TODD
Asset Management

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Todd Asset Management

Well, They Overshot It…

Todd Asset Management Q4 2021 US Market Review and Outlook

	4Q 2021	1 Year	3 Year*	5 Year*	7 Year*	10 Year*
S&P 500	11.0%	28.7%	26.1%	18.5%	14.9%	16.6%
Russell 1000 Value	7.8%	25.2%	17.6%	11.2%	9.7%	13.0%

* *Annualized Total Returns.*

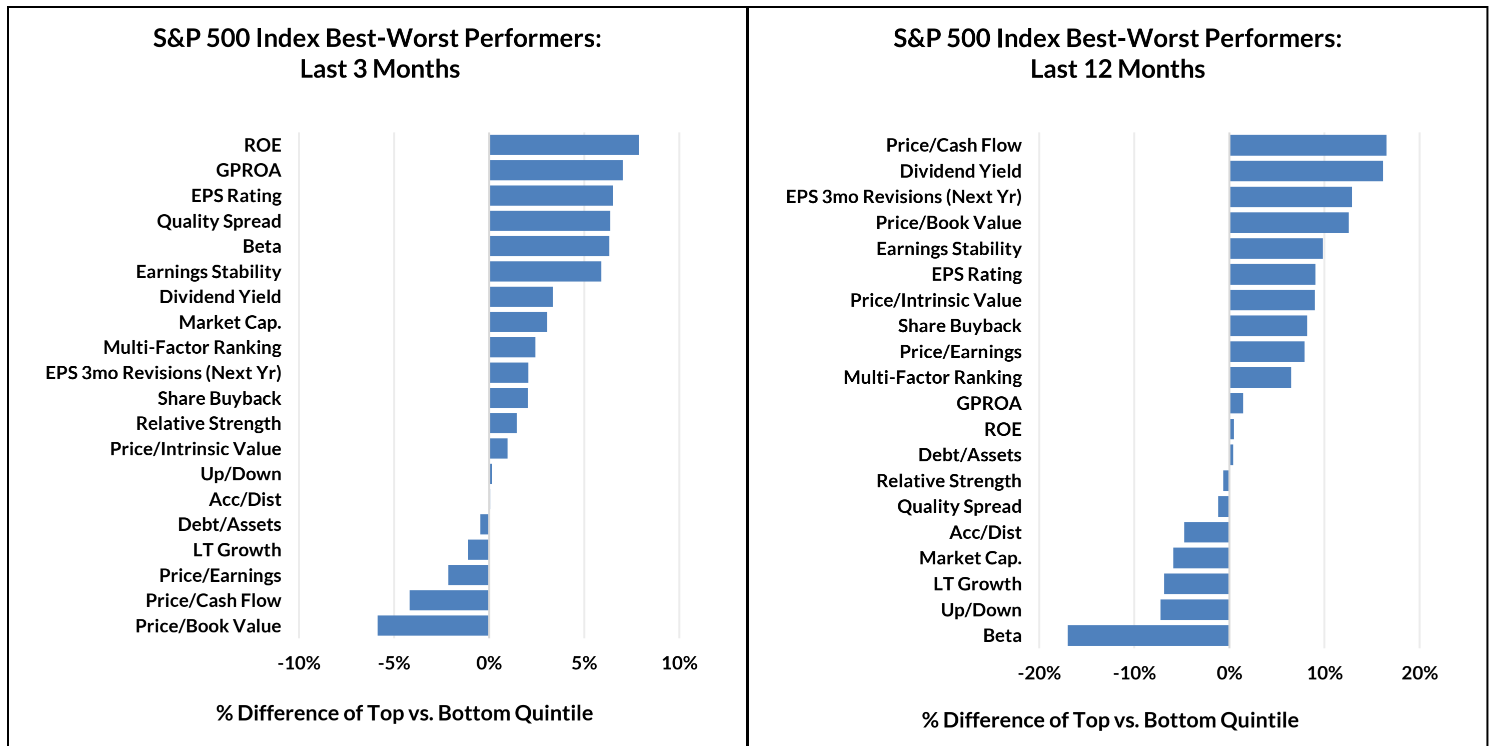
In April of last year, our quarterly review was titled "Aiming for an Overshoot". We noted that the Fed was going to keep rates low until the jobs market recovered and inflation was a problem, which they thought would take years. Well, they overshot it and we're entering 2022 with full employment and an inflation problem. Markets posted excellent returns last year and are still near all-time highs. Our sense is this year should produce good returns but probably not as robust as the 28% seen in 2021. The first half is likely to be dicey though as rotation from expensive growth stocks (that drive S&P 500 index returns) toward the neglected inexpensive stocks is likely to play out as the Fed raises rates to address the inflation we are currently experiencing. The major things we consider when making this forecast are:

