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1st QUARTER OUTLOOK

The Rotating Climb Higher

Before we peer into our crystal ball for 2022 let us first have a quick look back at what transpired in 2021. Succinctly put, it was a good year for stocks. Now, of course that does not mean all stocks did well, but the market averages all performed admirably. We saw many rotations throughout the year, some on a day-to-day basis. But the first part of 2021 saw the reopen trade take front and center. Traders rotated out of the shares of the stay-at-home winners of the previous year and placed their bets on vaccines and the hope that the world had seen the worst of Covid-19.

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Well, as we now know, it wasn't the end of Covid-19 as the world was introduced to Beta, then the viscous Delta variant, and of course the Omicron variant at year end. So, the rotation into value/re-open stocks reversed once again and in the second half of the year we saw the big growth names lead the market to new highs. The advance which was broader based early in the year became narrower in the second half of 2021. Importantly, the advance in share prices continued almost unabated throughout the year despite pandemic and inflation issues (we'll talk more about inflation in a minute).

Yes, we had a few minor pullbacks along the way, but investors stayed the course, and the market averages ended the year at or near all-time highs.

The pandemic was not a new issue for market participants to deal with as we moved into 2021, but inflation sure was. The type of inflation experienced in 2021 had not been seen in decades. We heard a lot about supply chains being frozen from reporting companies and then experienced it as the year unfolded. Sure, wages were increasing (a major inflationary pressure for companies) but prices of goods and services were increasing even faster. Still, despite these headwinds, stocks pushed higher and higher as the year unfolded.

Interest rates moved higher throughout the early part of 2021, but in the second half of the year the 10-year Treasury note which had touched 1.70% earlier in the year moved back down to finish the year near 1.50%. Low interest rates and continued accommodative monetary policy supplied much of the fuel needed to move stock prices higher in 2021. This, of course, was not new. Fed policy and low interest rates have helped move stock prices higher for more than a decade. But, as we will discuss, as we enter 2022 things are changing, and investors will have to grapple with conditions they have not seen, in most cases, in their lifetime.

The Winds of Change

Inflation

As mentioned, we enter 2022 with conditions that have not been seen in some time. Inflation is higher than it has been in decades with the Consumer Price Index sporting a six handle. Consumers have seen inflation over the past few decades, especially during spikes in energy prices, but consumers have not seen prices at the grocery store, the department store, the gas pump, restaurants, and other services rise in the manner which they have in recent months. For years, the Fed has been flushing the economy with money with the intention/hope of just getting inflation back to 2%. You see, a little inflation is actually good for the economy and the Fed has been desperately trying for years to produce some. But the great re-opening (though it has been interrupted periodically as Covid-19 variants appear) caused a huge spike in demand at a moment in time when production had not yet recovered. Shortages at the wholesale level are passed through to the retail level and the consumer is left paying more for goods and services.

“...but the Federal Reserve has made its choice and war on inflation has been declared.”

The obvious problem with inflation is that it becomes a tax on the individual, especially hitting hard those at the lower end of the economic scale. As mentioned, wages are increasing, but not at the same pace that the prices of goods and services are rising.

We will talk about the Federal Reserve in just a moment, but their dilemma as we look into 2022 is whether these inflationary pressures we have seen from the great re-opening are temporary (the Fed for most of 2021 used the term transitory which means

something slightly different), thus alleviated when supply chains fully reopen, or are they embedded into the fabric of the economy? Wage pressures are likely to remain. Commodity pressures and supply chain backups may or may not be a different story. Only time will tell, but the Federal Reserve has made its choice and war on inflation has been declared.

The Federal Reserve

As mentioned earlier, the Federal Reserve's monetary policy has been mostly accommodative (dovish) for years now. The Fed has a dual mandate of employment and price controls (inflation). Like the financial crisis of 2008, the pandemic caused massive employment dislocation. As businesses shut down, employees were laid off. In April of 2020, the Fed sprang into action once again lowering the Fed Funds rate to zero and providing liquidity via asset purchases (bond buying). These emergency measures were important in keeping things afloat at that moment. Fiscal policies (Congress-The Cares Act) are harder to enact and typically take much longer to do so. So, the Fed realizing the employment crisis at hand used what powers they had at their disposal to relieve the pain. The Fed's liquidity did, indeed, help keep the economy from diving even deeper into the abyss. Yes, it is true that much of the liquidity the Fed provides works its way into financial assets (stocks and bonds). But remember, a good portion of this country have their savings and retirement plans in financial assets. When those assets are moving lower in price folks feel a lot less wealthy. It's called the "wealth effect." When folks feel less wealthy, they spend less. Also remember, consumption is the major component of the economy. When

consumption tumbles the economy suffers-jobs are lost, etc.

