PCM
PEAK CAPITAL MANAGEMENT

A Minefield for Investors

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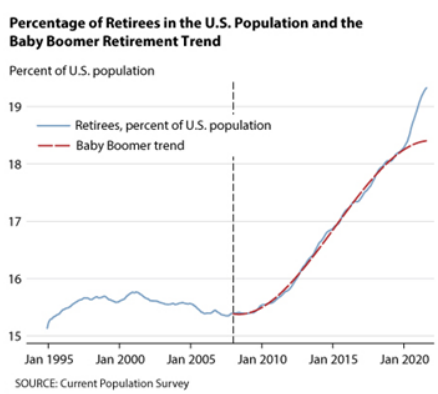
With markets seemingly priced for perfection, investors enter the new year faced with a minefield to navigate to avoid portfolios being blown up in 2022. After some mid-December volatility and concern over Omicron, Santa Claus appeared for investors, driving the markets back to all-time highs in most cases. However, some companies (and investors) are only receiving coal this year as their stocks badly trail the benchmarks. The Russell 3000, a broad market index, has seen 50% of the constituents drop by more than 20% from their peak and an alarming 20% of constituents have fallen more than 50% according to Bloomberg data. This level of divergence may be far more indicative of a coming bear market than a continued bull market as disruption becomes the "New Normal."

Investors are going to need to be particularly aware of four threats to their portfolios:

1. COVID (and the government's response)
2. Supply Chain dislocation
3. A Confused Fed
4. Political Instability (and desperation)



COVID has not only wreaked havoc on people's well being but is responsible for rapidly changing demographics that will impact the economy and markets. Rather than deal with uncertainty over lockdowns and fluid government policies, many have decided to retire early. According to St Louis Fed data, the Labor Participation Rate fell from 63% to 60% because of COVID and is creating persistent wage inflation and shortages. The latest variant, which in some respects closely resembles what used to be called a cold, is leading to new restrictions and is likely to crush demand and limit supply at a time when the government is unlikely to pass new stimulus as in 2020 and 2021. Some leaders appear bent on achieving zero COVID cases, which is unrealistic, and related policies are damaging to the real economy.

The dislocations in the supply chain are not going away in 2022 and could get worse before getting better. Talking to corporate insiders and analysts, I am hearing that the backlog on very basic components is growing longer, not shorter. We are likely to see rising prices in the face of falling demand, which becomes very difficult for the Fed to create policy around. This seems particularly true of technology hardware that now impacts everything from cars and trucks to hot water heaters and dishwashers. The obvious answer would be a jump in Capex spending, but companies are unwilling to build new capacity for products and technology they believe will be obsolete in the near future.

The Fed seems utterly confused to me. My guess is that they realize they missed the window to eliminate QE and start rate

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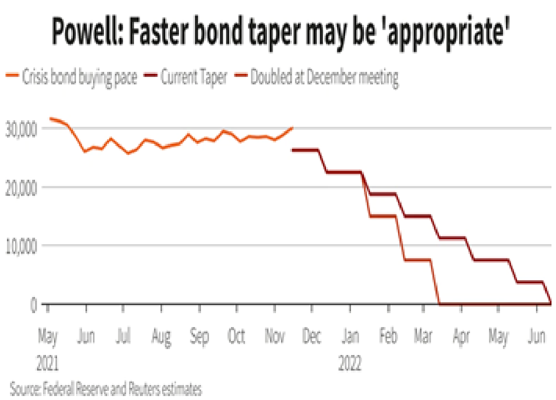
hikes when the economic growth was stronger. With growth weakening and real short-term rates approaching negative 6%, policy options are limited. If inflation was measured consistently with 1980 it would be 15% today and we still have rates near 0%. As an example, owner equivalent rents are only up 2.9% over the last year while home prices surged 20%. The Fed's belief that inflation was "transitory" may go down as the worst public mistake in Fed history. We have entered a stage of asymmetrical Fed policy: tightening will slow economic activity while loosening has little impact outside of financial markets. Notable economist Larry Summers has grown increasingly critical of the Fed and has called for the return of a Paul Volker type of leader at the Central Bank.

