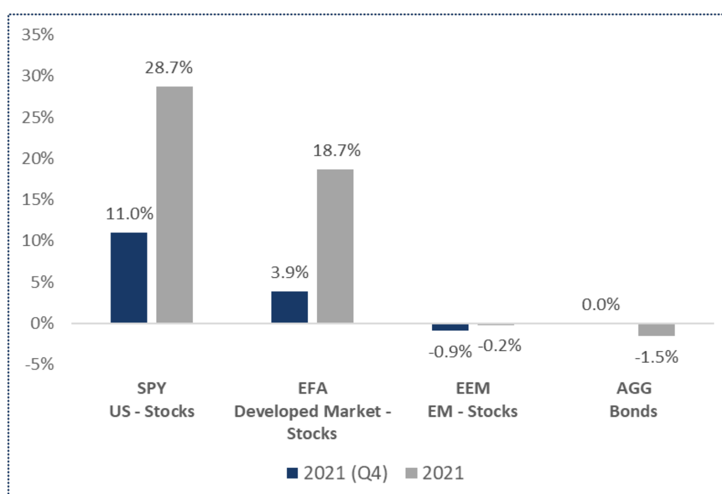
Open for Business, but Closed to Easy Money

“We believe time, not timing is the key to building wealth in the stock market” ***– Bill Miller***

Despite some end of year volatility, major indices rallied during the 4th quarter, with the S&P 500 up 11% and the Dow up 8%. For the full year, the S&P 500 was once again the best performer of the major world indices, returning 26.9% and recording 70 new record highs, the most since 1955. This was the third straight year of double-digit returns. The markets were once again driven by earnings growth. Heading into 2021, the market consensus was for year over year earnings growth of 22%. Incredibly, actual earnings grew 65% year over year, the largest upward revision since this data has been tracked starting in 1984. Record inflows into equity funds and a resurgence in stock buybacks also helped major U.S. indices.

Although US stocks performed well, bonds, represented by the Bloomberg Barclays Aggregate Index, recorded a negative return (-1.5%) in 2021. We have previously written about the low yield environment and the pressure that increasing rates puts on bonds. There is probably more pain to come from bonds as rates continue to normalize towards longer-term averages.



Another area of disappointment was Emerging Markets, impacted by a difficult year for Chinese stocks (-23%). This was the 4th straight year of underperformance by international stocks, in particular Emerging Markets. The question becomes is International now an opportunity moving forward?

2022 Outlook

We believe several important factors will drive the investment landscape this year including mid-term elections, inflation and increasing interest rates. Below, we also discuss our outlook on the major assets classes and where we see risk and opportunity.

Mid-Term November Elections

We aren’t in the business of predicting politics, but of course do keep a close eye on it given the potential impact on markets. Given the importance of the 2022 election cycle, especially in the House, we suspect market volatility will remain elevated for a good portion of 2022. If we study history back to 1938, the median return for the stock market in mid-term election years has been 11% versus 12% for all years. However, when we look under the hood, it has been a tale of two halves. Average returns have been barely positive in

