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# The New Year and the Equity Vigilantes

After a stellar 2021 with the S&P 500 up 28.68%, the markets pulled back in January 2022 with an S&P 500 return of -5.69%. Covid-19 hadn't seemed to slow the markets, but the prospect of the Federal Reserve raising its benchmark rate finally has given investors something to worry about. But on a broader scale, what does 2022 have in store for the economy and investors?

Looking forward, the big items on everyone's radar are the impact of Covid-19, the ability of the president to implement policies, the upcoming mid-term elections, bottlenecks, shortages, inflation, interest rates, and corporate profitability. While Covid-19 can still be a deadly disease, and while there will likely be setbacks, the disease's ability to disrupt daily lives and the economy appears to be diminishing.

Supply chain disruptions and shortages will likely persist in 2022. Sourcing goods by using the fastest, cheapest supplier was highly efficient. It just didn't permit leeway for things to go wrong. . Dependence on one country, especially China, for inputs has been recognized by many as a mistake. Labor shortages are real. The high level of retirements is not going to abate, while the skills gap will take years to reverse. As a result, businesses will spend the next few years building multiple sources of inventory, manufacturing, and means of distribution.

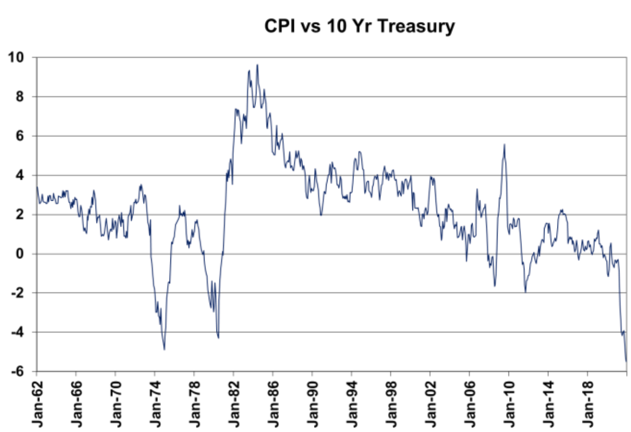
This real investment in the economy should be a tailwind for growth going forward, adding to both GDP and corporate profitability. On the other hand, additional business investment combined with the tight labor market, excess monetary growth, artificial stimulus from the federal government, and an increasingly difficult regulatory environment will likely mean that the inflation we are now experiencing is anything but transitory. The most recent inflation reading showed the Consumer Price Index (CPI) advancing 7.0% year over year. This is the highest in decades and may spike even higher. Inflation is likely to taper off later in 2022, but it should remain elevated by historical standards.

For those old enough to remember the late 1970s and 1980s, this was the transition from increasing inflation and high interest rates to diminishing inflation and falling interest rates. While the Federal Reserve's tightening gets much of the credit for this transition, one can't forget the role of the "bond vigilantes". Any time monetary growth or government policy appeared to be reverting to an inflationary stance, these investors would sell off bonds, driving interest rates up, thereby forcing the government to reconsider its policies.

That was then. Today, with inflation rising, one would expect these vigilantes to return. But though investors are beginning to demand higher interest rates on their fixed income investments, real interest rates are extremely low by historical standards. So while inflation hasn't caused a massive run on bonds, the Fed's indication that rates were likely to rise has caused the equity markets to sell off. This is reminiscent of 2018 when the Fed raised interest rates. The stock market sold off and the Fed was forced to reverse course.

So instead of bond investors controlling inflationary moves by the government, it appears we have equity investors limiting the actions of the Federal Reserve. Instead of "bond vigilantes", we have "equity vigilantes". No matter what the Fed claims, it is quite apparent that they are tuned into the actions of the equity markets. Yes, they will raise the Fed Funds rate and slow their easing. But they won't but the brakes on to the extent might be suggested by current inflation. They will merely tap the brakes.

As a result, the increases in interest rates will likely remain smaller than the increases in inflation. Indeed, the chart below, which shows the difference between 10-year Treasury yields and inflation, shows a gap even wider than the 1970s.




These negative real interest rates have implications for the bond markets, stock markets, and economy.

First, we don't expect interest rates to rise this year as much as inflation. As a result the real cost of borrowing will be extremely low for individuals, governments, and businesses. This should continue to fuel spending growth and keep real estate markets robust.

But as rates will likely rise somewhat, fixed income returns in 2022 are very unlikely to keep pace with inflation. Indeed, the Bloomberg US Aggregate Bond Index (the old Lehman Bros. index) returned -2.15% in January 2022 after returning -1.54% for all of 2021. At some point if rates rise enough, we might consider extending durations on our fixed income investments. But at this point, we'd keep durations short to minimize losses.

We are more optimistic regarding equity market returns in 2022. We expect them be positive and ahead of inflation in the coming year. What will be fueling this are the low real interest rates combined with positive earnings growth. We particularly like investments in the industrial and commodity sectors. Still, positive outcomes are not guaranteed. Expect volatility to be greater than in 2021. There is likely to be a strong Republican victory in the mid-term elections later in 2022. Irrespective of one's view of this, a change in the composition of Congress won't necessarily boost or harm returns in the near-term.

This year should mark the start of a transition to a saner, better functioning economy. Strains of Covid-19 appear to be getting milder, and we are learning to live with the disease in our midst. Businesses will be investing provided interest rates don't get too high. Yes, there are risks out there, including the risk of international confrontations. But these risks almost always exist and will likely not disrupt forward progress.

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