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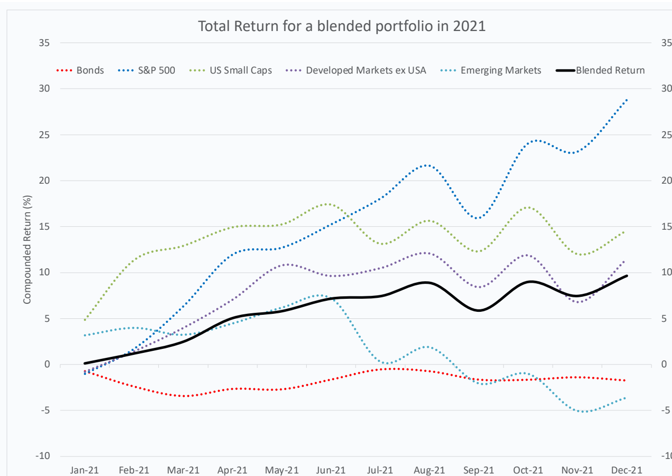
WHERE WE STAND – Q4 2021

A blended portfolio* of equities and bonds was up 3.49% in Q4 2021 and up 9.6% for the year 2021. See the black solid line in the chart below. The contribution to returns were led by US large caps (S&P 500), whereas bonds and emerging markets weighed on performance. US small caps and developed markets (ex US) rallied early on and

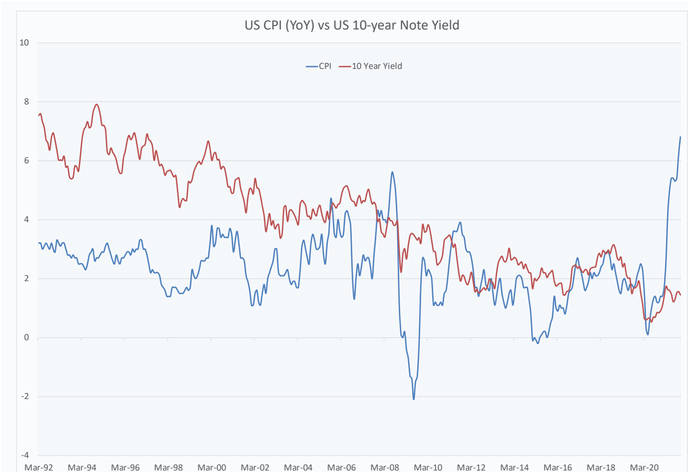


then meandered sideways for the remainder of the year. See the colored broken lines in the chart.

*A typical blended portfolio would be comprised of 60% equities and 40% bonds. For a benchmark, such a portfolio would arguably be 30% large cap US stocks, 10% US small caps, 10% developed markets ex-US, 10% emerging market stocks and 40% US government, investment grade corporate and GSE bonds.

US economic recovery continued to progress in the final quarter of the year as evidenced by the unemployment rate declining to just above 4% from 6.7% at the beginning of the year. S&P 500 earnings forecasts for 2022 continued to be edged upwards from $200 per share in early March 2021, to currently, around $220 per share as shown in the next chart (blue line). At the same time investor confidence remained highly elevated, with forward valuation multiples rising to over 22x earnings (black line). Therefore, both an increase in earnings expectations and, more so, an increase in earnings multiples, accounted for the rise in equity values during the year.

Although, US inflation (CPI) rose to over 6% during the quarter (blue line in the chart below), counterintuitively, bond yields remained suppressed, holding below 2% (red line). This fact is, largely, owed to the massive



purchase of long dated bonds by the Federal Reserve. Given the status of the 10-year treasury note as *the* discount rate used to value longer duration financial assets, this acted as a major underpinning to the valuation of such assets.

So, with bond yields contained and earnings expectations high, along with relatively high PE ratios,

the current narrative that financial markets are trading off of imply, rightly or wrongly, that:
-The US economy should continue to grow and avoid recession over the next number of years.
-Earnings will continue to expand without any pause.
-Although the Federal Reserve has indicated a concern about inflationary pressures in the economy, and although they will continue to tighten monetary conditions (including raising short term interest rates by around 1% in 2022), the result will be benign: a taming of inflation, and these actions not tipping the economy into recession.
-Although the immense, deficit financed, fiscal stimulus of the last two years will be coming to an end, this will not have too much of a negative effect on consumer demand, and not weigh too much on economic growth. (Pres. Bidens BBB plan, if passed, may influence the outlook. For now, there is uncertainty relating to its details, for example a change in the corporate tax rate.)

Of course, the reality of the investment environment in 2022 will test all these narratives in one way or another.

As you can imagine, investors are making generously sanguine assumptions especially since the backdrop to them is the unprecedented monetary and fiscal action from the financial authorities that have essentially robbed financial markets of the ability to objectively conduct price discovery of financial assets. For example, owing to the huge debt financed fiscal stimulus in response to the pandemic, US personal income, remarkably, actually went up in the (historically short lived) recession of 2020. One result was stay-at-home individual investors with limited opportunities in the real economy using that government created windfall to speculate in financial assets. And, on the monetary side, the Federal Reserve continued to buy trillions of government bonds and held interest rates at 0% while inflation rose towards 6%, an inordinately unorthodox policy move. This too has created valuation excess by causing yield starved investors to move further and further out on the risk curve to achieve some sort of income return.

The lesson of the last two years has been that monetary and fiscal authorities are increasingly pushing the boundaries of economic policy, via exceedingly loose financial conditions and deficit financed government spending, with ever decreasing efficacy, as evidenced by the general slowdown in the growth rate of the US economy in recent decades, notwithstanding this policy largesse/irresponsibility. Along the way they have created both increasing distribution of income issues (which will have important social and political effects in the future), and speculative financial market activity.

By the way, under the surface of the ongoing rally in large cap indices, which is led by an ever-narrowing list of names, the speculative excess has begun to be wrung out of quite a few areas of the market. Spacs, meme stocks, non-profitable tech stocks and many IPOs have seen marked price corrections in recent months. Off their highs: Zoom Communications (-70%); Peloton (-79%); Robinhood (the go to stock trading platform for stay-at-home traders, -78%); Roku and DocuSign (-50-55%); Ark Innovations (the fund that holds all the new-age technology stocks, -41%); SPAC ETF (-38%) and an IPO ETF down 26% in 2021.

Where We Stand

Our portfolios have held their own this year.
Although we have a much lower risk profile than the typical 60:40 portfolio mentioned at the beginning of this piece (including because our cash allocation is higher than 'normal'), we have achieved acceptable positive returns. This has been an unusual investment cycle in terms of its longevity, which we suggest is owed to the increasing disregard that policy makers have towards fueling longer term distortions in the financial structure of the economy.
We have stayed with value stocks and ETFs that all are very fairly valued with earnings multiples below the market average and all that pay healthy dividends. In addition, we have concentrated on being opportunistic during market pullbacks (which, so far, have unfortunately been few and far between).

We intend that the beta* of our portfolios will be lower than that of the market when we are late in the investment cycle, as we are now and when true value propositions are few and far between.

Our portfolios will benefit if financial assets continue to appreciate, and at the same time if the investment cycle turns, we will achieve relative preservation of capital and be able to find true investment value propositions that will be to our benefit in the future.

*Beta: The movement up or down in a stock or portfolio of stocks relative to that of the overall market. For example, if an index moves up 10% and a portfolio of stocks moves up 6%, the beta of that portfolio is 0.6.

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