So, one could argue that the Fed stepped up in a time of crisis and helped save an economy that was in danger of being destroyed by the pandemic. But the Fed's accommodating monetary policy also had consequences. Remember, the Fed for years has been trying to produce some inflation into the economy. But the dovish monetary policy combined with the massive fiscal spending stoked a lot more inflation than the Fed wanted. Hoping that the pace of rising inflation was "transitory" the Fed maintained its dovish stance in order to continue to address its other mandate-employment. One could say that the recent 3.9% read on unemployment is a success. There are more than ten million jobs available in this country and employers are having a challenging time filling needed positions.

As we mentioned, inflation is now the concern, and the Fed has reversed its dovish stance and has embarked on a concerted effort to fight the very inflation that they had a hand in creating. They are reducing their asset purchases which should end in the first quarter of this year. In addition, they are indicating that once asset purchases have concluded that they are likely to begin to raise the Fed Funds rate which now still sits a zero percent. Finally, they are even hinting that they might, at some point in the future, even begin to reduce the Fed's balance sheet, which could be done by runoff or actual selling of assets. This new direction is quite a change and is likely to produce a headwind that investors will be dealing with in 2022 and beyond.

"When the cost of money is zero, risks can be taken that would not be taken if the cost of money was higher."

Headwinds

As mentioned, the Fed's hawkish turn is likely to be a headwind for financial assets as we work our way through 2022. First, taking the liquidity punch bowl away by eliminating asset purchases takes a big buyer out of the market. Second, the possibility/likelihood of rising interest rates certainly puts a strain on bonds and can also eventually become competition for stocks. Remember, as interest rates rise, the prices of fixed income instruments (bonds) fall.

But, yes, stocks can also be affected by rising interest rates. Money market rates going from zero to 1% probably doesn't make folks decide to sell their stocks and move to money market accounts. But if rates continue higher at some point the "safe" yield can become competition for the more variable returns of the stock market. Moreover, just the appearance of rates moving higher and at a rapid pace could unsettle the stock market. None of this changes the fact that stocks, over extended periods of time, continue to be the best way to create wealth for investors. It only means that 2022, might be a bit more challenging than 2021 was with regards to the stock market and financial assets in general.

We have already seen, in a noticeably brief time, the affects that Fed policies and rising interest rates could have on certain kinds of stocks too. High valuation growth and technology names have had a difficult time recently while more stable, dependable earners have fared better. When the cost of money is zero, risks can be taken that would not be taken if the cost of money was higher. That is possibly the environment we are heading into in 2022.

Guessing where the stock market is going to end up on a yearly basis is a fool's game. We don't partake in such prognosticating.

“...make sure that your asset allocation is appropriate and that you understand where you have volatility vulnerability.”

But we will guess that this year will see more volatility than we had in 2021. Given that stocks never lost more than about 5% as measured by the S&P 500 during 2021, implying that 2022 will be more volatile isn't exactly going out on a limb. But in addition to mean reversion (the S&P 500 usually has nearly a 15% move down from the highs on average in a typical calendar year) we now know that the Federal Reserve will no longer provide the massive tailwind we have seen for years. We also know that inflation is likely to cause interest rates to go higher. So, in general, the conditions will be more challenging for stocks in 2022. But if we have already seen the worst of the inflationary spike (re-opening pressures abate) and if companies continue to do well and produce positive earnings growth as expected, stocks could still provide a nice return for investors in 2022. The ride might just be a bit bumpy.

Summary

2021 was the third good year for stocks in a row. But as we enter 2022 investors will be dealing with a new set of challenges. First, we have seen inflation reach a level that we have not seen for decades. Inflation is a tax on the consumer. Some companies can efficiently pass on price increases, some cannot. In addition, investors will be dealing with a Federal Reserve that is reversing course on the accommodative policies of the recent past. Remember the old Wall Street saying, “don't fight the Fed”- it can work both ways. If interest rates rise, fixed income investors will be challenged. The bull market in bonds has for the most part been in tact for 40 years. Most investors have never

dealt with anything but a bull market environment for bonds.

All of these challenges/headwinds simply mean that 2022 is going to likely be a little more “interesting” for investors than 2021 was. The answer for investors is to make sure that your asset allocation is appropriate and that you understand where you have volatility vulnerability. And remember, volatility creates opportunity.

As always, we appreciate that you entrust us to manage your money and guide you on your road to financial success. We strive to keep you informed and to provide you with the best service in the industry. This pandemic has certainly continued longer than any of us had hoped, but hopefully our daily updates have been comforting and informative during the past two years. Do not hesitate to contact us with any thoughts or questions. If you feel that we can help someone you know and love, get on their path to financial success don't hesitate to let us know. Stay safe and most of all try to stay healthy.