- The Fed is planning to stop bond purchases and expected to start raising rates in March. This is a dramatic shift in plans that has occurred over the past six months and indicative that they believe economic growth is robust enough that it can tolerate higher rates. Expectations of higher rates has led to a reduction in speculation in markets, which has tended to deflate the higher multiple growth stocks over the past six months. This market reminds some of us of the 2000 cycle shift towards value from growth.
- Inflation has reached levels last seen in the early 1980s because the continued economic recovery is unbalanced. Demand is strong for durable goods as the combination of high federal spending, low interest rates, and growing money supply left consumers and companies in a position where they want more "stuff". Economic reopening has driven a quick return to full employment as many people left the workforce (lower supply) and the remaining workers demand higher wages. Supply chain problems have limited availability of cars, chips and commodities, increasing prices. Some inflation should ease (supply chain), while some probably does not (labor).
- People are learning to live with Covid variants and mass lockdowns are not being pursued. We are experiencing the largest surge of new cases in the pandemic, but our collective reaction has been different this time. The services sector of the economy has not fully re-opened, and we believe it should as this wave passes.
- Markets probably correct in the first half of 2022. Since 1990, each time the Fed raises rates for the first time, markets have experienced three-to-six-month corrections of approximately 10% as they digest the news. Investors will wring their hands and the

headlines will be unpleasant. We believe the pent-up demand from supply chains, coupled with demand driven by full employment, better wages and capital spending should result in an economy that continues to expand for years to come.

The economy is in good shape, supported by continuing yet diminishing support from government spending and generationally low interest rates. Real GDP growth should still be above 4% in 2022 which is high compared to recent history. The growth scares we have seen with the Delta and Omicron waves are still masking better demand from the underlying economy. Consumers still have savings and jobs, while corporations have record profitability. Debt measures for consumers and corporate debt to assets are both down substantially over the past 10 years. Real estate remains in short supply, though we are interested to see if higher mortgage rates slow price increases as the year proceeds. The expected Build Back Better program is likely to either be downsized or simply not passed. The prior stimulus should still provide support for activity in the coming years, but the growth in stimulus is likely to slow. One item to watch will be the pace of downsizing the Federal Reserve Balance Sheet. Quantitative Easing (where the Fed bought bonds to ease financial strains) is likely to give way to Quantitative Tightening where the Fed sells bonds to downsize their balance sheet during good times. This new tool may be used to manage the yield on longer term bonds (to raise them) and ease demand and temper inflation.

