ALHAMBRA
INVESTMENTS

2021
Economic & Market Review/ Current Trends

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Every year around this time, investment firms publish their outlook for the coming year. We don't see much benefit in the exercise ourselves. The future is not predictable. We can't do it, Goldman Sachs can't do it, you can't do it and neither can that guy on Twitter.

We do think a thorough review of the past year is useful though. Our brains work against us when trying to recall even recent history; we remember things in ways that put ourselves in the most favorable light. And we can't learn from history if we don't remember it correctly. So, every year around this time I sit down to review the prior year and think about the current situation.

I have found that writing these big picture pieces is very useful. It makes me think clearly about the opinions I hold and whether they are coherent and consistent. Putting it in writing and knowing that others will read it focuses your mind.

It is impossible to be an investor and not have some view of the future. But that view needs to be informed by a clear view of the present. So, in this paper I'll review the past, observe the present, and speculate only a little about the future.

Joe Calhoun

"Do not dwell in the past, do not dream of the future, concentrate the mind on the present moment.".

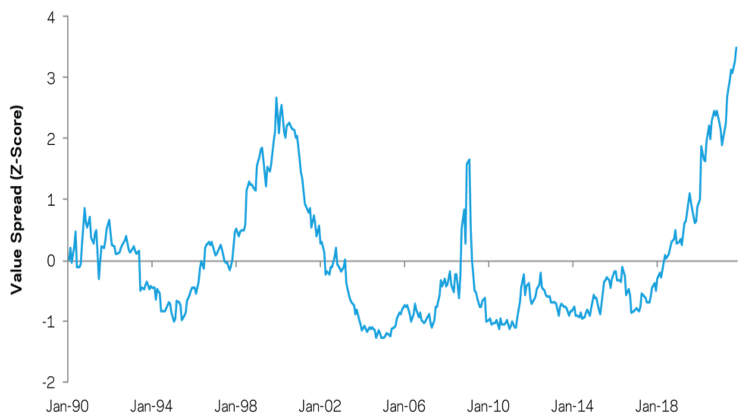
Buddha

"What day is it," asked Pooh.
"It's today," squeaked Piglet.
"My favorite day," said Pooh.

A.A. Milne

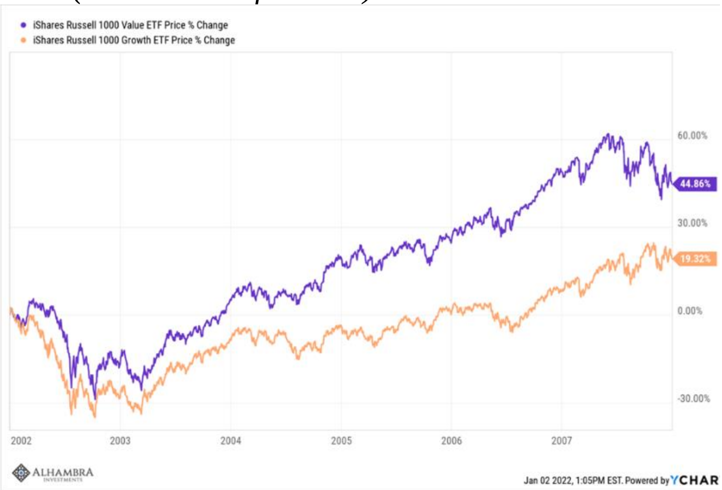
Value vs Growth

One of the most frustrating aspects of investing in recent years is the outperformance of growth stocks relative to value stocks. The value factor has underperformed for 13 years, the longest stretch on record to my knowledge. The difference in valuation between value and growth, on a global basis, is as wide as it has ever been, even exceeding the extreme of the dot com bubble in the late 90s.



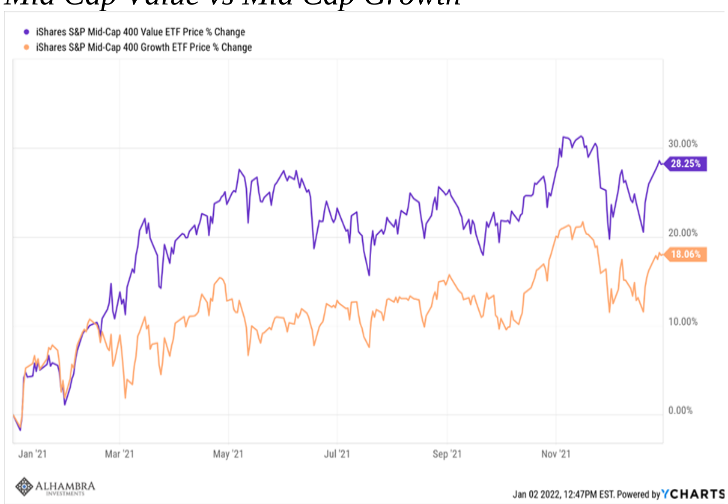
We generally associate value outperformance with weak dollar periods. There have been exceptions (early 80s) but in recent years value's outperformance has been almost exclusively during weak dollar periods.

Russell 1000 Value vs Russell 1000 Growth, 2002-2007 (Dollar Index fell 33%)

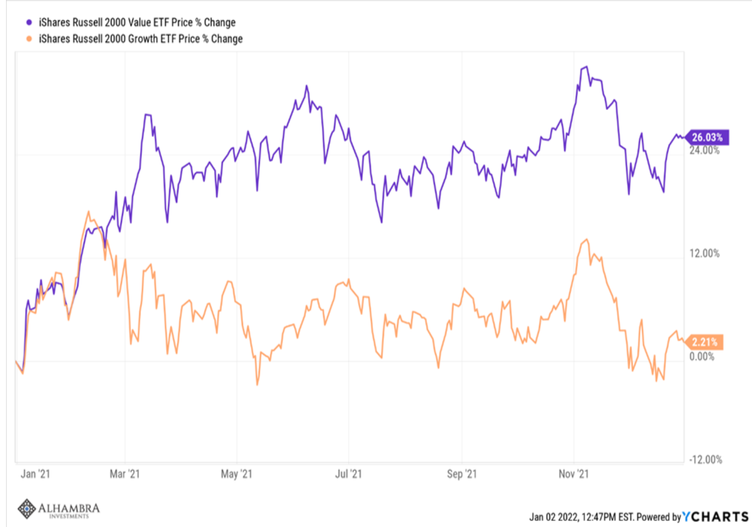


Last year was interesting because it appears we were starting to see a reversal of the long growth outperformance. Value outperformed growth in all but the large cap indexes.

