

2022

2021 was a good year for investors, but dominated by the performance of six large companies. In fact, it was the third good year in a row, and with only minor pullbacks—a highly unusual circumstance.

2022 has not started out on a good note. COVID has caused supply chain disruptions, and a combination of unprecedented fiscal and monetary stimulus has boosted inflation to a thirty-nine year high. Inflation, and the Federal Reserve's belated policy response to slow it, are battering both stocks and bonds.

Perhaps most importantly, minutes of the December Federal Reserve Open Market Committee disclosed that the Fed will not only be winding down its securities purchases, which have pumped trillions of dollars into the financial system, but will also reduce its holdings of treasury and mortgage-backed securities. These actions, which could begin in March, would tend to drain liquidity and tighten financial conditions.

The Fed's policy pivot actually looks relatively mild in the face of inflation figures, which on a headline basis has reached in excess of seven percent. If there were three 0.25% rate hikes by year end to 0.75 – 1%, that would still leave the real federal funds rate in negative territory when measured against some optimistic projections that inflation will cool to less than 3% by the end of the year.

In addition to Federal Reserve policy, Washington D.C seems to be in perpetual turmoil and the fiscal stimulus provided this year will pale in comparison to the last two years. Investors have never liked uncertainty, and we are seeing this both in terms of domestic policy and international turmoil.

On the brighter side, unemployment is low, and both our economy and corporate profits should expand this year. Expected corporate profits may be too high, however, since they assume a smooth reopening of the economy and that inflation will normalize. Market returns have always been influenced by corporate profits and interest rates, and in a higher inflationary environment with rising interest rates, it is the level of corporate profits that may determine equity returns.

As a practical matter, this outlook requires increased allocations to defensive quality equities and higher cash cushions.

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