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Q4 2021 Commentary: The way we were…

It was a very good fourth quarter and year for the stock market marked by a resurgent economy and surprising earnings growth. The S&P 500 rose by 28.7% in 2021, tacking on 11.0% in the fourth quarter. Our value-based, contrarian, strategy more than kept pace with the market's return. Bond market returns were more difficult. The Barclay's aggregate bond index was flat in the quarter, and for the year was down 1.5%. Rising interest rates, which negatively impact bond prices, were the cause of bond market losses. A strong economic recovery and higher inflation that has been more persistent than transient, has led the Federal Reserve to accelerate plans to raise interest rates. We expect the Fed policy change to increase financial market volatility as we transition to a higher interest rate environment.

Looking forward to what is to come in 2022, expect further normalization in the economy and financial markets. The process will continue to be slow and uneven, but life is returning to pre-pandemic norms. Unexpected events, like the appearance of the omicron variant, are likely to keep cropping up. Hiccups along the way that unsettle financial markets will be opportunities to position portfolios for the continuing recovery. The economy has been strong and wage gains put the consumer in a good position. Unemployment is a low 3.5%. We have massive fiscal and monetary stimulus to thank for that. However, easy money is going away. Government benefits are being scaled back, but this is also part of a reversion to the norm. The economy is indicating growth will continue and advance under its own power.

Of concern are ongoing supply chain problems that have disrupted the availability of components needed in many sectors of the economy. These shortages have led to higher prices. Some of the problem is due to covid related labor supply shortages. The other factor is the much higher than expected demand for goods as consumers shifted to buying more goods and fewer services. This situation is a symptom of the extraordinary circumstances of the pandemic. As the pandemic transitions to endemic, supply chain issues will be resolved, and inflation will ease. The Federal Reserve has indicated that it will raise interest rates partially in response to inflation pressure, but also because its zero-interest rate policy is no longer necessary to sustain the economy. Rising interest rates are a headwind for the stock market. However, rates will rise only when economic growth justifies it and the Fed will pause should growth flag. As long as rates rise in a measured fashion, the stock market will handle the change. If the economy does well, corporate earnings will also do well. Since earnings drive stock prices, the stock market should do well even if rates drift higher.

In its simplest form, the stock market moves higher and lower on changes in corporate expected earnings and how much investors are willing to pay for those earnings. Both components came together in 2021 to push stock prices substantially higher than anticipated. S&P 500 earnings vastly exceeded all expectations in 2021. Growth will slow in 2022 but should still exceed 10%. The stock market ended the year near its all-time high. However, under the surface many of the most speculative stocks have traded substantially lower. Stocks that seemed to trade untethered to any valuation measure are now trading as much as 70% off their pandemic highs. Valuation matters, and the day of reckoning for valuation has arrived. We own companies that are profitable and reasonably valued and therefore in fine shape. A stock market that pays heed to valuation is another return to normalcy that is good for us and our portfolio.