CARMICHAEL CAPITAL INC.

CLAUDE R. CARMICHAEL CFA, PRESIDENT
339 MAIN STREET, 2ND FLOOR, FRANKLIN, TN 37064
(615) 595-5800 – FAX (615) 595-5825
claude@carmichaelcapital.net

January 14, 2022

2021 Year-End Review
"Inflation – It's BAAAAAAACK!"

After the tsunami of financial stimulus that flooded into the economy and the financial markets over the past two years, inflation has come roaring back. This is no surprise to most observers; even the members of the Federal Reserve Board appear to have abandoned their use of the word "transitory" when speaking of recent inflation rates. The official Consumer Price Index appears to be running north of 7%. However, we all know of many examples of higher price hikes. Most telling is the fact that the government itself just increased the base Medicare premium by 15% starting this month. Since the Fed has the dual mandates of maintaining full employment and price stability, they are now in a very difficult position.

The stage is now set very differently than it was a year ago. We appear to be exiting a period of almost unbounded fiscal and monetary stimulus that brought peak economic activity and record high securities valuations. Now several headwinds are developing simultaneously. Inflation has ramped up and appears to have shocked the Fed into aggressive action regarding both interest rate hikes and balance sheet reductions (both leading to a tightening of liquidity). Direct payments of stimulus checks to citizens are ending at the same time that much of the massive infrastructure plans have stalled. Interest rates have climbed, and the long-term US Treasury bond has lost almost 9% of its principal value since early December. These developments have begun to spook stock investors at the beginning of this new year.

Stock indexes continued to march ahead at the end of 2021, but the gains were largely attributable to only a few of the largest companies. Over half of the gain in the S&P 500 from April through year-end was due to the price movement of only 5 stocks. This "narrowing" of the market's advance masked the carnage that was taking place in many of the more speculative sectors of the market. The "meme" stocks stumbled and fell early in the year, and high-priced growth and "theme" stocks suffered their own punishment as the year ended. Currently, many US technology stocks are tumbling as investors begin to pay attention to how sky-high valuations have become. The excitement around many "SPACs" (special purpose acquisition companies) has turned to tears as the prices for so many have plummeted.

For the first time in quite a while, we have seen a "rotation to value" as investors have sold higher priced and more speculative growth stocks to reinvest in more stable businesses with reasonable profits and sustainable dividends. This rotation has begun to benefit the kinds of higher quality, dividend paying equities that we favor.

We may now be entering a "post-peak" era that would have several implications for what we should expect as investors. As both the fiscal and monetary spigots are now being turned down, we may have already seen the peaks in liquidity (The Fed), fiscal stimulus (government infrastructure and social spending), economic activity (corporate profits rebounding), bond prices (low interest rates), speculation (SPACs and "meme" stocks), valuation (stock prices vs.

revenues), and price stability (low inflation). If so, we should be prepared for several changes in the investment landscape.

This next era may include rising interest rates. This would be negative for bond prices, and it is one of the reasons we have not been enthusiastic about major investments in the fixed income markets, especially with yields still near historic lows. In most cases, the upside potential does not appear to be worth the downside risk to us. We may avoid major commitments to bonds until interest rates stabilize at higher levels. However, banks and financial companies could benefit from rising interest rates if the increase is gradual and short-term interest rates don't exceed those for long-term bonds.

Higher interest rates tend to penalize growth stocks since they trade largely on the promise of high profits at some point in the future. The current value of those future earnings is diminished when discounted to present value at a higher rate. That could explain the recent retreat in many stocks trading at high prices relative to their current earnings. Lately we have seen the beginning of what may be a substantial rotation out of "growth" and into "value" stocks. If growth in the economy slows and interest rates rise, it may favor investments in high quality, well-established, dividend-paying stocks that are trading at lower prices relative to their earnings and revenues. This is where the bulk of our investments are found since these stocks are usually cheaper, pay a reasonable dividend, and would ostensibly provide more downside protection versus more speculative stocks.

For example, as some technology stocks have recently fallen, pharmaceutical stocks have rebounded sharply as the chances for wholesale revisions to their pricing appears to have diminished and their valuations have been historically low. Similarly, energy stocks have rebounded sharply as supply has been constrained and the peak of the divestment of oil-related stocks appears to have passed.

We should also be prepared for heightened volatility if these market headwinds continue to blow. To that point, it is as important as ever that the allocation of the assets in your portfolio (between stock, bonds, and cash) is consistent with your financial situation and personal appetite for risk. Everyone wants more invested in stocks when they're going up and less when they're coming down. Having the proper mix may allow you to avoid feeling forced to sell under the pressure of a market decline, when the better response would be to add to good quality investments that are marked down and "on sale."

To that end, please feel free to give us a call to discuss your investments and your asset allocation once you have reviewed the enclosed reports and statements. As always, we stand ready to work with your tax advisor to make sure you have all the documents you need for your tax filings. It is a privilege to work with you on your investments, and we welcome your thoughts and suggestions as we plan for a profitable 2022.

Happy New Year!

Claude R. Carmichael CFA Arthur Creel CRPC