ALTMAN
INVESTMENT MANAGEMENT

MARKET PERSPECTIVE

JANUARY, 2022

The most important attribute for success in value investing is patience, patience, and more patience. The majority of investors do not possess this characteristic."

- Peter Cundill

IN FOCUS: Looking Back at Fourth Quarter – and Ahead

This past year was no doubt a remarkable year for U.S. financial assets, as we experienced a resurgence in economic growth, employment approaching pre-pandemic levels and income exceeding 2019 highs. Although GDP growth in the third quarter was revised lower to 2.3%, we still grew over 6.0% in the first two quarters of the year.

A Look Back at Equities:

We finished the calendar year with U.S. equities returning an unexpected 28.7%, compared with a more modest 19.9% for other developed countries' equities in local currency terms - and practically no return for those of emerging markets, again in local currency terms. Equities of the world's second-largest economy, China, not only significantly underperformed U.S. equities but also recorded the worst performance of any major equity market, with a total decline -21.2% in Renminbi terms. Such strong 2021 equity performance came in the wake of an already extended bull market in U.S. equities.

Looking ahead, investors continue to monitor areas of uncertainty including high equity valuations, a shift in the U.S. Federal Reserve toward tightening monetary policy, risks of higher inflation, rising geopolitical risks with Russia and China, a virulent strain of domestic politics in the U.S. which may present an existential threat to U.S. democracy and a business-friendly environment. All this under the uncertainty surrounding the impact of known and unknown mutations of Covid-19, including the now highly contagious Omicron variant.

Inflation seems to be taking its toll on Fed policy and investor sentiment is concerned with higher input prices and continued capacity restraints. Inflation rates have become cumulative and the Fed now acknowledges that it is a phenomenon that can be very hard to reverse once it starts. Our forecast of 6.0% real GDP in 2021 and 3.5% growth in 2022 will most likely be shared with an elevated inflation rate of similar magnitude. We're expecting corporate profits reported to approach 47% in the S&P 500 in 2021 and high single digit growth in 2022. We believe that the supply chain problems get resolved soon and relieve current elevated inflationary forces.

Our 2022 forecast assumes a downward shift in consensus expectations for both fiscal and monetary policy, as the FOMC minutes will reveal that the Fed is reducing its balance sheet sooner and will start raising the fed funds rate pushing the 10-year U.S. treasury bond yield to above 2.0% by early 2022. The Fed has moved quickly away from the word "transitory" to using the phase "persistent" when discussing supply chain disruptions and inflationary pressures, which has resulted in consensus expectations of four fed fund rate hikes in 2022.

However, we expect the U.S. market will continue to demonstrate its preeminence relative to the rest of the world with remarkable resilience of its households and businesses sectors by endorsing technologies that allowed participants to adjust to a pandemic shut down. These emerging trends accelerated in a digital age and generated outsized returns on selective technology beneficiaries. The U.S. has accomplished this transition relatively smoothly creating a stronger recovery in growth, employment and profitability. This was accomplished with higher labor productivity and superior corporate management leadership. Accelerating earnings per share growth, higher research and development budgets, greater innovation, and more favorable demographics, have bolstered our view that the U.S. should continue to warrant a premium valuation versus other markets on a global basis.

Examining how the stock market performs in a rising rate environment, we observed that between 1965 to 2009 stocks and rates moved in tandem until the 10-year Treasury reached 4.5% when the negative correlation surfaced. According to our research, since 2009 that negative correlation moved back to an interest rate of 3.6%. With the 10-year at 1.78%, history would suggest that we have a long way to go before rising rates become negative for equities. Since rates have been so low for so long with such a high level of Fed Reserve intervention, past comparisons could cloud the waters. In 2021, investors have learned that fixed income investments are not so "risk-free" after all, as the average bond indexes showed negative returns. As interest rates continue to rise which we expect, fixed income investors will experience more turbulence in the year ahead and could result in two consecutive years of negative returns (which we haven't seen since 1974). It's interesting to note that despite these returns in 2021, investors still plowed $587 billion into bond funds or at twice the rate as stock funds.

