Talbot Financial – Fourth Quarter 2021 Review

The S&P 500 Total Return Index returned 28.7% in 2021 in the face of new COVID variants, higher inflation and a potential shift in Federal Reserve policy. The primary driver of the favorable return last year was strong growth in earnings from the companies in the Index. In fact, 2021 earnings for S&P 500 companies will be in the mid 30% range for the year.

Two of the top performing industry sectors for the year included Technology and Financials. Within Technology, both businesses and consumers accelerated the migration of data to the cloud and the largest companies continued to exert their market advantages. We believe both trends are sustainable in the years ahead. The Financial Sector performed well as the economy continued to rebound and banks began to prudently add loans to their balance sheets. Talbot Financial client portfolios remain overweight to both sectors as compared to the Index and we are optimistic about the prospects for these two industries going into 2022.

2022 Outlook

Both monetary and fiscal policy remain accommodative, inclusive of potential rate increases by the Federal Reserve later in the year. The economy remains on sound footing as most industries have fully recovered from the short-lived recession in 2020. Gross Domestic Product (GDP) is projected to grow at an above-trend rate of 4% in 2022. Large companies are posting record operating margins and their balance sheets and cash flows are strong. All of this suggests a healthy backdrop for continued growth in earnings in 2022. Furthermore, the companies owned in Talbot Financial client portfolios have higher projected revenues, operating margins and cash flows in the coming year, relative to the broader Index.

Inflation increased throughout 2021 and is a concern of many going into 2022. The reality is some inflation is good as it indicates an economy is growing. However, too much inflation can diminish purchasing power. The Consumer Price Index (CPI), which is a measure of change in price for a fixed basket of goods and services, is the primary measure of inflation. The December 2021 CPI reading was 7%, the highest level in 40-years. Much of this is transitory (e.g., Energy, Food, Supply Shocks), and should gradually dissipate throughout 2022 and 2023 as supply chains correct and more people return to work. However, some of the increase is core in nature and likely here to stay, for example, wage inflation. Our view is core inflation will settle in the 2.5% - 3.5% range for the foreseeable future. This is higher than the previous decade, but normal by longer-term standards.

Considering an outlook for higher core inflation, we evaluated historical data to determine how assets are best protected against increased inflation. We analyzed different asset classes and their long-term performance relative to inflation. Specifically, we compared stocks, bonds and cash to inflation over rolling 10-year periods from 1928 through 2020. The following table shows the results over 83 rolling 10-year periods (ie., 1928-1938, 1929-1939, etc.):

Stocks, Bonds, Cash, Inflation Total Returns (1928 - 2020)				
	10 - Year Rolling Returns			**1 - Year Return**
	Stock vs Infl	**Bond vs Infl**	**Cash vs Infl**	**Cash vs Infl**
Underperform	10	26	28	62
Outperform	73	57	55	31
Total	83	83	83	93
% over	**88%**	**69%**	**66%**	**33%**

In summary, stocks were the overwhelming winner, outperforming inflation 88% of the time. This compares to bonds outperforming 69% of the time and cash outperforming 66% of the time. Even more telling was how poorly cash performed against inflation on a year-by-year basis, underperforming an astonishing two-thirds of the time. We have often stated that "cash is not your friend." The results above substantiate that claim.

The takeaway is that stocks outperform inflation over longer term periods because of pricing power. As prices of goods and services increase, companies have the ability to pass those costs along. Those companies with greater market leadership have a competitive advantage relative to peers and tend to have greater pricing power. Screening for companies with sustainable competitive advantage is a pillar of our investment approach; and therefore, we expect that Talbot Financial client portfolio companies have material pricing power relative to peers to mitigate inflationary headwinds.

In conclusion, 2021 was another robust year for the financial markets. The economic and company specific backdrop for 2022 suggests continued solid earnings growth going forward. We acknowledge that inflation is worrisome, but ownership of a basket of high-quality companies minimizes this concern for long-term investors.

Our office in Bellevue is fully open and we would welcome the opportunity to review your portfolio in person, by phone or on a Zoom conference. Please contact us for a review, or to answer any questions you may have about your portfolio.

Best wishes, Talbot

Financial, LLC

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