Schroeder | Capital Management, LLC

Global Investment

Investment Review and Outlook – Winter 2022

The U.S. Economic Landscape:

This past week, Gross Domestic Product (GDP) for the final quarter of 2021 was reported at 6.9%, up from 2.3% for Q3. For the full year, GDP rose by 5.5% over the year earlier as the economy continued to rebound from the brief pandemic-induced recession in 2020. While consumer spending on services was solid, rebuilding of depleted inventories accounted for 70% of the overall quarterly GPD advance.

The start of 2022, however, reveals some obstacles that could lead to a more modest expansion rate during the year, including high inflation. Recent economic data has been mixed with readings on manufacturing and retail sales showing some softness. Higher producer and consumer prices along with supply-chain disruptions appear to be hurting business activity. Consumer spending, a key driver of the economic recovery from the pandemic-driven pullback, is now weakening. December retail sales decreased 1.9%, from the month earlier, far more than expected, and consumer sentiment in early January fell to its second-lowest level in a decade. This may also be the result of the continuing challenges associated with the high level of reported cases of the COVID-19 pandemic's Omicron strain. On a positive note, the housing market continues to be vibrant and is encouraging, particularly the increase in December residential construction activity.

Corporate Earnings Season – Mixed Results:

Wall Street's recent attention has mostly turned to the corporate world, with the start of Q4 2021 earnings season. Unfortunately, initial results have been mixed. Investors have reacted negatively to some disappointing earnings reports from an array of companies and their inflation-impacted forecasts. However, many companies have also demonstrated an ability to manage through the current supply-chain disruptions and higher inflation pressures with effective pricing power to pass along their higher costs to their customers. These companies will likely be rewarded by investors in the months ahead.

The End of "Transitory Inflation" - Chairman Powell and Federal Reserve Policy:

The Federal Reserve announced on Wednesday, January 26th, that it would speed up the end of the central bank's bond-buying program, a monetary measure used to stimulate the economy. The Fed will now closely monitor inflation, employment levels and overall economic activity to gauge when to begin raising interest rates. This new posture suggests that rate hikes will be sooner than had been envisioned in early November. The view of Fed officials through the summer of 2021 was that inflation in the U.S. economy was likely to be "transitory" due to supply chain dislocations, a worker shortage and a resurgence of demand across the economy, following the lockdown in early 2020. This view is now history as the Fed has retired the term "transitory".

Chairman Jerome Powell's quick pivot toward a tighter monetary policy reveals decision-making flexibility. While he may stick to his chosen policy path in the face of public pressure as long as evidence doesn't undermine his assumptions, Chairman Powell has shown a willingness to change course quickly when data emerges that suggests the world is different.

Inflation had been building for months but over a period of 13 days in the Fall of 2021, Chairman Powell decided that the Fed needed to get more serious about trying to choke it off. Validation for this changed perspective came on January 13th with a report that inflation rose by 7% in December 2021 from the year earlier, the most rapid since 1982 and the third straight month in which inflation exceeded 6%, year-over-year. This annual inflation rate is the most rapid pace in nearly four decades, principally related to supply and demand imbalances, labor shortages, and higher wages along with previous government stimulus-driven demand measures to boost the overall economy. Further validation of the Fed's new stance came on January 28th, reporting wage growth of 4%, year-over-year in 2021, the fastest pace in 21 years as a result of the tight labor market that currently exists.

The Federal Reserve will have its work cut out as it proceeds with its more restrictive monetary policy. Tackling current inflation will require a carefully crafted monetary policy that is not too restrictive to avoid an economic slowdown. The central bank is now poised to aggressively reduce liquidity by early spring and begin raising interest rates with three or four hikes possible by year's end 2022.

Securities Market Volatility:

Concern about the Federal Reserve embarking on a more restrictive monetary policy course, aimed at reining in inflation, and how aggressively interest rates will rise, is leading to increased stock market volatility and Wall Street will be watching. Geopolitical concerns including tensions between Russia and the West regarding a possible invasion of Ukraine, China's ambitious interest in claiming Taiwan, along with the unpredictable behavior of North Korea threatening peace on the Korean Peninsula and Japan, are also adding to market volatility and keep investors on edge.

Investment Strategy:

Investors are clearly nervous right now, with a notable movement away from the higher-growth stocks that historically are richly valued in the marketplace into the sectors regarded as defensive in the event of economic surprises. In past experience, an increase in uncertainty among investors has produced an uneven performance for the U.S. stock market. In a rising interest-rate environment, fixed income securities should be given a smaller weighting while favoring equities as the preferred investment vehicle, especially those with above average dividends. We are continuing to build well-diversified portfolios of quality companies and will be favoring consumer non-durables (a defensive stance), banks that will benefit from higher interest rates and energy related securities.

Our research is focused on companies that have solid earnings prospects with steady cash flows, strong balance sheets, low debt and historically attractive valuations. In the present economic environment, investment selections will increasingly include companies that possess the tools to address supply chain limitations and have the pricing power to effectively maintain profit margins that translate into solid corporate earnings, the primary ingredient in the valuation of a company's securities.

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