

From: Aequitas Investment Advisors

*Warner / Jim Spencer*

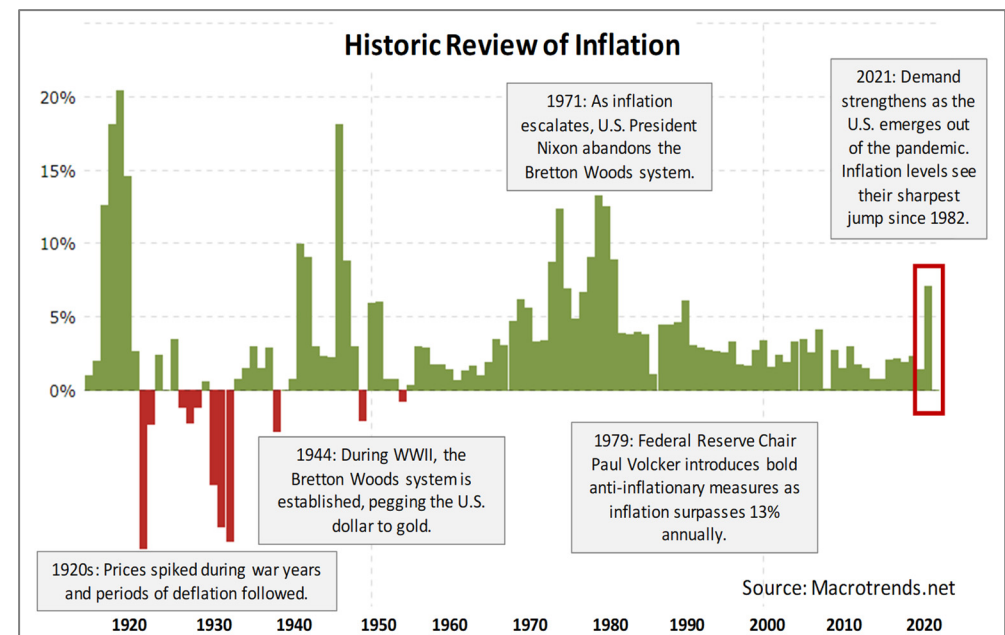
**Re: Two Unwelcome Spikes – Let's Hope They Both Recede!**

As we begin a new year with our lives back to being enshrouded by the clouds of Covid-19 (déjà vu all over again?), the Omicron variant has wreaked havoc and created a spike in Covid-19 cases to record levels with more than 5 million confirmed cases in the U.S. in just the last seven days! The bad news is that the Omicron variant is so contagious that most Americans will likely be infected. The good news is that Omicron appears less deadly than prior variants and the rapid surge in cases may be followed by a similarly rapid drop. Cases in South Africa and the UK are in decline, and even in the U.S. there is evidence that cases have peaked, including New York City. The other good news about Omicron is that the evidence shows that fully vaccinated individuals who become infected are likely to avoid serious illness. This is one reason why health and public policy officials are not recommending another shut down of the economy; rather, their advice is to become fully vaccinated (if not already), wear masks, avoid crowded gatherings and use common sense. We'll probably have to live with Covid-19 indefinitely, but many health experts believe that over the course of 2022, it will fade in severity and become endemic, rather than pandemic, and more manageable once there is greater population immunity. Perhaps the clouds may give way to clear skies!

The other spike we're facing is one of high inflation. This past week, the Bureau of Labor Statistics reported an inflation rate of 7% for calendar year 2021 – the highest since 1982! While high inflation is bad news for consumers, it's really a favorable indicator that the economy is in high gear and growing rapidly (perhaps too rapidly). The Federal Reserve's dual mandate is to maintain full employment and stable prices. With an unemployment rate of 3.9% (considered to meet the

Fed's definition of full employment), the Fed is now turning its focus on taming inflation and maintaining stable prices (some would say a little late). In December, the Fed announced it would begin scaling back its treasury bond purchases, i.e., tapering, and that it may hike interest rates as many as three times 2022. These moves are designed to "tighten" monetary conditions and,

hopefully, constrain inflationary pressures. The Fed must carefully manage this tightening process, i.e., pump the brakes rather than slamming them on, to avoid creating too sharp of a slowdown. Using the analogy of driving a massive tractor trailer rig, i.e., driving the economy, since March of 2020 the Fed has been applying enormous pressure on the gas pedal, activating the turbo charger, and pumping trillions of dollars into the economy by lowering interest rates and injecting liquidity to stimulate growth in an effort to pull the tractor trailer rig out of the ditch and back up the hill. The truck is now over the hill and speeding down



