Quarterly Commentary | January | 2022

A look back at 2021

At this time of the year, we always like to look back at our forecast from a year ago, before discussing our viewpoints for the upcoming period. While it’s near impossible to be correct on every item, we are pleased to see much of what we had anticipated for 2021 played out as we thought it would.

We expected the economy to be strong, and indeed it was in the first half of the year. Persistent supply chain issues restrained economic output, particularly in the second half of the year. We cited sustained levels of higher inflation as a risk for the markets, eventually forcing the U.S. Federal Reserve to consider a rate hike cycle. Initially, we didn’t see this happening in 2021. Indeed, both the Fed and the Bank of Canada have remained on the sidelines for interest rate policy. The Fed policy rate remained at 0%-0.25%, and the Bank of Canada rate at 0.25% for all of 2021, despite higher inflation than we’ve seen in decades. The central banks have been patient, given the persistence of COVID and the hard to predict economic consequences of the disease.

While COVID continues to be a problem, and we have yet to get to herd immunity, the world is getting vaccinated. Close to 80% of Canadians are now fully vaccinated, and in the developed world, most countries have gotten to a 60% to 80% full vaccination rate. The challenge remains in the developing world, as vaccine availability and skepticism has resulted in low vaccination rates particularly in Africa. The identification and possible origination of the Omicron variant in South Africa should not come as a surprise.

We had high conviction in our call for stocks to outperform other asset classes, namely cash and bonds. Our belief was that interest rates were likely to remain at levels that would continue to force investors into stocks, simply because from an asset allocation perspective, there is no alternative. Specifically, we wrote *“The conviction to increase stock ownership becomes stronger with the explicit promise of low interest for quite an extended time by the U.S. Fed. This has boosted stock valuations. We have used this phrase before, “don’t fight the Fed”. When the most influential central bank in the world is on a path of lowering rates, and keeping them low for years, stock markets and other risk assets typically do well, regardless of valuation.”* Indeed, stocks outperformed cash by a significant margin, and bonds detracted from performance throughout the year. For equities, we expected a bounce back in value / cyclical stocks versus growth stocks, and while there were periods of outperformance by value stocks during the year, continuing COVID worries meant growth stocks finished the year bettering value stocks once again. From a portfolio perspective, rather than take any “big bets” on a certain outcome, we used a barbell approach, a combination of exposure to reasonably priced secular growth companies (technology, ecommerce, healthcare), and more economically sensitive value names (banks, metals, energy). We leaned slightly more towards the economically sensitive names as we expected investors to begin to look beyond COVID and more towards the resumption of life as it was prior to the pandemic.

Squirrels, nuts, and the coming winter
December is typically a seasonally strong month for the stock market, yet the emergence of the Omicron variant and the U.S. Federal Reserve's more hawkish tone have led to greater uncertainty, and more market volatility. However, heading into the new year, we continue to expect stocks to outperform cash and bonds once again. While the Federal Reserve, having telegraphed three rate hikes for 2022, will become much less market friendly, but the transparency of their message should mute the impact of those rate hikes. Three hikes would bring the Fed funds rate to a still extraordinarily low range of 0.75%-1.00%. While the direction of interest rates should lead to a slight reduction in the valuation for the market, another strong year of earnings growth should more than outweigh this, leading to modest gains for stocks in 2022.

In 2021, companies reported earnings that were well ahead of expectations, and we see this continuing next year. Chart 1 shows actual earnings per share for the S&P 500 companies at the end of each calendar year (light blue) versus the initial expectations established at the beginning of that year (dark blue). Historically, expectations are usually too optimistic, highest at the start of every year, followed by a gradual reduction in those expectations as the year goes on. Although the full year 2021 earnings have not yet been reported, if the fourth quarter beats are similar to the first three quarters of the year, earnings should end up at $205.41/share, 22% higher than expectations at the start of this year. Chart 2 shows the magnitude of quarterly earnings beats for S&P 500 companies in the past ten years, keeping in mind quarterly earnings expectations see adjustments through the course of the year. Prior the pandemic, the largest quarterly average S&P 500 earnings beat between 2012 and 2019 was 6%. In 2021, the earnings beats ranged from 15% to 20+%! Consensus estimates are for S&P 500 earnings to grow by 8% next year, another healthy advance. With nominal GDP (not inflation

Chart 1: S&P 500 Earnings per share (EPS) estimates at start of the year versus actual EPS

