JURIKA · MILLS & KEIFER
Private Wealth Management

Quarterly Investment Commentary

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A Return to Normal?

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2021 started with high hopes and then immediately disappointed.

It was supposed to be the year that we brought sanity and competence back into Government, conquered Covid and returned to normal life. Instead, we got an insurrection at the Capitol; two new variants of the Virus, one more contagious than the next; an escalation of hyper-partisanship and political dysfunction; a break-down in the global supply chain and a surge in prices for almost anything, assuming that you could get it at all. Chances are, it was floating in a container off the coast of Long Beach.

In many ways, 2021 seemed more like an extension of 2020 than the bright new beginning we were all hoping for.

Despite the negative headlines, there was good news too: billions of people were vaccinated around the world, providing some degree of protection from serious infection; the global economy continued to recover and post strong growth, fueled by very large amounts of fiscal and monetary stimulus. Despite the challenges of the pandemic, people and businesses showed themselves to be surprisingly resilient and adaptive.

Strong economic fundamentals as well as a lack of good alternatives led to a continued flood of capital into financial assets including stocks and real estate, especially in the United States: the S&P 500 posted a stellar return of 28.7%, driven by very large technology companies which comprise close to 25% of the index. Within the broader U.S. stock market there were areas of strength like energy (+54%), financials (+35%), real estate (+42%) and technology (+34%), as well as some areas of weakness such as small-capitalization growth (+2.8%) and biotechnology stocks (-20.5%). Larger companies tended to outperform smaller companies by a wide margin.

Outside the U.S., returns were considerably lower. International developed markets (Europe and Japan) were up about 8.3% and Emerging markets were down 2.1%, largely as a result of concerns about China.

Commodities had a banner year, benefitting from a surge in demand for goods relative to available supply, and exacerbated by supply chain disruptions and growing inflationary fears. If people suspect that prices will be higher in the future, they will tend to buy more now.

Finally, it was a tough year for bonds, and perhaps the first of many to come. The Aggregate bond index declined by 1.2%. Bonds do poorly in an environment of rising interest and inflation rates, and both conditions were out in force last year and are likely to persist in years ahead.

A Return to Normalcy?

Perhaps we are naive optimists, like Charlie Brown believing that he will actually get to kick the football that Lucy is holding, but we actually think that 2022 may become the year of recovery and return to normalcy that we were all hoping would happen in 2021.

We also think that the investment landscape will be quite different this year than last, reflecting changing conditions in the global economy.

In the U.S., we expect the twin tailwinds of extraordinary government spending and easy monetary policy to wane and become modest headwinds. The current political and economic environment will make any major new fiscal spending program difficult to pass and will likely require higher taxes to offset new spending. Meanwhile, the Federal Reserve has already signaled a plan to taper asset purchases and start raising interest rates. Outside the U.S., inflation rates are lower and fiscal spending and monetary policy will likely continue to be more supportive of economic growth.

Although our outlook still favors owning risk-oriented assets such as stocks and real estate over bonds, starting valuation levels are generally high and expected returns are fairly low. This is especially true for U.S. stocks as a whole. Looking under the hood of the global stock market however, we do find significant and actionable divergences between various regions and sectors. In particular, we think that the areas that underperformed last year offer some of the most attractive areas for investment now, including Europe, Japan and Emerging Markets.

We also think it is a time to be more broadly diversified among asset classes, and more selective within asset classes. This favors using more active management approaches, especially in areas where there is a high degree of innovation, disruption, and regulation such as technology, healthcare and emerging markets, or where we see large distortions in valuations between companies relative to their fundamentals.

For example, we believe that electric vehicles will quickly displace gasoline-powered vehicles in the coming decade, but this does not mean that Tesla deserves an infinite valuation, or that every other car company that says it is going to make electric cars deserves Tesla's valuation. Similarly, cloud computing will continue to experience rapid growth but not every cloud computing company will ultimately be successful or even around in five years.

