Financial Markets Perspective

January 2022

Looking Back, Looking Ahead

Each year we review our beginning year forecasts and then make predictions for the year ahead. As the New Year began, it is time to evaluate how accurate our forecasts were and where we go from here. Remember that the goal of forecasting is not to predict the future but to review what you need to know to take meaningful action (if necessary) in the present. This process is also part of our investment methodology that is systematically employed in managing your assets.
Here is a review of the forecasts we made in January of 2021:

1. *Domestic economic growth in a range of 3–4%*
    - The Conference Board indicates a rate of 5.6% for full-year 2021 (results will come soon) above our median expectation of 3.5%. The combination of continued monetary and fiscal stimulus (low interest rates and increased government spending) contributed to better economic growth.
2. *Domestic inflation in a range of 2–3%*
    - We underestimated the impact of the federal government's efforts to reduce domestic oil production and the related impact on prices as well as increasing stimulus that put pressure on the ability of the economy to produce enough goods to satisfy demand. As a result, inflation as measured by the personal consumption expenditures index, surged late in 2021 and averaged 5.7% for the year.
3. *10-year Treasury bond yield in a range of 1–3%*
    - As 2021 came to an end, the yield on the 10-year Treasury bond was 1.51% on the back of continued low interest rates due to coronavirus concerns.
4. *Accelerating growth in foreign economies*
    - This was an overall big miss in our forecast due to the spread of not one but two variants of the coronavirus and the related bad decisions by specific governments to try to keep the virus in check.
5. *Oil prices in a range between $50–65 per barrel*
    - On the campaign trail, Biden vowed to cancel the Keystone XL cross-border permit should he win the presidency—and on his first day in office, he made good on that promise. The revoked permit became the final nail in the pipeline's coffin. The Keystone XL project would have benefited both domestic and Canadian producers and consumers by lowering prices for oil and gas at the pump.
6. *Improving corporate earnings and revenue growth domestically and abroad*
    - Domestic corporate profits continued to surge to record-highs in 2021 while profit growth abroad varied by country. For example, our neighbor across the pond had a decline in profits growth as the impact of Brexit took its toll while select Asian companies also had record profit growth.
7. *Continuing fiscal stimulus until the virus is minimized*
    - As the spread of the variants continued, fiscal policy remained stimulative only slowed by the Senate's rejection of President Biden's $2.5 trillion additional spending plan.

8. *A broad rally in domestic equities*
    - Domestic equities had a banner year with the S&P 500 reaching 70 closing highs on its way to a 29% return, led by the outperformance of Mega-caps.
9. *A rally in foreign and emerging market equities*
    - Asian and European equities also finished up in double figures with the exception of China and Hong Kong while Emerging markets were down primarily on the back of major declines in Brazil where equities suffered from rising inflation, slowing growth and political turmoil.
10. *Lower political uncertainty under the new Administration*
    - There was a general disappointment with the new Administration as factors such as the questionable withdrawal from Afghanistan, the actions to reduce domestic energy production and the failure to stop the spread of the virus contributed to higher political uncertainty.

In concluding our overall outlook for the economy and financial markets in 2021 we wrote the following:

"*The outlook for the economy and equity markets has never been better. The potential for a moderate tax increase is high but, given the growth rate outlook for the economy, such a tax increase would only slow growth, not reverse it. Unfortunately, there are several states that are planning major tax increases that may penalize businesses and high net worth individuals in those states. We may see pockets of shortages develop as demand surges for the balance of the year. The Wall Street Journal reports that a major shortage of packets of ketchup exist due to the surge in demand for take out! Investors should be less concerned about inflation arising from a shortage of goods due to a surge in demand than a surge in demand due to a collapse in supply. One example of the latter was the oil embargo in the early '70s when OPEC withheld oil from the U.S. and the lack of supply caused oil and gas prices to spike higher*."

While we did err on several details of our projections, we hit a home run on the overall positive outlook for the economy and equity markets. The combination of monetary and fiscal stimulus added up to a surge in demand across the economy leading to shortages even with the limits placed on consumers and business due to the Covid variants. Going back to our year earlier analogy between the progress of World War II and the turn in the U.S. equity markets, we continue the analogy with the inflation that followed the ending of the war due mainly to rising consumer demand and a shortage of consumer products. In 2021, the buildup in wealth at both the consumer and business level led to a surge in demand producing a pop in inflation. The inflation that characterized the post WWII environment was temporary and preceded a boom in the economy and equity markets that grew by double-digits all during the 1950s.

The 2021 experience was not all smooth as the virus' surge during the year interfered with economic activity. As an example, there was a huge backlog of unloaded cargo containers at major U.S. ports due to the lack of available workers—both at the port for loading and unloading and truckers to get the containers where they needed to go. Shortages in many consumer services businesses such as restaurants led to increases in compensation that benefited middle class families but the rise in prices during the year for the basics such as food and fuel erased many of those income gains.

