MARKETS IN FOCUS

FOURTH QUARTER 2021 JANUARY 13, 2022

GEMMER ASSET MANAGEMENT LLC
LOCAL PARTNER GLOBAL INVESTING

Market Benchmarks

Market Indices	4th Qtr	2021	3-Yr An
S&P 500 Index	+11.1%	+28.8%	+26.0%
Russell 2000	+2.0%	+14.5%	+19.9%
Global Equities	+6.3%	+18.3%	+20.5%
Int'l Index (EAFE)	+2.8%	+11.5%	+13.5%
Emerging Mkts	-1.6%	-3.6%	+10.1%

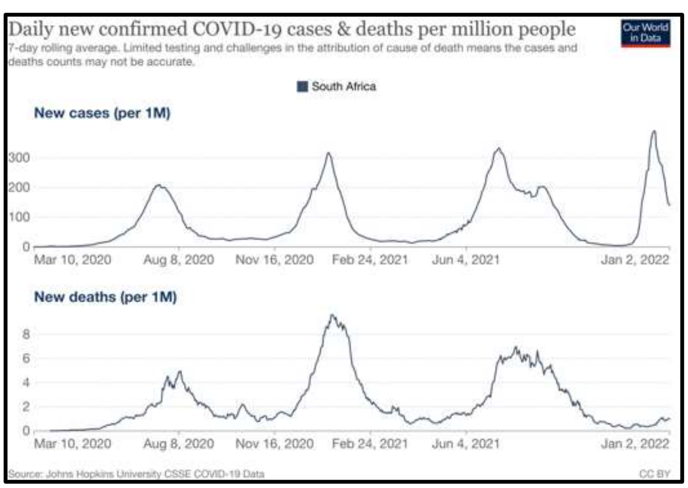
Other Indicators	12/31/21	9/30/21	12/31/20
Fed Funds Rate	0%-0.25%	0%-0.25%	0%-0.25%
2-Year Treasury	0.73%	0.28%	0.12%
10-Year Treasury	1.51%	1.53%	0.92%
S&P 500 P/E Ratio*	21.2	20.3	22.3
Crude Oil	$75.45	$75.12	$48.45
Core Inflation	4.7%	3.6%	1.4%

**Forward 12-month operating earnings per S&P*

Year-In-Review – For all the trepidation around Omicron and rising inflation, the equity markets closed the year on a strong note. Global stocks rallied +6.3% in the fourth quarter to bring the YTD return to +18.3%. Small-caps and the international markets trailed the large-cap S&P 500, but both finished up double-digits for the year. It is worth noting that the headline S&P 500 return was boosted by a small number of large-cap stocks such as Apple and Google. Under the surface things were much different. For example, small-cap growth equities gained just +2.5% last year, gold prices dipped -4.2%, and the Hong Kong market was off -14.1%. Furthermore, some of the more speculative segments of the U.S. market were hit hard. For example, the ARK Innovation Fund, a poster child for aggressive growth, lost -23.6%.

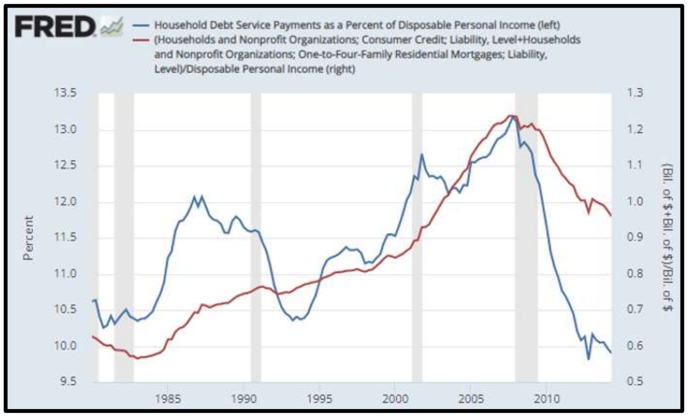
Bond market returns were generally underwhelming. Yields increased meaningfully in 2021 and intermediate-term government bonds lost -3.3% for the full year while short-term government bonds were off -1.1%. This was the first loss for U.S. government bonds since 2013, and only the fourth down year since 1976. However, there were pockets of resiliency. Lower quality corporate bonds gained +3.9% while bank loan funds gained between +2% and +3%. Conversely, emerging market debt struggled. Losses in this sector were in the mid-to-high single digits depending on the currency strategy.

