

## NEWSLETTER AND CAPITAL MARKETS REVIEW

### NEW YEAR 2022

**E**vidence of consumer price pressure abound ranging from rising food to energy to consumer staples. Overall, US consumer prices rose over 7%, a growth rate the US has not faced since the 1980s.

There are several well-documented reasons why prices have risen so rapidly, including the pandemic-forced economic shutdowns and supply chain disruptions of the past two years. How long will inflationary conditions persist, and will it become structural? Prior to the pandemic, the US was in a benign inflationary environment. Then, disinflation resulting from government-mandated shutdowns across the country suppressed prices. The annual change in US CPI averaged 1.4% from April 2020 to April 2021. The current CPI reading on December 31, 2021 is based off pandemic nadir levels, and the base effect may lead to higher "headline" inflation in the months ahead.

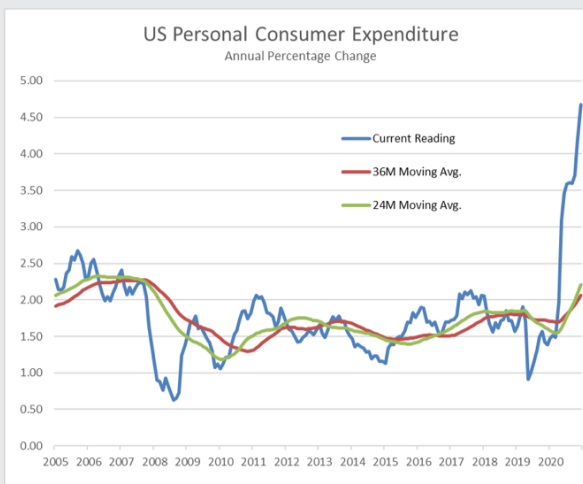
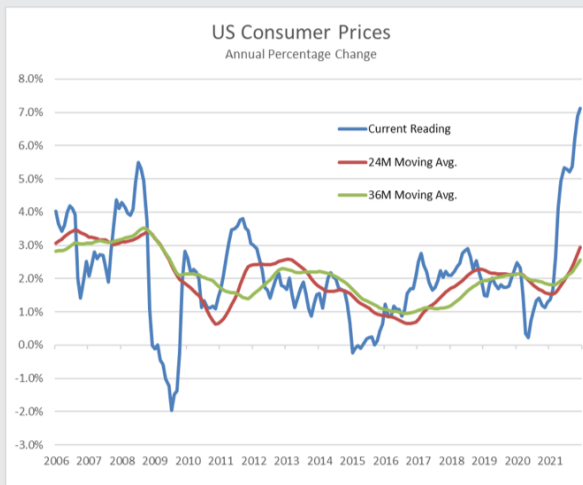
Similarly, the US Federal Reserve's preferred inflation gauge, the Personal Consumption Expenditure level shows similar trends to the overall CPI. The main differences between the two measures of inflation are energy and food prices, and as an astute colleague of ours has emphasized over the years, "the PCE is good as long as you don't eat or travel..."

We have plotted the 24-month and 36-month moving averages on the charts because it highlights an intermediate to short term normalization effect to the most recent data. What is interesting to us is that, while current inflationary readings are

alarming, the intermediate average over the past 24 and 36 months, while elevated, is not extreme. With that said, we are especially concerned about the tangible adverse impact on wage earners at the

lower end of the income scale, where, in effect, this kind of inflation in economic necessities feels like a new tax. This is something we will be exploring more in the months to come.

However, if annual gains in consumer prices do not maintain the same pace of inflation experienced through 2021 [which include 2020's low-base effect], forward looking inflation could moderate. Capital markets will likely remain on edge, and the US Federal Reserve will be challenged balancing appropriate monetary policy against inflationary trends that may prove temporary, but also may not.



## Portfolio Positioning

Policy status quo has kept us at portfolio status quo. Central bank policy and the surges of inflation are dragging on but not causing a crisis for fixed income. As rhetoric from the Fed is shifting to less accommodative we are on watch for language changes that warrant an asset allocation response. We continue to hold an overweight allocation to equities overall as well as a modest underweight in fixed income, also leaving cash meaningfully underweight. Within global equities, we are overweight with respect to the US, underweight in Emerging Markets, neutral with respect to Eurozone stocks and underweight Japan. Within fixed income, we are overweight in the US with a preference for mortgages and investment grade corporate credit. We have little to no exposure to non-US fixed income except through Green Bonds in our ESG series portfolios. All portfolios holding fixed income maintain lower duration than the benchmark.

