January 2022

As I write this letter, stock markets around the world have spent much of the last three weeks selling off sharply. After peaking on January 4, the S&P 500 has fallen over 12% from that high. This, after it returned over 28% last year (including dividends). In fact, most indices were up double-digits last year and many, like the S&P, were up well over 20%. How can investors bounce from optimism to pessimism so quickly? It's actually very common. Remember, the market doesn't require *all* investors to turn pessimistic to go down sharply. Less than 5% of shareholders deciding to sell at the same time is enough to induce a sharp decline in stock prices. That decline is enough for the other 95% to wonder, "Maybe I should sell too?" and away you go. Before you know it, the market is down 10% and all the media is in a tizzy.

At times like this, it's important to evaluate the realities of the market and the economy; in other words, what we know about the present versus what we don't know about the future. What we know is that the economies in the U.S. and developed countries around the world are continuing to expand from the pandemic-induced global recession of two years ago. This expansion will naturally slow over the next few years but will most likely continue. The delta variant of COVID, which was receding at the time we wrote our October letter, has been replaced by the omicron variant, which has once again frightened much of the public and policymakers. At this point, omicron appears to be following the standard trend of virus evolution: it is more contagious and less lethal than prior variants. It's still very dangerous, of course, but this is the pattern we have previously discussed, and we expect it to persist as COVID continues to mutate. Each variant will scare the markets as worries of economic slowdown emerge, but we expect these cycles will simply produce a "wave action" to economic progress.

We discussed inflation last quarter, namely, that we expected it to degrade over time as production and transportation problems are slowly repaired. That is still our view. We have seen such post-recession supply problems before, notably back in the mid-1980s, and they do eventually get better. The labor shortages will not improve as quickly, which is why we expect inflation to normalize at around 3% per annum when all is said and done, rather than the 2% (or less) rate we've seen in the last decade. But the economy and the markets can adjust to that rate rather easily without much damage to financial assets. And, as we noted last quarter, it's not a bad sign that there are unfilled jobs around. That's the sign of a strong economy, not a weak one. It may mean that corporate profit margins are reduced somewhat, but we note that they're at all-time highs anyway, and that corporate profits this year should be at record levels. More people working and making more money isn't a bad thing; it's the lifeblood of any economy.

What is new is that the Fed has decided to become an inflation-fighter. (At least they're saying they are.) People are always worrying about Washington and politics. Mostly, they're worrying about the wrong things. Their primary worry out of Washington almost always

should be the Fed. This is one of those years where the Fed's action should be considered a key risk factor.

The problem is that the Fed really can't do anything to fix the fundamental inflation problem, which is restricted supply. All they can do is dampen demand, which would also hurt economic growth. The stock market sold off recently, in our opinion, because it feared that an overly aggressive Fed might just come up with a "cure" for inflation that "kills the patient." Our best guess of Fed behavior in the year ahead is that they will raise rates a few times, the financial markets will sell off, and they will stop. As we noted above, we think it's likely that inflation will cool with or without Fed tightening.

But the Fed is always under pressure to "do something," which means we are probably going to see a fair amount of volatility this year as the market worries about what the Fed might do. But with the economy expanding nicely and corporate profits strong, we think the wise course of action is to remain optimistic for the year and beyond. In fact, years of higher than normal volatility often give us good buying opportunities, especially when the underlying economy is strong (which is the case now).

One more thing: years of higher-than-normal volatility are often years of higher-than-normal emotions for investors. This is dangerous. As we've advised many times, investing should not be an emotional endeavor, but a rational one. In fact, emotions are the enemies of successful long-term investing. As COVID, Fed actions, and other factors create gyrating markets, we can all benefit by striving to keep our emotions in check.

We appreciate your confidence in us.

Gratefully,

Mark A. Keller, CFA
CEO and Chief Investment Officer

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