CLOSE-UP:

A Note on Fixed Income and Currencies:

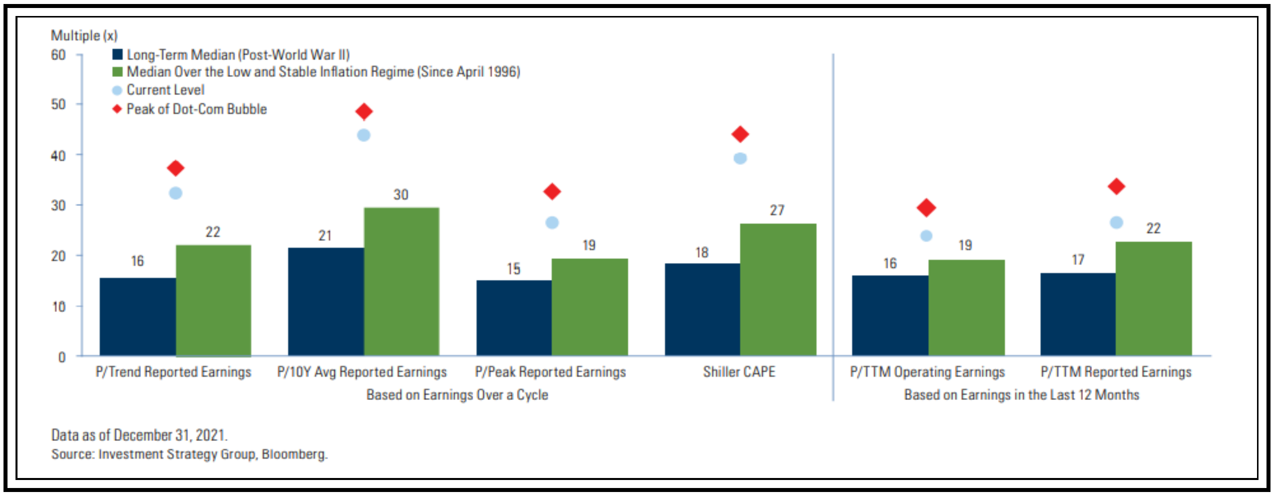
In fixed income, U.S. municipal bonds, with a 0.5% return, outperformed government debt in the U.S. (-1.7% return), Eurozone (-1.4% return), UK (-3.0% return) and Japan (-0.1% return), as measured by one- to 10-year market indices in local currency terms. U.S. high yield municipal bonds returned 7.8% and U.S. high yield corporate bonds returned 5.3%, compared with 4.2% for the Eurozone, -8.8% for emerging market local debt. Again, Chinese high yield corporate debt not only significantly underperformed that of the U.S. but was one of the worst-performing markets declining a staggering -26.3%. On the currency side, the Dollar Index (DXY) appreciated by 6.4% relative to developed countries' currencies and the Dollar Trade-Weighted Index (TWI), which measures the dollar against the currencies of key U.S. trading partners, appreciated 4.8%. The dollar advanced 3.6% versus gold.

Staying concentrated in U.S. equities:

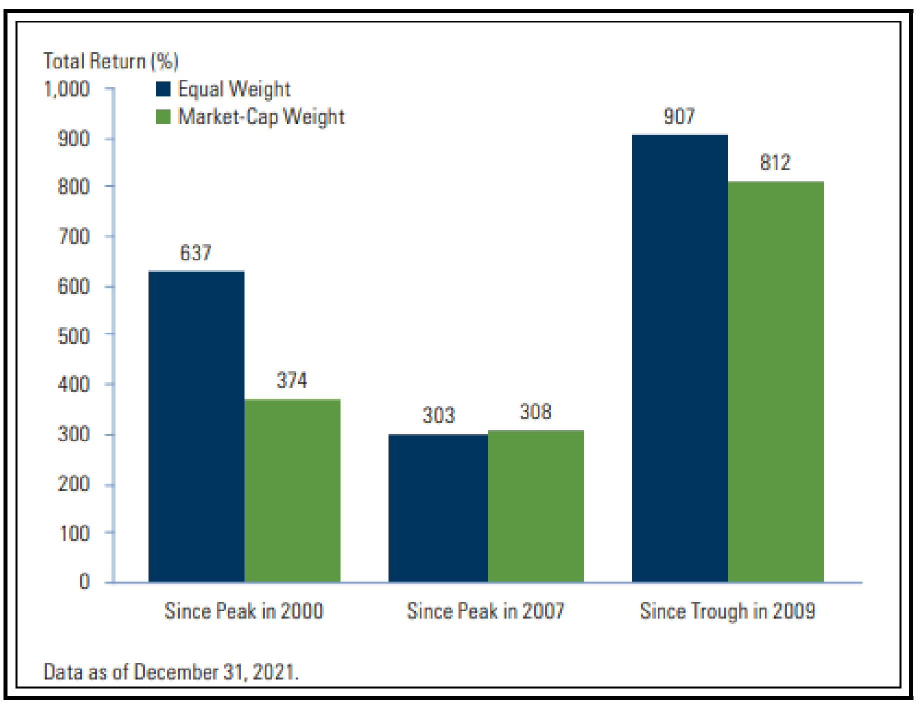
The U.S. market continues to demonstrate its preeminence relative to the rest of the world, with remarkable resilience of its households and businesses sectors. This has been accomplished by endorsing technologies that allowed participants to adjust to a pandemic shut down, which only accelerated emerging trends in a digital age, and generate outsized returns on selective technology beneficiaries. The U.S. has accomplished this transition relatively smoothly creating a stronger recovery in growth, employment and profitability. This was accomplished with both higher labor productivity and superior corporate management leadership. Accelerating earnings per share growth, higher research and development budgets, greater innovation, and more favorable demographics, have bolstered our view that the U.S. should continue to warrant the premium valuation versus other markets on a global basis.

