

2022 OUTLOOK

The Re-opening Of America, Part II - Living With Covid

Winter Newsletter - January 2022

We have officially entered year 3 of this pandemic.

2021 was a year pretty much everyone was yearning for, wishing to put 2020 behind us. It didn't pan out that way. More bluntly, 2021 was a year of fake outs. Hopes of bending the curve and beating the virus did not come to be. New variants popped up overseas, which quickly spanned the globe and inevitably landed on American shores. The re-opening of America has been beyond bumpy. There is some serious Covid fatigue. People are done with the virus, but the virus clearly isn't done with us. Living in Covid has become the main theme on Planet Earth.

RELENTLESS & REMARKABLE BULL

On paper, 2021 was a great year for investors. But somehow, it never felt that way. The Stock Market did much better than we and most on the Street anticipated. The year started with a crisis, unlike anything we've ever seen. Our nation's Capitol was attacked as Congress was certifying the election in our traditional and distinctive peaceful transfer of power.

The year did not start out well. The political divide continued to widen. After 2020, it didn't seem possible. But it is. Americans in general aren't excited about the path ahead. The University of Michigan's Consumer sentiment survey fell 13%, to 70, in 2021, the lowest end-of-year reading since 2008. That was the year of the Financial Crisis. People were not excited about 2021.



THE YEAR AHEAD



2022 will no doubt prove eventful. Corporate Earnings and the US Economy are still growing. But their growth rates are slowing. The Fed will continue to remove its aggressive life support policies from the financial system which were enacted in response to the Covid Crash. 3 interest rate hikes are already priced in. Will we get 4? The re-opening of America is an ongoing process with more fits and starts expected, but significant forward traction is likely. And of course, there is a midterm election in November. The campaigning and positioning have already begun. The stakes are high. Washington and our nation remain dead-locked divided. These are major ingredients for a volatile year for investors.

We are long-term investors. But we find ourselves hyper-focused on the short-term right now. There has been a rolling correction beneath the Market surface for months. The 2020 rally was led by the most growthy, disruptive digital companies in circulation. It wasn't about profits. It was all about the future in this Digital Age. Covid accelerated trends already in place. The physical economy was shut down and left behind. Those stocks reflected the shock. After 12 months of the raging Bull Market in Tech, the high-flyers finally experienced gravity. Growth stocks came back to Earth while the re-opening plays in the physical economy came back to life.

Leadership rotated so fast and furiously in 2021. There were so many fake outs. This trend shows no signs of abating in the dawn of 2022. The Market is putting a premium on predictable profits and value right now. The tightening Fed policy has recalibrated things. Future cash flows are worth less in a rising rate environment with less liquidity. It's been an adjustment period. Some of the most compelling long-term growth stories have been penalized. That creates a buying opportunity for quality assets on sale. But it takes patience. We see the first half of the year focused on profits and value. The second half could be setting up for a return to growth stocks. The process has been bumpy. We expect it to stay bumpy.

WHATEVER IT TOOK WORKED, PERHAPS TOO WELL



The 2020s have brought boom-bust characteristics, with heightened volatility. Cheap money pumps up the value of assets. That's the Fed way to deal with a crisis. The Fed said it would do whatever it takes to defend against the crisis. The Central Bank went bigger than it's ever gone before to combat Covid. The result was a soaring Stock Market led by hyper-growth companies. The present value of an investment's future cash flows goes up as the interest rate to finance that investment goes down. It's contagious. It triggers animal spirits which often leads to euphoria. It achieved euphoria along the way. Euphoria certainly doesn't exist today.

Cheap and abundant capital can justify all manner of wild and speculative investments. It was all on display from electric vehicles to stationary bikes connected to the web to volatile cryptocurrencies. It's an exciting time to be an investor with so much innovation and disruption. It just needs to stay grounded in reality. When it ends, the pain shows up. That's been evident the last few months as the Fed prepared its taper. Compelling opportunities exist with companies seeing bright and predictable futures for growth while their stocks got clobbered. Not all look attractive. But there are some long-term gems amidst the rubble. Taking the long view requires patience. We will be investing there.