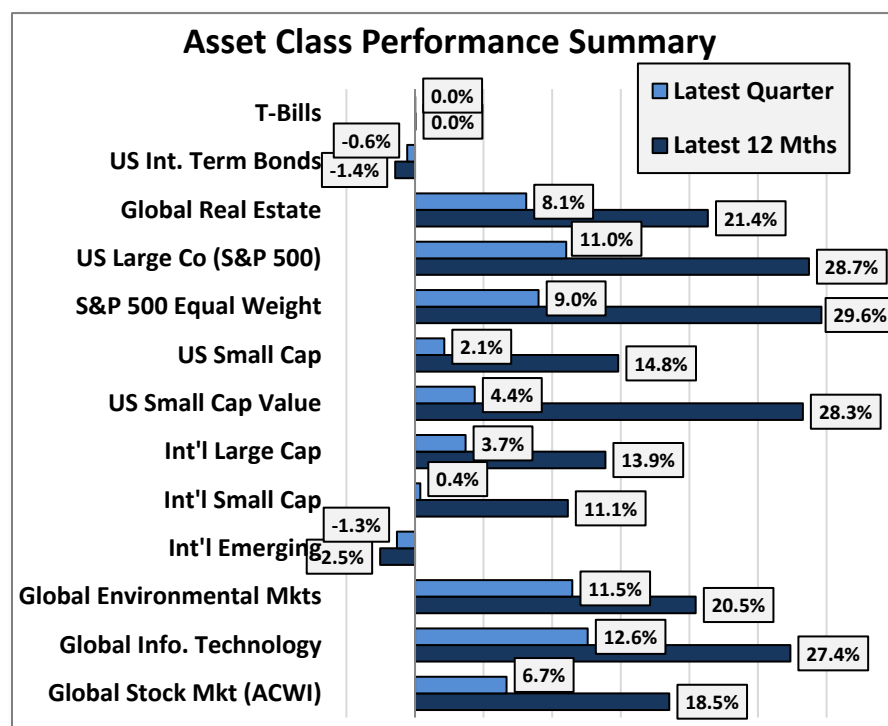
the other side and the Fed is now faced with the challenge of pumping the brakes to slow the rig down without losing control (come to think of it, if members of the Federal Reserve could actually drive trucks, that might help with the supply chain problem). Assuming the brakes can be applied effectively, the truck can then be slowed sufficiently to maintain a more sustainable speed without crashing (i.e., avoiding a recession while bringing inflation under control). A lot is riding on the Fed's ability to successfully manage this difficult task.

In this letter, we will review performance of the investment markets in 2021 and take a closer look at the spike in inflation and how we might adjust our assumptions as we plan for the future.



## Asset Class Performance Review

While the rate of inflation has been running hot, so too have the prices of most stocks around the globe. Over the trailing twelve months ended December 31st, the Global Stock Market advanced by 18.5% reflecting the continuing expansion of the economy in 2021. There were only two negative returns for the year; U.S. Intermediate Term Bonds (-1.4%) which were negatively impacted by rising interest rates; and Emerging Markets stocks (-2.5%) which suffered from the impact of China's regulatory clampdown. U.S. T-Bills were flat for the period. The other stock asset classes had robust returns ranging from 11.1% to 29.6%. The biggest gains came from U.S. Large Cap stocks, U.S. Small Value stocks and Global Information Technology stocks.

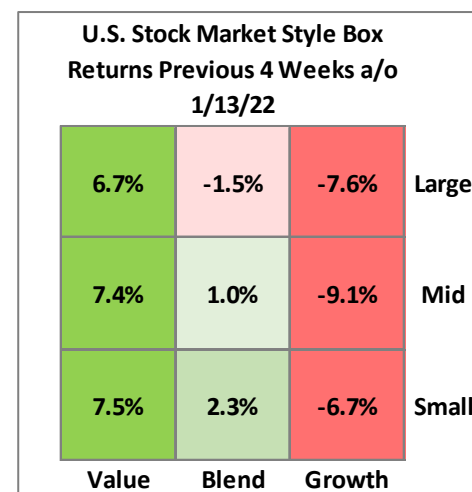


For the latest calendar quarter, returns were also quite positive led by Global Information Technology (+12.6%), Environmental Markets (+11.5%) and U.S. Large Cap stocks (11.0%). The other stocks asset classes had returns ranging from -1.3% to +8.1%. The broad Global Stock Market gained 6.7% for the quarter. Intermediate Term Bonds were down by 0.6% and T-Bills were flat once again. (Of note, the Omicron outbreak had a very limited impact on returns for the fourth quarter, although its effects more recently have coincided with the

negative impact of the acceleration in the Fed's monetary tightening).