From Delta to Omicron to ? – This time last year the Delta variant was running rampant throughout the world and posing major challenges for the medical system. As 2021 comes to a close we have moved on from Delta to Omicron. Omicron is certainly a different beast. The bad news is that it is very contagious. Close to 1.1 million cases were counted in the U.S. on January 3rd. While this was inflated due to delayed reporting over the holidays, it far exceeds last winter's high of less than 300K cases. We don't pretend to hold any great insight into the path ahead regarding COVID, but we take some comfort from the fact that Omicron appears to be far less deadly than Delta. For example, the new variant was first detected in South Africa. Case counts exploded there as well, but hospitalizations did not. As you can see in the chart below, mortality numbers are also little changed. Of course, the demographics in South Africa are different from those in the U.S., but the U.K. is much closer. There, case numbers are roughly 2X the previous high, but hospitalization numbers are relatively stable. The South African and U.K. examples give us some comfort that this isn't groundhog day – we are not on the path towards mass quarantines and shutting the economy down.



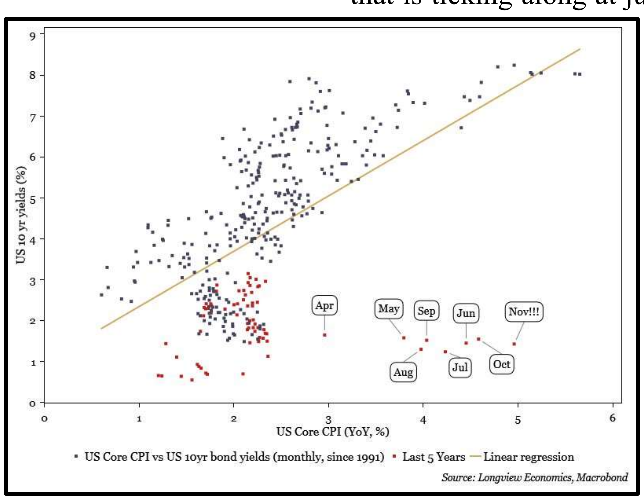
However, there are two important economic implications from Omicron. First, lives and businesses will be disrupted as people deal with temporary illness. Just witness the number of airline cancellations due to sick staff. This will do nothing to fix strained supply chains over the next couple months. Secondly, China's policy of 'zero tolerance' is looking more and more unsustainable. How they tackle this is an open question. Despite these two issues, there is a growing belief that COVID cases could peak in the first quarter, leading to an easing of restrictions by mid-year.

Don't Underestimate the Economy – Despite the headwind that Omicron is likely to present over the short- term, we think the U.S. economy should see another year of solid growth, albeit not as robust as last year's stimulus fueled recovery. A key argument for the optimistic case lies at the feet of the consumer. The red line in the chart at the top of the next page shows that consumer debt levels have fallen materially since the financial crisis. The more important line is the blue line. This shows how burdensome debt payments are for the average consumer. They are at the lowest level in the post-war period. Granted, those at the lowest income brackets are struggling, and things won't get easier now that the child tax credit expired, but in general, consumer spending should remain robust in 2022 baring an unforeseen shock.



The second tailwind for the economy is likely to be capital spending. One enduring lesson corporate America is likely to take from the COVID crisis is that they cannot rely on global supply chains. To address this, it will entail increased outlays to bring some production back into the U.S. From 2008 to 2020, corporate capital expenditures were basically flat and excess cash flow was funneled into dividends and share buybacks. However, this dramatically changed in 2021, and this should persist throughout 2022 and 2023. And the trend is likely to be exacerbated by the push towards 'net zero' carbon emissions. The level of investment needed to meet this goal is going to be enormous – credible analysts think we could spend over $100 trillion globally over the next 35 years.