## Risk Outlook

- **Inflation** – The headlines are increasingly troubling, but inflation does not seem to be systemic -- yet. In many regards it is surprising, maybe even astonishing, that inflation has not been more of a concern for years now. We are more than a decade in to post-Crisis easy monetary policy and a booming stock market only briefly interrupted by the pandemic. The market may be the answer, though. The coordinated government response to the economic damage of the pandemic has been massive. Had all of that stimulus settled into the “real” economy, inflation would be on a tear. We believe that the capital markets have been serving as a pressure relief valve, with stimulus settling out of the real economy and in to the capital markets inflating asset prices. Correlation does not equal causation, but there seems to be a relationship of some sort between the magnitude of the stimulus and the increase in aggregate value in just the public markets. We have seen spikes in prices of building materials and scarcity of new cars for purchase as examples. But, while we cannot discount those observations entirely, we principally see them as graphic examples of how interdependent world economies and supply chains are and how fragile they were with just-in-time inventory management. While investors have extolled just-in-time since Toyota popularized it, it

introduced an inelasticity into global supply chains that was not capable of absorbing the blow of COVID. We liken this to everyone on the highway cruising at 70 Mph riding bumper-to-bumper and doorhandle-to-doorhandle. It works fine until somebody swerves or stamps on their brakes. This was further exacerbated by climate-related issues with beetle infestation and fire affecting Western timber stocks and storms knocking petro-chemical production capacity off line among several other challenges. The results were issues such as a microchip shortage affecting the ability of factories to finish automobiles for delivery. We believe as major parts of the global economy get back on pace that the current situations will self-correct, but as investors and market watchers we are looking longer term at the confluence of business practices that are not sustainable, resilient or adaptive and externalities like global health and climate change which can and will disrupt businesses and markets again.

- **Rates** – Benign conditions do not always result in benign outcomes. As discussed elsewhere, even a slight normalization of the rate environment, which would reflect stabilizing economic conditions, could have profound effects in fixed income markets, severely dragging down assets like 30-year Treasury Bonds which are normally seen as safe harbors from risk. Wall Street has been cautioning about the risk of rising rates since the end of the Financial Crisis in 2009, but we have yet to actually have to live with those risks because a slow grind recovery followed by a series of crises including COVID have conspired to hold central bank policy where it has been – accommodative. A mild turn of phrase by the Fed Chair has resulted in temporary shocks in the bond and even equity markets, so we can anticipate that rising rates are not welcome in markets that have enjoyed easy money for more than a decade now. This compels us to think about risk in globally diversified portfolios differently, where the traditionally more conservative parts of asset allocations may actually represent more material risk in the nearer term.



## Risk Outlook [cont'd]

- **The National Balance Sheet** – Continuing on the related themes of inflation and rates, the Federal Reserve has begun to signal their intent to start winding down the extraordinary measures they have been taking through asset purchases. That has a couple implications – one is telling the markets that the training wheels can come off. The Fed feels like their additional help is no longer as needed. That is positive in tone which should be good for market sentiment, but offset by the disappointment of losing a major bond investor. This does mean a more orderly bond market where institutional investors are not competing with the government for bond inventory. Again, this is good, but it also means less liquidity. This is a slow turn of the battleship of state. They are not really shrinking the balance sheet. Just growing it less fast, so most of the market reaction will be sentiment-driven rather than based on real stresses from lower liquidity.
- **Spending** – We cannot get away from the not-so-invisible hand of government in how markets are functioning. It may not be a risk per se, but we are mindful of the legislative efforts around major spending initiatives coming out of Washington DC. Discussions around infrastructure have been bipartisan and bicameral, and the President signed the legislation in to law on November 15<sup>th</sup>. The \$1 trillion will be more fundamental to the economy because it is being spent on “stuff”, and that spending will take time to deploy (5 years) and for the bridges, roads, broadband, etc. to be built or restored. That spending becoming a sure thing does get discounted into the market so it has an immediate effect on asset prices, but in a more durable way than the sugar buzz of pure cash stimulus we have been getting. Next up is Build Back Better, which may or may not happen since it does not enjoy the bipartisan support of infrastructure. As we have been saying since the election, an evenly split government means a lot of triangulation and not a lot of surprises, so we do not think the market will either jump or drop materially on the outcome.
- **COVID-19** – We are now looking at the global transition of SARS CoV-2 and COVID-19 from pandemic to endemic, and what that means for progress and prosperity in developed and developing economies. Vaccine deployment continues and close on its heels the promise of new therapies in pill form that may make addressing severe illness as simple for COVID as Tamiflu does for influenza. New strains of the virus may contest the efficacy of those vaccines, but after two years the world has become more adaptive to the challenge and the need to hit the “off switch” on the world economy is far less than the early stages when the virus represented all danger with no defense. As we have previously expressed, the global community remains vulnerable to a have/have-not dichotomy based on access to virus-fighting resources. Indications are that pricing will be calibrated according to economic capacity, which is a promising development that may help to reduce the gap between developed and developing nations in the same way COVAX is working to do so through access to vaccinations. With these developments we may be less than a year away from COVID no longer being a meaningful factor in global economies.
- **China and Russia** – One of our long-term risk themes continues to be our focus on Chinese Communist Party actions which have not materially shifted for the better in the COVID era. From aggression in the Asia-Pacific region to military tension along the border with India to suppression of Hong Kong citizens’ rights and the interests of the Uighur population and the lack of contrition for their early role in failing to stop COVID-19 in its tracks, all may contribute to China-directed backlash or retaliation. There does seem to be regional coherency in the response as nearly all Pacific nations have aligned with the US against Chinese aggression. From lack of respect for intellectual property rights to involvement in global criminal drug trafficking to financial crimes and human rights abuses bordering on genocide, the country is finding it harder to get the global community to look the other way. We view this as a risk to investment in China and investment in companies reliant on a Chinese supply chain, but likely bullish for other parts of the Asia Pacific interested in usurping China’s role as the manufacturing floor for the world. Meanwhile Russia continues to operate from other pages in the same playbook, manipulating natural gas markets in Europe and massing troops on the Ukraine border.