Mid Cap Value vs Mid Cap Growth



Small Cap Value vs Small Cap Growth



Large Cap Value vs Large Cap Growth

Even though large cap growth outperformed, the spread wasn't that wide.

We believe the outperformance of value in most of the market last year may portend a longer-term shift. It could be that the market is signaling that the dollar's days of strength are numbered and we have some sympathy for that view. The long dollar trade is the consensus at this point and markets are already positioned for that outcome. The consensus can be right for a while but eventually crowded trades tend to peak and reverse.

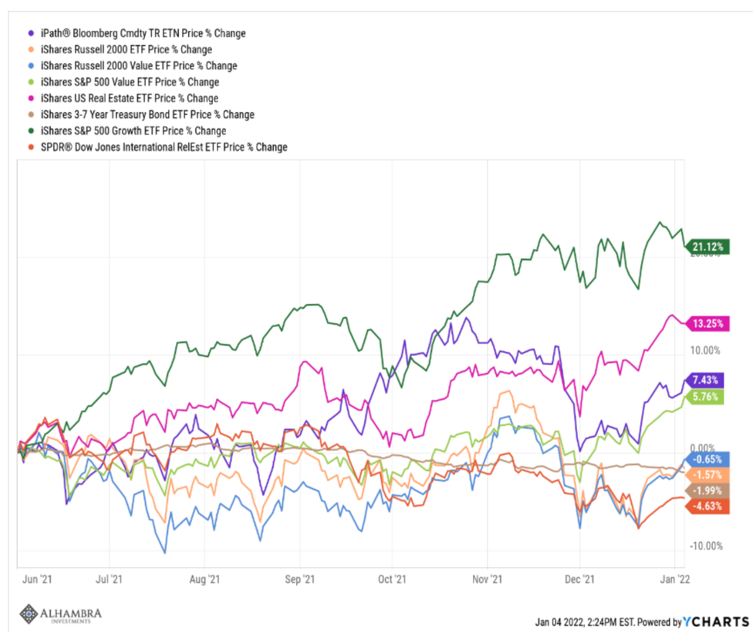
It could also be that growth has just become so overvalued that the investors can no longer justify its outperformance. The Russell 1000 growth index trades at 5 times sales and nearly 30 times trailing earnings at a time when earnings growth is expected to slow. There are also a record number of growth stocks trading at over 10 times sales – in some cases way over 10 times – a level that has been associated in the past with very poor forward returns.

The Russell 1000 value index, on the other hand trades for 1.75 times sales and half the earnings multiple of the growth index. With long-term earnings growth of about 13%, current multiples are quite reasonable. Long-term earnings growth for the growth index is not that much higher at 17% but you have to pay twice the price. From a fundamental standpoint, it is hard to argue for continued growth outperformance. Of course, in today's market, where NFTs, Reddit-pumped junk stocks, and joke cryptocurrencies allegedly have value, fundamentals don't seem to matter all that much. Until they do and then they matter a lot. Fundamentals inform us about risk, not return.

We have made a strategic decision as a firm to not make new purchases of US large cap growth index funds or ETFs. With 8 of the top 10 holdings in the S&P 500 also in the top 10 holdings of the S&P 500 growth index, we are also making only small purchases of this normally core asset. This has hurt our performance recently but we find it impossible to justify investing in these dramatically overvalued assets. We know too that any transition to value outperformance will not be smooth. Large Cap value performed well last year but that performance was concentrated in the first half of the year. From June 1st to the end of the year, the S&P 500 value index was up only 5.8%. And all of that gain came from December 20th to December 31st.

We did not make this decision lightly. We are fiduciaries and have to live within the bounds of the Prudent Man (person) rule. We cannot, at present, justify investing client capital in stocks trading at such rare multiples. The top 10 stocks in the S&P 500, representing 30% of the index, trade for an average of 44 times earnings and 12 times sales. The top 10 stocks in the S&P 500 growth index, representing 54% of the index, trade for an average of 46 times earnings and 13 times sales. While an investment case can be made for some of the individual stocks in the top 10, there is no such case to be made for them as a group.

The period from June 1st to the end of the year was a tough one for anyone investing outside of the large cap growth universe. The S&P 500 growth index gained 21.2% from 6/1 to 12/31. US REITs continued to perform well, up 13.4% during that period. But all other asset classes produced single digit or negative returns.

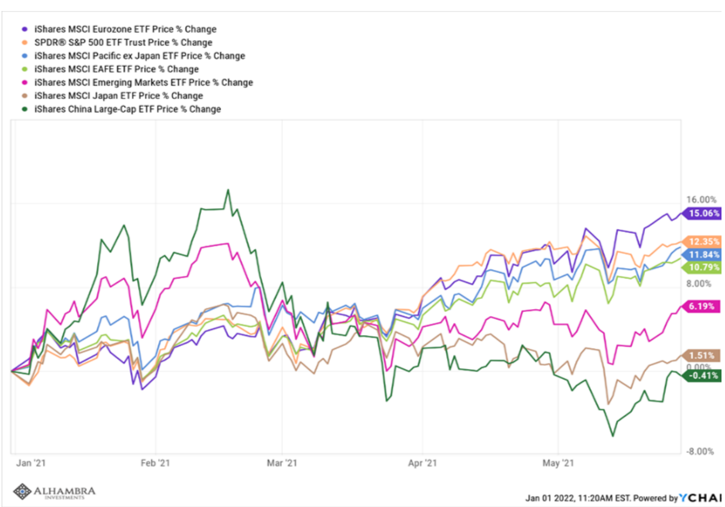


It would have been nice to enjoy the performance of the large growth stocks in the second half of the year but it would have also meant abandoning our disciplined approach and ignoring the principles upon which I founded this firm. We are conservative with client funds and we don't apologize for it.

2021 Markets Review

2021 can be divided into two distinct periods. The first 5 months of the year were a transition period from the weak dollar of 2020 to the strong dollar of 2021. Market performance during those two periods was strongly influenced by the dollar trend.