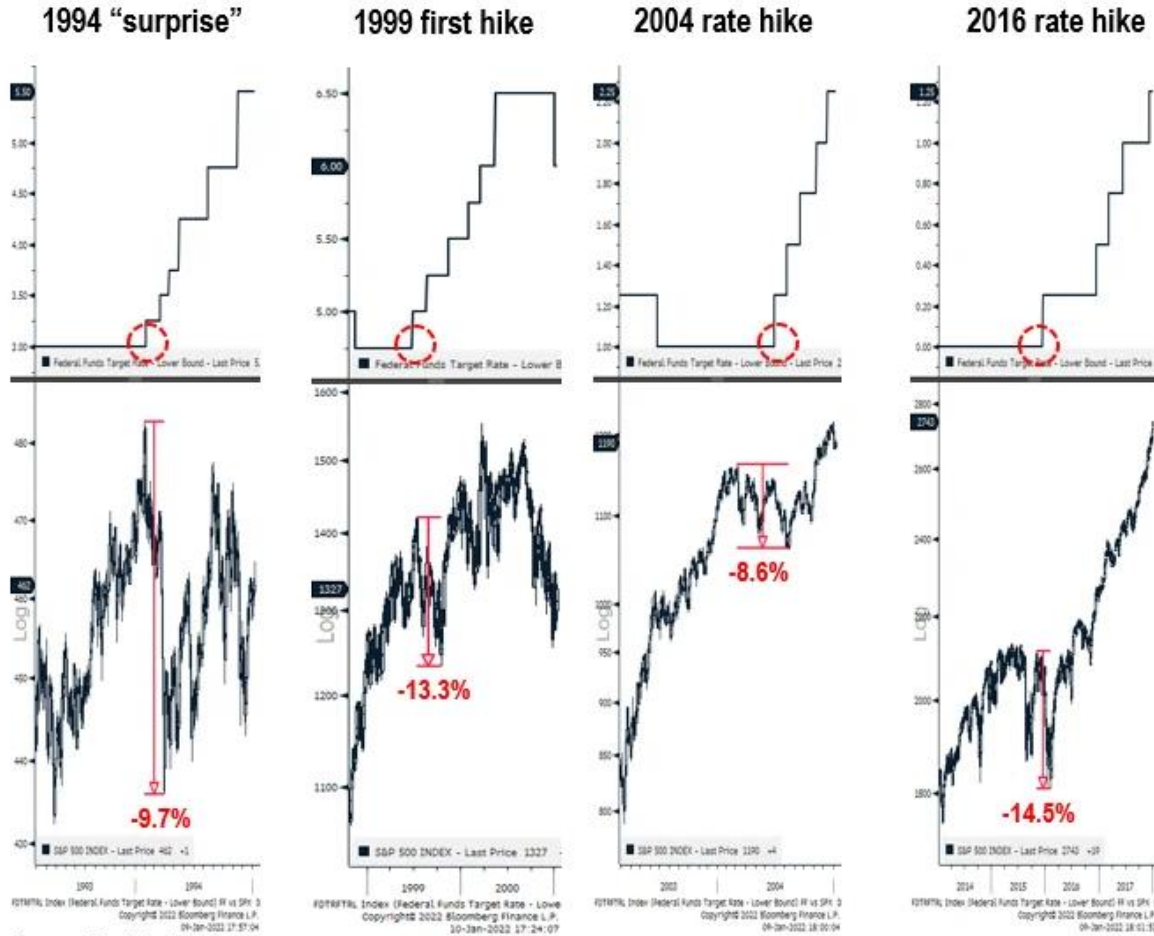
Once markets get past the uncertainty surrounding higher rates, economic confidence is likely to improve. We also believe inflation rates are likely to moderate (think 3-4%) from the current high levels (7%) as supply chains are re-opened after some covid shutdowns. This should provide a more constructive backdrop for stocks later this year.



Data Source: Bloomberg, William O'Neil + Co. and Todd Asset Management

The charts above illustrate the factors investors favored versus the ones they did not for the fourth quarter of 2021 (chart left) and the full year 2021 (chart right). While the full year results were more favorable for value, visibility and quality, the fourth quarter results were more focused on only quality and visibility. During the fourth quarter, investors were still factoring in a growth scare as supply chain and Delta variant concerns were prevalent. Interest rates were volatile but rangebound from 1.35% to 1.65%, and the safety mega-cap growth trade was on for the first month of the quarter. Full year results favored factors that showed better confidence in a cyclical recovery.