THE RE-OPENING OF AMERICA, PART II



The US Economy remains in growth mode, still recovering from the forced recession. But that growth is slowing. 5% growth in 2021 will lead to something closer to 3% in 2022. The Economy should still grow faster than it did pre-Covid. The new variants have certainly created friction to the re-opening of America, but the road to recovery is still the current path. Demand for stuff is strong. Supplies can't keep up. Strained supply chains and heavy demand for goods have pushed prices higher. That word is inflation, something America hasn't dealt with for a generation. Complicating things further is a really tight Labor Market as Covid cases spread.

There is evidence that supply chain strains have eased up a bit. New Covid cases brought another slowdown as workers called out sick. But data on Omicron from overseas suggests cases disappear as quickly as they showed up. That's a risk and an opportunity, in Market speak. Economic activity has slowed to start the new year. There is reason to believe it will quickly pick up heading into Spring.

Omicron put the brakes on a lot of activity to end the year. But demand to get out, to get on airplanes, to travel and recreate is so strong. The re-opening of America has been super bumpy. It could smooth out in 2022 with travel and entertainment industries experiencing a boom of activity. 2 Million people were passing thru TSA each day, in airports across the country, during the Holidays. Traffic was back to 90% of pre-Covid levels, despite Omicron's presence. Americans have been traveling from coast to coast. But not around the World. International flights are still down 40%. Corporate travel, to a large extent, has been grounded too.

The Market knows this and seems to be sniffing out more activity in the friendly skies. Travel and Leisure stocks have taken Omicron very much in stride. With pent-up demand for traveling seemingly bursting at the seams, we anticipate an active Spring Break season carrying into Summer vacations. Airlines and other travel and entertainment stocks are hinting at a story of a strong 2022 as America continues to re-open.

INFLATION



Inflation returned for the first time in a generation. Stuff costs more. The CPI (Consumer Price Index) rose 6.8% to close out the year. That was the highest in 4 decades. Supply chain strains certainly contributed. Higher Energy prices did too. Both are showing signs of peaking. Fed and Congressional aid are also slowing, taking some of the heat out of inflation. Housing soared, but rents have not. They will. The Rental Market tends to trail by as much as a year. That chase is already on.

Housing accelerated during Covid. People left the city and headed for the country. They left high tax states for low and no-tax states. They sought cheaper housing and drove that pricing up. That's inflationary. The Housing Market has been white-hot during the pandemic. It slowed ahead of the Holidays. New construction is picking up in January. There is so little supply while demand is high. Mortgage applications are also on the rise. Rents are about to be. That's a theme for 2022.

ENERGY FUELS AMERICA



Gasoline is experiencing record demand. You've no doubt noticed the price at the pump. Traffic is back. Freeways are full. Public transportation took a hit as people opted for the comfort and safety of their own vehicles during Covid. That trend should continue in 2022.

Energy was the best performing sector in 2021. There's reason to believe it does well again in 2022. First of all, it is a sector that was left for dead last decade. Fossil fuels were shunned by investors seeking greener and more sustainable solutions. Energy companies have become very disciplined with Capital expenditures after being burned for a decade from reckless spending. Investment has been lagging demand as the Environmental, Social & Governance (ESG) theme forced limitations. Production has been banned in many parts of the country, and around the World. People don't want drilling in their backyards but expect Energy prices to stay low. It doesn't work that way. This is such an important issue.

The result has been a global Energy crisis, where supplies were insufficient to even heat homes during the cold. Nations were scrambling for any Energy source to provide for the people. Oil, Natural Gas, even Coal saw demand skyrocket. Traditional Energy is both fast and economic. Those are incredibly important characteristics for growing economies facing inflation.



Renewable Energy is clearly the future, as well as playing a significant role in the present. But traditional Energy sources are still needed to fuel the global economy and there just has not been significant investment to keep up with demand. Besides, Energy companies are cheap compared to other

sectors. The Energy basket of stocks trades at a mere 11X earnings estimates, which is half that of the S&P.