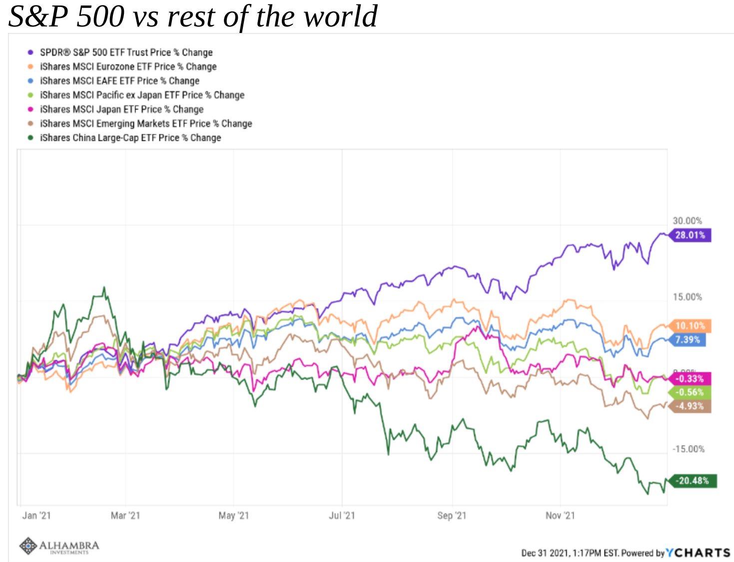
From the beginning of the year until the end of May, when the dollar made its final low for the year, US and non-US markets performed similarly with European stocks slightly outperforming the S&P 500.



The rest of the year, with the dollar in an uptrend, US markets drastically outperformed.

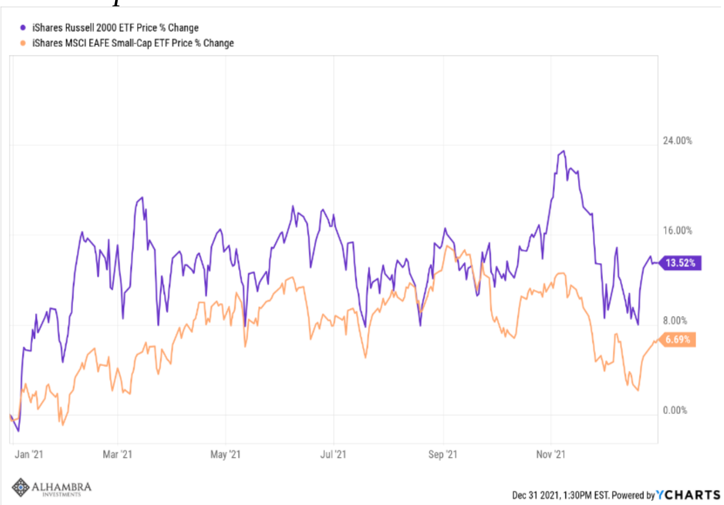
For the full year, the strong dollar was a tailwind for US assets.

S&P 500 vs rest of the world



That was true across multiple asset classes.

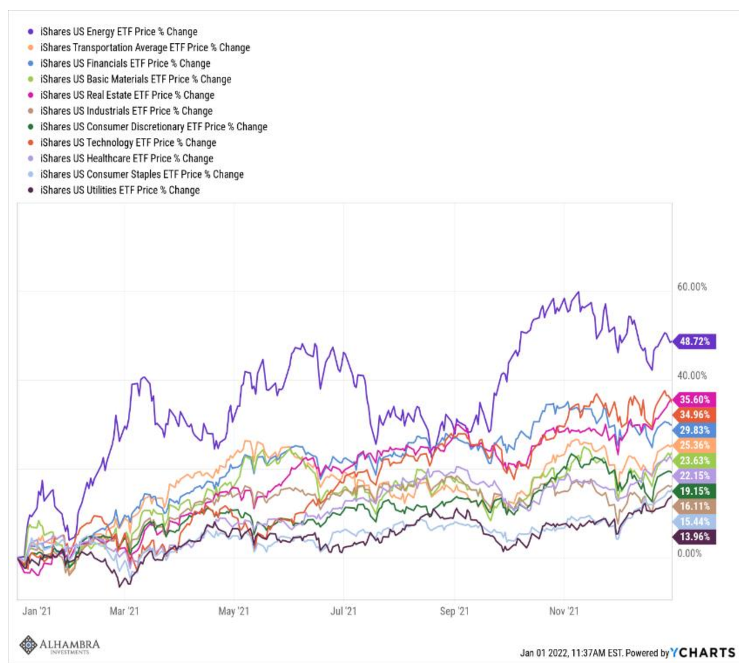
Small-cap stocks



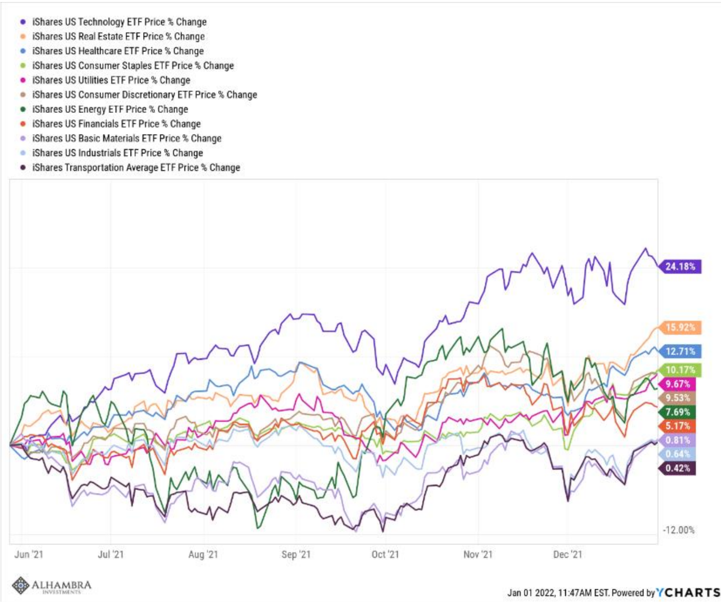
Real Estate

Full-year sector performance was somewhat surprising from a dollar standpoint. Energy and Real Estate, two sectors that normally perform well in a weak dollar environment, were the best performers of the year. Technology, which generally does perform well in strong dollar periods, was a close third.

But if we divide the year into the weak dollar and strong dollar periods, sector performance makes more sense. Through May, in a weak dollar period, energy vastly outperformed other sectors. Transportation, materials and industrials also did well in a rising growth environment and financials did well with a steeper yield curve.



In the strong-dollar second half of the year, energy fell to the lower half of the rankings and technology led the way. Healthcare, consumer staples, and utilities all jumped to the top five sectors in a falling-growth environment, while industrials, transportation, and materials fell to the bottom of the list.



