Independent Investment Advisory

GKV Capital Management

Quarterly Update

Fourth Quarter 2021

2021 Review

Persistent Transitory Inflation

Looking Ahead

Opening Thoughts

Although it does not yet feel like the pandemic is in the rearview mirror, from the perspective of the market we are getting close to the end. The pandemic created massive economic disruption and while some of the fallout continues, inflation for example, the economy has largely bounced back.

The economic disruption created significant investment opportunity. The worst move an investor could have made was to sell everything as infection rates soared back in March of 2020. Most of the economic metrices, as we begin 2022, are equal or better than where we were at the start of 2020, two very long years ago. The S&P 500 gained an impressive 48% the last two years combined, on the heels of a 29% gain in 2019. The index has annualized growth of more than 26% over the last three years. The growth is not unjustified. Corporate earnings for the companies in the index increased 30% from the start of 2020 to the end of 2021. Meanwhile, GDP grew at 7% although that is only through September 2021 which is the most recent data available.

Despite a difficult few years for all of us, you wouldn't know it looking at the data. Nearly every metric is positive. Moving into 2022, the challenge for portfolio managers will be how to best position portfolios as the dust continues to settle. For awhile now, stocks have been the best performing asset class with little competitive investment alternative. We remain modestly positive on the outlook for equities based on a favorable forecast for the economy. U.S. Corporate earnings will continue to grow albeit at a more normalized rate. Current estimates are for 9% in 2022.

There are some risks, however, they currently appear manageable. We ended the year with an increased cash position so that we can reallocate capital as new opportunities present themselves. We do expect the investment environment for stocks to be more challenging than the last three years. We are selectively reaping some of the big gains in expensive technology companies and redeploying those assets in companies with strong earnings and more rational valuations.

In short, we are cautiously optimistic going into 2022. We anticipate continued consternation around the pandemic. Supply chain issues may take time to unravel, and there will be a gradual reversal this year of the easy monetary policy by the Federal Reserve, but none of these should derail corporate earnings assumptions.

	2020	2022	Change
U.S. Real GDP	21.69T	23.2T	7.0%
S&P 500 Index	3230.78	4766.18	48%
S&P 500 Earnings	$155.84	$201.86	30%
Home Prices	242.17	279.03	15%
Disposable Personal Income	$49,935	$54,758	10%
Retail Sales	458.1B	566.1B	24%
Unemployment	3.60%	3.90%	
10-year Treasury Yield	1.92%	1.52%	

4Q21 Data Points

DJIA YTD	18.7%
S&P 500 YTD	26.9%
NASDAQ YTD	21.4%
US Bond YTD	-1.5%
10-Year Treasury Yield	1.52%
S&P 500 LTM Dividend Yield	1.38%
S&P 500 EPS Next 12-MTH	$220.11
S&P 500 P/E	19.5x

2021 Review

Equities continued a third straight year of outsized returns in 2021. Despite the pandemic, corporate earnings accelerated throughout the year, finishing an estimated 60% higher than 2020. Government stimulus, extremely low interest rates, coupled with a steadily reopening economy and an improving employment picture all contributed to push equities to new highs in the year.