For investors it was a very unusual year. First, those workers who chose to invest their retirement funds in stocks did very well. If they had selected government bonds, they would have ended the year in the red. Only high yield bonds provided a reasonable rate of return in terms of interest payments. Second, consumers who owned homes were able to refinance their loans as interest rates on mortgages fell near-record lows so that monthly payments shrunk by a substantial amount. In the refinancing process, the appreciated values of homes also supported higher mortgage values and an increase in borrowing. Lastly, for sellers, there was a bonanza in the form of increased values of homes resulting in cash bidding wars in

many desirable areas. Often, real estate did not even get to the MLS stage as buyers told their realtor to find properties that were about to hit the market. As those houses sold for record prices, states and localities benefited from the commensurate rise in real estate tax revenues. Also, the federal government began to get back some of the money they handed out as people with higher incomes owed more in taxes—even without a tax rate increase! We will find out what the extent of these gains are in the next few months, but the higher numbers will be impressive.

As the year ended, the major concern was inflation that appeared not be transitory. News commentators have made unlikely predictions that are tied to historic periods of inflation in places like post WWI Germany and Zimbabwe and more recently in Venezuela and Turkey. In those experiences, economies collapsed, and inflation roared into the millions of percent. The major data point used to compile the CPI inflation statistic is used car prices. As such when one person must pay more for a used car, the seller benefits—sort of like a zero-sum game. What are we missing here?

The question for each of us is: How did this so-called inflation affect us? Many businesses and consumers got a handout from the government—the payroll protection act—that gave money to those suffering from the economic shutdown (and with no tax consequences). Then many people found out they could work from home and not go into the office that resulted in savings on transportation costs among other daily expenses. For example, consider those who live in New Jersey and work in Manhattan: saving on train tickets, meals and just the wear and tear of the commute to the body. There is no way to put a price tag on being able to work from home.

Do not forget how businesses benefited from the forced shutdown. All those high-cost marketing meetings were canceled, and the use of videoconferencing accomplished similar goals without all the dinners, golf outings and unrelated expenses. As a result, corporations had higher margins that flowed through to the bottom line. Sadly, there were losers such as airlines, hotels, restaurants, and golf courses (to name a few) that lost a lot of business! The other side of that coin was the surge in new businesses. Stay-at-home folks used services such as Door Dash and Uber Eats to have food delivered avoiding the trip to the restaurant or supermarket. A lot of out-of-work teenagers benefited nicely from these delivery services and tips made the job even more attractive. Additionally, full-time workers who had entrepreneurial notions were able to finally go out on their own to start-up businesses.

Last year marked a true turning point in the expansion of space exploration. For the first time, commercial interests launched rockets into near earth orbit with paying passengers aboard. Jeff Bezos, creator of Amazon, launched his Space X rocket with none other than William Shatner aboard (Canadian born actor, author, producer, director, screenwriter, and musician). Other entrepreneurs are following suit such as Sir Richard Branson (British entrepreneur and business magnate) and Elon Musk (South African born entrepreneur and business magnate) just to name two. Compare these private sector successes with the ongoing problems with the government's NASA projects and their inability to effectively design and develop a replacement for the Shuttle.

The federal government's fiscal and monetary response to the Covid virus spawned some unusual speculation during last year. Cybercurrencies soared to record levels, some exchange-traded funds grew by triple digits in 2020 and continued that surge in early 2021 and the price of oil went from below zero in 2020 (in the futures market) to over $80 as the year began. Have we seen the peak in speculation? Not sure. The most favored Bitcoin fell from a high of $62,000 to nearly $42,000. The top performing growth-oriented exchange-traded fund in 2020 lost 23%. Even though the NASDAQ has been an outstanding index, over 36% of the stocks in that index fell by more than 50% last year! As we ended the year, the dollar was strong, gold finished down and interest rates were still near record lows. From our perspective, speculation will not be in the cards for 2022.

Fast forward to this year and, in general, we see consumers with high levels of wealth due to a strong stock market and increased real estate values, a corporate sector that is flush with cash, and a world that is generally at peace (give or take a few outliers). And despite the Omicron variant, the outlook for the economy and financial markets is generally positive as outlined below:

1. The U.S. economy likely will have grown at an above-average rate for the fourth quarter of last year. We expect growth to slow to an average of somewhere between 3-5% for the year on the back of receding Covid-related concerns and declining pent-up demand and supply concerns. Foreign economies will likely grow on average by more than 4% with individual countries showing different growth levels.
2. Fiscal policy could tighten under the administration's desire to tax large corporations and "wealthy" individuals. The Build Back Better plan is on the back burner for now and further fiscal stimulus is unlikely unless another variant surfaces that threatens economic growth.
3. Monetary policy will likely tighten as interest rates could be raised by up to 50 basis points to yield 1.75-2.00% for the 10-Year Treasury. As a reminder, this rate was 2.71% on January 14, 2019. The Fed could also reduce its balance sheet by suspending the purchase of mortgage-backed securities.
4. Inflation will likely be higher than expected a year ago due mainly to the political pressure to reduce domestic production of oil and gas and the continued spike in prices. Logjams at major seaports will gradually recede and consumers will slow their buying frenzy once they realize that there are plenty of goods to go around. We expect inflation to start out high and end lower by yearend. Average inflation for the year should be around 3-4%.
5. Corporate profits will continue to rise, albeit at a slower pace, and the overall stock market should benefit even though we have had three good years where equity returns were in the high double-digits. This year could produce a similar experience but with low double-digit returns as company profits could be squeezed by higher wage costs, interest rates and, potentially, taxes. Yet, companies could continue along the path of buying back stock and increasing dividends that should contribute to higher equity prices.

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