



MANAGED ASSET PORTFOLIOS

MAP VIEWS

MAP QUARTERLY COMMENTARY | JANUARY 2022

MAP Views

First Quarter 2022



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Stocks marched higher during the fourth quarter as investors shrugged off mounting inflationary pressures, increasing prospects for higher interest rates next year, and a surge of new COVID-19 infections stemming from the fast-spreading Omicron variant. Investors applauded favorable corporate earnings, a resilient consumer, and early data indicating that the Omicron variant, while very contagious, does not appear to be as severe as earlier variants. Inflation has pushed its way to 40-year highs, with November inflation data coming in near 7%. Supply chain issues continue to fuel higher prices and labor shortages, spurred by the COVID-19 pandemic along with government actions (both fiscal and monetary). We do not anticipate inflation hitting double digits as it did in the late '70s and early '80s. Still, however, we believe it will remain at levels higher than what the Federal Reserve (Fed) is comfortable with for the next few years. Of note, during the quarter, 285 S&P 500 companies mentioned inflation during their conference calls with investors – the highest on record. Additionally, according to data gathered by Sentieo, publicly traded companies mentioned the word "inflation" 4,450 times during their conference calls over the same period.

Despite pricing pressure, many companies overcame these hurdles and posted better-than-expected earnings—one of the key reasons behind the solid stock market performance. In short, never underestimate the ability of Corporate America to overcome obstacles. To put into perspective how inflation has hit some pockets of the economy, used car prices (as measured by the Manheim Used Vehicle Value Index) climbed more than the S&P 500 and even Bitcoin during the last nine months of the year. This statistic is even more startling when considering cars are usually a depreciating asset! While commodity prices go up and down, as we've seen with iron ore and lumber, wages, however, do not. As such, we believe the current higher level of wages will be a catalyst for inflation to remain sticky for the next several years. However, we believe some supply chain issues that pushed prices higher in 2021 will be resolved in 2022 - although some problems, such as the shortage of semiconductors and others, may linger into 2023. (For more on our thoughts as to why inflation is not likely to hit double digits, please look for our upcoming thought piece which will be published later this quarter.)

Comparative Returns

03/31/2021 - 12/31/2021

| | <u>Price Change</u> | <u>Relative Return</u> |
|----------------------------------|---------------------|------------------------|
| Manheim Used Vehicle Value Index | 33.82% | -- |
| S&P 500 Index | 19.97% | -10.35% |
| Bitcoin | -31.55% | -48.85% |

Data Courtesy of Bloomberg

In response to elevated inflation levels, the Fed decided to quicken its rate of tapering. Recall that the Fed had been purchasing \$120 billion worth of bonds every month to stabilize the economy and broader markets from the fallouts stemming from the COVID-19 pandemic. The Fed originally planned to reduce the amount of their monthly purchases by \$15 billion, ending the program around mid-year 2022. With inflation numbers now looking to be more than transitory, coming in near seven percent in November, the Fed has decided to now reduce the amount of monthly purchases by \$30 billion per month. Once the Fed completes the current round of tapering, they will likely raise interest rates by 25 basis points two to three times in 2022. Despite these actions, we believe inflation will likely remain above targeted levels. As such, we do not have confidence that the underlying economy will have the strength to digest more than the two or three rate hikes currently forecast, and GDP will likely settle in around 2 percent.

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Remember, the Fed has two primary mandates: full employment and stable prices. Currently, the job market is performing well short of pre-pandemic levels, while price increases are near four-decade highs. As we have stated, the Fed is between a rock and a hard place. A quicker taper is not likely enough to put the inflation genie back in the bottle, especially since the Fed's balance sheet will be near \$8 trillion despite their tapering actions. Additionally, we do not believe the Fed has the tools to address the structural issues keeping people out of the labor market. So compared to the last rate hike cycle, federal debt is in a worse situation, and the job market is nowhere near as healthy. Not exactly ideal conditions, but the risk of sustained high inflation is too significant to ignore.

Looking to the fixed income markets, we continue to keep our maturities short for the bond component of our portfolios. With that said, we have purchased some longer-dated Treasury Inflation-Protected Securities (TIPS) to enhance the portfolio's overall credit quality while offering some protection against inflation. Despite numerous headwinds, we believe the equity markets have multiple pockets of opportunity for investors in 2022. Since the economic crisis of 2008 – 2009, it seems that investors have focused their attention on only rewards while ignoring risks. In 2021, we witnessed the insanity of meme stocks, the explosion of cryptocurrencies, and stock market valuations pushed to record high levels. Remember that record low-interest rates at the hands of the Fed, benign inflation, and easy monetary conditions have been the backdrop for this madness.

With that stage set, the Fed is likely to dance carefully when trying to temper inflation in order to not dislodge the wealth felt by those who have benefitted from its long-term policies. This does not mean that valuations won't correct given the U.S. markets are expensive relative to their global peers and historical norms. For the first time since 2016, the S&P 500 handily outperformed the technology-laden NASDAQ Composite. The S&P 500 performed well because some of its largest technology members, including Microsoft, Apple, and Alphabet, had solid performances relative to many of the stay-at-home pandemic plays such as Zoom and Peloton that started in 2020. Additionally, the S&P 500 benefitted from strong returns in the Energy, Materials, and Industrials sectors. We view this as an early signal that the leadership baton is being passed from growth names to value names, which favors our investment thesis.

We wish everyone peace, health, happiness, and prosperity in the New Year. Although the years change, our commitment to seeking out the best risk-adjusted returns for our clients never does. Thank you for allowing us to serve as your investment manager.

Managed Asset Portfolios' Investment Team

Michael Dzialo, Karen Culver, Peter Swan, John Dalton, and Zachary Fellows

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