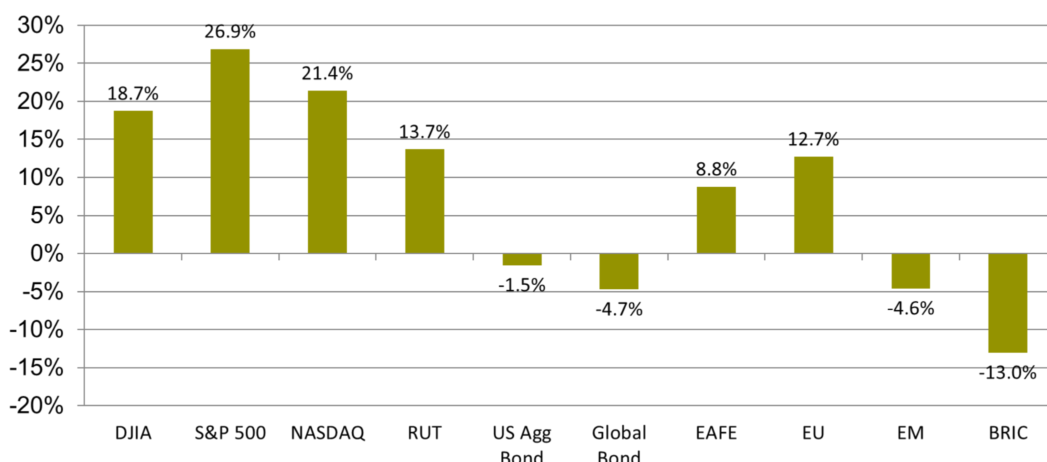
For 2021, the S&P 500 gained 26.9%, picking up 11% in the fourth quarter. The Dow Jones Industrials closed the year up 18.7%, gaining 7% in the last quarter. The NASDAQ, which is disproportionally weighted towards technology companies, returned 21.4% in 2021 and 8% in the fourth quarter. Small cap companies, as measured by the Russell 2000 index, lagged in the fourth quarter as continued COVID concerns caused greater uncertainty. Smaller companies are generally more sensitive to disruption than larger companies with greater resources. The Russell 2000 gained 14% for the year but added only 1.9% in the fourth quarter.

Despite the continued disruptions of the pandemic, the worst performers of 2020 were the best performers of 2021 as the economic recovery accelerated. Energy ended the year up 48% followed by real estate gaining 43% and financial services, up 33%. The other major sectors were all up double digits in 2021. The weaker sectors were consumer staples, up 16% and utilities up 14%. Consumer staples include household goods, food, beverages, hygiene products and other essential items. Throughout the pandemic, from 2020 to 2022, technology and consumer discretionary sectors outperformed the rest of the market as the pandemic shifted spending into these areas.

Estimates for earnings of the companies in the S&P 500 continued to be revised higher through the end of the year, although upward revisions slowed in the fourth quarter. The current forecast for 2021 is for the total earnings of the combined S&P 500 to reach $201.85, which is 2% higher than the $198.12 forecast at the close of the third quarter. The forecast for 2022 is currently $220.11 putting the S&P 500 at a historically expensive P/E multiple of 21.7. Earnings growth is impressive, and estimates continue to be revised higher, but the rate of those upward revisions has slowed appreciably. The 2022 earnings estimate implies a 9% growth forecast over 2021. With stock repurchases and continued economic improvements as COVID becomes endemic this forecast appears reasonable, in our view.

Once again, the U.S. equity markets significantly outperformed the global equity markets. The MSCI EAFE (Europe, Australia, Far East) closed 2021 up 8.8%, Europe finished up 12.7%, and emerging markets closed 2021 down 4.6% as slow vaccine rollouts and new waves of infection continue to keep poorer economies from reopening as rapidly. Global GDP shrank 3.1% in 2020 due to the pandemic, but is forecast to resume growth of 5.9% in 2021. Comparatively, GDP growth in the U.S. was forecast to increase 6% in 2021 and is estimated to increase another 5.2% in 2022 after a contraction of 3.4% in 2020. It has been some time since international equity markets have outperformed U.S. equities. The largest U.S. companies have significant international sales and therefore provide real exposure to the global economy in our view, eliminating the need to worry too much about diversification into international equities. Lingering impacts of the pandemic will take far more time to resolve in emerging markets than in developed economies. As a result, we have mostly avoided equities outside the U.S.

In April of last year, at the opening stages of the pandemic, unemployment spiked to 14.7%. Since then, the jobs picture has steadily improved. The jobless rate ended the year at

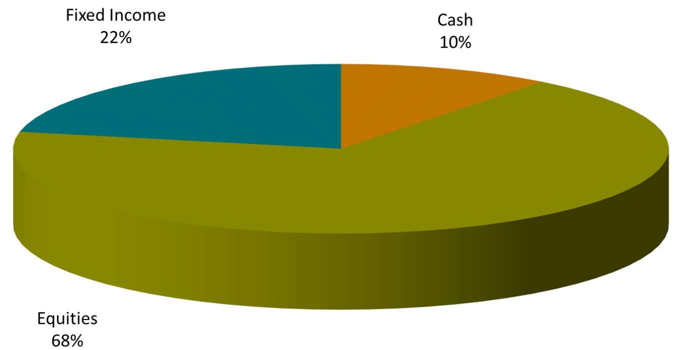


3.9%, which is within a stone's throw of the 3.5% where it started the pandemic back in February of 2020. For context, following the 2008 recession, the high point for unemployment was just over 10% in October of 2009 but took until 2015 to get back to 5%. However, some of the improvements in the jobless rate have occurred due to workers leaving the workforce rather than the addition of new jobs. Consumer spending has remained strong driving retail sales well above pre-pandemic levels. Retail sales for November 2021 were up more than 16% from a year ago.