Energy companies are extremely profitable at \$70 Oil. Money is going back to shareholders in the form of dividends and buybacks. We expect Energy and specifically Oil and Gas to be a major theme for the midterm elections. Big Oil has been treated like the Tobacco companies. To be clear, we don't believe Fossil fuels are a compelling long-term investment. But we do see value there for 2022. It is very clear, the World still runs on crude.

THE GREAT RESIGNATION



4.5 Million Americans quit their jobs in November. 1 Million of them worked in Bars or Restaurants. 700K worked retail. It's been called the Great Resignation. Unemployment is back near record lows. The problem is the labor participation rate is merely 60%, at multi-decade lows. In other words, for every 10 Americans considered of working age, only 6 are actually in the labor pool. Companies are desperate to find workers. Job openings are at record highs. There are over 10 Million job postings around the country. People are not looking for work. That has been a big driver of inflation too. Something's got to give.

Corporate America has been running lean for years. Productivity has soared which has led to higher profits. Loyalty in the workplace has thinned. It cuts both ways. After receiving generous unemployment benefits for an extended period the last couple of years, the savings rate spiked toward all-time highs. The rising Stock Market perhaps helped people feel more comfortable in calling it quits, temporarily or for good.

Whatever the reason, Labor continues to be a major issue. Demand does not. Demand remains quite strong. Things have returned toward normal, but there's still nothing normal about today. Some things will never return to pre-Covid levels. Corporate travel is showing very few signs of full recovery. It's less than half of what it used to be.

ROBOTS TO THE RESCUE



"Automation is stealing American jobs. China is too;" Those used to be considered the biggest threat to American employment. The biggest issue is actually finding enough Americans that want to work. Artificial Intelligence is providing a solution. The number of Robots performing tasks in malls across the country more than doubled last year. For now, they're doing boring, monotonous tasks like cleaning and scanning. But they're also flipping burgers and filling prescriptions. We are seeing more kiosks and less order takers in circulation. That's a trend that won't reverse.

IT'S STILL ABOUT THE FED

The Federal Reserve is switching gears. However, the Market doesn't seem to quite believe the Fed's path for removing its ultra-accommodative monetary policy. The tapering of asset purchases has commenced, with an expected conclusion in March. The next step would be a hike in interest rates. The Market has already priced in 3 of them in 2022, at 1/4 point each. We think that happens in June. We aren't convinced 3 hikes happen.

The Stock Market has gotten a little spooked that the rate hikes might occur sooner than expected. The thinking had been a June liftoff for interest rates, though more hawkish Fed talk has caused some stock selling with ideas of a move in March. The Fed has been very cautious in its approach and Fed Chair Powell learned an important lesson in 2018 when he ignored the Bond Market. He switched gears quickly in 2019, which set-up a continuation of the rally. James Carville is right; The Bond Market can intimidate anyone.



The front-end of the Yield Curve has been moving commensurate with Fed expectations, with the 2-Year Treasury yield approaching 1%. The curve was actually flattening; Not a positive sign. The 10 and 30-Year Yields jumped in January, but are merely at or below those highs from 2021. This suggests inflation is not that longer-lasting nag that many fear. We'd like to see the Yield Curve continue to steepen, which happens with healthy economic expansion. The curve has remained stubbornly flat, something we are paying close attention to. If the Fed raises rates while the Bond Market rallies, the Yield Curve would invert. Yields go down when Bond prices rise. The Fed does not want an inverted Yield Curve. Nobody wants that.

BONDS



The Bond Market, as measured by the Barclays Aggregate, declined last year for just the 4th time ever. There is a decent chance it goes down again in 2022. The 40-Year Bull Market in Bonds seems to be coming to an end as higher rates and higher inflation eat away at the low yields that Fixed Income pays after its multi-decade run. US Treasuries are considered the prized risk-free-return. However, with rates low and on the rise, traditional income investors could be looking at return-free-risk. That doesn't sound appealing. We continue to seek Boring Blue Chip dividend stocks for safe and predictable income. We plan to wait for higher yields to get more aggressive with Fixed Income.