Current valuations may be 40% above median levels during low and stable inflation, but they are not as overvalued when compared to median levels post WWII. Market returns have been broad based with the S&P 500 capital weighted index up 28.7% in 2021, as compared to 24.9% excluding FANGMANT stocks. During the Dot.com bubble (the year prior to the peak in early 2000), the S&P 500 index return, which was dominated by a few large cap technology companies at the time, was double that of the equal weighted index. Interest rates are also relatively low which supports higher valuations. The average yield on the 10-Year since WWII and mid Dot.com (1996) is 4.6% and 3.6% respectively. Even as interest rates rise and the Treasury climbs over 2%, it remains well below prior peaks.

Valuations have been higher during periods of low and stable inflation than over the entire post war period.

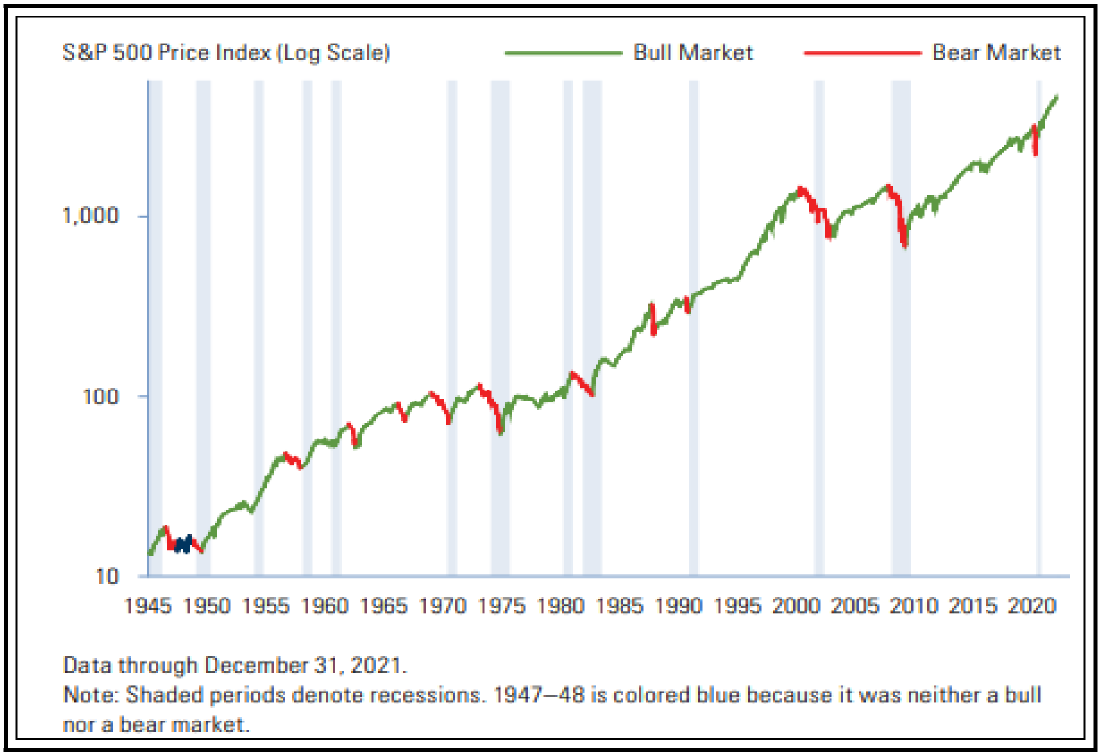


This bull market has not been driven by only a handful of stocks.