Strong consumer demand combined with manufacturing disruptions due to the pandemic have produced a sudden acceleration in inflation. With improvements in the unemployment rate, it is clear that the Federal Reserve will start aggressively raising interest rates in 2022. The 10-year treasury ended the fourth quarter at a still low 1.52% but we expect that we will see 10-year Treasury rates above 2% in the coming year. Rising interest rates have had a negative impact on bond prices resulting in a 1.5% negative performance for the U.S. aggregate bond index in 2021. With rising interest rates, we anticipate continued negative pressure on bond prices through 2022. The global aggregate bond index finished even lower, declining 4.7% in 2021.

Several factors prompted us to take some profits in the fourth quarter, reducing both equities and fixed income. At the end of the year our cash increased to 10% of assets from 2% at the close of the third quarter. At year end, equities totaled 68% of assets across all our client portfolios combined and fixed income positions finished the year at 22% of assets.

GKV Firmwide Asset Allocation



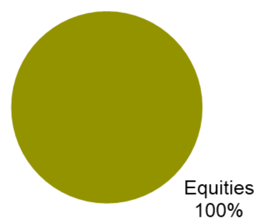
GKV Capital December 31, 2021

In the fourth quarter we reduced exposure to high valuation equities in retirement accounts where capital gains taxes would not be a factor. The short-term concerns around inflation and the likely need for the Fed to increase interest rates has encouraged us to increase our focus on companies with significant earnings. Continued concerns around the latest wave of the pandemic has also encouraged this shift. In the long-term our outlook for continued growth in equities is based on the assumption of continued growth in corporate earnings. We discuss our outlook in greater detail in the looking forward section of this quarterly update.

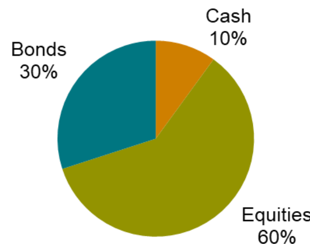
Our fixed income positions are generally very short in duration and are less sensitive to anticipated increases in rising interest rates. Rather than reinvest maturing bonds, we have been steadily reducing fixed income exposure over the last several years. We expect to continue to let fixed income exposure shrink throughout the coming year.

Long-Term Historical Portfolio Returns and Volatility

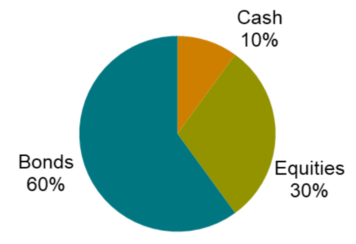
Aggressive



Moderate



Conservative



	Aggressive Total Return	Aggressive Std. Deviation	Moderate Total Return	Moderate Std. Deviation	Conservative Total Return	Conservative Std. Deviation
3 Year	14.2%	20.4	17.2%	11.5	10.8%	7.3
5 Year	15.2%	16.6	12.3%	10.2	7.8%	6.6
10 Year	13.9%	14.9	9.3%	8.8	6.8%	5.8
15 Year	9.7%	17.1	7.7%	10.3	5.8%	6.7

Performance Data for periods ended December 31, 2021
Annualized monthly standard deviation
Bond Index is Barclays US Agg TR USD

Persistent Transitory Inflation

"There's a real risk now, I believe, that inflation may be more persistent and…the risk of higher inflation becoming entrenched has increased."