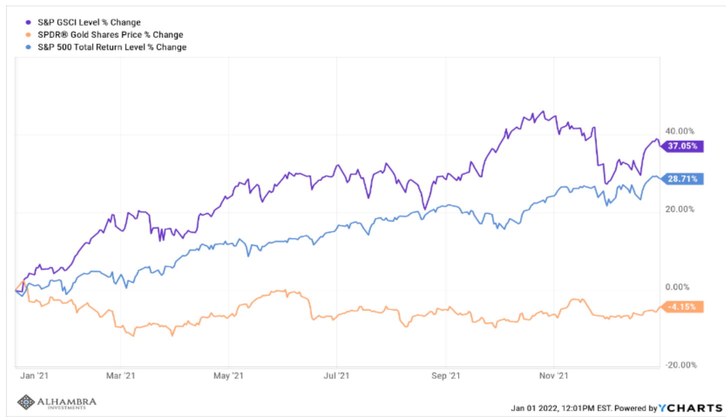
The one sector that defied prediction last year was real estate, which performed well throughout the year.

In our portfolios, we did not make any sector bets based on the environment because we didn't expect the growth slowdown to persist. Economies go through multiple slowdowns and accelerations during the course of business cycle. We expect this cycle, like the last one, to be fairly long. This was the first of what will likely be several periods of slowing growth over the course of the full cycle.

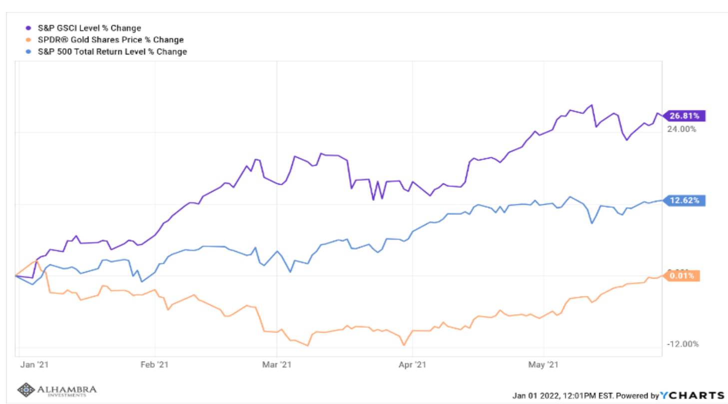
We are generally looking for strategic allocations on a sector basis and have two at present, biotech and financials. The biotech industry is, we believe, the most innovative industry in the world and is extraordinarily cheap. Financials are also quite cheap and we don't think the yield curve has yet peaked for this cycle. A steep or steepening yield curve is generally a positive for financials. And unlike the 2008 crisis, financials were barely affected by the COVID recession.

We may make more sector rotations in 2022 depending on how the economic environment develops and whether we see any long-term opportunities.

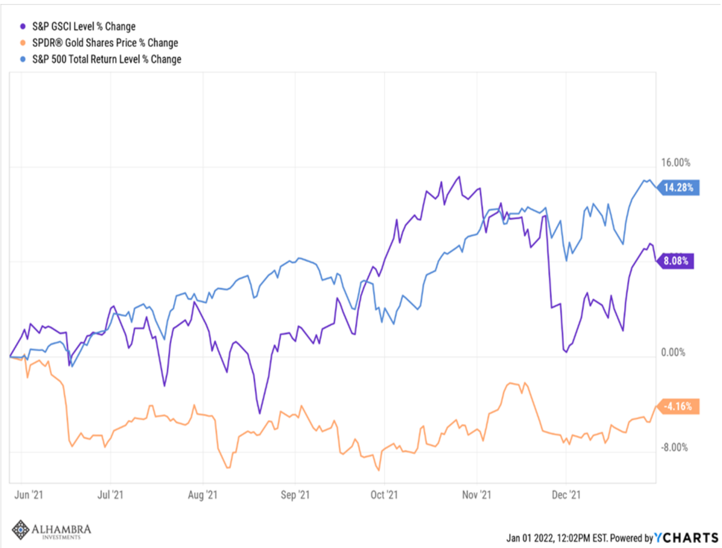
For the full year, commodities outperformed stocks and gold by a wide margin:



But it was a tale of weak dollar and strong dollar. General commodities, in a weak dollar, rising growth environment outperformed strongly through May…



…while large cap stocks outperformed from June to the end of the year. The surprise here is that general commodities outperformed gold in a falling growth environment. It was a very strange year for gold as it normally performs well when real rates are low and/or falling – it should have been a good year for gold and it just didn't happen.



Economic Environment

Right now, we still have the environment classified as *growth falling, dollar rising* but that is likely to change soon if current trends continue:

Growth Rising, Dollar Rising	Growth Rising, Dollar Falling
Growth Falling, Dollar Rising	Growth Falling, Dollar Falling

We focus on market-based expectations for growth as reflected primarily through the bond market. Specifically, we monitor the change in the 10-year nominal Treasury note yield, the 10-year TIPS yield, credit spreads, and the yield curve. These markets don't always agree so some judgment has to be applied. The wisdom of crowds depends to some degree on the crowd.

Bond Yields

The yield of the 10-year nominal Treasury note peaked in Q1 of 2021 and spent the rest of the year digesting those gains and forecasting, seemingly, the growth slowdown we saw in Q3. The yield now appears to be resuming its uptrend:

10-Year US Treasury Yield

TIPS yields also peaked in Q1 but fell all the way back to their previous lows:

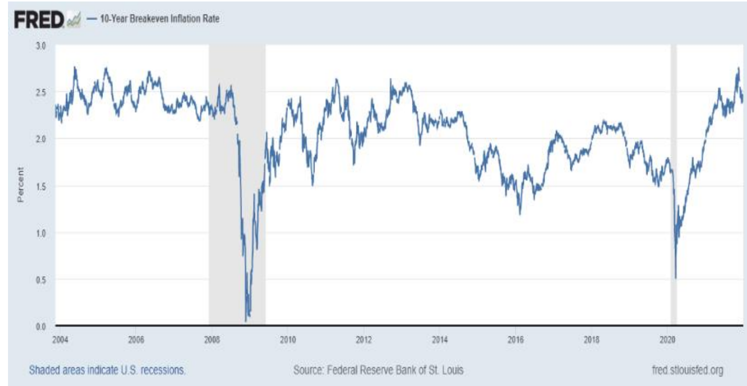
10-Year US TIPS Yield

The difference between the two yields is a market measure of inflation expectations. Because real rates (TIPS) fell more than nominal rates after the spring peak, inflation expectations rose:

10-Year Breakeven Inflation Rate

Inflation expectations for the next 10 years were 2% at the beginning of the year and rose to 2.6% at year-end. As the new year begins, nominal and real rates are both rising strongly. If that continues, it would indicate that inflation expectations are stabilizing and real growth expectations are resuming their rise. The economy definitely accelerated in Q4 so we come into the new year with positive economic momentum.

