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2021 Year End Review: Extraordinary Influences

Executive Summary

- A strong economy in early 2020 was upended by Covid and gargantuanly supported by fiscal and monetary action. Now, we have good economic conditions with higher-than-normal GDP growth, a strong labor market, and consumers and companies with strong balance sheets. Economically speaking, Covid and massive stimulus has created an inflation problem with supply and demand imbalances.
- We entered 2021 with the Federal Reserve pumping out full monetary support: overnight interest rates pegged to zero, heavy bond purchases to keep longer term interest rates lower, Federal government stimulus payments – round two approved on 12/29/20 at ($900B), with round three ($1.9T) approved on March 11th, weekly unemployment benefits extended, larger child tax credit (paid in advance), emergency rental assistance program, and student loan payments suspended. Counter to the support were waves of Covid variant spikes in January, June (Delta), and December (Omicron).
- If we ever get back to normal monetary and fiscal policy, we are not sure anybody will recognize it. But extraordinary fiscal and monetary programs are being wound down. The Federal Reserve plans to begin moving the Federal Funds rate up in March.
- Let's say that inflation made its way back down to 2%, add 1% (for the Fed's target for the natural interest rate), the Federal Funds rate should be 3% if we were back to normal monetary policy. Even if the Federal Reserve raises the Federal Funds rate four times this year, they will still be in a very accommodative position with the Federal Funds rate at 1.15%. **The Federal Reserve median projection for core inflation and the Federal Funds rate is 2.1% in 2024. That is still a very supportive stance almost three years from now.**
- Extraordinary monetary policy began in 2009 to help bring an end the Financial Crisis. All of generation Z (born 1996 to 2015), most of millennials (born 1977 to 1995), and even some of generation X (born 1965 to 1976) may not recognize just how loose monetary policy is and will continue to be. That is good news for increases in the Federal Funds rate to have a desired effect of containing inflation.
- What will the future course of Covid look like? Is Omicron indicative of a winding down of the potency of Covid?
- **It could be argued that the course of Covid will have more to do with containing inflation than the efforts of the Federal Reserve to lessen monetary support.**
- **Less influence from Covid could help lower inflation in two ways. 1. More people could go back to work, thereby lessening labor supply shortages. 2. Consumer spending could get back to a more normal balance of demand between services and goods, lessening the supply and demand imbalance for goods.**
- **<u>If it is agreed that planned Federal Reserve action will not likely resolve our high inflation problem</u>, and if Covid does not reach endemic status, then either we learn to expand our creativity to live with Covid or inflation will resolve itself by lowering demand**.

Macro-Economic Perspective

- Real GDP grew at a 6.3% annualized rate in Q1 and exceeded the previous peak in GDP that occurred in Q4 2019. Q2 Real GDP grew at an annualized rate of 6.7%, Q3 Real GDP growth was 2% annualized, and Q4 Real GDP growth was 6.9%. **Year over year GDP growth was 5.7% in 2021.**
- **4.9% of the 6.9% GDP growth in Q4 came from an increase in inventories. Normally, that would be unwelcome news for industries to over-produce. In the present environment an increase in supply is very welcome news.** One could argue that omicron reduced demand, but the counterargument is that it also could have dampened production. **The likely impetus for the inventory build-up was a very encouraging gain in productivity in December of 6.6%.**
- **Most recent projections for real GDP growth in the USA center around 4% for 2022 and 2.5% for 2023.** The 2022 forecast was recently lowered by 0.5% to 1% considering supply chain issues.
- Real disposable income (adjusted for inflation) rose 2.1% in 2021. Excluding government transfer payments, real disposable personal income rose 3%. This is just a point of interest, as massive as fiscal support was in 2021, it was even greater in 2020. Source: U.S. Bureau of Economic Analysis.
- Now that federal government transfer payments are close to pre-pandemic levels, the savings rate returned to the pre-pandemic level of 7.5% in Q4.
- **There has been a massive increase in M2 money supply (cash, checking and savings deposits, money market, mutual funds, and CDs) of 42% from February 17, 2020, to the end of 2021.** We expect to see the Federal Reserve return to their practice of maintaining a 3% to 6% increase in the money supply each year. Source: Federal Reserve Bank of St. Louis.
- **This bubble of money supply along with healthy personal income provides a backdrop for the healthy economic growth forecasted.**
- The velocity of money (the frequency at which one unit of currency is used to purchase goods and services within a given period) continues at an exceptionally low level. This lowers the risk of money supply growth adding to the inflation fire.
- **Household net worth peaked at $111.04T at year end 2019. Since then, it has risen 23.2% to $136.89T at the end of November 2021. This is also supportive of economic growth.** Source: Federal Reserve
- **Total personal consumption was up 13% year over year at year end, not adjusted for inflation.** Source: U.S. Bureau of Economic Analysis.
- On an inflation adjusted basis, **Consumer Spending (70% of USA economy) exceeded the pre-pandemic level in Q2 and continued up 2% and 3.3%, annualized in Q3 and Q4, respectively.** <u>Services expenditures also have now exceeded the pre-pandemic peak</u> as goods did in the 3rd quarter of 2020. Source: U.S. Bureau of Economics.
- **The recovery in the economy beyond the pre-pandemic peak level has been accomplished with employment still lower by 2.9 million workers.**
  - There are 10.9 million job openings, up 0.5 million since Q3 end.
  - Officially, there are 6.5 million unemployed.
  - **Labor supply remains an issue.** Extraordinary solutions are necessary including but not limited to use of automation, higher participation rates are becoming more challenging with the baby boomer generation having reached or reaching age 65 between 2011 and 2029.
  - **Supplemental data in U.S. Bureau of Labor Statistics indicates that there are 1.8 million people unable to look for work due to the pandemic. Let's hope this available pool of workers is higher than reported. As is, this represents a potential increase in the employment participation rate of 1.2%.**