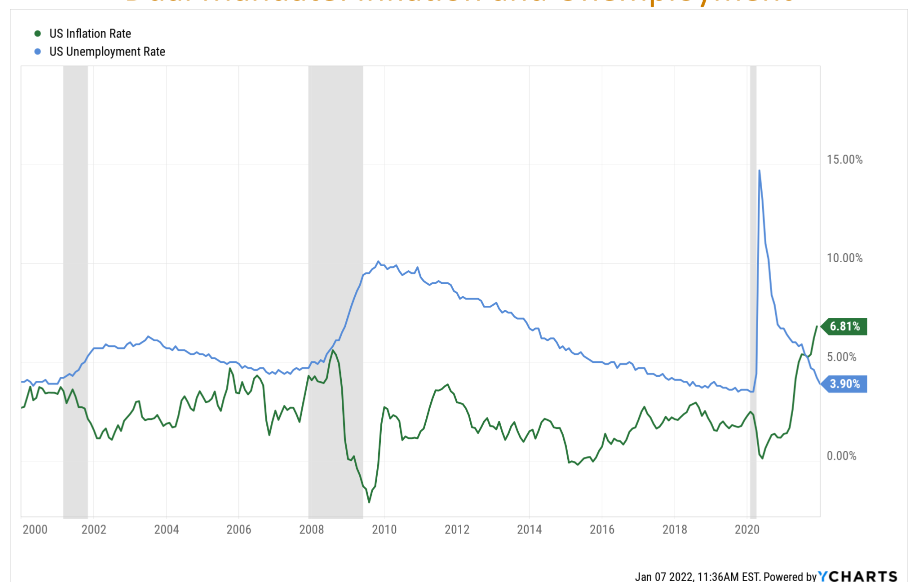
- Jerome Powell, Federal Reserve Chairman, December 15, 2021

One of several unexpected economic impacts of the pandemic is the recent sharp rise in consumer prices. The economy has rapidly reaccelerated since the dark days at the onset of the pandemic. Consumers have money to spend but with supply chain disruptions, many products are scarce. This past holiday season, discounts were nonexistent. Suddenly everyone is talking about inflation. Through the second half of 2021, Jerome Powell, Federal Reserve Chairman, brushed off inflationary concerns believing the price increases would be transitory. The Federal Reserve Governors anticipated that the snarled supply chain issues, whether semiconductor shortages for autos or bottlenecked shipping ports, would be worked out with a little patience. That patience has worn thin.

After the December Federal Reserve meeting, the label on inflation has been revised from transitory to persistent and the stock market reacted by selling off high priced tech stocks and pushed 10-year treasury rates to recent highs. This quarter we thought it useful to look at the inflation picture and how it may impact both the stock and bond markets this year. You can be certain we will be seeing a lot more headlines about inflation this year than we have in a long time.

Inflation is the decline in a currency's purchasing power due to rising prices. I have visions of my grandmother talking about the times when a cup of coffee cost a nickel. In the U.S., the last period of runaway inflation was far enough in the past that many Americans were not yet born. For those of us old enough to remember, the prospect of significant inflation is a worrying development. Cost of labor is one of the most significant corporate expenses. Prices go up, wages go up, pushing prices even higher in a negative feedback loop. In the 1968 to 1982 period, dubbed the Great Inflation, the consumer price index soared 7.3% annually resulting in a 186% total increase in prices. The Federal Reserve, in retrospect attributed the root cause to "policies that allowed for excessive growth in the supply of money". To break out of that cycle, the Federal Reserve increased interest rates which restrained the availability of capital and pushed the economy into a recession. To break the inflation spiral, Chairman Paul Volcker tightened the money supply and increased the federal funds rate pushing the yield on the 10-year treasury bond to 15% and unemployment to over 10%. The economy went into recession, but inflation peaked in 1980 and trended downward for decades. It was a bitter but necessary pill.

Dual Mandate: Inflation and Unemployment



The task of the Federal Reserve is referred to as a dual mandate. Maximize employment while keeping prices stable. The primary lever to manipulate the economy to these ends is interest rates. Lower rates make borrowing cheaper. More funds available to both companies and consumers increases spending on goods and capital investment, spurring economic growth. Greater economic growth creates more jobs, maximizing employment. As employment is maximized, workers become scarce, increasing wages to attract new workers. These increased wage costs get passed on as companies can increase prices resulting in inflation. Low unemployment is good for obvious reasons and the goal has generally been for the unemployment rate to be below 5%. The chart above shows the unemployment rate since 2000 and the dramatic recovery

since the start of the pandemic. Some inflation is a good thing and the long-term target for the Fed is 2%. A healthy economy should enable some pricing power for companies. If wage growth can't keep up with inflation, purchasing power declines.