Where might investors seek shelter against the devastating impact of inflation and slowing growth? There are opportunities but wise investors probably already realize that market returns in 2020 and 2021 will prove to have been borrowed from future years. When the Fed kept the liquidity spigots open, investors preferred corporate debt to Treasuries, stocks over bonds, and speculative growth over value. These trends of the last several years are likely to reverse starting in 2022.

For fixed income, I think 2022 will reward investors who focus on credit quality instead of chasing yield. Speculative debt has worked great the last two years, but poor fundamentals may lead to strong selling in high yield. A barbell approach with short duration and long duration Treasuries makes the most sense given policy and economic uncertainty.

For equities, companies with high profit margins and sustainable pricing power should be the focus. At the top of the list is healthcare, which currently trades at a historically high discount to the S&P 500. Banks are also attractive and should be the early winners of any Fed tightening while energy is likely to lead all sectors in 2022 as oil prices rise above $80 and valuations are very low today.

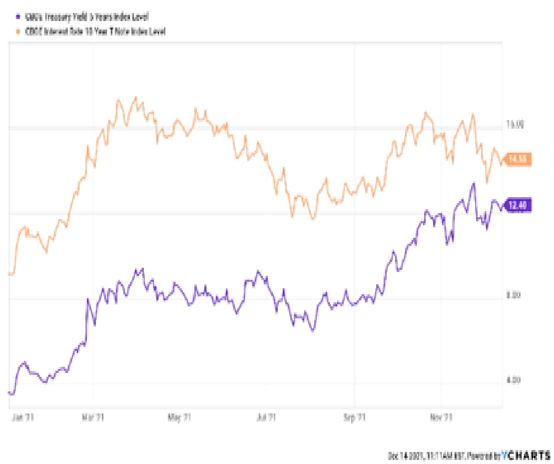
Tapping Excess Liquidity



The Fed signaled at their December meeting an acceleration of tapering their bond buying stimulus with a goal to end all bond purchases in March 2022, well ahead of the previously communicated pace. This is in response to both consumer and producer inflation which they can no longer refer to as transitory, but remain hopeful that it is not persistent. The first acknowledgement from Powell that the Fed is 'behind the curve' in fighting inflation, the Fed also ratcheted up where they see interest rates over the next two years. Offsetting the impact of the Fed reigning in bond purchases has been bank credit which has been expanding in recent quarters but historically has slowed dramatically when the economy shows signs of weakening or recession.

- Current Dot Plot suggests the Fed will hike rates .25% three times in 2022 and three times in 2023, although they do not expect to get to a neutral rate of 2.50% until some time in 2024.
- Analysts will be watching very closely the size of the Fed's balance sheet and if there are any attempts to reduce the bloated balance sheet. If the Fed sells assets it would accelerate tightening.
- Primary among concerns for investors should be Larry Summers' words: "There have been few, if any, instances in which inflation has been successfully stabilized without a recession."

Hitting the Curve



Historically, the yield curve for U.S. Treasuries has been a signal for a potential recession. In particular, when the shape of the curve begins to flatten or invert, the odds for a recession increase. If shorter-term rates (e.g., maturities of two or five years) begin to rise relative to longer -term rates (e.g., maturities of 10 years), the yield curve compresses. Changes in the yield curve could signal turning points in the business cycle. The chart to the left plots the 10-year and 5-year Treasury yields for the year and illustrates how the gap between the two yields has narrowed.

- Given the recent inflation headlines, it is a bit surprising that longer-term Treasury rates have not risen closer to pre-pandemic levels of roughly 2.5%. The 10-year rate has hovered around the 1.5% range after rallying earlier in the year from historic lows. The short end of the curve has risen as the Federal Reserve is almost certain to raise rates in 2022.
- One possible explanation for the yield curve flattening is that the market is betting that the Federal Reserve will raise interest rates too quickly and throw a wet blanket on the economy, thus putting us in a recession. Likewise, the COVID pandemic is a cloud that continues to loom over the global financial markets.