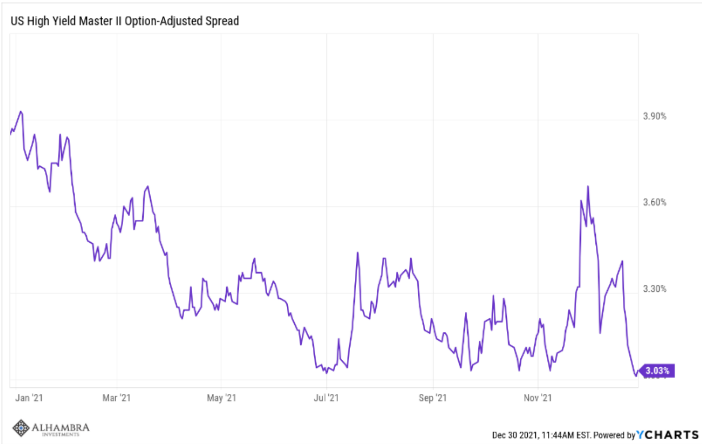
Current inflation expectations around 2.5% are consistent with what prevailed prior to the 2008 crisis so, while higher than recently, they aren't out of the ordinary:

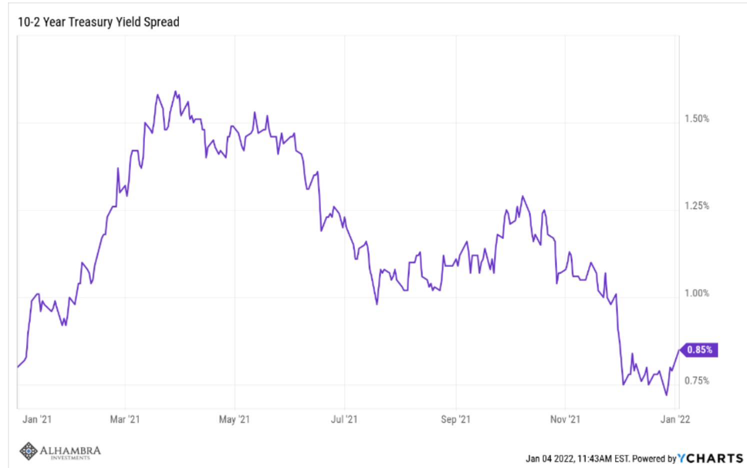


Credit Spreads

Credit spreads are the difference between the yield on a Treasury security and a lower rated security of the same maturity. The measure we use utilizes junk bond yields. Credit spreads don't measure economic growth directly but rather are a measure of risk-taking. Junk bond investors demand a premium over Treasury yields to compensate for the extra credit risk. Small premiums mean junk investors are not that concerned about default risk. When the premium grows junk investors are becoming more concerned. Obviously, the closer the economy is to recession the greater the default risk and the wider spreads become.

Spreads exhibited a pattern similar to our other measures of economic growth, hitting a low at the beginning of Q3, widening as we entered Q4, and now falling back to the lows. There is little concern about recession or default in the junk bond market.





Yield Curve

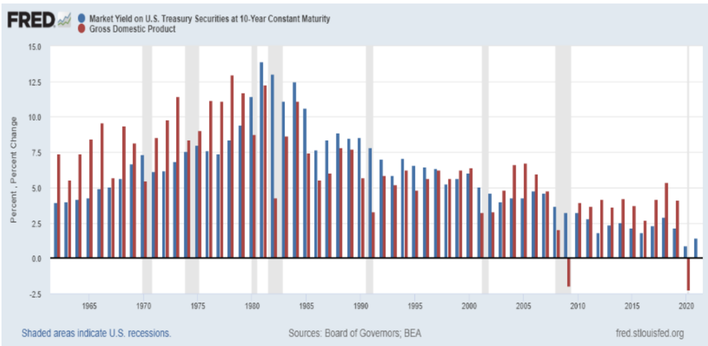
Next, we look at the yield curve which also tracked the Q1 peak and Q3 slowdown in growth expectations. The 10-year/2-year Treasury curve hit its nadir well before the onset of COVID, inverting in late August of 2019. It steepened steadily, even through the start of COVID (as short rates collapsed faster than long rates) but peaked at the end of March 2021, coincident with the peak in long-term rates. More recently the curve has flattened due to rising short term rates, a response to expected changes in Fed policy (end of QE, rate hikes).

The flattening stopped in December though, and the early trading in the new year shows it starting to steepen again. If the uptrend in long-term rates continues, I would expect the yield curve to continue steepening. The last three recessions have seen the curve peak at a spread of about 2.5%. The recent peak around 1.5% is more akin to what prevailed in the 1970s and early 1980s but the Powell Fed is not the Volcker Fed. Powell may have claimed a road to Damascus conversion to hawk recently but I'm not buying it.

Our measures of growth expectations all improved over the last year and Treasury yields appear to be continuing that trend into the new year. It should be noted though, that yields are still quite low and reflect subdued expectations regarding long-term growth.

The long-term trend of nominal rates shows current rates as being at the low end of what prevailed for the 10 years prior to COVID:

The 10-year Treasury yield averaged 2.5% from 2009-2019. Nominal yields track nominal growth:



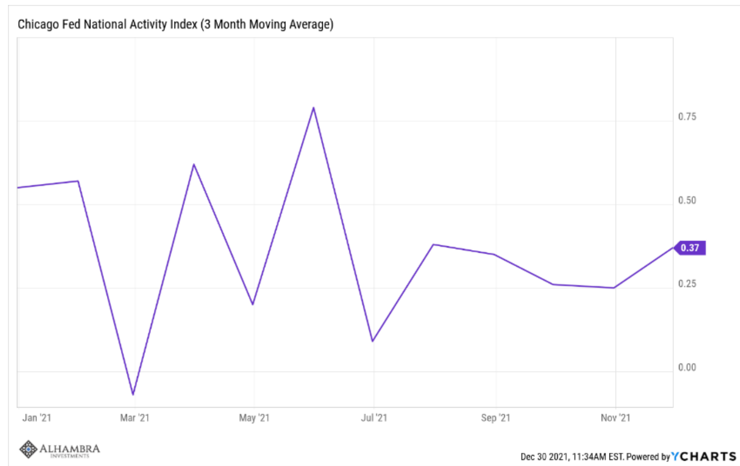
Nominal growth averaged 3.4% over the same time frame. Nominal rates today that are below the average of the previous cycle imply that nominal growth expectations are also below the previous cycle average. Real growth will be determined by inflation and for now real growth expectations are quite depressed as shown by TIPS yields (real yields). As the supply issues are resolved inflation and inflation expectations should moderate and TIPS yields should rise.