With a strong recovery in the job market and ultra-low interest rates, many have grown concerned that it's time to dial back the stimulus and start worrying about inflation. The initial consensus of the Fed was that the sudden inflation pressures were due to supply and demand imbalances resulting from the pandemic. The sudden reacceleration of the economy in 2021 coupled with sluggish manufacturing and distribution due to COVID related employee shortages resulted in demand far outstripping supply in certain industries. The global economy has become finely tuned over the last twenty years with consistent trends in demand enabling companies to accurately forecast needed product. Globalization has kept inflation at historic lows despite very low unemployment. Core consumer prices, which exclude volatile food and energy categories, were up 4.7% in November from a year earlier. That's well above the Fed's target of 2% and the long-term average of 3.2%. Including food and energy inflation jumped an alarming 6.8% in November from the prior year.

At the Federal Reserve meeting December 14-15, officials indicated that they are concerned about inflation. It may end up that much of the recent inflationary pressures do indeed show themselves to be transitory, but the Federal Reserve is now hedging its bets. It will be considerably more painful if the recent rising prices are the start of a runaway cycle. Based on the minutes from the December meeting, Wall Street now anticipates three or even four rate hikes this year and a reduction in the Fed's massive bond purchasing program. These moves were already anticipated to a degree, but the increased level of concern around burgeoning inflation and the possibility rates may have go higher, sooner than was initially expected has spooked the market, particularly for overvalued growth stocks. Chairman Powell's comments after the meeting were more hawkish than they had been previously. "There's a real risk now, I believe, that inflation may be more persistent and…the risk of higher inflation becoming entrenched has increased." In response the yield for the U.S. 10-year treasury bond jumped to 1.71% after spending most of the pandemic hovering around 1%. By historical standards however, 1.7% is still an extremely low yield.

There are signs that inflation pressures here in the U.S. may be reaching a peak. Although, the sudden rise in inflation measures has been alarming, it may still be possible that much of the causes turn out to be transitory in the end. The Institute for Supply Management's composite index, came in at a reading of 58.7 in December, showing an expansion, but it was the lowest level in the last eleven months and well below expectations. Importantly, the data showed that manufacturers' input prices and delivery delays declined over the prior month. Global supply bottlenecks appear to slowly be resolving. Like the ebb and flow of infection rates of the pandemic itself, we may find that the disruptive cycle of regional economic shutdowns will continue to keep a recovery in product supply uneven longer than anticipated. When companies have plenty of product on the shelf, prices stop rising.

The Federal Reserve has the tools to fight inflation, but the concern on Wall Street is what the cost might be. If we move from transient to persistent inflation we will have higher rates, slower economic growth and the possibility of a recession sooner than hoped. The next meeting of the Federal Reserve is January 25th and 26th and will obviously be closely watched by investors.

Higher interest rates from the incredible low levels of the last several years will not have a significant impact on growth stocks. But a recession will. Wall Street is very forward looking. Even if the odds of a recession in the next two years is low, but the likelihood shifts to 20% from 10% hypothetically, the still unlikely albeit more possible scenario, encourages profit taking and a reallocation of investment capital to more conservative assets and companies better positioned to weather a storm. Companies with rapid growth and no earnings trading at high multiples to prospective sales get sold first.

Corporate earnings have always driven stock prices and they will continue to do so. We have some concern that to fight inflation the Federal Reserve will necessarily have to tighten the money supply, increase interest rates and effectively increase the cost of capital. This will have an impact to some degree on economic growth and earnings growth. Additionally, growth in earnings will slow in 2022 and 2023 from the rapid rise in earnings with the restart of the broader economy from the depressed level at the second half of 2020. Earnings for the S&P 500 declined 22% in 2020 from 2019 but then went on to grow 65% in 2021 and are forecast to increase another 9% in 2022. It is true that some industries such as elements of travel and entertainment have yet to fully recover, but most of the recovery has already happened. With an outlook for rising interest rates, even marginally as we anticipate, the value of the stock market is unlikely to meaningfully outpace the growth in earnings in 2022. We would be pleased with a 9% return for the S&P 500, but do not anticipate something better. And of course, there are risks. Anything that would cause Wall Street to reduce the earnings outlook, will have an adverse impact on stock prices.