We see two headwinds for the economy over the coming twelve months. The first issue is the slackening of fiscal spending. Many of the programs implemented during the teeth of the COVID crisis have expired or will soon. For example, the expanded child tax credit program that sent checks directly to lower income households recently sunset. This will directly impact roughly 35 million families. This so-called fiscal cliff could pull growth down by between 1% and 2% depending on whose estimates you believe. The wild card, of course, will be how quickly our political class turns towards the mid-terms and away from the legislative agenda this year.



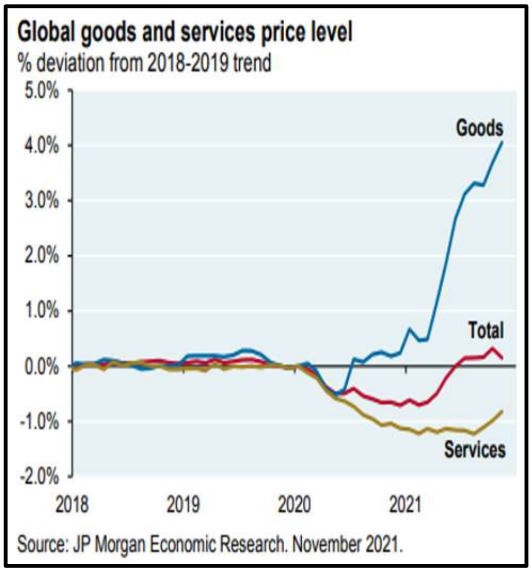
The second possible headwind are interest rates. As we discuss below, higher inflation is likely to force the Fed to raise rates this year, possibly starting in March. This will feed through into all sectors of the economy from housing to corporate bond issuance. How big of an issue this will be is unclear. The housing market in the U.S. remains very tight with exceptionally low inventory levels. Higher rates will probably bring the housing market off the boil, but much will depend on both the inflation picture and the Fed's response.

<u>What to Make of Inflation</u> – The big financial story for 2021 was probably the rise of inflation. Prices took off last year with inflation hitting the highest levels since disco balls were thought appropriate decorations. In November, headline inflation hit +5.7% while core prices excluding food and energy hit +4.7%. As you would expect, parts of the financial press declared an inflation crisis and threw around terms like hyperinflation and Weimar Germany. You'd be forgiven for thinking the market totally ignored the news, though. Gold prices declined, and as you can see from the chart below, bond yields became totally disconnected from inflation rates. What's going on?

The bond market is betting inflation cools over the next few months. The reason is tied to how our spending habits changed once COVID hit. The chart at the top of the next page shows that our collective spending on goods like Peloton machines and backyard BBQ's went through the roof once we were locked in our homes, and the prices of all those things soared. However, service prices remain subdued. The market is betting that this trend is nearing an end, and that could very well be the case if Omicron peaks in the next few weeks and we are back to some semblance of normality around the middle of the year. People will go from buying things to buying services (vacation anyone?) and this will alleviate some of the price pressures over the short-term.

The secular case for inflation remains, though. There are three factors behind this. First are rental prices. There is a huge disconnect between home price appreciation that is running at roughly +20% year-over-year and rental inflation that is ticking along at just +3%. Given the backdrop of a hot job market and rising wages, it is only reasonable to expect somewhat higher rental prices this year. And it doesn't take much of an increase to push the inflation numbers higher given that rent makes up over a third of most inflation indexes.

The second factor is wages. We have all encountered labor shortages in our daily lives, whether it is at local restaurants or trying to get a car repaired. The jobs market is exceptionally tight, and the number of unfilled positions is at all-time highs. As a result, businesses are being forced to increase wages to attract talent (chart at bottom of the page), and this will filter through to higher prices at some point.



The final dynamic is energy costs. The U.S. economy hasn't fully reopened yet and crude oil is knocking on the door of $80/barrel. Europe is suffering through a full-blown energy crisis with natural gas prices up multiples over the last year. At the heart of the problem is relatively robust demand and a lack of investment in productive capacity over the last few years. As much as we might not like it, oil and gas remain key inputs, and higher prices are going to either weigh on profits or boost inflation this year. This will become doubly so if Omicron becomes less of an issue in the second half and people start travelling again.