Economic Data

We also track the Chicago Fed National Activity index, a broad measure of economic performance, as confirmation of what we see in bond markets. The CFNAI is a weighted average of 85 existing monthly indicators of national economic activity. It is constructed to have an average value of zero and a standard deviation of one.

Economic activity fluctuates around trend growth so a positive index reading corresponds to growth above trend and a negative index reading corresponds to growth below trend.

We use the 3-month average of the CFNAI to smooth out the month-to-month fluctuations. The dip into negative territory in February reflects negative data from late 2020. The index peaked in May and moderated, reflecting the slowdown in late Q2 and Q3. The recent upturn shows the emerging reacceleration in Q4.



Dollar

The other half of our economic environment classification is the direction of the dollar. We put a lot of emphasis on the trend of the dollar because it impacts investment. A strong dollar is associated with low inflation and generally high-quality growth (the 90s until we took it too far). In a strong dollar environment, investors tend toward investments of the mind (technology, etc.). During weak dollar periods, investors tend toward investments in the real (gold, commodities, real estate, etc.). In the former environment investments enhance productivity and therefore growth. In the latter, they do not.

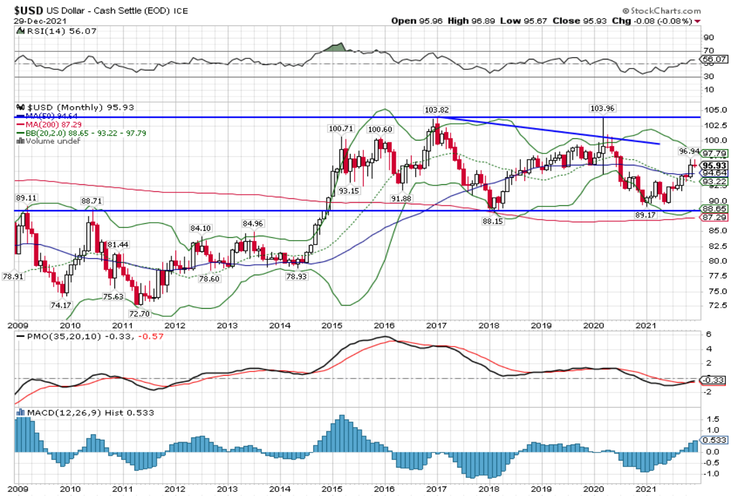
Think about the late 90s, which saw huge gains in productivity, versus the period from 2002 to 2008, when investment was directed to real estate and commodities due to a weak dollar. The period from

2015 to COVID was also a strong dollar period that produced strong investment.

(Note: There is such a thing as taking dollar strength too far, which we've seen repeatedly in recent decades. The Mexican crisis that produced Brady bonds in the 80s was such a period. The late 90s was such a period and produced two EM currency crises. The dollar also rose rapidly during the acute phase of the 2008 crisis. And the most recent episode of extreme dollar strength was during the onset of COVID. These periods of rapid and extreme dollar strength are examples of Jeff Snider's dollar shortage thesis.)

The dollar is currently in a short-term uptrend. That and the Q3 growth slowdown kept us cautious for the second half of 2021. Falling growth/rising dollar environments are periods of vulnerability because a minor shock – much less one like the COVID shutdowns – can push us into recession and trigger a run toward the dollar. 1999-2002, 2008 and 2019/20 were all rising dollar/falling growth periods.

From a longer-term perspective, the dollar has been strong and steady for 7 years.



The dollar is currently almost exactly in the middle of the range that has persisted for the last 7 years. We assume the dollar will eventually move out of this range but when – and in what direction - is impossible to predict. For now, we pay attention to the short-term trends in case they turn into long-term trends.

The consensus trade today is for dollar strength and speculators have accumulated a fairly large long position in the futures markets. Futures traders are generally trend followers so extreme positioning is common at turning points. Today's positioning is not as extreme as it has gotten in the past. For now, the short-term trend is up and the intermediate-term trend is neutral but we are watching for a reversal. We don't currently see any signs of stress in currency markets.

Discussion

The US economy made significant progress in 2021 in its recovery from the COVID shock. Three stories dominated the narrative around the economy in Joe Biden's first year – inflation, the labor market, and

COVID. Prices rose in 2021 at rates not seen in decades, the November CPI reading the highest since 1982. The accelerated price hikes pushed the Federal Reserve to announce a quicker normalization of monetary policy (or at least the intention to do so). QE is now reckoned to be over by March and the market is busy pricing in at least 2 rate hikes for 2022.

The rise in prices is a supply/demand phenomenon that is much more about the government response to the pandemic than anything monetary. The Trump and Biden administrations both responded to the COVID recession with classic demand stimulus solutions. Increased demand met COVID limited supply and prices did exactly what the textbooks say they should.

That doesn't mean the inflation isn't real, just that it isn't from a monetary source and therefore probably won't be sustained. Supply and demand will once again balance someday and the price hikes will stop. There is the possibility that today's inflation turns into something more permanent and monetary but that hasn't happened yet.

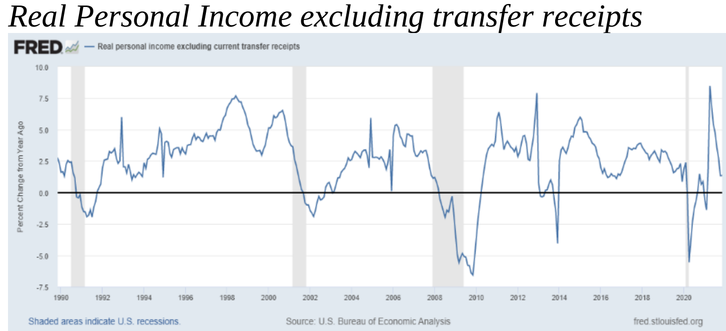
Inflation is likely to moderate in 2022 but there is a load of uncertainty around that expectation. Lower inflation requires only that goods demand fall back toward the pre-COVID trend and that the supply chain catch up a bit. And given the inventory build in 2021, a slight fall in demand for goods could easily reduce growth and prices as the excess is worked off. Fiscal policy may play a role too as I am skeptical the Biden administration will be able to pass another big spending bill in an election year. If the consensus is that excess government spending caused our current inflation problem, then failure to pass another spending bill would ease concerns about future inflation.

The labor market also produced data in 2021 not seen in decades. In early December, weekly initial jobless claims fell under 200,000 to a level not seen since 1968. There was widespread skepticism about the numbers when they were released – seasonal adjustment problems were the most common complaint – but the low numbers have persisted for several weeks now.

