Mountain Pacific Investment Advisers
877 Main Street, Suite 704
Boise, Idaho 83702
(208) 336-1422

William J. Palumbo
Bruce A. Reeder
Chelsie Wasden
Matthew Lindstrom
Nathan Oakley

January 2022 Market Commentary

In 2021, the S&P500 Index marched steadily higher in a tight trading range, pausing only six times for declines of 3-5%, and finishing the year up 28.7%, at 4766. The seven largest technology stocks now comprise 27% of the Index, a record level of concentration that, in the past, has signaled peak performance for such an overbought sector.

In November, we presented a market overview to the Board of Trustees of the largest investment fund in Idaho, the $24 billion Public Employee Retirement System. We began the presentation with a historical perspective. From 2009 (the first year of the pre-Covid expansion) until 2021 (or estimated 2022):

1. The S&P500 increased 13.5% annually
2. Earnings per share increased 11.4% annually.
3. The price-earnings multiple (valuation level) increased from 15 to 20 times
4. The net profit margin doubled, from 6.7% to 13.3%
5. The average 10YR Treasury yield declined from 3.25% to 1.50%
6. The Personal Consumption Expenditure (PCE) Index, a measure of inflation without food and energy, increased from an average level of 1.5% to 4.7%.
7. The Federal Reserve's bond portfolio (a measure of its monetary expansion) increased by $6.5 trillion

In summary, stock prices increased faster than earnings because profit margins widened and interest rates declined. Profit margins responded to advances in technological productivity, and interest rates responded to the Fed's massive purchases of bonds to increase their balance sheet, known as Quantitative Easing (QE).

The stock market is caught in a "tug of war" between strong earnings growth and a major shift in Fed policy. In 2021, corporate earnings increased to $210 per share, 29% higher than the pre-Covid level in 2019, and earnings are expected to rise another 14% this year. This explains why the S&P500 almost doubled, from 2478 to 4766, over three years! However, the sudden and rapid reopening of the economy has strained corporate supply chains and the labor market, pushing inflation (PCE) up to 4.7%. In response, the Fed is aggressively reducing its bond purchase program (QE) in the first quarter and then may start raising its policy rate, Fed funds, from its current level of 0%.

A recent manufacturing survey indicated that supply chain constraints have already started to ease, which could provide some cost relief this year. However, wages may continue to rise as employers compete to fill jobs needed to expand capacity. A highly infectious Covid-19 variant is spreading rapidly worldwide, threatening to prolong global supply chain pressures and the domestic labor shortage. Some observers worry that unrelenting cost and wage inflation will eventually become embedded in economic decision-making and spiral upwards, such as in the 1970s. However, the secular forces that restrained inflation for the last decade remain in place, that is, technological productivity (cost reduction), global competition, and a plentiful supply of labor worldwide. And this year, there will be less Covid-related fiscal and monetary stimulus to stoke domestic inflation.

What forces will prevail in this economic "tug of war"? Strong corporate demand or the accompanying rise in material and labor costs? Although cost inflation could limit earnings growth to less than 10% this year, most companies are protecting record profit margins by raising prices, streamlining their cost structure, and spending more on automation. We are paying close attention to what managements are saying about profit margins this year.

Investors already expect higher inflation to continue this year while the Fed adjusts its policy stance. If inflation proves to be more virulent than the new Covid variant, the Fed might have to raise its policy rate faster than expected. This could trigger an overdue correction (10%) in stock prices and a shift in investor focus from speculative growth to quality. In our investment process, consistency and durability of earnings reign supreme.

Some clients have asked about socially conscious investing. This investing is not new on Wall Street, but it is garnering more attention than ever before. There is an acronym for this style of investing, "ESG," which stands for environmental, social, and governance. Environmental refers primarily to a company's global carbon "footprint," that is, its consumption of fossil fuels. Social and Governance refer to a company's diversity on their Board and in their workforce, compensation fairness, data security, the rights of shareholders, and community support.

Most of our companies now publish an annual report on their progress relating to ESG, also called "sustainability." Certain financial firms now use these ESG reports to "rate" public companies on the strength of their programs. Investors expect their company to develop strong ESG programs within the larger framework of a high return on investment. ESG advocates believe that improvements in sustainability will eventually lead to more strategic utilization of company resources and higher investment returns, and there is some preliminary data to support this. However, ESG programs are too new to draw any definitive long-term conclusions about their effect on investment performance.