Looking Ahead

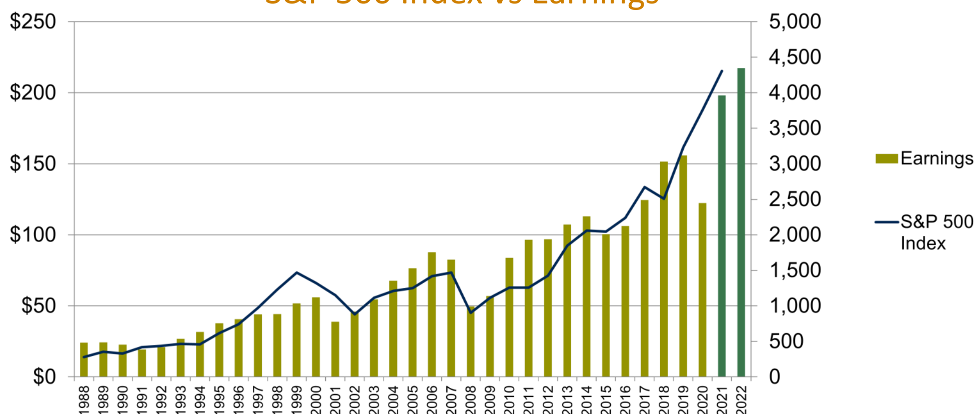
We can't pretend to know exactly what equity returns will be in any given year but there are historical averages that provide some guidance for future expectations. Since 1950, the S&P 500 has produced a compound annual return of 7.5%. Of course there is enormous volatility in the stock market from one year to the next. The average return provides a good starting point for expectations but the actual results often deviate substantially from the average.

A measure of the volatility in the market, again from a historical perspective is to calculate the standard deviation. For the S&P 500 index, the standard deviation is 16.2 since 1950. While the historical annual return is 7.5% annually, from one year to the next the market finished the year 16.2% higher (23.7%) or lower (-8.7%) two-thirds of the time. That's a big range. One-third of the time the swings higher or lower have been even greater. The volatility is significant.

While we do not try to time the market- sell exactly at the high and buy exactly at the low, we do make adjustments to portfolios based on the outlook for the economy. Stock prices are ultimately driven by earnings. In anticipation of recessions, the market has sold off dramatically. In anticipation of recoveries the market will rise dramatically.

We are still in the process of a substantial recovery. The near-term outlook for the economy is positive with solid earnings growth forecast to increase 9% this year over last. Last year, however, earning grew 60% from the depressed levels of the self-induced recession at the outset of the pandemic. While 9% is a good annual growth rate that should move the value of stocks higher through 2022, it is considerably less than 60% of 2021. In other words, with a more normalized rate of earnings growth, we should anticipate a more normalized return for equities.

Some sectors of the economy and specific companies have yet to recover from the pandemic. For the quality companies that have yet to participate in the recovery, we see opportunities for additional gains. Much of the speculation and narrow investment concentration in a few pandemic winners is likely to broaden in our view. As the cycle moves beyond recovery, companies with growing earnings will outperform. After taking some profits in the fourth quarter we expect to find opportunity to redeploy cash into some of these areas.



Our outlook for 2022 is contingent upon the 9% earnings forecast and likely growth into 2023. We believe equities will move higher this year, but the gains will be considerably closer to historical averages.

S&P 500 Earnings and Index Valuation

	2014	2015	2016	2017	2018	2019	2020	2021E	2022E
S&P 500 EPS	$113.01	$100.45	$106.26	$124.52	$151.60	$155.84	$122.38	$201.85	$220.11
EPS y/y growth	5%	-11%	6%	17%	22%	3%	-22%	65%	9%
S&P 500 Index	2059	2044	2239	2673	2507	3231	3756	4766	
Index y/y return	11%	-1%	10%	19%	-6%	29%	16%	27%	
Trailing P/E	18.2x	20.3x	21.1x	21.5x	16.5x	20.7x	30.7x	23.6x	
Forward P/E	**20.5x**	**19.2x**	**18.0x**	**17.6x**	**16.1x**	**26.4x**	**18.6x**	**19.5x**	

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