Frankly, even if the level of claims is understated by a bit, current claims are still in line with the numbers just prior to the onset of COVID. And those numbers were, in turn, well below the lows seen in the 2002-2008 expansion when they never fell below 300k. They were also lower than the best levels seen in the 90s and the 80s when the population was quite a bit lower.

But what got the most headlines was the Great Resignation, the phenomenon of millions of workers dropping out of the labor force. The Quits rate rose to an all-time high even as Job Openings did the same. The labor force participation rate has recovered some since the worst of the pandemic but is still below the pre-COVID rate. The lack of workers pushed up real incomes by 1.6% (YOY as of November). Part of that was due to "stimulus" payments from the federal government but not as much as you might think. Excluding transfer payments real personal income was up 1.4% YOY.

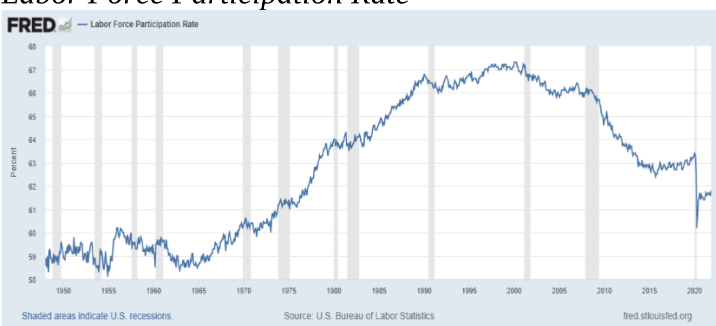
Real Personal Income excluding transfer receipts



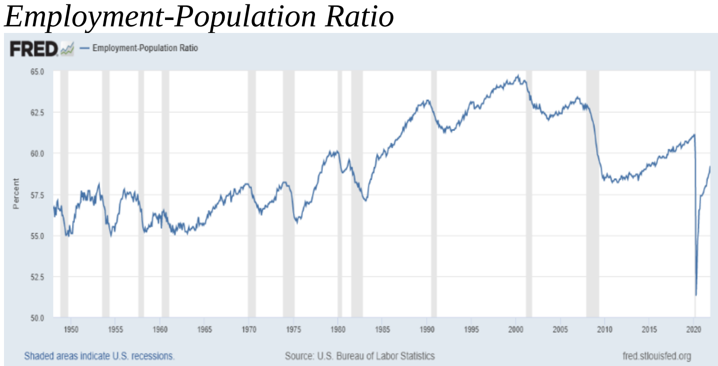
The Great Resignation has been portrayed as a new phenomenon, something induced by COVID. People are said to be re-thinking their relationship with work and life, finally refusing to put up with bad working conditions and low pay. Women are said to have been forced out of the workforce due to a lack of childcare and others have decided that working in the time of COVID is just too dangerous.

All of that is true and yet the Great Resignation is not new. The labor force participation rate and the employment to population ratio both peaked around the turn of the century. When COVID hit, both measures of workforce participation were well below the peak rates seen 20 years ago. Both had been trending higher prior to COVID but it seems likely that any recession would have pushed them down again.

Labor Force Participation Rate



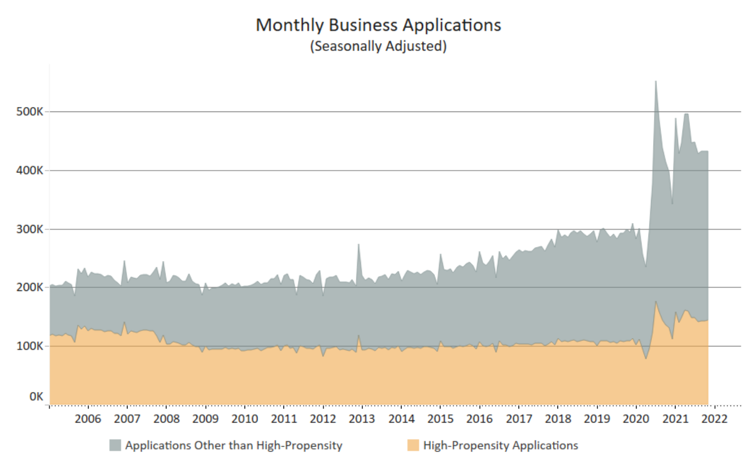
Employment-Population Ratio



Prior to 2008, the change in these statistics was not all that meaningful. The levels were consistent with what prevailed back to the late 80s and well above the levels of the 1970s. The damage from the 2008 crisis, though, appears to have been much deeper and long lasting than anything we'd seen before. The recovery from that episode didn't really get started until around 2015, seven years after the crisis period.

From a purely economic growth standpoint, more people participating in the economy is positive for total growth. I'm pretty sure that maximizing workforce participation should not be the primary economic goal, but that is a question for us as citizens not for us as investors. What we are concerned with is how this will change in the future because that has a direct bearing on economic growth. The good news is that workforce participation is already on the upswing.

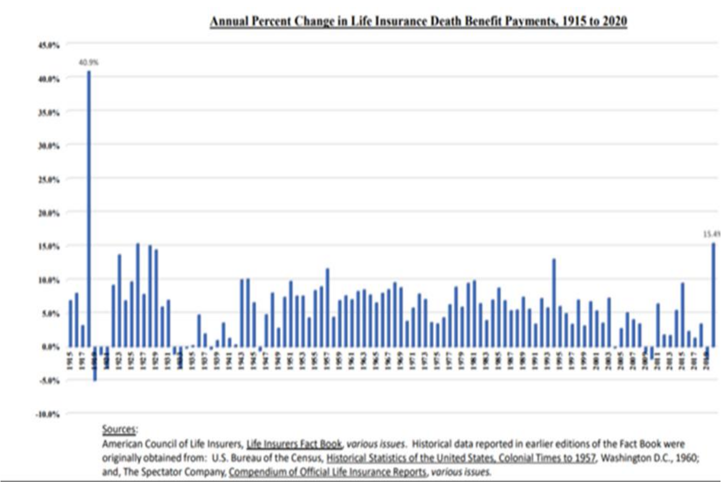
Other good news can be found in another trend that accelerated during the COVID years – new company formation. Monthly business applications turned up about the same time as the workforce participation statistics around 2015. But COVID put that trend into overdrive:



The rise that started around 2015 was likely driven by gig work or other forms of self-employment; high propensity applications are those that have indicated they will hire employees. But since COVID, we have seen both types of applications surge. That seems very positive for future growth. Productivity is the other piece of the economic growth puzzle and new companies are historically the source of much innovation.