The Bond Market serves an important purpose. It's where the smartest money lives. The Bond Market is full of signals. It's our sense that the Fed is talking tough to influence their desired outcome. They have no interest in creating a crisis. With financial support abating, the US Economy runs the risk of a major slowdown if Covid continues to creep and infect. We expect the Fed to tread lightly with a great deal of caution. The Market continues to recalibrate this significant event.

MIDTERM ELECTIONS



The odds of the Republicans re-taking the House are very high. In the Post-War era, the party of a first-term President has averaged a 26-seat loss in the first midterm election. Republicans need only to pick up 5 seats to flip the House. All signs point to a Republican House majority in 2022. The Senate is much more complicated, and with a 50-50 split already, at this stage it looks like a toss-up.

Given the deep divisions in Washington, it is unlikely Congress passes any significant legislation in 2022. Campaigning has already begun and both parties are jockeying for position for some highly contested races. The prospects for the Build Back Better (BBB) plan keep fading away the closer it gets to November. The heightened interest is not just on American shores. Our adversaries know full well the extent of America's political divide and implications with the November elections. Sensing vulnerabilities, they're watching very closely.

Congressional Democrats and the White House started the new year by attempting to revive the Build Back Better plan. It doesn't have the support of all Democrats. From one of our Washington sources: "Regardless of how investors view the merits of BBB, the failure to pass this bill would negatively impact economic growth forecasts by delivering less spending than had been previously anticipated and by not extending some fiscal programs that began in 2021." The Market seems to have re-priced those expectations.

An important issue for Americans who live along the coasts is the State and Local Tax (SALT) deduction. Build Back Better, in its current form, would raise the cap to \$80,000 from the existing \$10,000. According to our sources, a change is in doubt. A revised BBB could still include some SALT adjustment, but the amount would almost certainly be scaled back.



GEOPOLITICS AND TRADE - BIG TESTS AHEAD

Tensions between the United States and China continue to simmer. Both nations need each other yet neither have much trust. Unlike the Cold War between America and the Soviets, which was ideological in nature, the US-China relationship is driven more by economics. That said, power is the center of all.



China hosts the Winter Olympics in February. This will be an important and challenging test. The World will be watching how the Games go with Covid on the trail. China has a zero-tolerance policy towards the virus. It shuts down things quickly and abruptly. President Xi has not even left Chinese soil for 2 years. Having athletes from over 100 countries congregate and compete will seemingly be high risk for cases. The Winter Olympics will be open to spectators. But only if they live in China. Overseas fans have been banned. Besides, the United States enacted a diplomatic boycott. 3 other nations followed suit.

The Phase 1 Trade deal with China, reached in 2020, expired in December. China has not been holding up its end. The natural response would be to raise tariffs again. The Biden administration is in tough spot. They can't afford to look weak on China. Both parties and the American people support tough on China policies. But increased tariffs would raise prices on imported goods. The American people are already facing inflationary pressures, and aren't happy. The most likely outcome is to remain tough on Chinese Tech, focused on cheating, stealing and spying.



War fatigue has absolutely set in on the American people. The withdrawal in Afghanistan sent a clear message. The rest of the World watches closely. American resolve is being tested. That

will continue. Russia's bold activity around Ukraine is a major test. President Xi is watching very closely to see what the White House does about Russia-Ukraine and will extrapolate that towards Hong Kong and Taiwan. There's also the issue of North Korea and Iran, who show no signs of letting up on their nuclear capabilities.

Planet Earth is a complex place. What's most dangerous is the fact that we live in a G-Zero world. That means no real global leader. Trust is lacking. Alliances have frayed. The Market has largely ignored geopolitics for years. At some point, it will pay attention again.