Key Economic Data Points: Inflation Readings Still Worrisome

For December, personal consumption expenditures (PCE) price index was 5.8%, the core reading was 4.9%. These inflation readings rose throughout 2021. **The pace of the increases decreased in December**. Could this be a turning point? Last quarter we introduced the Federal Reserve Bank of Atlanta's

Sticky inflation Index (weighted basket of items that change price slowly, such as wages and haircuts), it has continued to trend up to 3.5% in December from 1.5% in January. FYI: Higher inflation does not necessarily equate to negative market returns. The average rate of return for the S&P 500 during the 17 highest years of inflation in the USA was 9.4%. Twelve of the 17 years had positive return. Two of the five negative years occurred during the oil embargo (1973 and 1974).

The Federal Reserve has had to eat some humble pie regarding their belief that inflation would be transitory in 2021. DBFM tended to agree with them. Continued waves of Covid strains have altered the landscape. We refer you back to the last three bullets in the Executive Summary on page one.

Although, we do not expect a less accommodative Federal Reserve (yet still accommodative) will cure the present demand / supply imbalance issues causing inflation, we do believe it is the proper course of action as not to exacerbate the problem.

Industries have been highly creative in dealing with Covid as evidenced by surging GDP beyond the pre-pandemic peak level with 2.9 million less workers. We do need to break from Covid to epidemic status or we need to continue to be creative.

Longer term we have concerns with low growth and low inflation because of high government debt.

Growth Projections look promising. Projections for real GDP growth in the USA center around 4% for 2022 and 2.5% for 2023. Global growth: 4.3% and 3.5%, respectively. Euro-area: 3.8% and 2.3%, respectively. U.K.: 4.2% and 2.1%, respectively. China: 4.7% and 5.2%. South Korea: 3.2% and 2.7%. India: 8.3% and 6.4%. Japan: 3.4% and 1.7%. Canada: 4% and 3.1%. Mexico: 2.8 and 2.1%.

Employment: There is evidence that corporations are raising capital investment for automation to help deal with lower employment participation rates since Covid. GDP growth can be achieved via greater employment and/or greater productivity from a given employment level. **Job openings were 10.9 million at year end. This represents 7.3% of the present workforce in the USA.**

Consumer spending (70% of GDP): Personal consumption expenditures (annualized) exceeded the pre-pandemic peak in June and were up 13% for the year (including inflation). The Institute of Supply Management (ISM) reading for service continues at elevated levels, October 66.7, November 69.1, December 62.3, and January 59.9. The trend is down the last two months (Covid spike), but these are exceptional numbers. A reading of 50 is the dividing line between decline and growth.

Manufacturing (11% of GDP): The ISM reading for manufacturing also remains high October through January ('22) at 60.8, 61.1, 58.8, and 57.6, respectively. The trend is down but is still elevated. **The Federal Reserve reported a 4.0% increase in industrial production in the 4th quarter. This is the sixth consecutive quarter with a gain of at least 4%. Expect a short-term benefit of a shift away from "Just in Time" inventory management towards "Just in Case" inventory build-up in reaction to Covid's effect.**

Construction (4.1% of GDP): Construction rose 9% in 2021 from $1.5042T 2020-year end to $1.6399T 2021-year end. Residential construction was up 14.7% while non-residential construction was up 3.9%. Data from the Department of Commerce.