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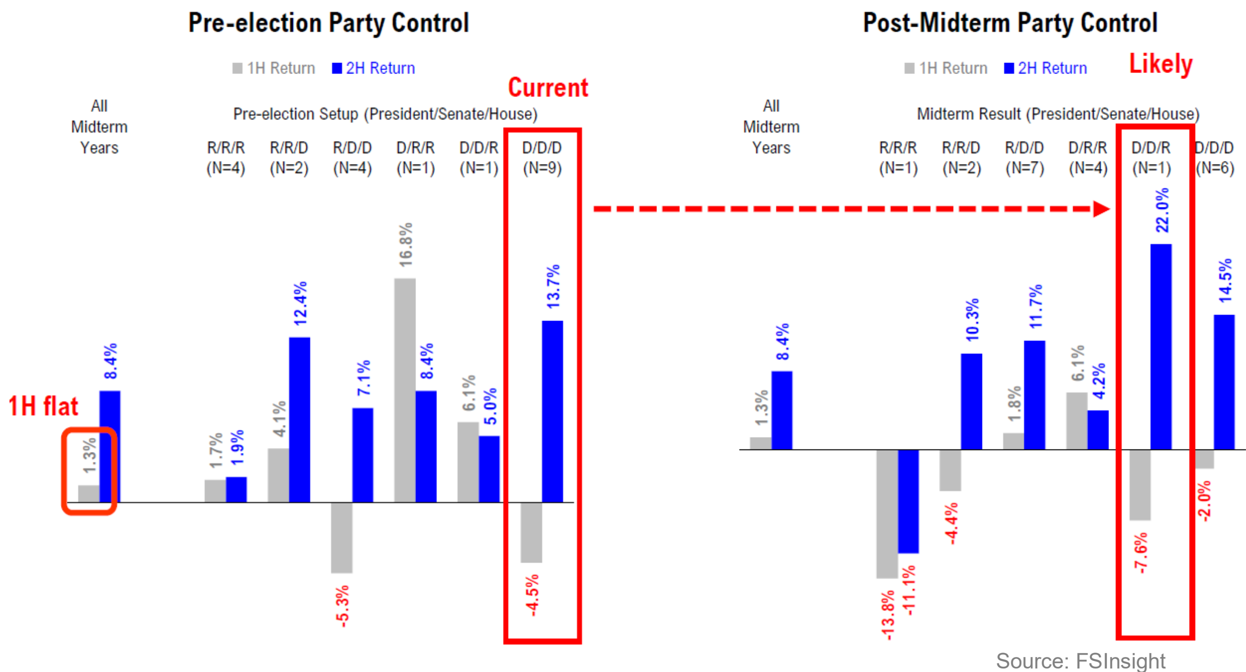
the first 6 months with all of the returns generally coming in the second half of the year. As the chart below shows, the swings have been even more dramatic when we have had a similar pollical alignment to today with the Democrats controlling the White House, the Senate and the House. As we previously discussed, the market likes certainty and there will be a lot of uncertainty. Historically, the party out of power has done well in a new president's first mid-term election, and Republicans see rising inflation and a softening in President Biden's approval rating as reasons for optimism to regain control in 2022.



Source: FSInsight

Inflation

Last year, the US experienced its highest inflation in recent memory. There are significant fears that this inflation will continue to wreak havoc similar to the 1978–1982 time frame. We believe these fears are overblown for several reasons:

- Covid will eventually slow down, which means that the supply chains and labor issues will eventually return to normal.
- Many stimulus checks have been used to purchase durable goods and these purchases typically only occur every few years.

The chart on the following page shows that the inflation level of core services has remained in line with levels experienced over the past couple of decades. However, core goods inflation has gone parabolic (*yellow line below*). When we compare the goods inflation over the last year to the average of the previous decade, approximately 75% of the increase comes from new and used cars, household furnishings, recreation, and apparel (Source: FSInsight).

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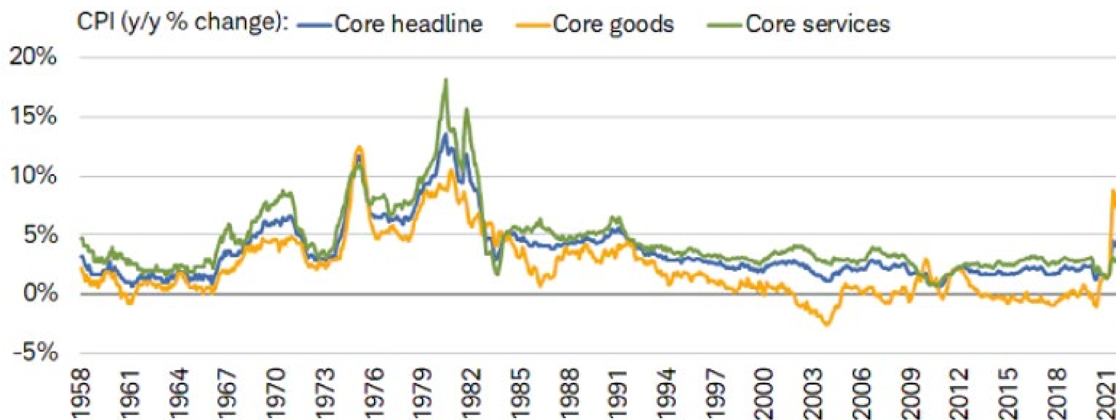


Source: Charles Schwab, Bloomberg, as of 10/31/2021.

We believe the cost of "goods" will normalize as factories in China reopen and the global supply chain gets back to normal. However, this is a very complicated world economy and will not happen overnight.

Our bigger concern with inflation relates to wage inflation in an economy that has a tight labor market. We hear from clients in all industries, public and private, that it is very hard to find skilled workers. If inflation does persist in 2022, it will most likely be a result of a competitive job market versus the covid related supply and demand issues.