Interesting Charts We've seen Recently



Source: Fundstrat, Bloomberg

The chart above, from Fundstrat, illustrates market action over the past 30 years around the first Fed Funds Rate Increase. In each of the four instances, markets declined about 10% for periods ranging from 3 to 6 months, but then recovered after the initial uncertainty.

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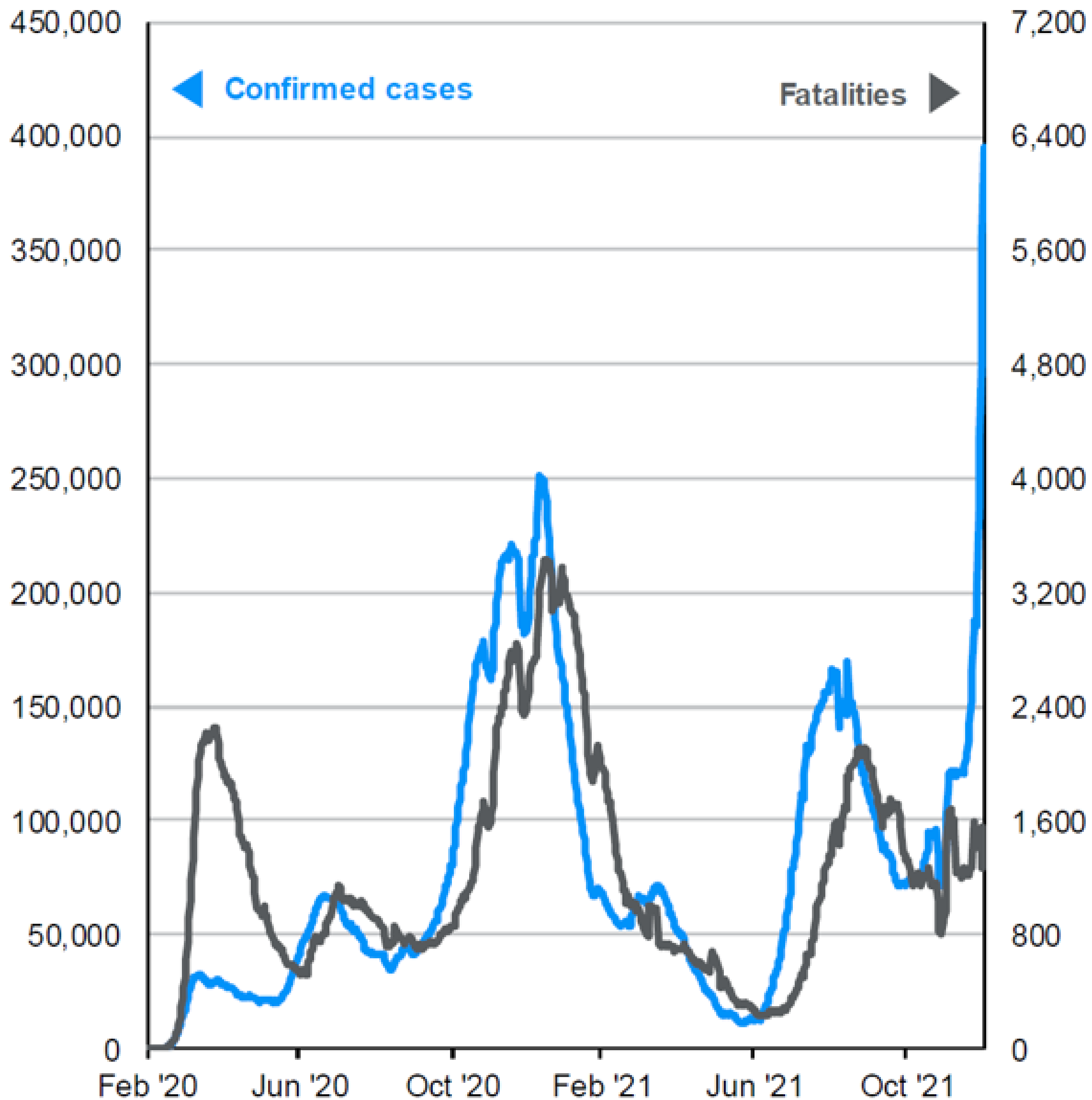

Source: JP Morgan

This chart is self-explanatory. Covid cases (blue line) have surged to record levels, while deaths have not. We are not trying to minimize the toll Covid has taken on society but are encouraged that this variant is not as deadly as prior versions. Some analysts even speculate that the new case surge has already peaked. If that is the case, economic growth should get a boost.

