap tech stocks, leading large cap growth to recoup its underperformance and end the year ahead of value. Fear of new lockdowns and travel restrictions somewhat damped current inflationary concerns. The Bloomberg Commodity Index, up 32% year-to-date at October 31, declined by over 8% in November. Oil prices fell over 20% during the month. With the omicron variant resulting in more infections but significantly lower hospitalization rates, the risks from the virus relate primarily to exacerbating current labor and supply chain shortages. New cases in South Africa, where scientists first identified the variant, have declined by over 50% since the peak in mid-December. Cases appear to have plateaued in the United Kingdom, second to be hit by omicron. In the United States, new cases currently are running over three times the peak of previous waves. Fortunately, deaths and hospitalizations remain below levels of previous waves. With the introduction of boosters and a new, cheaper to produce traditional vaccine, medical science appears to be winning the arms race with the virus and hopefully this will be the last major outbreak of COVID-19.

The Federal Reserve responded to the highest inflation in recent memory by announcing the tapering of securities purchases. Their announcement stated interest rates would be maintained at current levels until "labor market conditions have reached levels consistent with the Committee's assessments of maximum employment." The market expects this condition to be met, with the futures market discounting three rate hikes later this year, which would bring the fed funds rate to around one percentage point by January 2023. The bond market reaction to this news appeared muted at first, but since the start of the year the yield of the 10-Year Treasury Bond increased to 1.78%, the highest level since the COVID-19 outbreak and only about ten basis points lower than the 1.88% yield on December 31, 2019.

A handful of mega cap companies drove the gain in large cap growth stocks last year. Microsoft, Apple, Alphabet (Google), NVIDIA and Tesla together accounted for nearly half the return of the Russell 1000 Growth Index. This performance masks real carnage among smaller, more speculative growth stocks – at year-end 40% of the names in the NASDAQ 100 traded 50% or more from their peaks earlier in 2021. As of January 10th, the tech-heavy NASDAQ 100 Index had declined 10% from its November peak – meeting the somewhat arbitrary definition of a 'correction'. The performance of the ARK Innovation ETF (ARKK) provides perhaps the best example of the shift in markets. This actively managed fund became a bellwether for the recent boom in lower quality tech stocks, with large positions in emerging tech companies such as Tesla and Zoom. The fund returned 157% in 2020 but fell 24% last year and shows double-digit losses so far in 2021. Additionally, insider selling in companies held by ARKK spiked, with $13.5B of sales by company executives in the last 6 months of 2021 relative to only $11M in purchases [1]. Compounding losses, a 3 times leveraged version of ARKK was launched mid-December on the London Stock Exchange and US private banks sold their clients leveraged structured notes tied to the fund's performance.

We expect volatility to continue as uncertainty lingers around inflation, the pandemic and the path of economic recovery. A risk of a recession remains as consumers may cut spending and employers shed workers in response to rising prices. The inflation of the 1970s ended with a sharp recession with the highest unemployment to date since the Great Depression. The Federal Reserve triggered this recession by hiking interest rates to record levels, with the yield on three month T-bills reaching over 15%. While traditional inflation hedges such as gold and energy stocks fared well during the 1970s, they underperformed in the recession of early 80s. During the recovery from the 2008 Global Financial Crisis, the economy likewise had to navigate between inflation and recession (deflation). Tighter monetary and fiscal policy during that period kept inflation in check, making a recession the greater risk.

A high quality business, by definition, possesses a strong balance sheet and the ability to set prices. These attributes provide investors a measure of protection against either inflation or recession. The balance sheet protects against financial distress of a recession while the company also can raise prices and pass through inflation to its customers. These attributes make **owning high quality stocks the best option for long term preservation and growth of wealth**. Typical of bull markets, wealth becomes confused with market value. However, market value simply represents the latest transaction price multiplied by the number of outstanding shares. If a trade for 100 shares of Apple is made at a dollar higher than the previous price, $16 billion of new 'wealth' gets created for all the company's shareholders ($1 multiplied by the roughly 16 billion shares outstanding). Similarly if an investor sells out a small position at a dollar less per share less than the previous price, the world is $16 billion dollars poorer. As all investors in Apple cannot convert their shares into cash at the current market price, the perception of wealth becomes somewhat illusory. The real measure of wealth lies in the future earnings of Apple, not the price at which the last few shares traded.

Fortunately, **the earnings of US publicly traded companies exhibit far less volatility than their share prices**. A study by investment firm Grantham Mayo Von Otterloo & Co (GMO) reveals a consistent 'company level' performance of the components of the S&P 500 over the past 20 years of around 4.5% annually, net of inflation. The S&P 500 companies achieved these results over the past twenty years while the index delivered annualized real (net-of-inflation) returns of 0.5% for the first ten-year period and 14.6% for the second ten years. Changes in valuations account for the discrepancy. Price / Earnings ratios declined during the initial ten years then rose during the second ten-year period. Looking forward, it seems imprudent to anticipate continued increases in valuation, which leaves scenarios where multiples either remain relatively steady or decline. A real return from US large cap stocks of 4-5% therefore seems reasonable assuming no decline in valuations. Under current circumstances where investment grade bonds offer certain losses relative to even low rates of inflation, 4% real from stocks provides an attractive return. US stocks historically returned around 6.5% net of inflation, but over the same time period bonds returned over two percentage points above inflation. Stock valuation models begin with the yield of a safe investment, such as a Treasury bond, then add a return spread, as investors reasonably require higher returns from stocks than bonds. The 20th century, on average, offered a proposition where investors could either earn 2% net of inflation from bonds or 6.5% from stocks – a difference of 4.5 percentage points. The markets offer a similar spread today but relative to much lower prospective bond returns. The risk then becomes whether bond yields will remain at these low levels or revert back toward historical averages, triggering a downward revaluation of stock prices.

Three possibilities exist over the next few years: a tightening Fed may trigger a recession, current inflation could prove to be transitory and stable economic growth resumes, or inflation could remain stubbornly persistent, analogous to the 1970s. Hopefully the odds are tilted toward the middle scenario, but portfolios need to be robust enough to handle any of the three potential outcomes. Owning quality companies and real assets purchased at reasonable valuations remains the only way to deal with economic uncertainty. Diversification and risk control will determine success. We continue to work with clients to review their cash flow needs and ensure adequate reserves are available to meet several years of distribution requirements.

[1]Financial Times, Jan 9 2022 https://on.ft.com/3f5DuCG

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Smart Investing Webinar:

Tuesday, January 18, 2022 at 11:30 Central on Zoom

We invite you to join Steve Browne, CFA, CIO and Alison Moss, CEO, for our Smart Investing Webinar.

Link to join the webinar:

https://us02web.zoom.us/j/82618953825?pwd=Skc2V0x4WUV6MFd1OURacE1DaTVRZz09

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Mark your calendars:

April 12th at 11:30 AM Central
Smart Investing Webinar- First Quarter Market Review

July 12th at 11:30 AM Central
Smart Investing Webinar- Second Quarter Market Review

October 11th at 11:30 AM Central
Smart Investing Webinar- Third Quarter Market Review