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The Year That Was

We have just come to the end of a year no one even in the world of science fiction could have conceived in their wildest dreams. After being basically locked up for almost a year the world came out from Covid and it looked like the nightmare of Covid was behind us. There appeared to be a light at the end of the tunnel and by late fall we started to realize the light was an onrushing train in the form of the Omicron. We are all getting far too familiar with the Greek alphabet! Nevertheless, markets all over the world, particularly the U.S. were stronger than one could ever have expected this time last year. The S&P 500 continued higher in the fourth quarter reporting the seventh consecutive quarter of strong positive returns. The index gained 11.3% in the quarter for a spectacular return of 28.7% for the year. We were one of the strongest markets in the world. Growth continued to lead Value although the gap narrowed quite substantially as investors felt more confident of a strong post Covid recovery. Financials and Energy, after lagging for a lengthy period, had spectacular returns up 34.9% and 54.4% respectively. Real Estate was also a stellar performer up 17.7% for the quarter and 45.4% for the year. The international markets lagged substantially with the MSCI EAFE index was up 2.7% for the quarter and 11.9% for the year. Despite much talk of inflation and a strong economy Gold was down 3.6% for the year largely displaced as an inflation hedge by the ubiquitous Bitcoin which went to all-time highs. Despite much talk in the press about inflationary pressures, the U.S. aggregate bond market ended the year basically flat and negative returns continue in many foreign markets.[1] Morgan Stanley economists expect the GDP will be up 5.3% in the first quarter of 2021 and it projects a slight decline in growth for the year. Finally, the Dollar was steady during the year contrary to earlier predictions which envisioned a weaker U.S. currency.[2]

Transition Time

There can be little doubt that after three years of double-digit return in major stock markets, largely fueled by massive amounts of liquidity this is destined to be a more challenging year. On the fiscal front, it seems unlikely that there will be any more large spending programs of a type seen over the last couple of years. Spurred on by a strong inflationary trend, the Fed has stated that they plan to institute more stringent monetary policy. This will be done on three fronts: buying fewer assets, raising interest rates four times in 2022 and, finally, reducing their balance sheet

by not rolling over maturing issues. How far this tightening goes will largely depend on inflation which we feel is a transitory phenomena caused by supply chain problems. All this is very normal in the third year of an economic cycle when the economy tends to heat up. One must also bear in mind that we are starting at a level of negative real rates so that there should be room for the Fed to maneuver without causing major dislocations. Supply chain problems could ease quickly in certain areas but less so in others. We are also in a phase of the market where the economy is gaining strength and Value stocks tend to gain favor over Growth stocks because the economy is growing. There has already been a substantial move in this direction. While the large Growth stocks are down about 10% to 15% from the top, the smaller "super" Growth stocks are down around 40% since the top! Forty percent of these stocks are down 50% from their highs![3] The switch from Growth to Value stocks in the U.S. over the last couple of months is about as dramatic as we have ever seen.