Home sales: National Association of Realtors (NAR) reported that existing home sales were ups 8.5% in 2021 at 6.18 million homes. New household formation was 1.6 million in 2021. (Data from Fed Reserve of St. Louis). New residential construction unit permits (1.873 million), new housing unit starts (1.702 million) exceeds new family formation. (Data from U.S. Census Bureau). This increase in supply is most welcome given a lack of inventory. **The NAR reports that supply of homes for sale is an extremely low 1.8 months.** Six months' supply is considered a balanced marketplace for buyers and sellers. NAR also reports that **the median price for a single-family home sold peaked in June and has leveled off since then at**

around $358,000. Affordability will remain a problem, especially for first time buyers as long as inventory remains low, and the Federal Reserve raises rates in 2022 as projected.

Securities Market Perspective

In 2021, a 100% stock portfolio with 20% invested in international was up approximately 23.51% with dividends reinvested. Intermediate term bonds (Barclay's Aggregate Bond Index) were down 1.61%, an improvement from a decline of 3.57% by the end of Q1, and short-term bonds were down 0.47% (Barclays U.S. Gov't Credit 1 to 3 Year Bond Index).

One would think that interest rates would have risen more (bond prices down more) in 2021 with higher inflation. But the Federal Reserve was buying massive amounts of Treasuries and mortgage-backed bonds to keep longer bond rates down. The existence of $10T in negative yielding foreign government bonds (down from $18T in 2020), creates additional demand for USA bonds. The Federal Reserve started reducing their bond purchases in late November and plan to end the purchases in March this year, in addition to raising the Federal Funds rate beginning in March. **Since a recent low of 1.35%, the 10-year Treasury bond yield has increased to 1.93% as of 2/4/22. The market yield is rising ahead of the planned action by the Federal Reserve.**

Valuation Discussion Points:

- **By the end of the year, as measured by price to book value, growth stocks were 180% above their long-term average of 4.83 at 13.51. Value stocks were 23% above their long-term average of 2.18 at 2.68.**
- For the year, on a weighted average basis, growth stocks were up 24.7% and value stocks were up 24.92%.
- Large cap growth recovered significant ground with the two Covid resurgences in the last half of 2021 and outgained large cap value by 7.78%. But value beat growth in mid-cap and small cap stocks on the year by 15.61% and 25.43%, respectively.
- It is interesting to note that large cap growth performed better than large cap value when Covid was spiking. We estimate there is a draw to stay at home tech (large cap growth) when Covid is threatening. But mid-cap and small cap growth categories have a larger percentage of companies with low or no earnings. Their valuations are dependent on future earnings which are worth less in present value when interest rates rise.
- **Low interest rates were providing cover for higher valuations particularly for growth stocks. With assurances of interest rate increases, you can expect greater headwinds for growth stocks in 2022.**
- In 2022, investments with the greatest declines are highly speculative, such as meme stocks (GameStop Corp), SPAC (Special Purpose Acquisition Company) sometimes called blank-check firms—begin as shell companies – such as DraftKings, and crypto currency. Declines have been as high as 40 to 90%.
- As of 1/31/22, one third of the S&P 500 companies had reported results for the 4th quarter. Earnings per share gains are forecasted to be 24% and sales gains at 14% for the quarter.
- **Going forward, we expect the pace of earnings growth to stay healthy but decline from that experienced in 2021 when comparisons to the previous year was easy. Therefore, we expect future gains in equity prices to come along more grudgingly than they have since the end March 2020.**
- **Investments with better (but not high) correlation to higher inflation are natural resources (copper and oil), value stocks (especially with pricing power and dividends), energy, and real estate. Gold is farther down the list.**

Bonds:

- In 2021, lower quality bonds performed well. Conversely, highest quality bonds experienced negative return.
- The Federal Reserve is informing of interest rate increases in 2022. Market interest rates are already rising ahead of their planned action. This will not end the stretch for income as nominal interest rates will still be low and real interest rates will be negative.
- We anticipate that the economy will perform well in 2022 which will be supportive of high yield bonds (low default rates). With rising interest rates, high quality and low duration bonds should also perform better. Short term/low duration bonds are less impacted by rising interest rates.
- Counter balancing of portfolios remains an important hedge against volatile equity markets. DBFM continues to pursue additional avenues to enable positive bond return and portfolio income in this low and rising interest rate environment. While we were successful in 2021, this remains a challenging task.

Wrap up:

- High savings, high money supply, healthy consumer and corporate balance sheets, and potential for significant employment growth point to continued economic strength and growth.
- Inflation, emotional reaction to rising interest rates, and military conflict can lead to near term stock market volatility, but they are not highly correlated to annual market declines.
- The course of inflation is dependent upon reducing or eliminating supply constraints. Labor supply/participation and semi-conductor supply constraints may offer the greatest challenges to resolve.
- The path of Covid and man's ingenuity may have more to do with resolving supply constraints and inflation than Federal Reserve policy change.
- Cheers to much lower extraordinary influences in 2022 and beyond.

Please feel free to contact us with any questions, or if you would like to schedule a virtual, face to face, or phone meeting.

Thank you,

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