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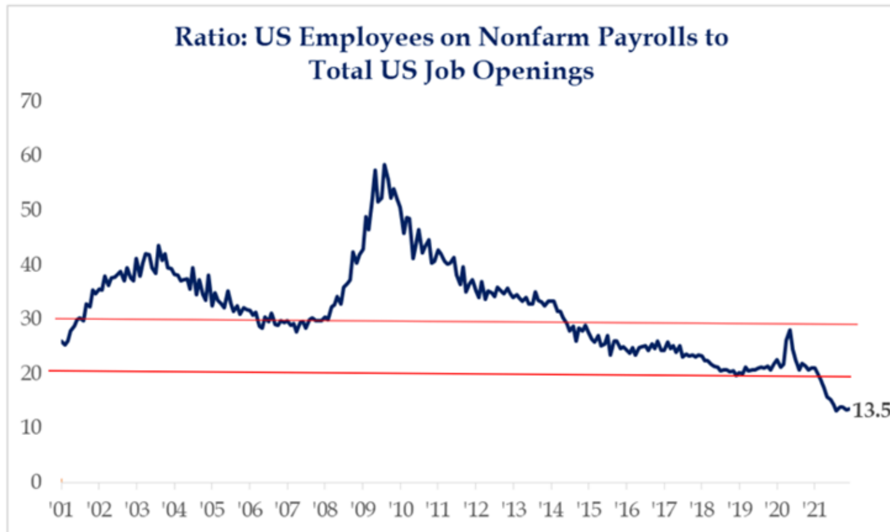
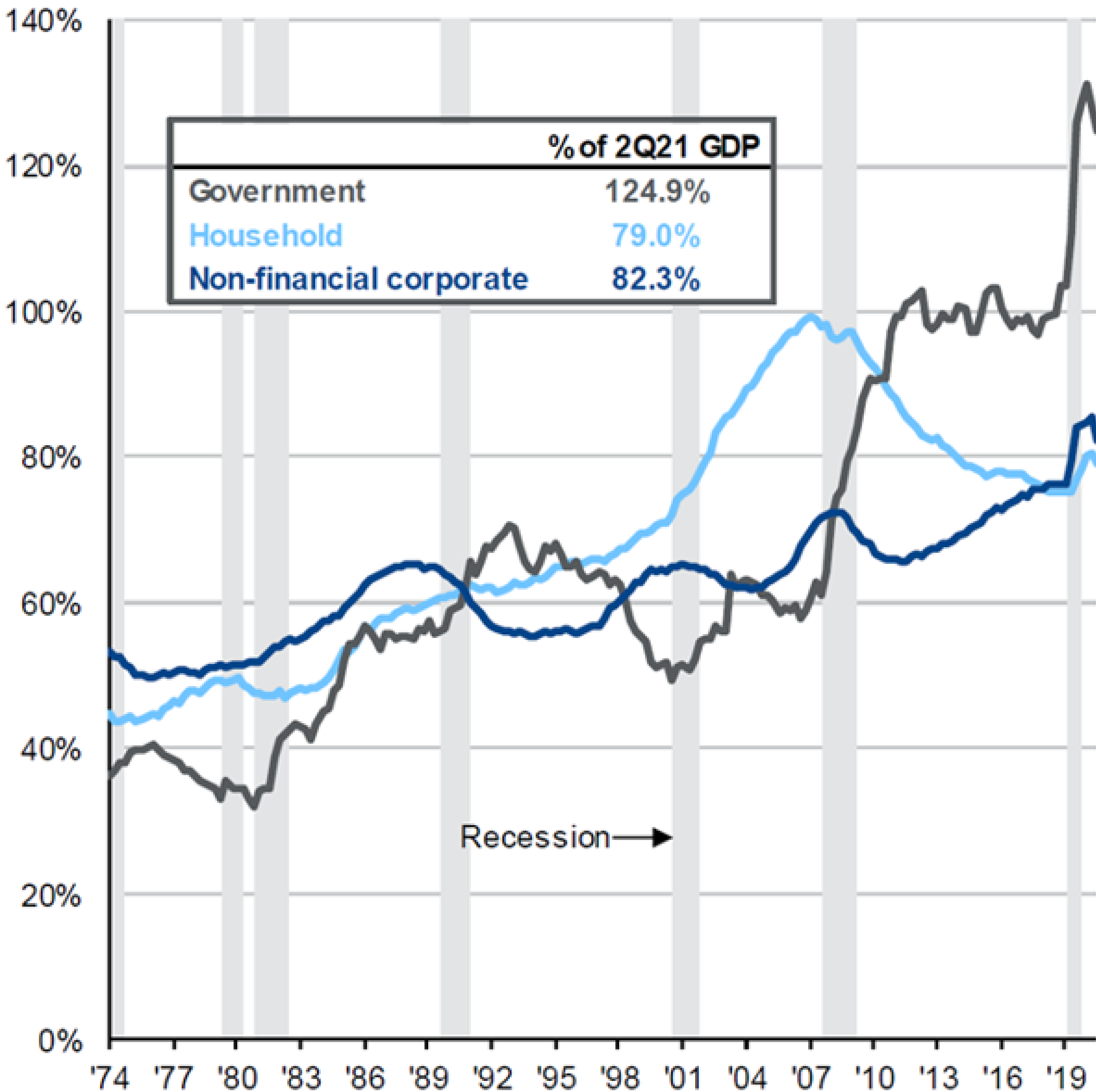
RATIO OF PEOPLE ON NONFARM PAYROLLS TO TOTAL JOB OPENINGS FROM JOLTS AT HISTORICAL LOW



