Q4 2021

Maclura Investments

Year-End Review and Outlook

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In our 2020 review that we published a year ago, we concluded that most people would have classified 2020 as a miserable year, but for investors, it was extraordinary. That conclusion also seems appropriate for 2021, as Covid variants (Delta and Omicron) interrupted our expectations of a return to a more normal environment for the world's economy, but markets continue to benefit investors, particularly in the U.S. equities market.

The Morningstar U.S. Market Index, a broad representation of the overall equities market, was up 25.78% for the year, bettering the results of 2020 when it was up 20.90%. For the past 10 years, the index has returned a cumulative annual growth rate of 16.36%; an impressive feat but unsurprising given the easy monetary policies implemented by the Federal Reserve since the Great Recession of 2008 - 2009.

Morningstar Index Market Returns	2016	2017	2018	2019	2020	2021
U.S. Market	12.44%	21.47%	-5.05%	31.22%	20.90%	25.78%
Developed Markets	5.80%	20.30%	-10.98%	24.98%	13.88%	18.98%
Emerging Markets	8.32%	32.46%	-15.83%	15.18%	15.91%	-2.42%

Developed and Emerging Markets, as illustrated in the above table, had difficulty in keeping up with the U.S. Markets, as Covid hindered a return to normal in most of the exporting countries. Most U.S. fixed income benchmarks had returns in a range of plus to minus 3% for the year. In an environment of rising interest rates, bond indexes, fixed income mutual funds, and fixed income exchanged traded funds (ETFs) will continue to be negatively impacted as bond prices go down as interest rates go up.

								2021				
	Morningstar Index Market Returns	2015	2016	2017	2018	2019	2020	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	2021
Growth	U.S. Growth	5.54%	3.16%	29.52%	0.78%	35.90%	44.65%	0.61%	13.90%	1.50%	7.29%	24.79%
Growth	Large Growth	7.71%	1.79%	31.15%	2.94%	33.81%	38.86%	-0.73%	15.42%	2.35%	3.59%	21.47%
Growth	Mid Growth	-0.71%	6.46%	25.67%	-3.16%	36.01%	46.17%	-1.62%	11.33%	0.20%	4.76%	14.97%
Growth	Small Growth	-0.18%	9.61%	23.77%	-5.67%	27.60%	43.52%	-0.42%	4.79%	-0.35%	-0.65%	-1.00%
Value	U.S. Value	-2.16%	20.79%	14.23%	-7.51%	25.09%	-1.31%	12.49%	4.03%	-1.36%	7.40%	23.98%
Value	Large Value	-1.43%	18.91%	15.09%	-5.90%	25.70%	-0.62%	10.13%	3.82%	-1.26%	7.62%	21.49%
Value	Mid Value	-2.57%	25.21%	13.02%	-10.63%	24.81%	-3.76%	17.21%	4.19%	-1.49%	7.25%	29.02%
Value	Small Value	-8.65%	27.96%	8.40%	-16.61%	19.96%	1.01%	21.41%	5.41%	-2.06%	5.13%	31.79%

At the end of 2020, there was much debate regarding the style of stocks that would lead 2021: value or growth. The results in the above table show that both styles had favorable results, particularly large cap growth and small cap value stocks. The only down sector for the year was the small cap growth benchmark, as the threat of higher interest rates negatively impacted that relatively expensive sector.

2022 Outlook

There are three factors that will have material impact on the market over the next year and beyond: Covid, central bank actions, and inflation. All of these factors are interrelated and influence the outcome of each factor; however, inflation has some interesting influences that could determine where it evolves over time.

The first factor, Covid, provides a real quandary. In our 2021 outlook, we believed that the vaccine rollout would provide a much needed “light at the end of the tunnel” conclusion for the Covid pandemic. Unfortunately, the world continues to try to figure out how to live with the evolving situation as variants continue to close down portions of economies throughout the world. There is no doubt that Covid is truly the wildcard for 2022 market returns, and it is really anyone’s guess on whether it intensifies or diminishes in its ability to impact the world’s economies. Nonetheless, it is our expectation that the “return to normalizations” become more prevalent throughout the world. Regardless of how “normal” looks, the actions resulting from the virus over the past two years on society and businesses have provided enough material for historians to keep busy analyzing its impact for decades.

