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January 24, 2022 – Weekly Notes

Economic Commentary:

Omicron, inflation and supply-chain woes have all had an impact on the economic numbers for the end of 2021 and the start of 2022. The first estimate of fourth quarter GDP growth will be reported later this week, and the current expectation is that the growth rate will be something between 4.75% and 5.25%[1]; anything less than 5% will probably play out as a serious “wake-up call” regarding the outlook for robust economic growth in 2022. However, various reports from businesses and analysts seem to indicate that the omicron impact will fade over the month of February and that difficulties in getting products manufactured and delivered are beginning to ease, although not uniformly across all business sectors. Given that household and corporate balance sheets remain healthy, it is unlikely that spending will be significantly constrained in the aggregate over the longer term; more selective spending in the face of rising prices might be more the pattern than any outright curtailments. The Federal Reserve will have much to discuss at its two-day Federal Open Market Committee (FOMC) meeting starting Tuesday, and the FOMC report (followed by Chairman Powell’s press conference) is likely to garner much greater attention than the already intense focus of the last few FOMC meetings – the most recent of which was in December, before the significance of the Omicron wave became apparent. While a major change in the Fed’s stance of fighting inflation by tightening monetary policy (rapidly phasing out bond purchases and raising interest rates in 2022) is not expected, it is quite possible that the Fed will seek to reassure markets that Fed will continue to exercise caution in making these monetary policy adjustments and that after the first interest rate increase there will be an extended “wait-and-see” period before the next. It is important to keep in mind that the Fed does not wish to stand in the way of the already problematic return to the labor force of millions of individuals who have left it in recent months, and continuing job creation and rising wages are key factors in any effort to return labor markets to something resembling “normal.”

Data to Watch:

1. US Conference Board Consumer Confidence Index for January, released Tuesday, January 25
2. US Federal Reserve Interest Rate Decision, released 11am, Wednesday, January 26
3. US GDP Growth Rate, first 4Q 2021 estimate, released Thursday, January 27
4. US Personal Income and Spending for December, released Friday, January 28

Suggested Reading:

1. https://www.wsj.com/articles/procter-gamble-says-shoppers-are-unbowed-by-higher-prices-11642593626?mod=hp_lead_pos6
2. https://www.wsj.com/articles/states-are-swimming-in-cash-thanks-to-booming-tax-revenue-and-federal-aid-11642761003?mod=hp_lead_pos11
3. https://www.wsj.com/articles/the-spac-ship-is-sinking-investors-want-their-money-back-11642761012?mod=hp_lead_pos6
4. https://www.wsj.com/articles/fed-launches-review-of-possible-central-bank-digital-currency-11642706158?mod=hp_major_pos2#cxrecs_s
5. https://www.nytimes.com/2022/01/21/opinion/inflation-us-economy-biden.html

[1] Source: Robertson Stephens, Trading Economics US Calendar, Atlanta FED - GDP New

Investment Commentary:

Keep Things In Perspective

Market volatility continues, driving price swings through equity and fixed income markets as investors struggle to reprice assets in a shifting macroeconomic rates and inflation outlook. During 2021, the largest peak to trough price decline was 5% compared with a historic annual average of approximately 15%[2]. With stocks down from 2021 highs and interest rates having risen in 2022, market participants are faced with a fair amount of uncertainty in the short-term including the magnitude and speed of Fed tightening policies.

Background

Heading into 2022, there was growing consensus that the U.S. Federal Reserve would be on the move in 2022 to remove the extraordinary accommodation offered as the COVID crisis unfolded in March 2020. This makes sense. The U.S. economy is no longer in a health crisis period, and ultra-accommodative liquidity policies present more inflation risk than upside benefit. The question is whether the economy can handle higher rates — and our view is that the answer is "yes." With above-trend GDP growth and strong corporate fundamentals, along with above-trend inflation, we believe a less accommodative policy stance is necessary. We believe it is likely inflation slows as we head toward mid-year and base effects take place (we will be comparing 2022 data against the high 2021 results) and we see uneven alleviation of some of the supply chain-induced pricing pressures. That said, there is a risk that the ongoing strength in housing prices and wages continues to apply upward pressure on inflation data, which would, in turn, apply pressure on the Fed to continue to apply the brakes.

