ICR® 4th Quarter Newsletter – January 2022

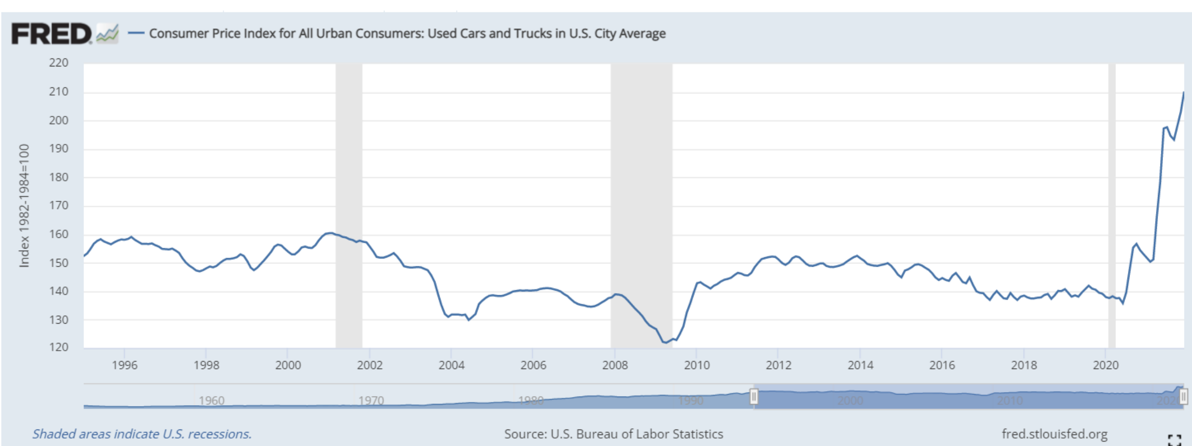
Markets finished the year on a strong note with the S&P 500 gaining over 10% in the fourth quarter of 2021. The economic rebound continued and corporate earnings growth reached decade-high levels. Sectors that perform better in higher inflation environments like energy, materials, and real estate led the way while more inflation-sensitive sectors like financials and telecom lagged. Small cap stocks didn't fare as well as their large counterparts, returning less than 2% during the quarter.

Developed country foreign stocks were positive, but continued to trail behind U.S. stocks. The MSCI EAFE index gained only 2.4% in the fourth quarter and finished the year with an 8.8% return. Emerging markets, on the other hand, lost value both in the fourth quarter (-1.7%) and for the year (-4.6%). Given their prolonged underperformance, foreign stocks are now significantly cheaper than they have been in the past 20 years relative to the United States. On average, foreign stocks have tended to trade at about a 13% discount to the U.S. as measured by price-to-earnings. Currently, though, foreign stocks are trading at about a 33% discount. These types of conditions tend not to last and usually revert to the mean. However, the timeframe for that mean reversion is always uncertain.

Bond yields bounced around as investors grappled with the effects of inflation and the potential for rate hikes by the Federal Reserve. Ultimately, the ten-year Treasury yield finished close to where it started the quarter (1.51% vs. 1.48%) but going as high as 1.68% at one point. The Fed has accelerated the end of its quantitative easing program and is providing guidance that points towards three rate hikes this year. One concern that investors have is that if inflation continues running high, the Fed may need to raise rates faster and higher than they're currently projecting.

Given its dual mandate of maximum employment and price stability, the Fed faces a predicament wherein they may need to raise rates to fight inflation, but raising too much could put the current economic recovery at risk. But, if inflation doesn't start to moderate on its own, the Fed will have no choice but to do what they can. The current 7% annual inflation rate is generally seen as an unacceptably high level by both the public and policymakers. Over the past 30 years, inflation has only briefly breached 5% once and has generally averaged about 2%. So, it's no surprise that 7% inflation feels uncomfortable given what we've all become accustomed to.

Will inflation stay at these elevated levels? Most economists agree that elements of the recent inflation spike are likely to fade as supply chains continue to recover. For example, a full percentage point of the 7% inflation is attributable to the huge increase (25%) in the price of used cars in 2021. It's hard to imagine the price of used cars continuing to grow at a 25% annual rate given that since 1995, used cars had actually had a negative impact on inflation up until the past year and a half.



While it seems unlikely that used car prices will continue their recent trajectory for a prolonged period, the computer chip shortage is persisting and continuing to cause disruptions for the manufacturers of new cars. Median chip inventories have gone from 40 days' supply in 2019 to less than five days currently, and manufacturers have indicated that they don't see that changing in the near future. Until these issues are sorted out, the situation is likely to have an inflationary impact on any products that use computer chips.

In addition to the above issues restraining supply, the fiscal response to COVID has put more money in the pockets of consumers and increased aggregate demand. It's now been ten months since the last stimulus payments went out, so the effects of that newly created money entering the financial system should theoretically be fading. But wages are up – especially for lower wage workers who tend to spend the highest share of their earnings. Higher wages are a positive for society in general, but could have an inflationary impact as those workers look for ways to spend their newfound earnings.

While it seems likely that the currently elevated levels of inflation will gradually begin to subside, it's still important to consider what an investor can do in a sustained inflationary environment. Historically, stocks have provided a decent hedge against inflation but it's important to own high-quality companies who are in a position to pass along increased input costs to their customers. Companies operating on small margins and with little pricing power are likely to be punished by high inflation. Real assets (materials, real estate, etc.) and the stocks associated with them also historically tend to keep up with inflation. And, of course, inflation-linked instruments offered by the U.S. Treasury where the interest payments are based on the inflation rate can provide some protection.

Investors have varying goals, but even the most conservative of investors generally want to see their investments maintain purchasing power, which means at least keeping up with inflation. With interest rates still at historically low levels, this presents a dilemma for the more conservative investor as buying stocks to help keep up with inflation tends to increase volatility, but holding low-yield bonds or cash in a sustained high-inflation environment would mean a loss of purchasing power. If this predicament rings true for you, please contact us so we can discuss what solutions might be appropriate for your situation.

As always, thank you for the opportunity to manage your assets and we wish you health, wealth, and happiness in the new year.

Sincerely,

James A. Heine

James L. Cobb

Market Report (as of 12/31/21)

Index	**2021 (%)**	**3-Year Annualized (%)**	**5-Year Annualized (%)**
S&P 500	26.9	23.9	16.3
Dow Jones Industrial Average	18.7	15.9	13.0
U.S. Aggregate Bond Index	-1.5	4.8	3.6
MSCI EAFE (Foreign Index)	8.8	10.8	6.8