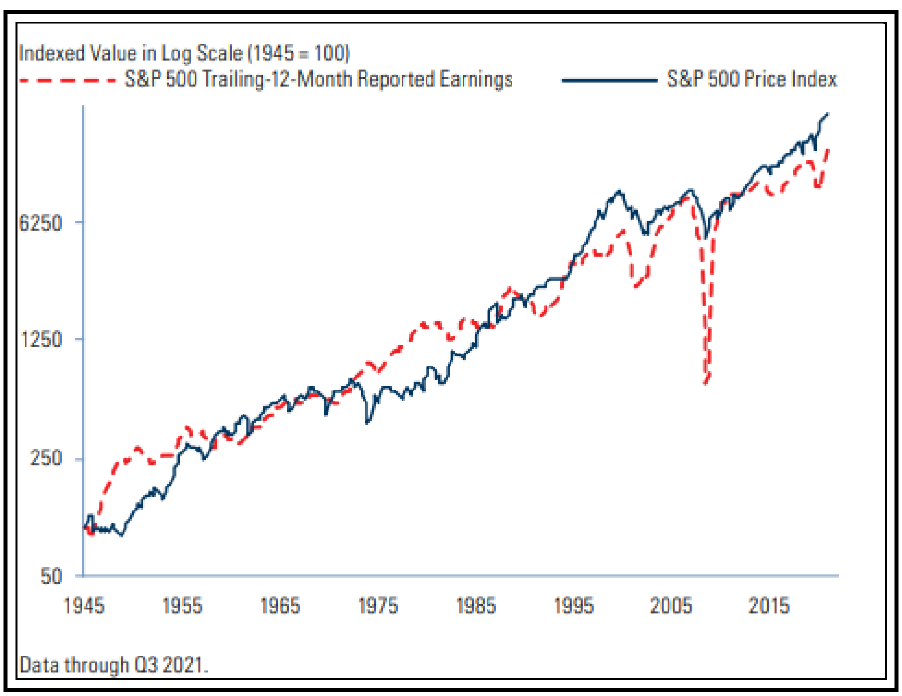
Source: Goldman Sachs Outlook – January 2022

<u>US equities have generated positive returns most of the time over the long run (69% of the time equities are rising).</u>



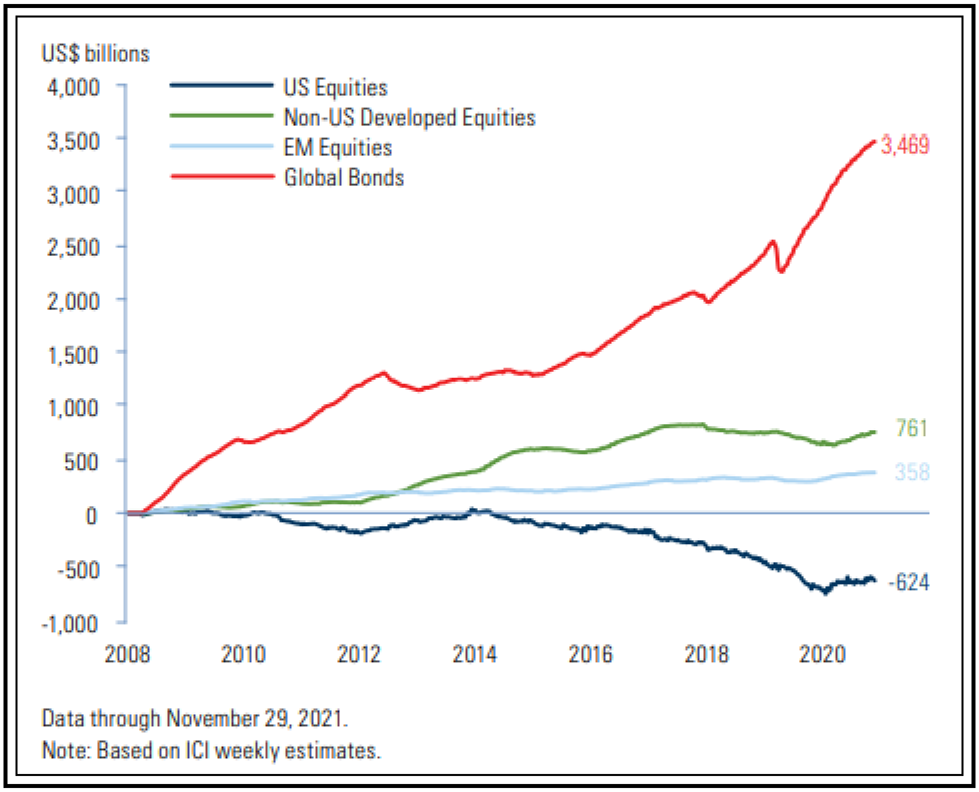
Source: Goldman Sachs Outlook – January 2022

