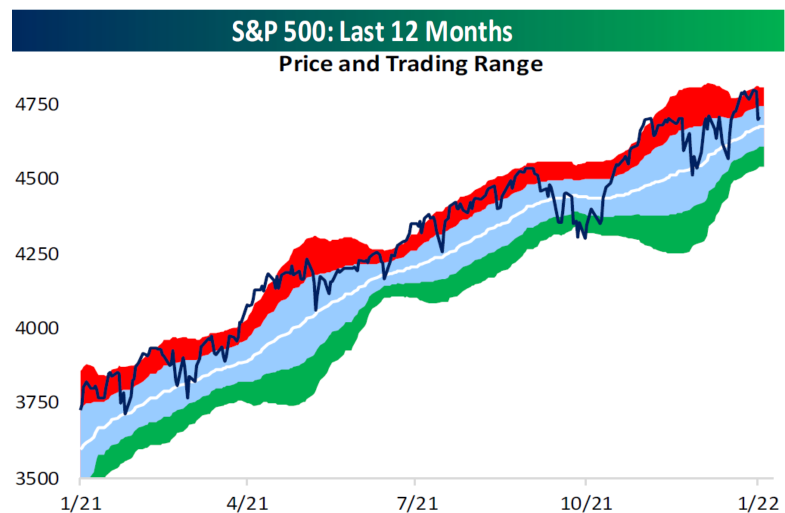
Capital Ideas

01/12/2022



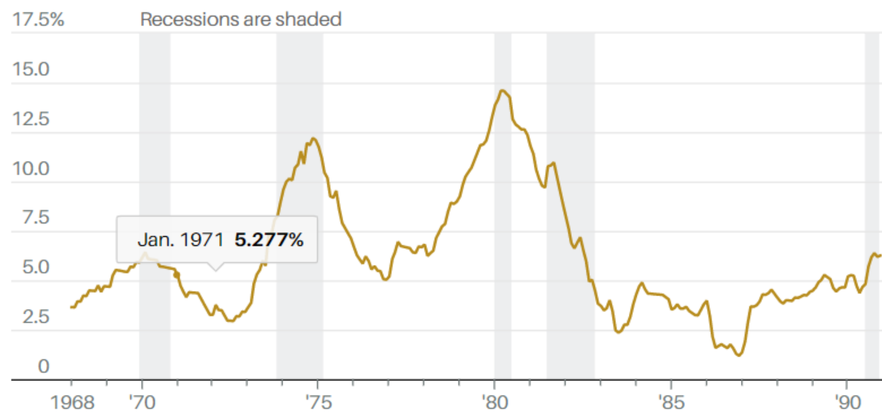
Source: Bespoke Investment Group

At the end of every year we remind you that we agree with Yogi Berra. "Predictions are difficult especially about the future". And they seem to become more difficult as the news flow accelerates making information more abundant but its useful lifespan ever shorter. Successful investing involves rapidly converting information to useful knowledge and then synthesizing a workable investment thesis from it. That thesis could be as broad as an interest rate theory involving central banks or as specific as which company is best positioned in an industry. Long-time clients know we try to do both. First, we develop a view on the economy then select investable industries and determine the best approach to invesst through either buying ETF's or specific companies which fit our thesis. In addition to using this type of fundamental analysis for investment selection, we make use of technical factors to try and time optimal entry or exit points for selected investments. That process enables us to deal with the difficulty of predicting the future. Rather than make random assumptions or repeat other people's opinions we base our judgements on established data sources such as S&P, Bespoke Investment Research, or MRB Partners along with data from the Fed and BLS. That will apply now to our "predictions" concerning 2022.

Corporate earnings are the major determinant of stock prices, and the market is forward looking so future earnings are the most important element. As a result of expected strong economic growth, average predictions for S&P 500 earnings are a record of $240 "per share". Still, we believe the Fed will tighten meaningfully this year and that will hold the markets advance in abeyance for

The Great Inflation

The consumer-price index jumped 186% from 1968 to 1983. The period of hyperinflation ended with a recession.