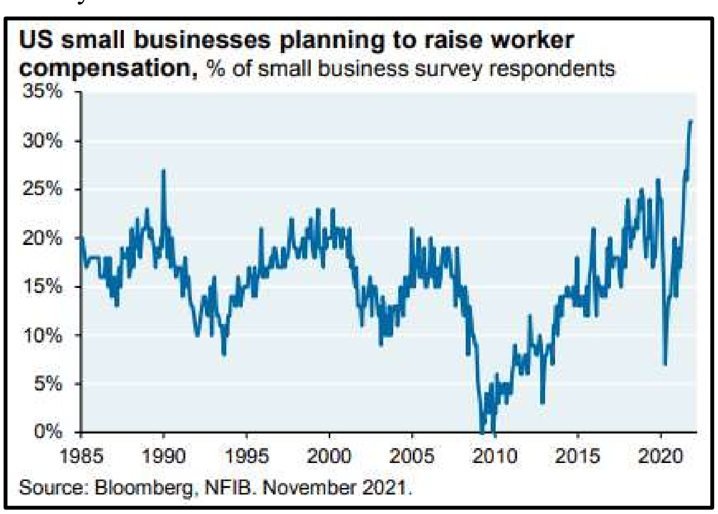
The bottom line is that inflation may moderate somewhat in the first half of this year as supply bottlenecks ease and last year's price shocks fail to repeat (used car prices are unlikely to double again!!). However, we think inflation is going to run hot for some time to come. How hot is really anyone's guess, but somewhere between 2.5% to 3.5% seems likely. This isn't hyperinflation by any stretch, but it is higher than we've experienced in many years.

<u>What's it All Mean for the Markets?</u> Before we pull out the crystal ball, we should discuss what we call the hierarchy of financial market prognostication:

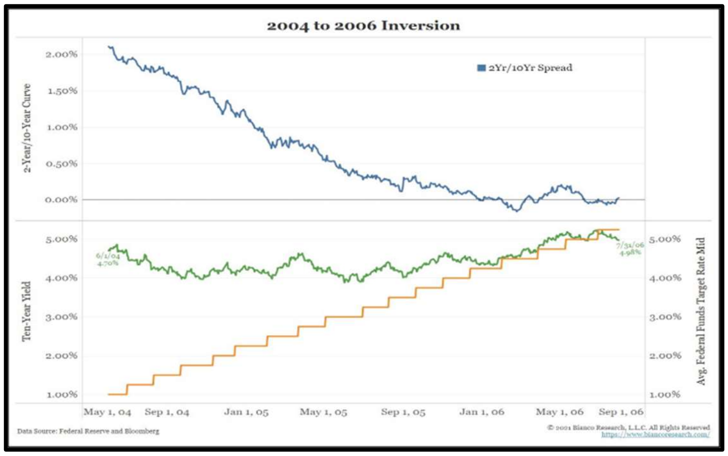
1. At the top of the pyramid are facts. Naturally they are few and far between when it comes to market outlooks because we are trying to predict the future.
2. The next level down are what we'd call logical inferences from past events. This is where we try to overlay past experiences on today's environment. For example, usually when the Fed increases interest rates the economy eventually slows. Not always true, but there are enough examples to give you some confidence in the prediction. At the end of the day, we are talking about tendencies.
3. At the bottom of the pyramid, because they are so numerous and pervasive, are outright guesses.

What do we know with some certainty? We'd argue that while not a fact yet, the Fed raising interest rates in 2022 is about as close as you can get to a given. The market is placing 90% odds on three hikes this year and 60% odds on four hikes. A hike at the March meeting is quite possible. We also expect the Fed to start reducing the size of their balance sheet this year (quantitative tightening – QT).