COVID

These are extraordinary times for a lot of reasons, not least of which is the impact of COVID on our lives, economy and markets. I am not an epidemiologist and I don't play one on TV so I have no idea what to expect next. But history and common sense do provide some clues. Consider this chart from the American Council of Life Insurers. This shows the percent change in life insurance benefits paid in 2020 to be the highest since the 1918 Spanish Flu:



Obviously, 2020 had a lot of excess deaths but that isn't the interesting part of the chart, in my opinion. It is not a great chart so it's hard to see but there were four years in the 1920s that were as high or nearly as high as 2020. That is likely an echo of the 1918 flu pandemic, mutations that continued to cause excess deaths for years after the initial episode passed. Two things can be taken from that. One is that we'll be dealing with this virus for years to come. And two, it didn't prevent the Roaring 20s, so the impact on the economy doesn't have to be severe.

There is also the matter of the Russian flu of 1889-90 which was also called "The Grip". We don't know that it was a flu because they didn't have the technological know-how back then but we do know that the symptoms were very similar to COVID, including loss of taste and smell. Here's something else we know; it is remembered today as being 1889-90 but there were recurrences in 1892,93,95,98 and 99. It eventually either died out or morphed into something our immune systems could handle, like a cold or flu.

The point is that if you think the omicron variant is the end of this you may be in for a surprise. History says this is going to keep coming back in various forms until our immune systems adapt. How we respond to it between now and then is vitally important from an economic standpoint. If we respond as some countries – and states – have, with draconian lockdowns, it will continue to have a deleterious effect on the global economy. I fully expect new variants to emerge but I also suspect that, unless a new variant is something more deadly than we've seen so far, the economic impact will continue to wane. COVID isn't going away but the economic impact from here on is likely to be more nuisance than disruption.

Outlook

Economic growth in 2022 is likely to be less than 2021 as the rebound from the COVID recession fades to the underlying trends. Another year of 5%+ growth doesn't seem likely. Absent another big spending bill from the Biden administration – and that seems less likely by the day – the fiscal response to COVID will fade as time passes. There may still be some positive news at the state level as a lot of states are cutting taxes due to surpluses built up from federal largesse during COVID. But there aren't going to be anymore checks to everyone or hastily arranged unemployment benefit programs to defraud or PPP loans to keep businesses afloat.

Economic growth can be boiled down to just two things. Population growth and labor force participation affect total GDP; more people working produces more stuff. Productivity growth affects per capita growth; the same number of people produce more stuff. As a country we've made a decision to limit immigration over the last few years and that has had negative impact on population growth. The US population grew just 0.3% in 2021 (YOY through November), an all-time low.

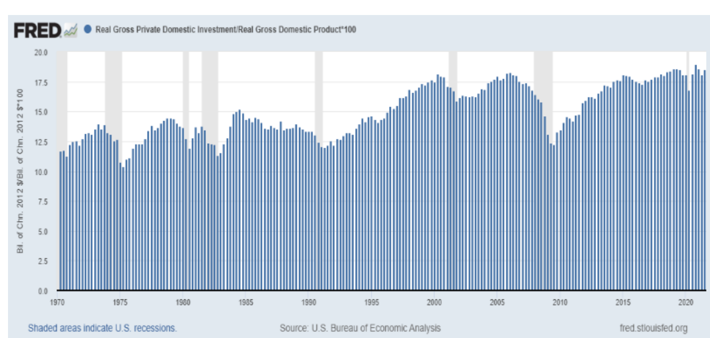
Labor force participation has yet to regain its pre-COVID levels but it is recovering much faster than in the wake of the 2008 crisis.

Productivity growth coming out of the COVID recession did rebound – we recovered to new high levels of GDP with fewer people working – but sustaining a higher rate of growth will require productivity-enhancing investments. There is some preliminary evidence we might be doing that with core capital goods finally breaking out of a 20-year range:

At the same time, the "investment" in crypto assets and the so-called web 3.0 seem like a vast waste of capital. I'll reserve judgment but so far, all either of these have produced is lots of hype and technologically-savvy pump and dump schemes. The metaverse (web 3.0) is nothing more than the latest round of virtual reality voodoo, a technology of alleged great promise that I've been hearing about every five years since I first read a bio of Jaron Lanier back in 1990. Crypto is a technological dead end with no use beyond showing off or finding greater fools. At some point, we're going to wake up and wonder how so many people got suckered into so many frauds while the SEC sat on its hands.

Once all the COVID distortions are over, we are left with the mundane blocking and tackling of running an economy. I think there are some reasons to be optimistic about productivity growth and maybe even workforce participation. Population growth though, is not going to recover anytime soon so gains from that part of the equation are likely to be minimal. Future growth is going to be largely dependent on productivity growth and that means investment.

Again, I think there are some reasons to be optimistic about investment in the economy. Overall investment has recovered quite quickly. Real Gross Private Domestic Investment as a % of GDP didn't drop much during COVID and has recovered quite quickly:



The drop in this metric after 2008 was severe and took until 2015 to recover to the previous level. It isn't coincidence that other metrics of growth started to pick up around the same time. The optimistic case for economic growth flows through this high level of investment. It may well be that COVID turns out to be a short disruption of the improved trends that prevailed prior to its onset.

What all this adds up to is an economy that is still growing slightly above trend. The indicators we watch show no signs of stress or fear of recession. The economy accelerated out of the Q3 slowdown and enters the new year with positive trends. Interest rates are rising, credit spreads are narrow, and the yield curve is starting to steepen again.

The dollar is also in a steady uptrend and it isn't hard to see why. Europe is in the midst of a self-imposed energy crisis, China is busy with Cultural Revolution - the Sequel, and Latin America is giving socialism another try. I'm not a fan of our fiscal situation and in the long-run, if we keep running up our debts, the dollar will likely be the relief valve. But right now, the US and its dollar don't look so bad.

Conclusion

What will 2022 bring? You know what I'm going to say – I don't know. It is logical to expect a moderation of both economic growth and inflation but economies aren't always logical or rational. It is logical to expect value investments to finally outperform growth investments, for valuation reasons if nothing else. But there have been plenty of other years when that seemed logical too and it didn't matter.

The good news is that it doesn't matter if our crystal ball isn't working. No one else has one that works either. That's why we depend on the next best thing - markets. In 2022, we'll do what we've always done, allow the wisdom of crowds – and our own sense of what is prudent - to guide us and respond with moderation.

Happy New Year to all our clients and readers. Let's have a great year!

Joe Calhoun

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