The visibility of the other two factors (central bank actions and inflation) are more easily forecasted. For the past 13 years, the majority of the world’s central banks have had accommodating monetary policies, providing significant capital to help restart and strengthen local economies to a self-sustaining level. These actions resulted in near zero to negative interest rates throughout the world as central banks acquired debt to provide liquidity. In September, the U.S. Federal Reserve initially announced that it was going to taper its monthly $120 billion bond buying program by $15 billion a month but then increased the tapering amount to $30 billion as inflation continued to be robust. Additionally, the Federal Reserve’s latest projections showed three rate hikes in 2022 and three rate hikes in 2023. With these actions and projections, it is natural for interest rates to start rising from historically low levels but still far from levels that should negatively impact most equities. From the current Fed Funds target interest rates of 0.00% - 0.25%, most projections believe the three increment increases would raise the Fed Funds rate to 0.75% by the end of 2022.

With rising interest rates, the market could see a repeat of 2021 where high valuation small cap stocks with long duration cash flows continue to be negatively impacted as capital moves to more value and large capitalization stocks. As discussed in previous quarterly market commentaries, regardless of the Federal Reserve’s actions, there continues to be a significant amount of liquidity (capital) in the economy which should continue to be deployed into equities with the mantra frequently repeated over the past several years, There Is No Alternative (TINA), with interest rates continuing to remain low.

Inflation continues to be a complex and controversial factor impacting the markets. Complex because of the multiple factors influencing inflation, such as monetary and fiscal policies, global supply chain disruptions, limited supply of goods, etc. Controversial because of the confusion of the meaning “transitory.” There is no question that aggressive accommodating monetary policies can drive inflation, but the world’s central banks were confounded by the lack of inflation after 11 years of quantitative easing policies. It wasn’t until Covid hit that inflation started to materialize. No doubt that the recent spike in inflation is significant, but inflation will still likely be “transitory,” regardless of the political pressuring of Fed Chairman Powell to remove the “transitory” reference to inflation from its official communication in September.

While it would appear that “transitory” to Washington, D.C., means a time frame of a few months, Federal Reserve Chairman Jerome Powell’s reference to “transitory” was always for a limited extended period of time, such as multi-year. It is unlikely that we are heading into a time period of rampant inflation as seen in the 1970s and 1980s because of the lack of supply of nearly everything. If the inflation was being accommodated with an adequate supply of goods, then a higher level of inflation would be sustainable. But as the global supply chain returns to normal, and it eventually will, the economy will see a significant pullback in the inflation rate, which will result in a market that will favor large, well- positioned companies taking significant market share gains from smaller companies. This will likely take two years to unfold, but the markets will eventually return to normal supply, and there will be an uneven playing ground for those companies not prepared.

There is a wildcard on the long-term inflation outlook, and it has been festering for years out of sight of most individual investors’ perspectives as the capital markets have been influencing companies throughout the world to embrace the Environmental, Social, and Governance (ESG) factors. Most individuals who hear of ESG don’t understand what it means, but the ESG movement has done more to influence companies to adopt certain non-financial factors into running their business than any political movement or policy has done. One of the policies encouraged to be adopted by this movement is the net-zero carbon policy, where corporations pledge to be carbon neutral by a certain time in the future. Companies are announcing these pledges in an effort to remain favorable to institutional investors for access to capital when it becomes necessary. While it’s always noble to be good stewards of the environment, the realistic probability that all these companies reach their goals in a timely and economic manner is slim to none, and slim just walked out of the door. This will likely result in companies trying to obtain their net-zero carbon goals at any cost, eventually driving up inflation, but it will be towards the end of this decade before we see how it unfolds. Fortunately, there are ways to invest which capitalize on this trend by investing in companies that help measure corporations’ progress in obtaining their ESG goals. While the revenue is small from this portion of the business for most companies, it is expected to grow significantly as the net-zero deadlines approach.

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At the end of 2020, we projected that while there would be volatility in the future, the overwhelming factors pointed to a market that should have double digit returns in 2021. With the Morningstar U.S. Market benchmark returning 25.78%, we reached that projection. For 2022, we project that the market returns could be more muted for the year, with returns in the range of high single digits to high teens for equities and fixed income benchmarks in the range of -3% to 3% for the year. Any time there is a transition in monetary policy, there can be an increased level of volatility, and we expect that 2022 will be no exception. We would not be surprised to see the market down roughly 15% at some time throughout the year but still finishing in the range given above. Hold on tight, 2022 is going to be an eventful year!