## Recent Shift in Investor Sentiment

We have seen a rather dramatic shift in investor sentiment over the past four weeks, not only due to concerns about the spike in Covid-19 cases, but more likely in reaction to the Fed's December meeting minutes which indicated it will begin withdrawing support for the economy faster than previously expected in an effort to combat inflation. This rather abrupt shift sent shock waves through the investment markets. The yield on the bellwether 10-Year Treasury Note spiked from 1.4% to 1.7% within a few days of the announcement, and the prices of Growth stocks began to plummet. Conventional wisdom suggests that Growth stocks might be more negatively impacted by higher interest rates than Value Stocks. In her January 20<sup>th</sup> column, CNBC Markets Editor Patty Dommm put it well, "Tech and growth stocks, which are most highly valued, are therefore disproportionately hurt by higher yields. Investors are willing to pay up for tech and high-fliers for the promise of future growth. When the Fed takes away cheap money, those types of stocks look more expensive." Indeed, over the past four weeks through January 13th, Growth Stocks have fallen precipitously while Value Stocks have risen sharply. Note in the U.S. Stock Market Style Box to the right that Growth Stocks (the right-hand column of the box in red) are down by close to 8% on average, while Value Stocks (left-hand column in green) are up by 7% on average - a spread of 15%! Whether this divergence will continue or not, the impact of higher interest rates and higher inflation has already made a significant impact on the investment markets.



Investors may be rotating out of Growth Stocks not only due to concerns about their lofty valuations, but also due to the relative attractiveness of Value Stocks which are priced more reasonably and are heavily weighted toward sectors which have historically benefited from rising interest rates, such as Financials and Energy. Furthermore, Value Stocks are also more heavily weighted toward the Healthcare and Consumer Staples sectors which tend to outperform when the stock market takes a negative turn.

## How Might Inflation Impact our Financial Plans?

Each of us has undoubtedly noticed the dramatic rise in prices for certain goods and services over the past twelve months. Essentially, inflation has spiked primarily due to pandemic-induced supply chain constraints exacerbated by surging consumer demand as economic growth has strengthened. The primary drivers of the 7% spike in inflation in 2021 were Energy and Transportation, up

Component	2021 Annual Change
Food & Beverages	6.0%
Shelter (Housing)	5.1%
Apparel	5.8%
Transportation	21.1%
Medical Care	2.2%
Recreation	3.3%
Education & Communication	1.6%
Other Goods & Services	4.5%
Energy	29.3%
Headline CPI	7.0%
Core CPI (ex Energy and Food)	5.5%

by 29.3% and 21.1% respectively. Included within the broad components were important sub-categories, including Gasoline (+49.6%), Used Car and Truck prices (+37.3%), Natural Gas (+24.1%) and Meats, Poultry, Fish and Eggs (+12.5%). If one didn't drive a car, use energy to heat or cool one's home, buy a new or used car, or eat very much, then last year's inflation wasn't so bad. Unfortunately, the average

consumer cannot be so picky as to which goods and services he or she might need; however, each consumer has different spending habits and, as a result, applying the 7% spike in the Consumer Price Index across all items would not be appropriate. Given differences in individual spending patterns and categories, we will be spending additional time in future meetings with our clients to make sure the expenses we are itemizing are current, i.e., adjusted to reflect any inflationary impact which may endure, so that moving forward we can continue to improve the accuracy of our long-term financial planning projections.