Muted Market Expectations

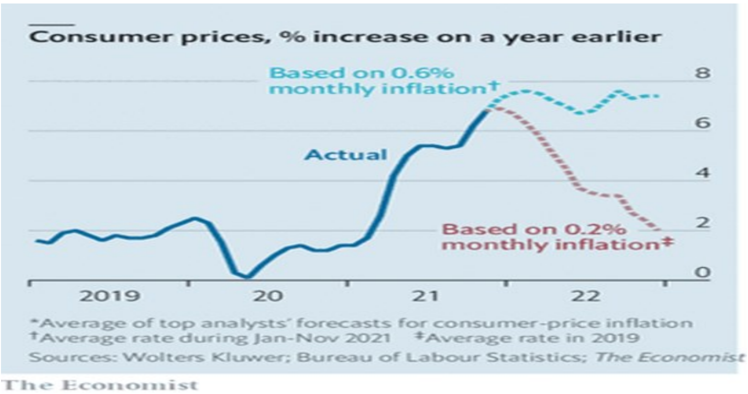
Source: Investopedia

As we head into the beginning on 2022, given midterm elections will occur later this November, it is important to examine how markets have performed in previous midterm election cycles. Since 1942, the S&P 500 has averaged a gain of just 6% in midterm election years, more than two percentage points below the S&P 500's 9.1% rise during the average year. As of December 28th, the S&P 500 Index (4,786.35) is up 28.14% YTD. However, as history has shown, many are forecasting a rather "muted" performance in 2022. With uncertainties around tightening federal reserve policy, rising yields, decelerating economic growth, and midterm elections, markets may face potential headwinds throughout 2022.

- According to Capital Group, Over the past 21 midterm elections, the President's party has lost an average of 30 seats in the House of Representatives, and an average of four seats in the Senate.
- Major investment banks such as Goldman Sachs and JPMorgan have year-end 2022 price targets of 5,100 and 5,050 respectively. These price targets only amount to returns of 6.55% and 5.51%.
- In contrast to Goldman Sachs and JPMorgan, Morgan Stanley's 2022 year-end price target is much more bearish. The investment bank predicts the S&P 500 Index to finish at 4,400, or about an 8% decline.

Macro View – 2022 Global Macro Outlook

From Covid to global supply chain disruptions, it's safe to say that 2021 was filled with many challenges. While we can hope that 2022 will bring an end to some of the challenges we faced this last year, one thing is certain, Inflation is here to stay. The only thing that proved transitory about inflation in America in 2021 was the consensus that it would subside. According to the chart below by The Economist, consumer prices are now rising by nearly 7% compared with a year earlier, the fastest pace since 1982. The economist then talks about two scenarios as we head into 2022: the first, inflation subsides back to pre-pandemic levels of around 2%. However, the second scenario is not as pleasant as they see inflation soar to almost 8% by the end of Q1 and remain elevated throughout the remainder of the year. Currently, Morgan Stanley Economists are projecting the Federal Reserve will likely wait until September 2022 to raise interest rates. However, if scenario two plays out, they may be forced to act sooner in what many are predicting to be a June interest rate hike.



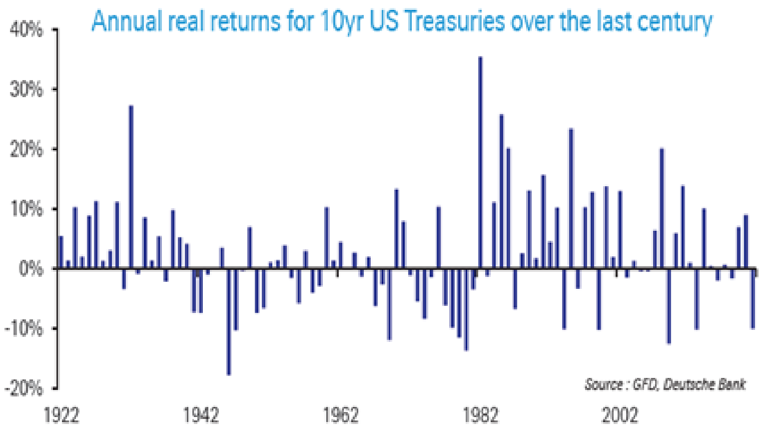
Taking Stock – Nvidia

The semiconductor chip shortage in 2021 impacted multiple aspects of the economy and shed light on what appears to be a systematic flaw in the global supply chain. Despite these shortages, Nvidia Corp (NVDA) has been the top performing chip stock in 2021, soaring 132% as of December 28th. With the explosion of gaming, analysts expect Nvidia's strong performance to continue into 2022. UBS analyst Timothy Arcuri expects Nvidia to benefit as it builds more stable revenue streams around its GPU and software segments. These GPU chips are essential for video games, whether you are on a PC or console (PlayStation, XBOX). However, Nvidia is far more expensive than its semiconductor peers on P/B basis (31.49 vs. 6.2 – YCharts). Time will tell if investors continue to invest in Nvidia in 2022 or look to some of its less expensive peers like Advanced Micro Devices Inc (AMD) or Taiwan Semiconductor Manufacturing Co Ltd (TSM).