We saw similar distortions leading into the dot-com bubble where every company associated with the internet was valued as if it was going to be the next Amazon. The internet didn't go away, but only a few of the companies back then ultimately lived up to their lofty expectations at the time. Many more disappointed or disappeared.

Omicron: Covid's Last Hurrah?

While the headlines about Omicron are gripping, especially with respect to the soaring infection rates, there is also good news: Omicron appears to be a more benign variant of the virus, and people who get it are so far tending to experience mild symptoms, especially if vaccinated. In addition, its higher degree of contagiousness means that Omicron is quickly displacing the more dangerous Delta variant. Most people will be exposed to Omicron: it's more a matter of when than whether. But, most people will also not get terribly sick and should then be immune from further infection.

And so, the hopeful scenario is that Omicron actually moves the world more quickly towards herd immunity and thereby reduces the probability of a new and more dangerous variant emerging.

Between now and then, things will likely get worse before they get better. If the experience in the U.S. and Europe tracks the experience in South Africa, we would expect infection rates to peak in the next few weeks before falling off dramatically. Hospitalization and death rates will lag but should be much lower than with Delta as a percentage of the population, although still large enough to fill hospitals and stress the healthcare system. In other parts of the world where vaccination rates are lower, the challenges and human cost may be even greater and more tragic.

We also expect disruptions in other labor-dependent areas of the economy such as airlines, transportation, schools, law enforcement and emergency services, where workers get Covid and need to self-isolate.

Our hopeful scenario is that by mid-February, a lot of this disruption will have run its course and we will all be able to return towards normalcy, with Covid rapidly receding in the rearview mirror.

Inflation:

We think current inflation rates will fall but remain well above historical averages.

The unprecedented amounts of fiscal and monetary stimulus have boosted economic growth and propelled financial markets to record levels. They have also led to significant inflationary pressures as demand for goods and services has eclipsed the available supply. These pressures in the U.S. have been exacerbated by supply chain disruptions and labor shortages.

Some of these inflationary factors are temporal and will pass. Others will be more persistent.

Prices for many commodities and goods will likely fall as producers boost production and supply rises to meet demand. Most disruptions in supply chains will likely be resolved in the coming months.

Energy prices may remain higher for longer. There has been chronic underinvestment in fossil fuel production over the past decade as developed world countries have embraced clean energy initiatives. In addition, nuclear power plants have been phasing out as marginal producers of electricity. New green energy production has not kept up with the growing gap between supply and demand and will take several years to catch up. This should lead to higher sustained prices for fossil fuels.

Inflationary pressures in wages and rents are also likely to be more enduring. There is an ongoing shortage of labor in the U.S. Several million workers left the labor force since the beginning of Covid and have yet to return. At the same time, immigration has been largely shut down. There are a record amount of jobs available relative to jobs being sought and employees have a lot of bargaining power over employers. This is leading to rising wages and higher labor costs throughout the economy.

Finally, there is also a high level of demand for real estate relative to supply, especially in single and multi-family homes, and anything tied to infrastructure and logistics. Rent increases tend to persist.

Economic Growth:

Global economic growth is slowing but is still strong and above its historical trendline. We will likely see a hit to growth in the first quarter as Omicron rolls though the economy, but after that we think that growth will bounce back and average about 3.5% for 2022. In Europe, GDP growth is expected to average just under 3% for the year and in China it should be around 5.0%.[1]

Geopolitics:

While everyone is focused on Covid, investors seem generally complacent about Geopolitical risks, which is never a good idea. The World is lacking a clear hegemonic leader; the role the United States used to play with much more credibility than it does today. Meanwhile Russian troops are massed on the Ukrainian border, and China is acting increasingly belligerently towards Taiwan, as well as any dissenting populations within the country, like the Uyghurs. We are mindful that it is typically not the things that you worry about that roil markets, such as Covid and inflation, but rather the things that come out of left field.

