4Q 2021
Market Commentary

Happy New Year! Indeed, SKBA Capital Management is happy to announce that as of December 31, 2021, the company repurchased the outside ownership interest of our former minority partner, CCM Holdings. As a result, SKBA is now 100% owned by employees and original founders. We are extremely excited to take this new step forward! As employee owners, we have skin in the game in terms of capital investment in the firm along with personal investment through our 401k plan in the same strategies we employ for our clients. So our interests have been and will continue to be aligned with serving you and your investment needs.

What a year 2021 was. The two most dominant themes impacting the year were wave after wave of COVID-19 cases, from Delta to Omicron, and the monetary policy mismanagement of the Federal Reserve Board, which was late to acknowledge the no-longer "transitory" price inflation problem.

We have written two client newsletters specifically dealing with these subjects, the first in February 2021—*The Great Inflation Awakening*—and in the upcoming newsletter—*The Long Wave Was Not a Friendly Gesture*—we discuss the prospects for ending the COVID pandemic. We hope you find them to be both insightful and entertaining.

The Fed's suppression of interest rates and the Federal government's massive stimulus payments combined with the partial reopening of the economy were the forces that led to the economic boom experienced in 2021. Real GDP and the GDP deflator measurement of the rate of price inflation should both close the year at levels not seen in decades—roughly 6% for each measure. As a result, nominal GDP growth, a proxy for overall U.S. corporate revenues, should have grown by nearly 12% in 2021. No wonder U.S. corporate profits are estimated to have rebounded around 45% (operating earnings), even as every company coped with rising labor, materials and transportation costs. How much of the margin improvement is sustainable is a big question, but at the same time, it's not hard to understand why stock market returns were so robust when supported by this kind of underlying earnings growth. Don't expect the overall market advance to be as robust in 2022 even if inflation and real GDP growth moderate to the 4% level. Such an inflation level is still far too high for the Fed to tolerate.

Overall, stocks rose nearly 28% when measured by the growth-weighted S&P 500 and a still robust 21-25% when looking at "value style" benchmarks like the Russell 1000 Value or the Morningstar Large Cap Value. So it was once again a tale of two markets—growth stocks led the way compared to value stocks. Furthermore, stocks vastly outperformed bonds as the 30-year Treasury bond produced a negative return for the year at -4.5%.

Price inflation vastly surpassed Fed expectations closing the year near 7%, the real yield (the nominal yields minus the expected rate of price inflation) plunged. Yet even so, the Fed's suppression of yields and pursuit of the false promise of MMT (Modern Monetary Theory) could not keep yields down at the long end of the maturity curve. Despite falling the 4th quarter, the 30-yield T-bond yield rose 25 basis points (0.25%) from the end of 2020 to the end of 2021. There is likely more to come in 2022.

Furthermore, it was also a tale of two halves of the year as economically cyclical stocks outperformed in the first half only to see the COVID shelter-in-place media and tech stocks recover in the second half of 2021. In either case, absolute returns were extraordinary, and in a typical year such as this, one would expect the higher beta growth strategies to be the overall winner. Yet the driving factor was the wave after wave of COVID infections. Just as the Alpha wave had peaked in early 2021, the Delta wave swept ashore, causing the Federal Reserve Board to lose its nerve regarding the plan to taper its Treasury and mortgage-backed bond purchases to withdraw its extraordinarily easy monetary policy. Fed Chairman Powell's news conference in June declared the wave of rising prices was still "transitory" and the Fed was considering postponing any taper decision to the fall. Talk about a huge mistake—this was one! But it

signaled to investors that maybe the economy would slow, price inflation would wane, and interest rates may go down not up. The COVID stocks took off in the summer and economically-sensitive stocks languished. Now Powell confesses the term “transitory” should be retired and the taper of bond purchases will be accelerated through the end of March of 2022.

The Omicron wave arrived at the world’s shores in October, once again triggering fears that the reopening of the U.S. and world economies will be put on hold or worse, take a step backwards. The growth-stock-dominated S&P 500 soared nearly 11% in the 4th quarter on this news, and value stocks lagged. But as we explain and forecast in our latest newsletter on COVID, Omicron could turn out to be transitory as well. Surely the ease of transmission is causing the disease to spread like wildfire, but its impact on health appears likely to be far less than that of Alpha and Delta. We demonstrate this in our worldwide statistical analysis. Even the CDC has reluctantly announced that as Omicron is more contagious but less virulent, the recommended days of quarantine has been cut in half, from 10 days to 5. While every death is a tragedy, the combination of the rapid pace of vaccination and boosters, application of new and old therapeutic anti-virial drugs, and lightning-fast spread of Omicron cases, particularly among the unvaccinated, the long-talked about herd immunity may arrive quicker than the skeptics believe.

Such a development should change the market’s dynamic once again as worldwide reopening gets back on track, allowing interest rates to rise while stocks benefiting from the reopening recover their relative strength. We look forward to that day.

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