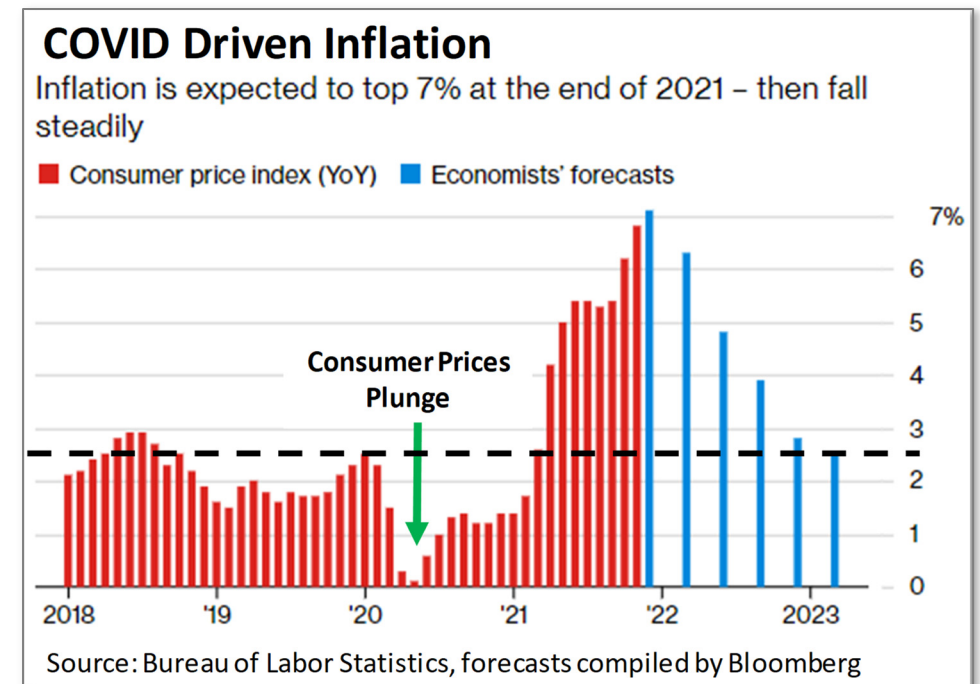
In the most recent Barron's magazine, highly regarded economist and financial analyst Abby Joseph Cohen commented on the inflation scare and we thought her words were worth sharing:

Many of today's headlines....are just wrong. They take an overly simplistic view of what is happening. The inflation data, for one, overstate what's going on. I recognize that there has been an increase in core inflation, and that wages are rising. But we have to recognize that much of the increase in measures

like the government's consumer price index comes from factors that are one-time events. There has been a huge increase, for example, in the price of used cars. Well, families don't buy cars every year. There has also been an increase in home prices, but homes are not recurring purchases. We are going to see inflation data come down. Keep in mind that the CPI last year was also boosted by the sharp rise in energy prices. With crude oil already having reached about \$80 a barrel, prices aren't going to rise to that same extent this year.

## Inflation was High in 2021, but What's "Expected" in the Future?

We think it's safe to assume that many of the causes of the inflation spike in 2021 were one-time events caused by the Covid shutdown and reopening coupled by supply chain constraints. For the ten-year period prior to 2021, inflation averaged a mere 1.7% annually, but for the past twenty-five years including the 2021 spike, inflation has averaged 2.3% annually. In the graph below, note the dotted line which indicates where inflation might be by early 2023 (i.e., close to 2.5%) according to a survey of economists conducted by Bloomberg. Looking out

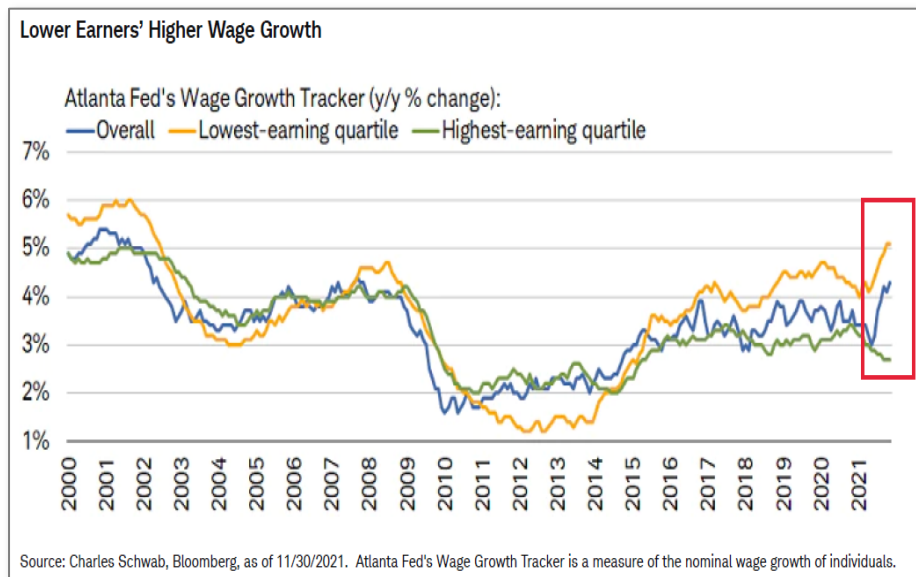


further, the Federal Reserve's latest forecast indicates inflation should settle down to a range of between 2.0% and 2.4% in 2024. They are maintaining their long-term target of 2.0%. We agree that inflationary pressures will likely recede, but

we believe it would be prudent to plan on a higher inflation rate than the Fed's long-term target.