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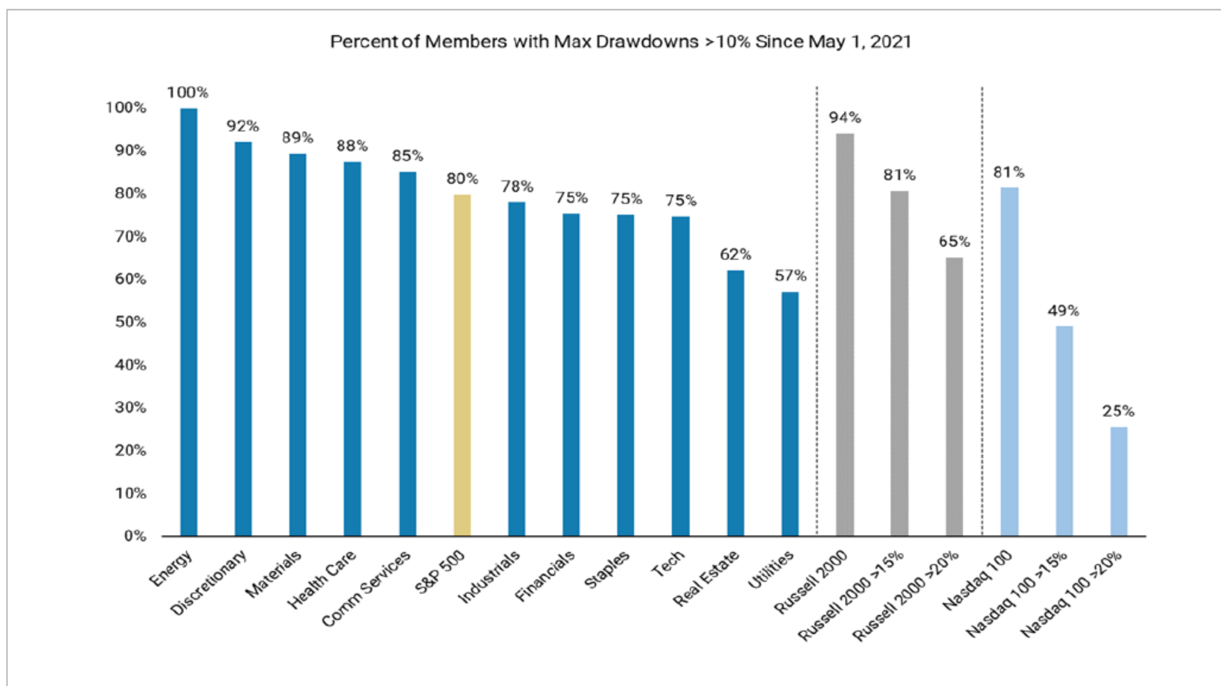
Mid-Cycle Transition Correction Under the Surface but Not at Index Level…Yet



Source: Bloomberg, Morgan Stanley & Co. Research

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Fasten Your Seat Belts

The main thing to bear in mind with the above scenario, is that it is quite normal at this point of an economic cycle, particularly given the very strong recovery we are witnessing today. We, as a group, are quite sanguine about inflation and, therefore, interest rates. One should not forget that inflation is calculated on a year over year basis and the comparisons are to months where the population was largely locked up and purchasing very little. Also, we are coming off historically low rates of inflation. Finally, real interest rates (inflation minus nominal rates) are still in negative territory which should support the equity markets. It is hard to remember, reading the financial press, that we are coming off years of worrying about deflation… Although there is no certainty, we feel that inflation will slow down as the year progresses and that, ultimately, the Fed will be able to engineer a soft landing. Nevertheless, there is no question that this year will be a far more challenging year in markets than we are used to. If interest rates do go up and if the Federal Reserve continues its policy of monetary discipline, a lot of companies that are losing money or selling for unmerited price to earnings multiples are bound to suffer. There will continue to be a strong move into those companies with a solid balance sheet, good earnings power, and strong pricing power. As of the second week of January we are in the midst of a correction which could well last for a while. So far, we are less than 5% off the all-time high in the S&P 500 and it would not be unusual to lose another 10% to 15% before markets settle and give rise to many opportunities. We feel strongly that the balanced portfolios of The Hampton Group should be able to weather this type of correction in good shape. As always asset allocation is of utmost importance and if the equity positions are well balanced between Growth and Value and there is a reasonable cash reserve one should not try to trade short term swings. We have spent a great deal of time looking for alternatives to the very low rates in the fixed income markets and believe that we have some interesting ideas. In summary, fasten your seat belts for the short term but this volatility should recede as we get into a more stable and, hopefully, Covid diminished second half.

We hope this finds you well and wish you and your families a healthy, happy and peaceful 2022…

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The MSCI Europe, Australia, Far East (MSCI EAFE) Index is a capitalization-weighted index that tracks the total return of common stocks in 21 developed-market countries within Europe, Australia and the Far East. An investment cannot be made directly in a market index.

Information contained herein has been obtained from sources considered to be reliable, but we do not guarantee their accuracy or completeness.

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[1] Morgan Stanley, Month End Asset Return Analysis, January 2022
[2] Morgan Stanley, “On the Markets”, January 2022
[3] MSIM Applied Equity Advisors, “2022 Equity Market Outlook”, Andrew Slimmon, January 2022