Source: Ycharts

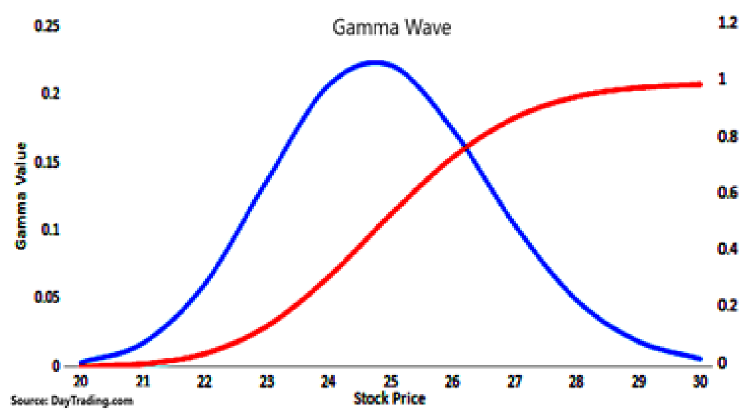
Fixed Income - Not So Safe Haven

U.S. Treasury bonds have historically been referred to as a 'safe haven' for investors who look for stable, if modest, returns. While the longer-term trailing returns on 10-year USTs have been above average, 2021 was not a good year for Treasury investors. Only once in the last 40 years have Treasuries posted worse results and that was when the interest rates soared as the Fed fought stagflation in the late 1970's and 1980. Investors who utilize Treasuries as a volatility hedge saw equity-like returns in 2019 and 2020 and the trailing 3-year returns are attractive at around 7% per year. This is not unexpected as USTs are typically lower in the year prior to a rate hiking cycle but surprisingly turn positive after the first rate hike and remain positive for 12 months. We will be watching to see if history repeats.



Technical - Riding a Gamma Wave

Gamma for traders refers to the sizing of the hedges that market makers employ to protect them against large swings higher or lower. It can almost be viewed as adding a momentum component to a momentum strategy and when certain thresholds of price support or resistance are broken, it can create an avalanche or eruption. Technical traders track levels that if breached could lead to wild swings. Current support is at 4,513 on the S&P and 15,085 on the Nasdaq, while resistance is at 4,712 and 16,050 respectively. A breach of these levels given the amount of option open interest could lead to a positive or negative gamma squeeze. The most famous gamma squeeze in the recent past has been Game Stop (GME) when a group of investors in a chat room exploited short positions by hedge funds, pushing the stock from $18 to $325 in a month.



Cracks Beneath the Surface

Clint Pekrul, CFA

The S&P 500 Index is on pace to deliver a roughly 30% return for the year. If you look under the hood, you'll notice that the top ten holdings in the index represent roughly 30% of the index's total market capitalization – roughly $13 trillion. Furthermore, if you aggregate the year-to-date returns across this group of top ten holdings (weighted by their respective market capitalizations), the result is a gain of roughly 46%.

To say that the S&P 500 is a highly concentrated, mega-cap growth index is an understatement. To get a better sense of how stocks in general are performing, it is helpful to dig a bit deeper under the surface beyond the mega-cap names.