Markets:

Stocks: As noted above, valuation levels for most risk assets are high, and especially in the U.S. Within the U.S. market, there are significant divergences between sectors and types of companies. Large companies are more expensive than small companies and growth and technology-oriented companies are considerably more expensive than more defensive or economically cyclical sectors like healthcare, financial services, and industrial stocks.

Europe and Japanese stock markets are about 30% less expensive relative to the U.S. based on a forward Price to Earnings ratio basis. [2]

Emerging markets are even more attractively valued, selling at about half the valuation of the U.S. stock market [2]. Investors have shunned emerging market stocks because of concerns over China, its heavily leveraged real estate sector, and the Government's crackdown on a limited number of technology, education and gaming companies. We think this is an overreaction. There are thousands of companies in China that have not been the target of government regulation and there is a lot more to the developing world than China. Developing economies, particularly in Asia represent a vast consumer, business services and industrial market and account for the majority of marginal economic growth in the world.

Real Estate:

Real estate is expensive but is an attractive asset class and should continue to benefit from strong demand for industrial infrastructure and logistics facilities, as well as single and multi-family housing.

Commodities:

Industrial commodities offered strong performance in 2021, reflecting the excess of demand for goods relative to available supply. As noted above, we think that pricing for oil should remain firm, but we may see some correction in industrial commodities as rising supply catches up with declining demand.

Surprisingly, despite inflation worries, Gold and Silver lost money last year. We think that it makes sense to have some exposure to gold in portfolios as a hedge against inflation.

Bonds:

For more conservative and moderate risk-oriented portfolios, bonds are a necessary but unattractive asset. The current yield on a 10-year Treasury bond is about 1.6% and inflation is currently running about 6%, reflecting a negative real yield of 4.4%. Moreover, if interest rates should rise further, the value of the Treasury bond will fall. Shorter-term government bonds provide a safe parking place for cash, but produce no income and will almost certainly lose purchasing power over time.

Corporate bonds offer a slightly better yield than Treasuries, with less sensitivity to interest rates. High-Yield bonds are typically yielding a little over 4% but also offer significant downside risk in the event of a downturn that impacts credit markets. Outside the U.S., yields are even less attractive with the exception of emerging market bonds where yields are averaging 4% to 5%.

Strategy:

Based on our outlook, our strategy has not changed much, but we have used weak markets to increase exposure to underperforming areas where we see long-term growth potential. This includes biotechnology and other innovative areas of healthcare, as well as emerging markets.

We have also been reducing our exposure to growth-oriented technology. We still believe in technology and innovation as an area of long-term focus for portfolios, but think that current valuation levels are stretched.

Conversely, we have been adding to areas that offer more value both within the U.S. and internationally.

Finally, we have been adding private real estate and private credit to client portfolios where appropriate.

We continue to underweight bonds relative to our long-term allocation targets.

Please let us know if you have any questions and/or if there is anything we can help you with relating to your financial life. And, if we can ever be of any help to a family member or friend, we always welcome referrals from our clients.

Jurika, Mills & Keifer
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Notes:

[1] BCA Research 2022 Outlook
[2] J.P. Morgan Guide to Markets

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Based in the San Francisco Bay Area, Jurika, Mills & Keifer provides wealth management, planning and advisory services to a limited number of individuals, families and foundations.

We combine a forward-looking view of the world with a deep understanding of our client's needs and aspirations to build and preserve wealth and financial well-being over time.

Over the years, we have built a reputation for independent thinking, sound judgement, and a high level of individualized advice and service.

We welcome the opportunity to discuss your financial goals and priorities and how we can help you achieve them.

Jurika, Mills & Keifer, LLC
Private Wealth Management

Main Office
3595 Mount Diablo Blvd, Suite 300
Lafayette, California 94549

San Francisco Office
Four Embarcadero Center, Suite 1400
San Francisco, California 94111

415-677-5430 Phone
info@jmkadvisors.com

jmkadvisors.com

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