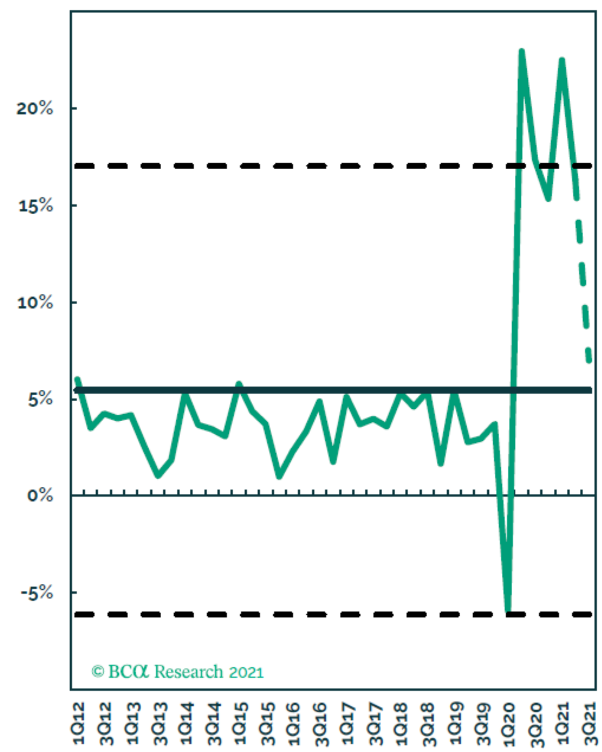
	CY10	CY11	CY12	CY13	CY14	CY15	CY16	CY17	CY18	CY19	CY20	CY21*	CY22
EPS (Start of Yr.)	79.96	98.24	109.16	115.18	122.63	128.82	127.79	133.22	147.57	174.04	177.92	167.38	222.32
EPS Actual	87.11	98.99	105.35	111.45	119.06	118.82	119.40	133.61	161.56	163.13	174.50	205.41	

Source: FactSet

adjusted) growth expected to be in the 8-10% in 2022, it's reasonable to expect sales growth to track nominal GDP, thus the earnings estimates may be on the low side once again, setting up for a year of more modest earnings beats.

As for inflation, we believe we are at or near peak inflation. There's already softening of some inflationary factors, including pullbacks in commodity prices from recent peaks, and near term weakening in the Baltic dry index, which measures average prices paid for the transportation of dry bulk materials on cargo ships. This is a positive from the perspective that the Federal Reserve is unlikely to need to hike rates at a pace that is much faster, or by a greater magnitude, than what they've already communicated. We see inflation on a downward trajectory and expect it to eventually settle at a level that will be much lower than current readings but higher than where it was prior to the pandemic primarily due to higher wage costs.

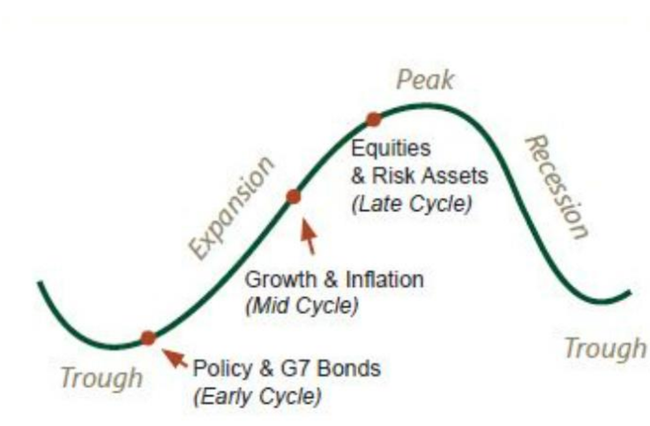
Chart 2: S&P 500 quarterly earnings beats



Source: BCA Research

With the rate hike cycle about to commence, we are entering a new investment backdrop, likely with more market volatility, but nevertheless a good environment for the stock markets. Even though there are worries about the rate hikes, statistically, the market usually does well in the year following the initial hikes, that's because hikes occur when the economy is strong, and on solid footing, an environment which is typically great for companies. It's when rate hikes proceed at a rate and magnitude that leads to a dramatic tightening of overall financial conditions that it becomes a problem for stocks, but we are still far from that point.

Chart 3: The Policy, Economic and Investment Cycles



Source: MRB Partners

COVID continues to be the great unknown. We still don't know what magnitude the Omicron variant will have on the global economy, and for how long. While there is some hope that the health impact from Omicron may be milder than for previous COVID strains, there's not yet enough information to be sure. Indications, however, show that the health impact on the vaccinated population is less, and this is good news since more and more of the world's population is getting the jab.

We are not concerned about greater market volatility, nor do we have concerns about garden variety market pullbacks. These are necessary elements of any healthy bull market. It is however the larger, end of bull market cycle declines (the 2000 and 2008 bear markets), that we are most vigilant in trying to identify. We strive to be pro-active in reducing portfolio risk when warranted. For now, there's simply too much good news on the economic and profit front to be bearish.

Once again, we expect stocks to outperform other asset classes, however our level of conviction is lower than it has been at any time in the past year. This is because central bank policy (interest rates), the economic cycle (growth and inflation), and the investment cycle (stocks and risk assets) are all out of sync (Chart 3). This environment leads to more uncertainties that could prompt us to reassess the outlook with greater frequency. However, like squirrels, we're looking to collect as many nuts as we can before winter's arrival. We see an opportunity to collect more nuts in 2022, fattening up the portfolios before it's time to hunker down.

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