INVESTED IN THE DIGITAL AGE

The United States is unequivocally the center of the universe for innovation and productivity. This pandemic period has even extended America's lead as China tries to tighten its grip on Covid and Tech. Oil was the Prize of the 20th Century. It fueled economic expansion for 6 decades. Data is considered the Prize of this Digital Age in the 21st Century. The Tech Titans were built on data. They produce data. They harvest data. They track data. They sell data. 21st-century intelligence is driven by data. That intelligence is both human and artificial. Data will likely dominate and disrupt far longer than Crude's reign.

We still like Tech. We will always like Tech. We seek out innovative and disruptive companies that have a bright future for growth. We also like predictability and stability. The Tech Titans provide that. The Tech Titans are core holdings. They have quality characteristics that are very unique within the Stock Market. But price matters. It's the ultimate equalizer between buyers and sellers. After such massive runs, we see a breather ahead. Growth stocks don't do as well in a rising rate environment. The cost of capital increases. Future cash flows are worth less with higher rates. The Market in 2022 is more about the now.

As long-term investors, we don't plan to abandon these quality companies. The question is really the weight in the portfolio. We will likely reduce our position sizes as we see another rotation of leadership back to Value. The recent strength in Financials proves that Q4 is in the past and Bank stocks are sniffing out accelerating earnings growth with higher yields and rising rates.

INVESTING OVERSEAS



After staying home for the extended period, we see international travel picking up in 2022. The emphasis will likely be on European vacations. We also see investors embracing international stocks again. They're cheaper and pay larger dividends. International stocks have not performed like the US for over a decade. That trend is ripe for change. We see a catch-up ahead in this Value-oriented space and will be embracing the international theme.

The United States dominates in Tech and innovation. But Emerging Markets have the demographics. 65% of India's population is under the age of 35. In Vietnam, a quarter of their population is under 15 years old. These represent the future global consumers and wealth accumulators. As countries try to reduce their dependence on China, particularly with supply chains, Southeast Asia has become a major beneficiary. It's still very early days.

EARNINGS IN FOCUS



Earnings drive stock prices. Earnings Season begins again in January with Corporate America reporting Q4 results. They should be good. S&P 500 earnings are expected to grow by just over 20% for the final quarter of 2021. That would mark a spec-

tacular 50%+ earnings growth for the year. But that growth rate is slowing from unsustainable levels. Q3 saw a 40% increase in earnings, which tailed a whopping 91% in Q2 and 52% in Q1. Those were against very depressed comparisons from the Covid crash in the Spring of 2020. Earnings contracted 17% for the full year 2020. They're expected to grow 16% in 2022. It's a much slower pace than last year. But it's much faster than experienced in the years leading up to Covid.

The Stock Market is still on the expensive side by historic standards. Higher interest rates and a less accommodating Fed have already chipped away at elevated valuations. But there are many places inside and outside the S&P 500 that are cheap and attractive. Short duration assets do better in a rising rate environment. Those are companies that are profitable now and generate a lot of cash, unlike the hyper-growth companies focused on the future. Certain Small Caps, Cyclical, Financials, Health Care, Energy, Utilities, Consumer Staples and International fit that bill. That's our target for the first half of 2022.



Here's the Bull case, something the Fed would like to see: Covid concerns ease enough that global supply-chain strains get soothed. Chip supplies grow to meet demand. That would lead to an increased availability of goods which would shift consumer demand toward services. In that scenario, the labor shortage gets remedied as kids stay in school and people eagerly come back to work. All of this would ease inflationary pressures, allowing the Fed to raise rates only marginally while the Economy strengthens. Stocks would rally. This is a very possible, if not plausible scenario. We'd like to see this play out too. But a lot has to go right for the sequence of events to take shape. With so many variables in play for 2022, Covid and the midterm elections being the most impactful, we don't see how the path ahead remains anything but bumpy.

The background of the page features a light blue graphic of a line and bar chart. The line chart has several data points connected by thin lines, and the bar chart consists of vertical bars of varying heights. The overall aesthetic is clean and professional, with a focus on data visualization.

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