Marketline December 2021

Stocks:

Stocks settled back into a bull trend in December, to end the year just a few points off all time highs. Strength this month was largely in the non-tech sectors. The Nasdaq managed a 0.7% rise, but the Dow increased 5.4% and the S&P was up 4.4%. Consumer stocks, health care, and minerals and mining were particularly strong. For the year as a whole, the S&P rose roughly 28%, a stellar year by any measure. The pre-pandemic high in stocks was marked in February 2020, with the S&P at 3380. We're now ***41% above that peak***, having more than recovered from the 2020 recession. These numbers provide a reminder that selling on bad news isn't necessarily the right course of action.

Progress in the indices aside, the last few months have been marked by a rolling correction. We've seen rotating declines in technology, utilities, communications, and consumer stocks. Some headline growth stocks - Zoom, Peleton, Teledoc, Roku - are down high double digits in the last few months, and in keeping with years past, small cap companies logged another middling year, well behind their larger brethren. Overall, this underlying weakness is what we call "poor breadth". A healthy market generally sees a wide variety of stocks participating; weak breadth can be a sign of a volatile market ahead.

Overseas stocks performed well, with Canadian issues up just shy of 3%, Mexico's Bolsa surging 7.7%, and Europe – where the recovery has been skimpy – rising 4.6%. Still, the US market once again trounced most foreign alternatives for the year. Some areas were particularly miserable in 2021, such as Hong Kong's Hang Seng, off over 14%.

Last month we mentioned that challenges ahead include the Fed's tightening moves in response to inflation; marginally less fiscal stimulus (no more pandemic checks); supply chain problems; and the response to Omicron, the new virus variant. Many companies – especially large companies – have seen earnings surge during the pandemic, with a few exceptions in the travel and 'going out' sectors such as restaurants; investors might wonder whether these spectacular results can continue. A correction would not be a surprise. For our part, we're using the first week of the year to sell off two overvalued issues to rotate down the value ladder. We're adding to our holdings of Cognizant, which is a technology consulting firm with specialties in finance and health care – this stock has been left behind by the recent rally in its peer group.

Bonds:

Yields generally rose last month but most notably, the yield curve flattened again. We measure this by looking at the difference between short term rates and long rates. At the end of July, for instance, the long Treasury bond was selling at a yield of 1.9%, identical to December's close. Back then, the one year note was at a measly 0.06% for a difference of 1.84 percentage points. Today, the one year note is at 0.38%, for a difference of 1.52 percentage points. If the yield curve were completely flat, short term rates would equal long term rates and the difference would be zero; we're a long ways from that but there's important information in the trend we're seeing: The Fed hasn't hiked once in this cycle – yet – but rhetoric alone is causing short rates to rise (and prices to fall). Meanwhile, as Fed purchases of bonds taper off, the long end of the curve is not reacting much.

Why would long term interest rates remain steady despite inflation, and the Fed's taper? Three answers come to mind:

1. The market needs more time to react; when the Fed finally stops buying bonds rates will rise more.
2. Foreign financial players (banks, etc) are requiring more collateral or want to bank more US dollars.
3. Or, investors expect the economy to slow as the Fed continues on its course, justifying lower rates later on.

Our favorite theories here are numbers 2 and 3. And since we think the short end of the yield curve will continue to reprice downward, we have sold several million dollars worth of short callable municipal bonds in select accounts, to replace them with longer callable bonds at higher yields. This trade gets us away from the weaker short end of the curve and reduces reinvestment risk, in case the calls do come into play such that we lose the bonds.

Note! For those curious about Bitcoin, NFTs, and blockchain, read our latest blog called *Decoding Cryptocurrency* at our website https://cascadeinvestors.com/blog/ where we explain this chaotic phenomenon in plain English.

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