Source: Strategas

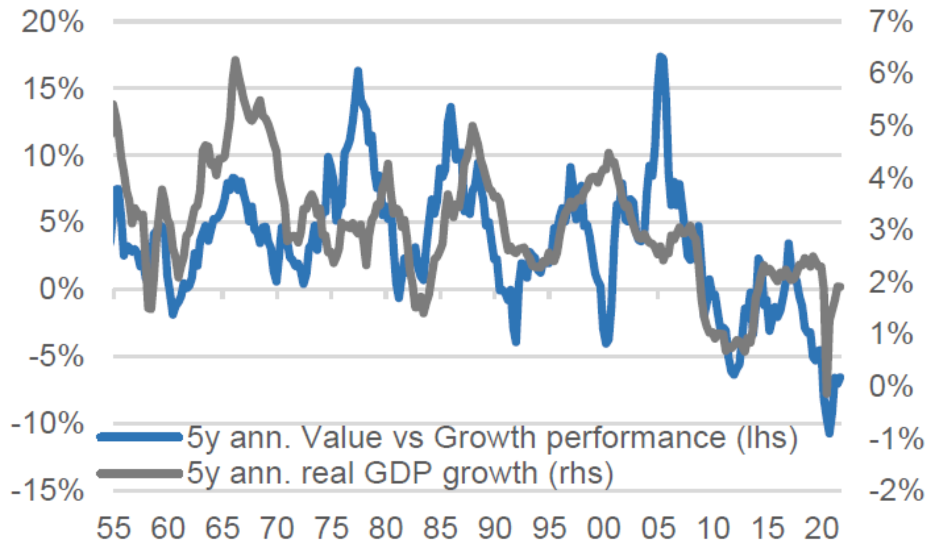
Job openings compared to nonfarm payrolls is at a historic low. There is one job opening for every 13.5 employees according to the surveys, compared to nearly one for every 60 employees in 2010 (chart above). This is leading to a surge in average hourly earnings as seen in the chart below from Evercore ISI. As reopening continues, we expect wage inflation to remain high.