### Some Good News in the Inflation Numbers

While the impact of inflation on consumers is bad news at least temporarily, rising inflation is a sign of strong economic growth and strong consumer demand. A favorable socioeconomic development is that one of the major factors propelling inflation is strong wage growth for lower paid workers. According to the Brookings Institution, the good news is that wages are rising sharply for low-wage jobs which represent more than 50 million Americans, or about 44% of the country's adult working-age population. Note in the graph below wage growth for the lowest earning quartile rose by about 5% year-over-year through the end of November 2021 (compared to a decline for the top earners). While some might cynically suggest that this 5% annual wage increase was more than eaten up by the 7% inflation spike, the reality is that the 5% wage hike is likely to endure and improve the lives of millions while inflation will likely recede.



### A Counter Argument to the Persistent High Inflation Scenario

In its Saturday, January 15<sup>th</sup> Barron's magazine, Barron's Weekly Roundtable of investment strategists posited their forecasts for 2022. The title of the article, *Expect a Tough Year for Stocks, but Lots of Opportunities for Bargain Hunters*, provides a tip as to the consensus view of the roundtable strategists (we might add

"and a Good Year for Portfolio Rebalancing" to the article's title). The strategists discussed the inflation topic at length, but one counter argument stood out to us as offered by Rupal J. Bhansali, Chief Investment Officer of Ariel Investments:

We shouldn't get carried away with recency bias. The inflation numbers are running hot, and there is a feeling that inflation will persist. But what if disinflation returns? Could it be that inflation has persisted because Covid has persisted? The San Francisco Fed published a chart showing that Covid-sensitive inflation is running at 5%, but non-Covid-sensitive inflation is around 2%, as it was pre-pandemic.

In future years, secular forces such as debt, demographics, and digitization could prove deflationary, which would be worse for markets than the current inflation. High debt levels mean we have borrowed from the future to consume today. Unless debt levels continue to go up, demand levels will come down and reduce demand, which implies deflation. This is not theoretical; it played out in practice in Japan, where no amount of monetary or fiscal stimulus could prevent deflation.

Baby-boomer retirements and workforce resignations also curb demand, leading to deflation. And the work-from-anywhere workforce, an outgrowth of Covid, can also be deflationary because it can lead to lower wages. Since wage inflation is the most persistent type of inflation, if it can be deflated, it's a big deal.

### Portfolio Positioning

We anticipated that the Fed would eventually raise short-term interest rates, which is why we have recommended a shorter average duration for our clients' bond allocation. Looking forward, we are contemplating a further adjustment to our bond fund mix and will be communicating a specific recommendation to applicable clients, knowing that as these rates rise, we believe that investing in short-term high-quality bonds is an effective way to reduce overall portfolio risk.

Within the stock asset classes, we continue to believe that our current tilt toward Value and Smaller Cap stocks, as well as profitability and sustainability, should prove beneficial going forward, especially relative to Large Cap Growth Stocks. Further, if stock market volatility increases, as the Barron's Roundtable strategists predict, our disciplined portfolio rebalancing process should allow us to continue to capitalize on buying stocks at more favorable prices.

## Closing Comments

As financial planners, we at Aequitas have always carefully considered the impact of inflation on our client's financial plans, whether planning for retirement and estimating future living expense assumptions or determining sustainable portfolio withdrawal rates for individuals and families, as well as for our non-profit clients. Future interest rate assumptions and inflation scenarios also impact how we might adjust our model portfolios to avoid pitfalls and take advantage of potential opportunities.

As we are entering the third year of Covid-19 with no immediate end in sight (but ever *hopeful* this will all end soon), we recently heard an NPR commentator remark that *we've all become variants of our former selves*. Indeed, our lives have changed, and some things may never be the same, but perhaps this will lead us to discover new opportunities. In the words of spiritual teacher Eckhart Tolle, "Some changes look negative on the surface, but you will soon realize that space is being created in your life for something new to emerge."

We hope that you and your loved ones are safe and healthy, and we look forward to our upcoming meetings together in 2022 and, hopefully, the chance to meet in person once again!