When the Fed has hiked rates in the past, what has happened? This now gets us deep into logical inference territory. The chart at the top of the next page shows the Fed rate hike cycle from 2004 to 2006 (orange line) and the yield on the 10-year Treasury (green line). The top panel shows the spread between the 10-year and the 2-year bond. As you can see, even though the Fed hiked rates in 2004, 2005, and 2006, the yield on the 10-year didn't move much. Furthermore, the spread between the 10-year and 2-year narrowed significantly to the point it went negative (a so-called inverted yield curve). We saw something very similar during the rate hike cycle from 2015 to 2018, although 10-year yields increased modestly. One inference from this is clear – Fed rate hikes usually flatten the curve but don't necessarily push up long-term yields. Now this cycle could be different because inflation is running much hotter than in the past, but we probably will have to temper our bearishness about bonds at some point in the next few quarters. For the time being we are playing bonds with a barbell approach – overweight corporate credit where you can still earn positive real yields, and overweight short-term bonds to keep some dry power. There is every chance intermediate-term government bonds have another down year, but there could come a point in the next couple years where increasing traditional bond exposure could make some sense if the Fed hikes rates too far.



Another thing that jumps out at you when you look at past rate hike cycles is the fact that once the Fed starts hiking rates, they typically don't stop until they break something. During the 2004-2006 period they ended up popping the housing/credit bubble. In 2018 they didn't cause a recession, but they did trigger a bear market in equities. A flat or inverted yield curve was an early warning sign that the Fed had gone too far. Does this mean stocks are at risk today? The historical pattern says not necessarily. Typically, stocks are higher twelve months after the first rate hike. Trouble usually doesn't set in until years two or three. Today's positively sloped yield curve also gives us a green light for now.



But we do think there are areas of vulnerability. Rate hikes combined with QT means the liquidity environment is getting less favorable. This may not be good news for those highly leveraged companies that do not make money and rely on issuing new debt or equity to fund themselves. As you can see below, the percentage of growth stocks that aren't profitable has never been higher. We think this segment of the market is at risk in a tighter liquidity environment and are avoiding it. We'd rather own higher quality, lower valuation stocks with solid earnings and cash flow. However, if the selling in the speculative sectors picks up too much, we could see a 10%-15% correction in the broad market. Rather than trying to time the unknown (trying to do so would be nothing more than a guess), holding a balanced portfolio is the rational way to deal with such uncertainty. At the end of the day, higher quality U.S. stocks should see earnings growth in the low double digits in 2022, and while multiples will probably contract (just as they did in 2021), we think we see another year where good quality stocks outperform bonds by a decent margin (albeit with much more volatility).

Finally, the biggest question longer-term is how far will the Fed hike rates this cycle? Will they keep pushing rates up and risk a recession to fight inflation, or will they back off at the first sign of unease? All we can do here is make an educated guess – we think the Fed will back off before the economy rolls over. After all, the total debt load in the United States today is over 400% of GDP, something we have never seen before. It won't take much of a rate increase to put pressure on the economy, and no politician alive today will tolerate a prolonged deleveraging cycle regardless of how high inflation is. And we should not forget that governments have a long history of inflating away their liabilities. This is exactly what we did during the 1940s and 1950s to deal with the massive debt built up during WWII.

Data through 9/30/2021 | Source: Source: GMO
*The universe and rebalancing methodology is similar to that of the Russell 3000, but the definition of "Growth" is a proprietary GMO composite of metrics.

Looking Ahead – Another year is in the books, and for all the teeth gnashing and anxiety, it proved to be a good year for global stocks and investors in balanced portfolios. Equities shrugged off worries about inflation and COVID and proved once again that earnings are ultimately the key driver behind stock returns. We suspect 2022 proves to be a lower octane version of 2021 – earnings continue to grow, inflation percolates, multiples contract, but in broad terms, stocks once again beat bonds. Under the surface we are worried about the more speculative segments of the market in a tightening liquidity environment, but we think this is a year of rotation into higher quality companies, not anything worse. We also think we'll be talking about heightened inflation risks for some time to come. As a result, we probably see much more volatility this year, but we don't think the Fed will risk a recession to bring inflation down. Now whether they decide that on their own or the market forces them to that conclusion remains to be seen.

David L. Gemmer
Charles Blankley, CFA