Interest Rates

Rates are poised to go higher in 2022, but how far and how fast will they rise? Review of the Fed's minutes in December indicate that the first-rate hike could be as early as March and the early odds point to three increases, taking the Fed Funds rate from 0% to 0.75%. While this is not a dramatic increase, it does have a negative effect on the economy by increasing the rates on things like mortgages, auto loans and bonds. Assets have been driven by low rates since March of 2020 and this year will be the first test as to whether markets can handle higher rates.

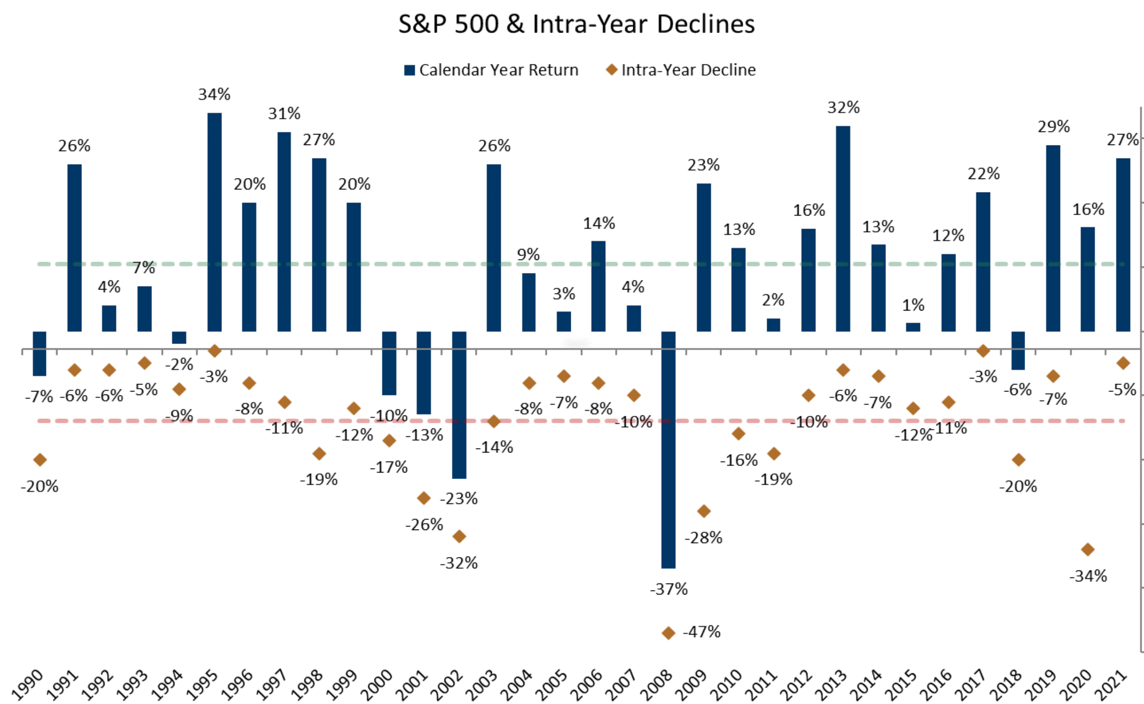
Given the higher inflation environment, real rates are negative, calculated by subtracting the 10-Year Treasure Rate from current inflation (CPI). Europe and Japan have had negative real rates for much of the past decade, while this is a more recent phenomenon in the US, starting in 2020. Although this is unusual for recent history, there have been other periods in our history with negative real rates. In fact, if we go back to 1880, about 26% of all periods in the US have had negative real rates (Source: FSInsight).

The question is, what does this mean for our investors? Historically, it has been challenging for bonds, but positive for stocks. The best markets of the early and mid-1900's experienced their strongest returns of those time periods. In theory, this makes sense. While we aren't necessarily fans of looking at data from this long ago, some of the same concepts apply. If you can't beat inflation with bonds, investors will gravitate to

other risk assets to find higher yields to try to outpace inflation. Today, we often hear the saying, “There is No Alternative (to stocks)” (TINA) and this is certainly how investors have reacted thus far pouring trillions into the stock market.

2022 Asset Class Outlook

Stocks – Coming off a relatively calm year, in which the largest market corrections was only 5%, we are anticipating increased volatility in the 1st half of 2022 with the potential for a strong second half. Going back to 1980, the average intra-year decline for stocks is 14%, so 2021 was certainly a treat. Although most years experience significant ups and downs, 32 of the last 42 years (76%) have experienced positive returns (see chart). **This volatility is the pain that we all experience to achieve higher returns over time.**



Source: JP Morgan

When it comes to stock market risk, we are most concerned with significant declines (>20%) that are associated with very long recover times (>12 months). Although we don’t have a crystal ball, it doesn’t feel like we are in a prolonged downturn environment. Instead, our outlook is more along the lines of the typical mid-term election year, which we discussed above and is more of a tale of two halves.