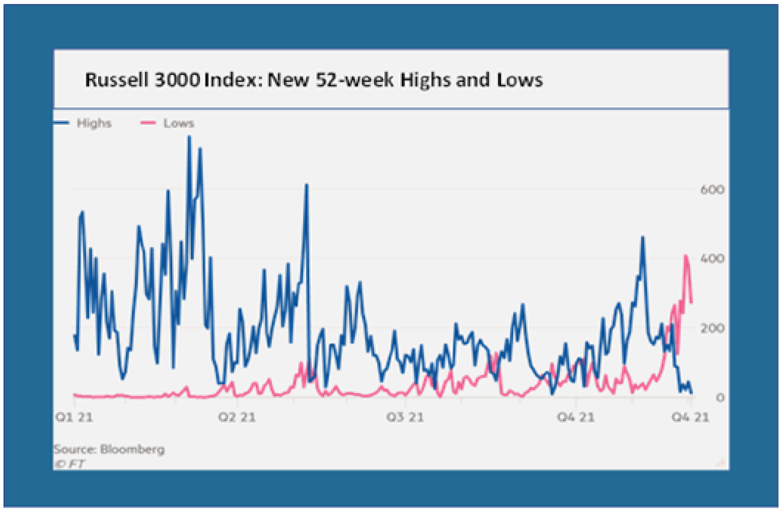
Like the S&P 500 Index, the Russell 3000 Index measures the performance of publicly traded equities in the US. However, rather than tracking the 500 largest companies by market capitalization, the Russell 3000 Index includes medium and small capitalization stocks. The universe the index tracks is six times larger.

The Russell 3000 Index isn't quite as "top heavy" as the S&P 500 Index despite being a capitalization weighted benchmark. The top 10 holdings in the Russell 3000 Index represent approximately 24% of the total index capitalization.

By mid-December, the Russell 3000 Index was approximately -3.4% from its 52-week high, which also coincided with its all-time high. Below, however, are a few telling statistics that will certainly raise eyebrows:

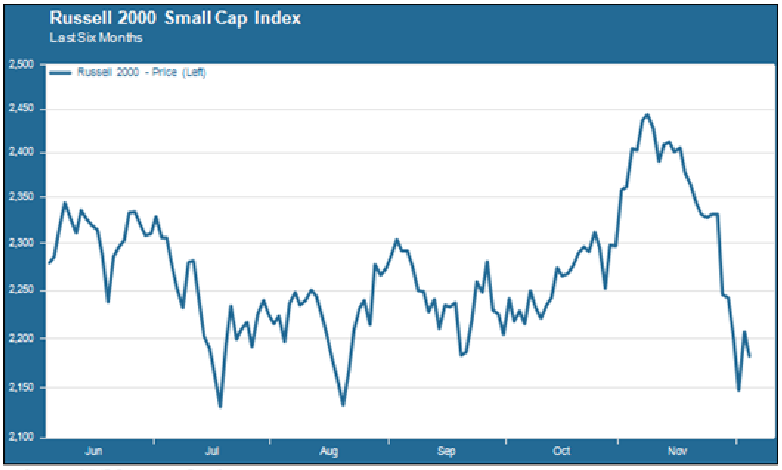
- 2288 stocks (76.2% of the index) are -10% or more below their respective 52-week highs
- 1884 stocks (62.8% of the index) are -15% or more below their respective 52-week highs
- 1564 stocks (52.1% of the index) are -20% or more below their respective 52-week highs
- 1283 stocks (42.7% of the index) are -25% or more below their respective 52-week highs
- 1068 stocks (35.6% of the index) are -30% or more below their respective 52-week highs
- 913 stocks (30.4% of the index) are -35% or more below their respective 52-week highs
- 793 stocks (26.4% of the index) are -40% or more below their respective 52-week highs
- 559 stocks (18.6% of the index) are -50% or more below their respective 52-week highs

To help visualize what is happening below the surface, the chart below illustrates the number of stocks in the Russell 3000 Index that are reaching 52-week highs and lows. We can clearly see a rotation – or a flip – towards the right-hand side of the chart that shows a dip in the number of new 52-week highs and corresponding rise in the number of 52-week lows.



Source: MVF Research, Financial Times, Bloomberg

To be clear, the number of new lows illustrated above tend to be dominated by small cap names. If we look at the Russell 2000 Index, which represents the smallest 2000 names in the larger Russell 3000 Index by market capitalization, we'll notice some recent underperformance versus the broader market. The chart below illustrates the recent roll over in the Russell 2000 Index:



Source: MVF Research, FactSet

The recent underperformance of small caps could be an indication that investors are shunning riskier parts of the equity market. In general, small caps tend to be more sensitive to changes in interest rates and the overall business cycle.

It's clear that mega-cap growth names have been doing much of the heavy lifting in terms of performance. However, we are seeing meaningful disconnects across market capitalizations that are worth our attention.