The Great Transition

As excess liquidity withdraws from the markets, equity investors are increasingly focused on determining the appropriate price for a stream of fundamental earnings which is typical during material inflection points. Additionally, the market is remembering that not all earning streams are created equally. For example, the relative valuation gap between growth and value is approximately 2.6x the historic average valuation difference[3]. The relative outperformance year-to-date of value over growth is approximately 7%[4]. We have also seen emerging markets and developed non-U.S. modestly outperform the U.S. These are some examples of why an intentionally constructed portfolio may help during periods of the Great Transition.

What's Next?

We believe that downward pressure on equities is not necessarily signaling the end of the current bull market, but rather the arrival of a more thoughtful market where fundamentals are increasingly relevant investment considerations. Strength in the underlying economy and corporate revenues should help sustain earnings growth which overtime support valuations. Although successful market-timing may improve portfolio performance, it is very difficult to time the market consistently. In addition, unsuccessful market-timing can lead to a significant opportunity loss.

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[2] Bloomberg
[3] Bloomberg
[4] Bloomberg

Keep Things in Perspective

To provide historical context, the table below illustrated how the stock market responded during other past growth scares and bear markets. It also shows the period positive market performance in the 12 months that followed these crises.

	Black Monday	Gulf War	Asia Monetary Crises	Tech Bubble	Financial Crisis	US Credit Downgrade	Trade War
Dates of S&P's Biggest Declines	8/25/87 – 12/4/87	7/16/90 - 10/11/90	7/17/98 – 8/31/98	3/27/00 – 10/9/02	10/09/07 – 3/9/09	3/10/11 - 10/3/11	10/3/18 - 12/24/18
U.S. Stocks	-33.5%	-19.9%	-19.3%	-49.0%	-56.8%	-19.0%	-19.6%
Next 12 Months	21.4%	29.1%	37.9%	33.7%	68.6%	32.0%	37.1%

Source: Morningstar

Wealth Planning Commentary:

Tax Update:

The $1.75 Trillion Build Back Better (BBB) Act is dead as a package. However, Democrat Senator Manchin, who's opposition helped lead to its demise, is now open to separately discussing some of the major provisions that were written into the BBB.

Senate Finance Chair Ron Wyden believes he can meet Manchin's demands by focusing on: climate and clean energy funding, expanded Affordable Care Act funding, universal pre-K, and prescription drugs.

New tax revenues to fund these programs are also part of the discussion. Manchin is particularly sensitive to increasing the deficit and inflation. Given the complexity of the negotiations it may be a couple of weeks before we gain clarity on any proposed tax changes. We do know that gaining support from democrat senators from NY and NJ will require the SALT cap be eliminated or increased.

Liquidity Planning

Withdrawing from your portfolio in times of adverse market conditions may negatively impact your long-term goals. Liquidity is important for financial health, peace of mind, and is a key component in keeping your long-term investment plan intact.

Liquidity is the amount of cash and equivalents held separately from the portfolio that is dedicated to short-term goals and funding expenses. It is most useful when income is no longer available and portfolio withdrawals are disadvantageous due to market conditions. Think of liquidity in terms of the number months to fund lifestyle expenses and add an amount for any short-term goals Since 1928 the average bear market was about 10 months, and we believe a good starting point for liquidity is 12 months.

A sufficient liquidity amount is unique to your circumstances, economic environment, and how much risk you are willing to take. Risk in this context is the probability of needing to withdraw from your portfolio.

Clients who are building wealth, dual income, and in an expansionary economic environment will likely require less than 12 months of liquidity. For retirees who depend on their portfolio 18-24 months of liquidity may be more appropriate. High and ultra-high net worth clients' liquidity calculations may also consider estimated taxes, capital calls, cash for new investment opportunities, and additional margin for property maintenance.

Lines of credit and margin accounts may also act as an additional buffer in the event of a market correction. Although interest rates are likely to increase and may be a less attractive source to fund lifestyle.

Liquidity is important for long-term portfolio resilience especially in the current market environment. It may also provide a peace of mind.

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