BLOG POST
A Minefield for Investors
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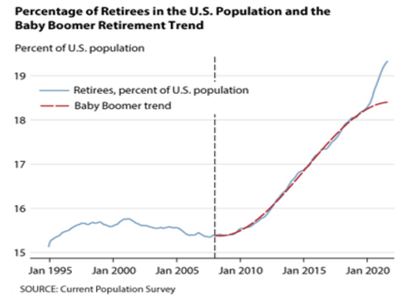
With markets seemingly priced for perfection, investors enter the new year faced with a minefield to navigate to avoid portfolios being blown up in 2022. After some mid-December volatility and concern over Omicron, Santa Claus appeared for investors, driving the markets back to all-time highs in most cases. However, some companies (and investors) are only receiving coal this year as their stocks badly trail the benchmarks. The Russell 3000, a broad market index, has seen 50% of the constituents drop by more than 20% from their peak and an alarming 20% of constituents have fallen more than 50% according to Bloomberg data. This level of divergence may be far more indicative of a coming bear market than a continued bull market as disruption becomes the "New Normal."



Investors are going to need to be particularly aware of four threats to their portfolios:

1. COVID (and the government's response)
2. Supply Chain dislocation
3. A Confused Fed
4. Political Instability (and desperation)

COVID has not only wreaked havoc on people's well being but is responsible for rapidly changing demographics that will impact the economy and markets. Rather than deal with uncertainty over lockdowns and fluid government policies, many have decided to retire early. According to St Louis Fed data, the Labor Participation Rate fell from 63% to 60% because of COVID and is creating persistent wage inflation and shortages. The latest variant, which in some respects closely resembles what used to be called a cold, is leading to new restrictions and is likely to crush demand and limit supply at a time when the government is unlikely to pass new stimulus as in 2020 and 2021. Some leaders appear bent on achieving zero COVID cases, which is unrealistic, and related policies are damaging to the real economy.

The dislocations in the supply chain are not going away in 2022 and could get worse before getting better. Talking to corporate insiders and analysts, I am hearing that the backlog on very basic components is growing longer, not shorter. We are likely to see rising prices in the face of falling demand, which becomes very difficult for the Fed to create policy around. This seems particularly true of technology hardware that now impacts everything from cars and trucks to hot water heaters and dishwashers. The obvious answer would be a jump in Capex spending, but companies are unwilling to build new capacity for products and technology they believe will be obsolete in the near future.

The Fed seems utterly confused to me. My guess is that they realize they missed the window to eliminate QE and start rate hikes when the economic growth was stronger. With growth weakening and real short-term rates approaching negative 6%, policy options are limited. If inflation was measured consistently with 1980 it would be 15% today and we still have rates near 0%. As an example, owner equivalent rents are only up 2.9% over the last year while home prices surged 20%. The Fed's belief that inflation was "transitory" may go down as the worst public mistake in Fed history. We have entered a stage of asymmetrical Fed policy: tightening will slow economic activity while loosening has little impact outside of financial markets. Notable economist Larry Summers has grown increasingly critical of the Fed and has called for the return of a Paul Volker type of leader at the Central Bank.

Where might investors seek shelter against the devastating impact of inflation and slowing growth? There are opportunities but wise investors probably already realize that market returns in 2020 and 2021 will prove to have been borrowed from future years. When the Fed kept the liquidity spigots open, investors preferred corporate debt to Treasuries, stocks over bonds, and speculative growth over value. These trends of the last several years are likely to reverse starting in 2022.

For fixed income, I think 2022 will reward investors who focus on credit quality instead of chasing yield. Speculative debt has worked great the last two years, but poor fundamentals may lead to strong selling in high yield. A barbell approach with short duration and long duration Treasuries makes the most sense given policy and economic uncertainty.

For equities, companies with high profit margins and sustainable pricing power should be the focus. At the top of the list is healthcare, which currently trades at a historically high discount to the S&P 500. Banks are also attractive and should be the early winners of any Fed tightening while energy is likely to lead all sectors in 2022 as oil prices rise above $80 and valuations are very low today.