ZWJ

INVESTMENT COUNSEL

2021 proved to be a perplexing year in the markets, as inflation ramped up but interest rates refused to follow suit, and big tech drove equity returns but smaller growth names lagged behind dramatically. Our client portfolios, a mix of growth and value companies, performed well. It was equally perplexing outside the markets, as the third major coronavirus wave called omicron proved highly contagious but with apparently less severe outcomes. The President promoted his big spending bill but the Senate refused to go along. As we begin the new year, we are waiting on three significant questions.

First, will the yield curve rise to reflect the inflation rate, and how will the markets adjust to that? Second, will the internal rotation of the stock market finally bring down the remaining few big tech high-flyers, and how broad and deep a pull-back might we see? Third, will the failed spending bill and the coronavirus pandemic controls come back piecemeal, or is the political class now in re-election mode and are we in the endemic phase of the virus?

As we have noted many times in the past, inflation rates and interest rates generally maintain a strong correlation. High inflation tends to be paired with high interest rates, and vice versa. After a long period of lower-than-desired inflation, the rate moved up. Then it moved higher than the policy makers targeted. After messaging that these higher inflation numbers were "transitory," they abandoned the message and adjusted their policy to accelerate the removal of the current monetary stimulus.

Inflation comes from many sources, but Milton Friedman captured its essence when he declared that inflation was "always and everywhere a monetary phenomenon." By that, he meant inflation is at its root an injection of money into the economy. The transfer of Aztec gold to Spain was a historical example of hard currency inflation; there were many more Spanish doubloons in circulation, and the economy lifted prices to bring the new supply of money into balance with the capacity of the economy. Our monetary policy since the Great Financial Crisis of 2008 has been an injection of money into the economy by modern means: the creation of credit backed by the government introduced money into the global economy. Yet, this time prices did not rise, for globalization meant local workers had little pricing power and so there was no wage inflation. This time, the inflation was felt in asset prices, as low interest rates meant income-oriented investors were subtly steered towards riskier investments like stocks rather than bonds.

Economic historians will debate which was the cart and which was the horse, but the massive injection of liquidity paired with the lockdowns as a response to the coronavirus in 2020 and 2021 led to a sharp rise in producer prices and a sudden increase in demand for goods over services. Interest rates were kept very low, and we got through the crisis, but the seeds of inflation were sown.

Inflation takes a while to move through our complex economy, so we do not really know with precision when and how it will manifest itself, nor do we know when it will ease. Those of us who remember Jimmy Carter and his Misery Index of inflation plus interest rates should try to remember a decade earlier when Lyndon Johnson decided to fight the war on poverty and the Vietnam War simultaneously, kicking off the inflation rise that only reversed nearly 15 years later. It is a cautionary tale for those who claim to know when this bout of inflation will end.

This cautionary tale explains our wariness regarding the fixed income market. If, as we believe is the case, interest rates should reflect inflation rates, then it is highly likely that interest rates are moving up. This implies a negative return for fixed income strategies for 2022. While it is true that cash pays nothing and that inflation means negative real returns for cash, cash is by definition a short-term asset that provides flexibility as investors navigate dynamic markets. Bonds are long-term assets, and we question the wisdom of buying long-term investments that provide a negative real (inflation-adjusted) return. Our strategy for 2022 in the bond market is to be very

Continued on Next Page ☞

selective about adding new bonds until we see evidence of flat-to-positive return expectations for that asset class.

Rising inflation and rising interest rates have historically been drags on equity performance. We expect the current rotation within the market to continue, thanks to the increase in inflation we have already seen and the increase in interest rates we expect to see this year. Offsetting the view that there remains a bubble of speculation in the overall market is the continued liquidity being provided by the central banks. While the Federal Reserve Chairman has abandoned the term "transitory" to describe inflation, he has indicated he will end his asset purchasing program and even begin to raise short-term interest rates. Neither step is scheduled until Spring. Companies are likely to report excellent results in the next earnings season, as the $5 trillion monetary injection related to the coronavirus response continues to support demand. But the pass-through of rising input costs is not complete, so we will not be surprised to hear companies suggesting temporarily lower operating margins while they absorb higher costs, particularly labor, before they impose higher prices. Large consumer-focused companies like Heinz have already indicated they plan to raise prices by as much as 20 percent as they adjust to higher costs of production.

Markets are generally a combination of short-term whimsy and long-term ruthless reality. Like Scarlett O'Hara in "Gone With The Wind," the market sometimes responds to negativity by putting off a bad thought until tomorrow. The Reddit meme stocks – now spelled stonks by the Gen Z traders – and the cryptocurrency explosion are two examples of the short-term whimsy the market can embrace. In the long-term, however, markets respond to underlying economic realities. If interest rates and inflation rates rise from current levels, then the market will inevitably adjust, with the higher rates having the greatest impact on the most highly valued companies.

There can be a significant lag between the change in the short-term winds and the change in the long-term tides, and that is where we think we find ourselves today. Already we have seen massive insider selling as the market continues to set all-time highs. At some point, others will follow suit if only because they understand the insiders know a great deal about the stocks they are selling. As already noted, we have seen a long internal correction, for there just are not as many true growth companies as there are "growth" stocks. This is most clearly captured in the relative performance of the ARK Innovation ETF run by growth maven Cathie Wood and the S&P 500 index. While the market is up 28%, that growth fund is down 24%.

What to do in the equity markets as we open 2022? We think continued trimming of the big tech winners makes sense. We continue to find attractive values thanks to the ongoing internal correction. If interest rates and inflation rates are going to remain elevated for some time, then the kind of names we tend to add to portfolios should do well. With lower valuation multiples, they are not priced for perfection, and with basic business engines they are not banking on a restructuring of the economy. This may be a year in which one does not immediately reinvest the proceeds from stock and bond sales but waits for a better point in the markets to redeploy that cash. For while cash is a long-term losing investment, it provides excellent short-term flexibility.

Flexibility and discipline are the watchwords for the year. They are hallmarks of our philosophy and our process. We do not have a "product" at ZWJ; we have clients. Each client has his own mixture of risk issues and return expectations, and those are refined through regular conversations. In those conversations, we can expand on some of the issues raised in this letter, and together we can amend our client's investment plan as needed. In those conversations, we will always return to the core principle that one should be very attentive to the price one pays for an asset. As long-term investors, we recognize the tides are stronger than the winds, and reality triumphs over whimsy.

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