We also believe the market is at an inflection point in terms of what is going to lead moving forward. Growth stocks have dominated since the beginning of COVID, however, when we look at individual names, many have corrected by 30-50% over the past 6 months, while value companies have generally done well. It’s reasonable to say that some of the growth stocks got ahead of themselves and the market is most likely going to be carried by the blue chips and companies that will benefit from the full reopening of the economy.

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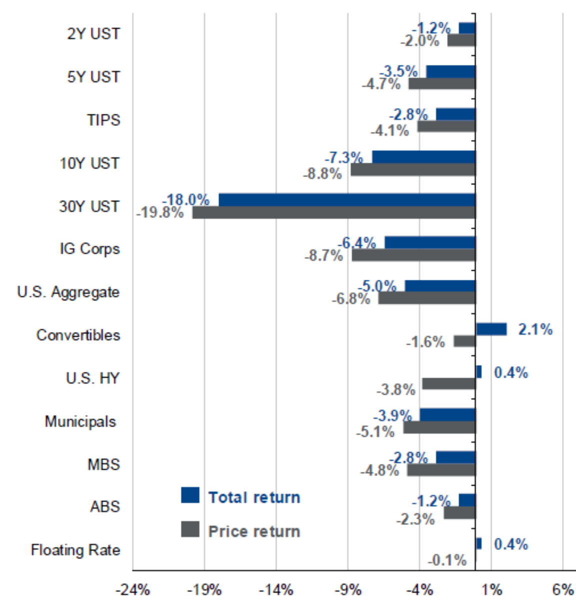
We also believe that international stocks may finally have their day in the sun, and for a number of reasons, look very attractive moving forward.

Bonds – We have the same outlook for bonds that we had last year. The Aggregate Bond Index is currently yielding less than 2% and all or a majority of that income could be eroded by rising interest rates. As you can see from the chart to the right, rising rates affect nearly every type of fixed income investment. We are currently focused on floating rate and high yield bonds as they have historically performed the best during rising rate environments. Some clients have asked, "Why should we invest in bonds today?" and that is a great question. If one has the stomach for a higher allocation to stocks or the means to invest in alternative investments, an allocation to bonds might not be necessary. For the average investor, however, bonds serve two purposes. The first is to provide cash for an unexpected need when stocks might be down and the second is to provide dry powder in the event of a large market decline. Bonds are not likely to keep pace with inflation in the short term but can still have an important place in a diversified portfolio.



Source: JP Morgan

Real Estate – Low rates and inflation are a pretty good recipe for real estate, which generally has the characteristics of low fixed rate debt and escalating rents. Good real estate investments can offer much higher income than bonds and the potential for appreciation, making it a great diversifier to both stocks and bonds. Like the stock market, valuations have become extended in certain sectors, but given low rates and inflation, we believe there are tailwinds that make Real Estate an attractive investment opportunity moving forward.

Other Alternatives – We are also seeing plenty of opportunities in the private markets which include private equity, venture capital and private credit. Like the stock market, private equity and venture investments are showing some signs of being overvalued, so one must be cautious, focusing on manager selection and continuing to adhere to your investment disciplines, so as not to chase opportunities.

For investors looking for income, private credit investments have some of the highest yields of any asset class. Private credit is relatively new to many investors but is essentially negotiated loans and other types of debt financing originated by non-bank lenders. These loans can include business loans, consumer loans

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and loans secured by real estate. Due to the illiquid, private, and non-bank nature of these loans, they typically pay interest to investors in the 6-8% range, significantly higher than the interest offered by bank accounts and bonds. Like any asset class, there are investments that are more conservative and investments that are more aggressive. We like the more conservative investments in this space that focus on seniority in the capital structure with plenty of collateral to protect the loan. Cliffwater, one of the leading research providers in the direct lending space suggests that “a diversified portfolio of middle market loans has the potential to deliver All-Weather returns for investors. Historically, middle market loans have demonstrated limited downside volatility during periods of broader market stress and have also performed well during periods of rising interest rates, unlike traditional bonds.”

Conclusion

Thank you for taking the time to read this letter and we look forward to a great 2022. As always, please let us know if you have any questions related to your investments, taxes, or general planning or if there have been any changes to your overall plan or risk tolerance.

Sincerely,

Canal Capital Management

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