## ESG Considerations

### *Past formance is no guarantee of future returns*

We have discussed on a number of previous occasions the relationship between climate change and market risk, and we got to see that on full display through the holiday season. An astonishing late-season tornado, possibly more than one, tore a nearly unprecedented path of destruction from Tennessee to Kentucky in the first half of December, leveling homes, businesses and whole municipalities with a considerable loss of life. Concluding the month and the year, a brush fire was ignited in the middle of a wind storm clocking 115mph peaks in Boulder County, Colorado, incinerating more than 1,000 homes in a day. This came on the heels of a stretch where the region saw less than 1.5" of precipitation over a period of 5 months prior to the snows that put out the fire.

Taken as isolated incidents, events like this can be discounted to a degree. December tornadoes are unusual but not exceptional. The long track of the KY tornado was approaching the longest recorded, but was not out of league with historical events. 100mph winds on the Colorado Front Range in the early Winter are infrequent but not impossible. 2021 was dry but not the driest on record. What becomes of note, and what catches the eye of market observers, is when 100-year events start occurring with greater regularity and greater density. In financial services, the regulatory mantra is "past performance is no guarantee of future returns". That is hedging language to avoid the expectations created by promissory statements or prior observations.

This matters from a financial perspective because our edifices, our infrastructure, our supply chains, our financing and our insurance presuppose that climate systems will continue to act as they have for the prior observable period. But now, we find ourselves needing to throw out the Farmer's Almanac and heed the "past

performance" admonishment. Just because your city has not burned down or been flattened or flooded in the last hundred years does not mean that expectation holds for the future. Unfortunately, our economic systems are not adjusting quickly enough to that changing reality.

Based on the median selling price of homes in and around Boulder, a fairly tight market because of an inflow of high tech companies and jobs as well as the pandemic exodus from urban centers, \$1 billion in homes went up in smoke, and that does not account for the infrastructure damage done. In a reasonably affluent area it can be assumed that most if not all of that property was insured, which means the property and casualty insurance industry had to absorb a billion

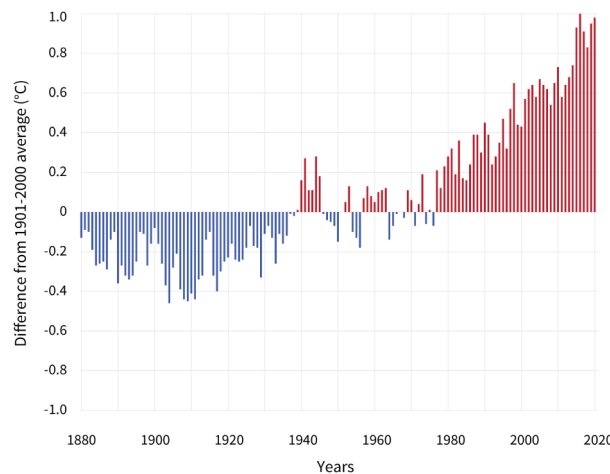
dollar hit that in all likelihood was not priced in to their risk assumptions for that area. Tornadoes in Kentucky are not as unexpected as 24-hour 1,000-home blazes in Colorado, but it is safe to assume nobody assumed or priced the risk that Mayfield, KY would be effectively wiped off the map, and with it homes, businesses, jobs and lives.

