

A Sea Change 2022 Annual Letter

January 27, 2022

It was a year of great anticipation. The 2021 stock market delivered all-time closing highs - even value stocks had a good year! But main street America is still struggling to find normalcy. When the beloved Betty White passed on December 31, it was yet another reminder of how different our world looks today than it did a few years ago.

We can't forecast the future, but we can apply historical patterns to build durable portfolios. Instead of the crystal ball annual forecast, we hope this Useful-To-Know annual letter addresses questions we have heard lately.

It is a frequent refrain from our letters that we believe the S&P 500 is significantly overvalued. The most supportive Federal Reserve (Fed) policy in U.S. history has created large pockets of speculative extremes. Under pressure from the highest inflation in 39 years, the Federal Reserve recently pivoted its policy focus. The speculative segments of the market dislike the Fed taking away the punch bowl.



“[The Fed] will only remove the punch bowl after it sees people staggering around drunk.”

Former Treasury Secretary Lawrence Summers – May 26, 2021

We believe the speculative frenzy has likely peaked. The January 6 release of Fed meeting minutes outlined three policy measures – higher short-term rates, tapering of bond purchases, and reduction of the Fed \$8.8 trillion balance sheet. The last measure was an unexpected glass of ice water in the face of speculative investors this month.



The Fed has retired the word “transitory” in their description of inflation. We hate to be right on this, but we never thought inflation would be transitory.

“Unfortunately, which we wrote about last quarter, we believe a persistent shift in price inflation is coming with significant implications for portfolio design. Today, our view is that we are witnessing currency debasement with too much stimulus in the hands of people chasing too few goods.”

July 28, 2021 – Spectra Letter “Rethinking Gold”

We start this year by including a Q&A in our letter. The sea change is a combination of forces coming together – the Fed, inflation, and asset prices. Using questions we have heard recently, we would like to unpack each force on its own.

What is the Fed doing? Why does it matter?

In early 2020, the economy was nearly shut down by the pandemic. The Fed and Congress acted aggressively by dropping short-term rates to zero, buying assets to support the bond market, and giving taxpayers large cash payments. These efforts, although necessary, were too much for too long. As a result of this overstimulation, inflation is running at a 39 year high of 7.0%. For reference, the average annual inflation from 2000 -to- 2020 was 2.12%.

The Fed has been a reliable source of liquidity for years. And Congress did their part too by putting \$2 trillion on main street America in 2020/2021. Much of this liquidity flowed into speculative assets – tech stocks, meme stocks, and thousands of cryptocurrencies. With this Fed policy shift to fight inflation, investor psychology has u-turned on sky-high stock valuations as reflected in the tech-heavy NASDAQ **-14.6%** year-to-date. As you know, our strategy seeks to avoid speculative excesses, but you are likely to see the NASDAQ and S&P 500 further convulse in 2022.

Will inflation persist?

Yes, we think higher than average inflation will persist for several years. Wages are soaring in a super tight labor market, and housing prices, rent, and food are too. Because inflation psychology is very powerful, it will be hard for the Fed to put the inflation genie back in the bottle.

What are the most vulnerable assets to this inflation sea change?

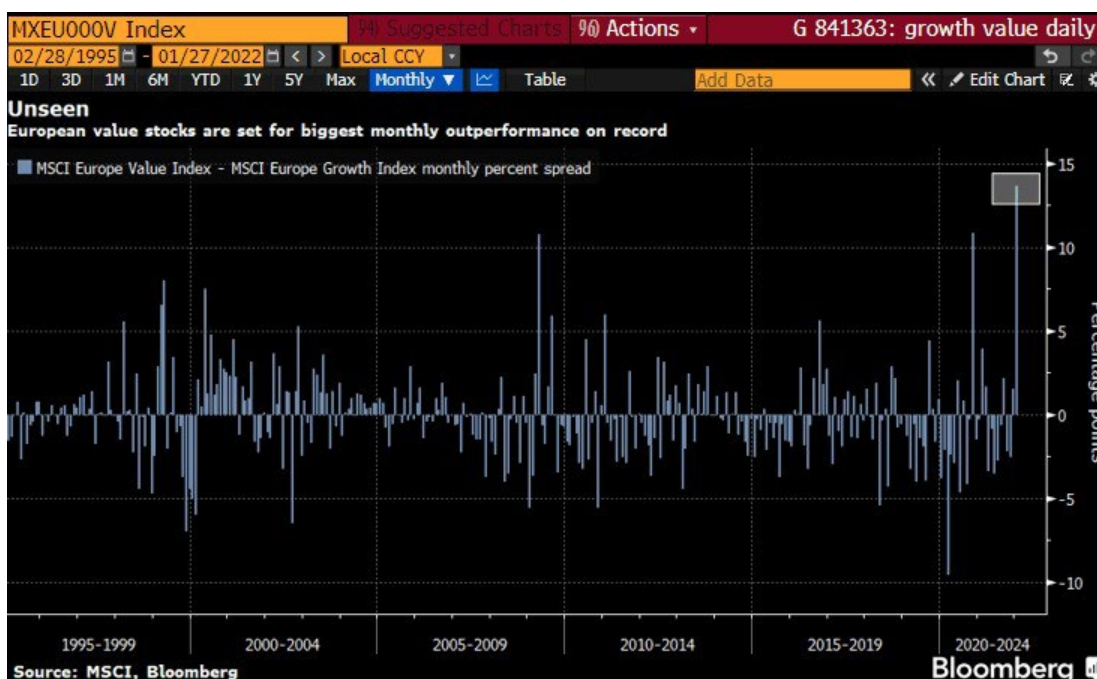
This is the BIG question and focus of our research and writing for the last 18 months. In our “*Time to Get Real*” piece, we looked at 20+ assets through minor and grinding bouts of U.S. inflation.

In summary, on a broad basis, equities are vulnerable. U.S. stocks are particularly exposed because of existing high prices. With a less supportive Fed, the funding for expansions, M&As, IPOs, and buy-backs will get harder. This sea change is terrible for the bubble

stocks that pay no current dividends. We sense the market will prize stocks that pay cash flows associated with inflation-adjusted (real) GDP. Value stocks tend to be in this category, and they are reasonably priced today. If the market feels like the Fed can't get inflation under control, we have inflation hedges in place today: gold, short-term quality bonds, and managed futures.

What are the opportunities in this sea change?

It is no secret that money flows toward excitement, and the tech bubble has inflated further with the government liquidity campaign. As Fed policy and this frenzy unwind, we believe investors will reset their strategy to a value-based style that is sensible and better fights inflation. Early indications are positive that a rotation is underway. In the brutal tech/growth stock sell-off this January, European value stocks registered the biggest monthly outperformance relative to European growth stocks on record.



Some market strategists define this rotation “the reflation trade,” and our strategy is positioned to further benefit from this rotation.

In closing, markets have enjoyed calm seas for the last decade. With inflation low for so long, the Fed has had an accommodative policy to support full employment goals. But they also have a policy mandate to minimize the harmful effects of inflation on the economy. With inflation now spiraling upward, it could mean that investors rush out of bubble assets and into specific inflation-fighting assets. That has been our belief, and our equity strategy is positioned for that sea change in investor preferences.



Spectra

We look forward to spending time with you in 2022 and appreciate having you as a client and a friend. Thank you for the trust you have put in our team.

Very truly yours,

Scott A. Roads
Founding Principal

Julia E. Zaino
Principal

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