Source: Evercore ISI



The chart above shows debt levels as a percent of GDP for the Government, Households and Non-Financial Corporations. Household and Non-Financial Corporate debt did not increase dramatically during the pandemic. Government Debt soared during the crisis and at some point, those levels will need to stabilize. There seems to be plenty of room for Households and Corporations to add leverage and drive economic growth through that demand.

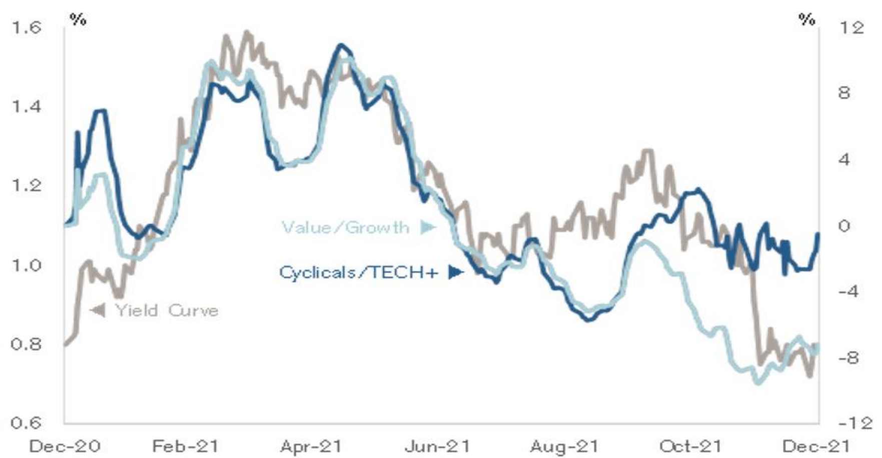
Value outperforms with strong (GDP) growth



Source: Kenneth French, Bloomberg, Evercore ISI Research

Value is positioned well versus Growth for the upcoming cycle. When 5-year annual GDP growth (grey line-chart above) rises, Value beats growth. GDP growth should improve in coming years as monetary and fiscal stimulus work into the economy over a long period. Additionally, as seen in the previous chart, the consumer has repaired their balance sheet over the past ten years, turning what has been a headwind into a potential tailwind for the economy. Confidence in this growth can be estimated by the change in the yield curve as noted below. Over the past year, when the curve increased (on better confidence), Value outperformed Growth (light blue line) and Cyclicals outperformed the Secular Tech trades (dark blue line). As the Fed tightens, we expect the yield curve to increase (especially if they pursue quantitative tightening.)

Relative Returns vs. Yield Curve (2-10 Spread)



Source: Credit Suisse

The economic recovery is young. There will be bumps along the way, and we would not be surprised to see market weakness surrounding the initial rate hike from the Fed. We would suggest the Fed is raising rates because they believe economic momentum is sustainable and it is likely to wring some speculation out of the markets. Once that speculation is wrung out, we believe markets will be on solid footing to improve on the back of an improving economy driven by rebuilding of inventories, capital spending, improvement in employment and rebound in services.

Please feel free to contact any of us for additional information.

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01/18/2022
S&P 500 – 4577
Russell 1000 Value – 1646

Refer to the following page for more information on the commentary presented. This is pertinent to this letter and should not be reproduced or duplicated without this disclosure.

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Russell 1000 Value Index is a widely recognized index of market activity based on the aggregate performance of common stocks from the Russell 1000 Index, with lower price-to-book ratios and lower forecasted growth values. The performance data was supplied by Frank Russell Trust Company.