Q: Should we celebrate or mourn the death of Build Back Better?

Joe Manchin, the WV Democrat who torpedoed the BBB legislation, is being hailed as either hero or goat (not in the Tom Brady sense) for his firm stance against the multi-trillion dollar spending package. While he singly appeared to be the face of opposition to the legislation, I personally believe there were many of his Democrat colleagues who let out a sigh of relief following his public announcement. The political process has often been compared to making sausage, something that should probably be offensive to all who make sausage. Manchin is correct that much of the spending on the bill would result in throwing fuel on the inflation fires that are already burning. While some of the social provisions like expanded childcare tax credits would benefit the people of WV, he correctly points out that the vast majority of the spending on the Bill would not benefit WV in any way and yet his constituents would still be saddled with the debt and the higher prices that would accompany the spending.

This spending in this Bill, when accompanied by the $1T infrastructure Bill already passed, demonstrates how wide spread the concept of Modern Monetary Theory (MMT) has become. Many of those elected in the House and Senate simply do not believe there should be any cap on what Congress spends, which is an idea that should concern all of us regardless of political affiliation.

I guess it depends on what side of the political spectrum with which you identify. For the progressives in the far-left faction of the Democratic party, West Virginia senator Joe Manchin will forever be reviled for essentially blocking the bill's passage. If you're a Democrat you've got to be frustrated because there was a small window to pass major legislation before the mid-term elections. It is likely the Democrats will lose seats in both houses of Congress in 2022. If you're in the right wing of the Republican party, you're probably claiming a victory for conservative causes.

From an economic standpoint, passing a $1.7 trillion spending bill when inflation is running at its fastest pace since 1982 might seem irresponsible. Opponents of the bill claim that it will add to the government deficit over the next 10 years and will flood the US with new spending at a time when inflation is running hot. The bill would essentially represent a fiscal expansion that could push inflation even higher. Supporters of the bill claim that it is fully paid for with new taxes and is deficit neutral. While there are many long-term benefits afforded by the bill, such spending now seems like a risky proposition.

Q: Will ARKK float or sink in 2022?

The ARK innovation ETF made a huge splash during the recovery of the Nasdaq following the short but steep COVID recession in 2020. The Fund had steadily climbed since its inception in 2014, but never garnered much notoriety in the financial press and Cathie Wood was far from a household name. After falling about 35% between January and March 2020, her bets on transformative technologies exploded higher, with the Fund gaining nearly 400% over the following year. Heralded as a genius, everyone wanted to know what she thought about the future and where she was allocating capital. Her picks did come crashing back to life since, but the Fund remains up almost 100% from where it sat at the beginning of 2020.

I do believe we are entering a shift in investor behavior that ultimately will favor value over growth as Fed policy makes a rapid turn from supporting the market with low rates and liquidity to tightening conditions in response to the inflation threat. The tailwinds of massive excess liquidity will be replaced with the headwinds of higher discount rates for future growth that tend to hurt tech companies disproportionately. Some of the names in her Fund will sustain strong growth and have pricing power and will thrive, but many will not. In rising rates your portfolio duration matters, and growth stocks have long durations. I would personally wait for a fundamentally more attractive time to buy.

After becoming everyone's darling in 2020, shares of ARKK have hit a rough patch in 2021. After soaring over 150% last year, ARKK easily doubled the return of the S&P 500 Index. The fund was certainly the benefactor of the stay-at-home trade due to the COVID pandemic. Fast forward to this year and the story is much different. Shares of ARKK are lower year-to-date by roughly -25% (as of December 29th) and are off their all-time high by approximately -40%. With the S&P 500 higher by roughly 30% for the year, ARKK has given back much of the alpha that it delivered in 2020.

One can't help but to make comparisons to the NASDAQ runup in 1999 and subsequent selloff in the years that followed. While I agree with Kathy Wood's long-term thesis of investing in disruptive technologies, you must be mindful of valuations. The stocks she holds in the portfolio are by-and-large highly speculative and very long in duration. Some of the companies she is betting on might not earn a profit for many years and are highly sensitive to changes in interest rates. Likewise, they might not have pricing power in an inflationary environment. The effect of higher interest rates might not be fully priced in to ARKK shares, so there might be more downside in 2022.

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