It is not that weather-related disasters have

not happened. It is the frequency and concentration that are of concern. There is correlation in that frequency and concentration are rising along with temperature. And, there is causation in that rising temperatures increase atmospheric energy and intensify the weather phenomena that lead to cyclones, straight-line wind storms, drought or flood. And, there is further correlation and causation that ties human activity to rising temperatures.

*[Chart: Yearly surface temperature compared to the 20th-century average from 1880–2020. Blue bars indicate cooler-than-average years; red bars show warmer-than-average years. NOAA Climate.gov graph, based on data from the National Centers for Environmental Information.]*

GLOBAL AVERAGE SURFACE TEMPERATURE

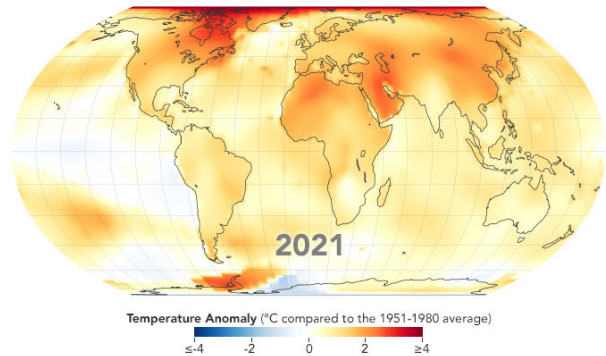




## ESG Considerations [cont'd]

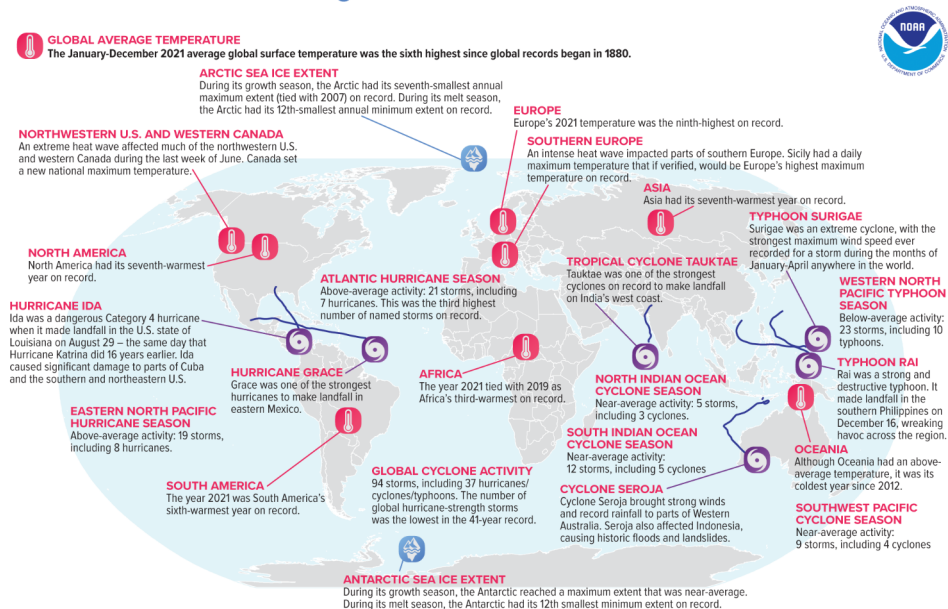
2021 tied 2018 for sixth warmest year on record, and nine of the ten hottest years on record have occurred in the past decade [NASA Earth Observatory and NOAA National Centers for Environmental Information (2022, January 10)].

Banks, insurers, and capital markets are starting to take note and are beginning to price climate risk. There are even “weather derivatives” that allow farmers or agribusinesses to hedge the risk of a failed crop from weather. That risk is becoming steadily more expensive both because of the risk data coming from forward looking models of climate change and because the steady drumbeat of Cat 4/5 hurricanes, F4/5 tornadoes, wildfires, and other extreme phenomena are factoring into the historical data as well. If we continue on this path and do not stake steps to mitigate what is driving climate change while also investing in more resilient and adaptive infrastructure, businesses and communities, that risk will become increasingly unaffordable and will weigh on the economy and markets and drive down returns while increasing volatility.