Note: Seasonally adjusted.
Source: Labor Department via St. Louis Fed

the first part of this year. However, as markets adjust and look forward to continuing strong earnings growth, strength in the later half may push the S&P 500 up for a total advance of 10-12 percent this year. That opinion is based on two factors. First, corporate return on equity at 19% is at record highs. Secondly, that is being achieved without high leverage by companies that are cash rich and relatively debt free. So, profits are from operations not financial engineering. We note that many companies have raised new capital at record low cost and therefore can continue to churn out these solid profits regardless of Fed policy. Along with this broad outlook for higher stock prices is our continuing cautious approach to bonds. As you know, we have been negative on holding portfolio allocations to bonds for several years now.

We believe last year was the first year of a long bear market in debt securities. A quick glance at the long-term inflation chart contained in this letter is worth the 1000 words needed to explain our position. As we predicted some years ago, inflation has likely seen its secular low. Because bond prices normally correlate inversely to levels of inflation (i.e. higher levels of inflation generally result in lower bond prices and vice versa), we believe the long bull market in debt has seen its highs. As central banks begin to providing less monetary stimulus, easing back from the financial repression of the last ten years, rates should rise seeking a more natural level. Bond prices, moving inversely to interest rates, will respond accordingly with the greatest losses occurring in the longest maturities.

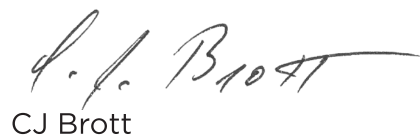
Inflation has been a topic of great concern for investors recently The most recent annualized CPI rate of 6.8% is the highest in nearly four decades. When making our 2019 predictions for 2020, we discussed the possibility of increasing inflation being caused initially by supply chain induced shortages, which could develop into an inflationary wage price push. Over time, that push can develop into a wage price spiral. Combined with a shrinking labor force the phenomenon has already been seen in two recent labor contract - Deere and Kellogg. In both cases, the union opted for COLA contract clauses rather than immediate pay increases. Based on our view regarding the higher probability for increasing inflation we continue to avoid bonds and last year started investing instead in commodities. As 2022 unfolds, we believe price inflation will continue but not at the extreme levels many commentators are predicting. We still believe

that the continuing adoption of advanced technology will be the moderating force to inflation in our postindustrial economy.

Because the secular change in the trend of inflation is so important, as 2022 unfolds Federal Reserve policy will continue to be a greater focus for us than is normal. Its policy has a direct bearing on bond prices but is less quantifiable for stocks. Interest rate changes work directly as discount factors for bonds whose returns are contractually guaranteed. For stocks, whose earnings are less predictable, the effect is less determinate and works in two ways. First, by raising the cost of capital the Fed can slow or speed corporate growth and therefore earnings. Currently this effect is blunted because corporations are unusually liquid and therefore do not need bank loans to fuel growth. The more important issue is the implicit discount factor interest rates have on P/E ratios when applied to future earnings. Many of the most promising companies have developed exceptionally high price-to-earnings ratios as the secular bull market progressed and the Fed continued holding interest rates artificially low. As the Fed pivots to a normalized rate structure, the adjustment to lower P/E's has been abrupt and is probably overdone. In our opinion, much of the selling in high technology stocks will finish in the first half of 2022 and earlier investments made in high technology companies should be held. Any new technology investments should be made in older companies whose management is fully committed to restructuring for the new economy. It is our belief that more companies such as Microsoft (which pivoted 3 years ago with a new CEO), GM and IBM will emerge. This will happen as the benefits of investing in new technology new thinking and new methods of doing business become apparent. Much like the period 100 years ago, new management with new methods, combined with a younger, more flexible generation of workers exploiting the wreckage of the old industrial economy will create the high return companies of the future. We believe the advent of COVID and the changes it forced was an accelerant to this wave of creative destruction. And much as the Spanish Flu marked the beginning of the original Roaring 20's, COVID may usher in this decade of rapid growth.

In summary, we view 2022 as a pivotal year. As interest rates normalize and hopefully life returns to a pre-COVID normal, we look forward to continuation of several important trends. Corporations will continue to profitably incorporate greater amounts of technology into their operations. Artificial intelligence will expand and accelerate the development on everything from new drugs to unforeseen business opportunities. Bonds will again become "certificates of confiscation" and stocks will remain the best long-term hedge against inflation.

Sincerely,



CJ Brott

Karen Burns