<u>Prices of US equities follow the path of corporate earnings in the long run.</u>



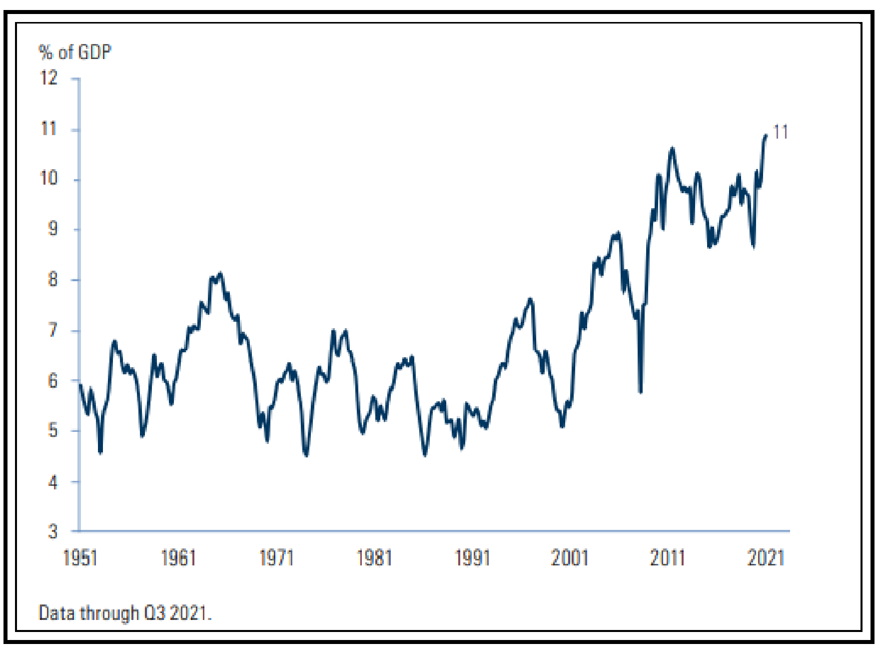
Source: Goldman Sachs Outlook – January 2022

<u>Irrational exuberance has not resulted in mutual fund flows into equities- quite the opposite versus 2000. US allocations into equities barely exceeded outflows – the first year since 2014. Investors have favored bonds and non-US equities throughout this bull market.</u>



Source: Goldman Sachs Outlook – January 2022

<u>Although the US equity Market Cap as a percentage of GDP is at a record high. US corporate profits are also at record highs. See chart below of U.S. after-tax corporate profits as % of GDP.</u>



Source: Goldman Sachs Outlook – January 2022

IN SUMMARY:

We remain convinced that staying fully invested at the high end of our asset allocation strategy (70% equity/ 30% fixed and cash) as we enter 2022 remains a prudent course. Since the trough of the Global Financial Crisis, we have encouraged this position consistently, especially during market downdrafts when investors, fearing much steeper declines, were tempted to exit the equity markets. We have also encouraged our clients to remain invested after strong market rallies when high valuations and economic and geopolitical risks prompted many to consider locking in their gains and exiting the equity markets. We believe we are currently in one of those latter environments. We have had three consecutive years of double-digit returns: last year's 29% return followed an 18% return in 2020 and a 31% return in 2019, for an annualized return of 26%. In considering these strong returns, and a nearly 13-year bull market, a number of market pundits are warning of bubbles bursting and imminent corrections.

While the margin of safety has declined given the current high valuations in equities, we continue to recommend staying invested at this time in the equities outside the dominant index players. As we witnessed in 2020 and 2021, financial markets' reaction to the pandemic was unpredictable. We are reminded that investment success does not favor timing investments but staying the course by taking a long-term view - and this is reflected in stock market returns over time. The reason why most investors don't achieve high single digit historic returns in their investment portfolios is partly because they let their emotions get in the way - chase the latest fad for "fear of missing out", pile into equities at market peaks or sell at market troughs – with disregard for the fundamental drivers of the underlying businesses that they own. However, we remain vigilant with respect to the known risks outlined above – and are watchful for early signs of other risks that will surface in the future.