[Chart: Global temperature anomalies in 2021 relative to 1951-1980 average. Earth Observatory, NASA]

## Selected Significant Climate Anomalies and Events in 2021

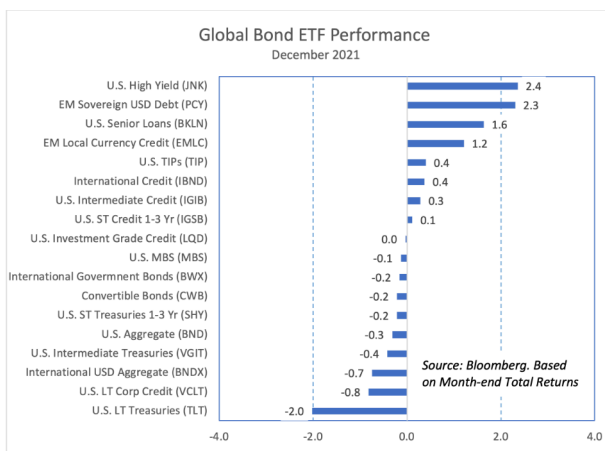
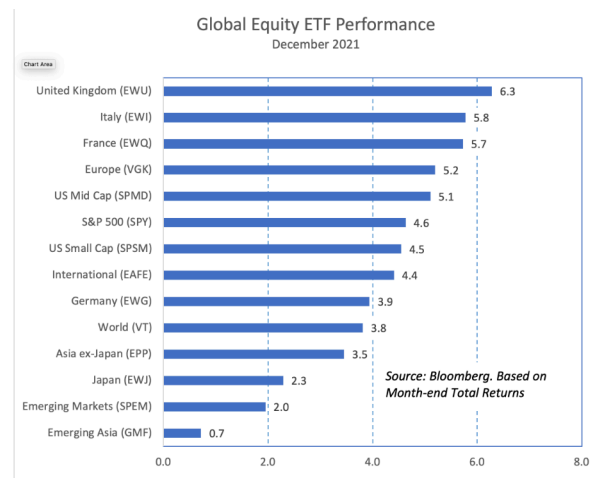


## December 2021 Capital Market Review

There are three stories for performance in December for the year just concluded, equity returns, dispersion, and the loss of the safe harbor. Big equity returns for the month finished off an exceptional year for stocks. The pandemic-induced correction was steep and deep but also short-lived in 2020, and stock markets have been on the march since then. Ongoing easy money and low rates from policymakers, stimulative spending from legislators, and a rapidly recovering global economy, supply chain and COVID issues notwithstanding, have reset and even distorted expectations for stock returns. The dispersion between good and bad outcomes does seem to be increasing at asset class, market and individual security levels. In December the spread between the best and worst performing broad asset classes in both equities and bonds was in the realm of 400 - 500bp. There have also been ample opportunities for active management and security selection to matter, and as a consequence we see non-index portfolio strategies leading their categories. Lastly, as we have been pointing out for some time, we stand on the precipice after about 4 decades of bonds being a stable platform for an asset allocation where the risks are strongly asymmetrical – a small move in rates has a large effect on prices, and bonds may no longer be the safe part of a classic balanced strategy.

### Equity Markets

It was a booming finish to a booming 2021 with a big month for equities across the board. Emerging markets brought up the rear with what in any other year would be a nice month's return of 2% (SPEM), but was 200 - 400bp behind developed markets for the month. Emerging Asia was a "drag" insofar as it eeked out only a sub-1% return. Europe in general delivered quite nicely, outstripping a very handsome 4.6% return for the US (SPY). Maybe the most interesting thing is that the December chart looks nearly like the mirror of November, when everything was negative from less than 1% to almost 7%. For the most part, individual markets were up roughly the same magnitude in December that they were down in November.



### Bond Markets

In addition to continuing to fail in their foundational "safe harbor" role in asset allocated portfolios, dispersion of returns across fixed income asset classes continues to be high. Unsurprisingly, equity-sensitive assets like high yield had a big December, tracking the stock market, while the bedrock assets like US Long Term Treasuries gave up their gains from November. Of note, as expected, Treasury Inflation-Protected Securities (TIPS) are booking positive returns regardless of other assets as inflation drives higher. Emerging Market debt earned back a good amount of their losses from the prior month as well.

*The returns cited reflect total return performance of exchange traded funds listed in the corresponding bar charts*



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SUMMIT, NEW JERSEY, 07901

(866) 894-5332

[WWW.WILDECAPITALMGMT.COM](http://WWW.WILDECAPITALMGMT.COM)

[CONTACT@WILDECAPITALMGMT.COM](mailto:CONTACT@WILDECAPITALMGMT.COM)



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