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2021 Year-End Review and 2022 Forecast

12 January, 2022

I like to start these year-end reviews by looking back at the predictions I made at the beginning of the previous year. Quite often this analysis shows just how difficult it is to predict market and economic events – usually I get something right and a few things wrong as well.

At the beginning of 2021 I provided an analysis which showed how growth company stocks had outperformed value four years in a row, which was unprecedented going back to 1980. In the industry we categorize growth stocks as those companies that are expected to have above average earnings growth compared to the market as a whole and value companies as having slower growth but more stable businesses that quite often pay out higher dividends compared to growth companies. So, for example, many technology companies would fall into the growth category, and large pharmaceuticals and oil companies might fall into the value category.

Given the four-year outperformance of growth over value, I predicted that we might see value companies outperform in 2022 and indeed that was the case in the first half of the year as value stocks were at one point 10% ahead in performance compared to growth. However, mid-year something changed; I believe it may have been a general sense of optimism as statistics showed an uptick in economic activity and the effects of covid were, it seemed, getting under control as countries lifted restrictions on travel and

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quarantine and many people went back to work. Mid-year, growth stocks, especially technology companies, took off and ultimately outperformed value for the fifth year in a row.

I also predicted that emerging markets would outperform in 2021 and indeed things started out that way, by mid-February the emerging market index was 7% ahead of the US and other developed market indices. A number of emerging markets continued to outperform but China dragged the index down as the Chinese government decided to impose restrictions and "share-the-wealth" strategies on many of the more successful publicly-traded firms, like Ali Baba for example. Interestingly the Taiwanese market was up over 20% for the year, whereas Hong Kong was down 5%, in-line with the emerging market index, and China was down 23%. Both Hong Kong and Taiwan are considered developed markets, whereas China is considered "emerging".

Although emerging markets represented a relatively small portion of our investment strategies, our investment portfolios were poorly positioned for this selloff in China and we didn't react quickly enough to the news coming out of that country, which dragged down our investment returns. However, the good news is that, with the exception of our most aggressive portfolio strategy, all our strategies outperformed benchmarks on average this year, in some cases by a considerable margin. This outperformance was mostly due to a call we made on interest rates, inflation, and the bond market.

It seemed a good bet at the beginning of 2021 that inflation would kick in post-covid, interest rates would go up at least a bit, and therefore bond prices would fall. In response to these expectations, we decided to focus on dividend-paying investments rather than bonds on the income side of the portfolio. This made the more conservative portfolios more volatile but it was the risk we assumed in return for avoiding what we felt was a poor bet on fixed income investments. This risk paid out; as can be seen in the chart below bond prices were negative for the year whereas our dividend-paying investments did well and yielded a much higher income stream, in the 5% to 10% range.

Our bet on gold did not pan out in 2021, which perhaps surprises me more than anything since, given the inflationary environment and some uncertainty in investment markets, coupled with very low interest rates, I would consider this to be an attractive environment for gold and other commodities. We continue to hold gold in most portfolios as a diversifier and a hedge against inflation. Our investments in oil

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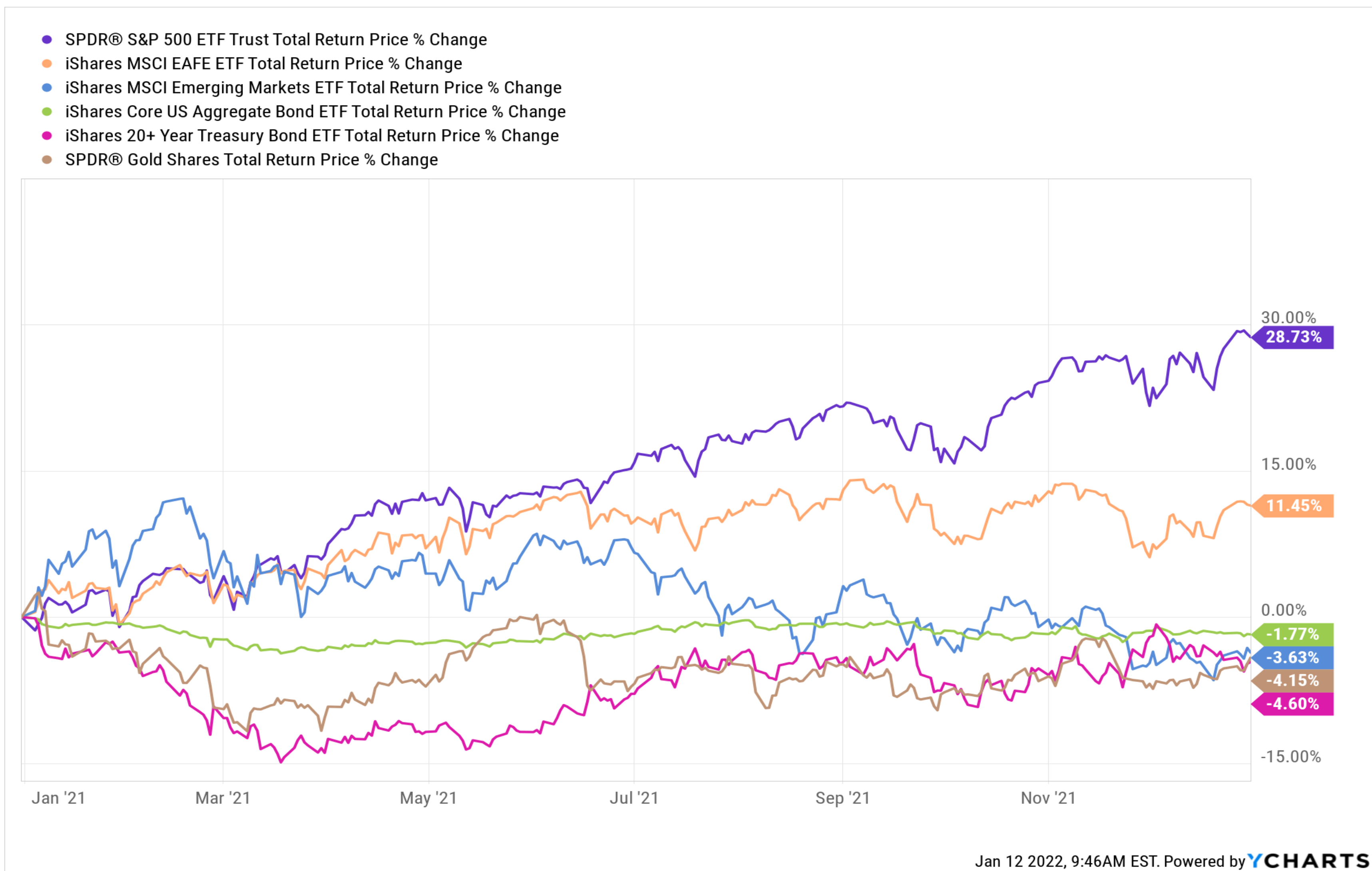
companies have paid out as the price of oil increased about 60% in 2021 – many of these companies also yield good dividends in the 5% or greater range.



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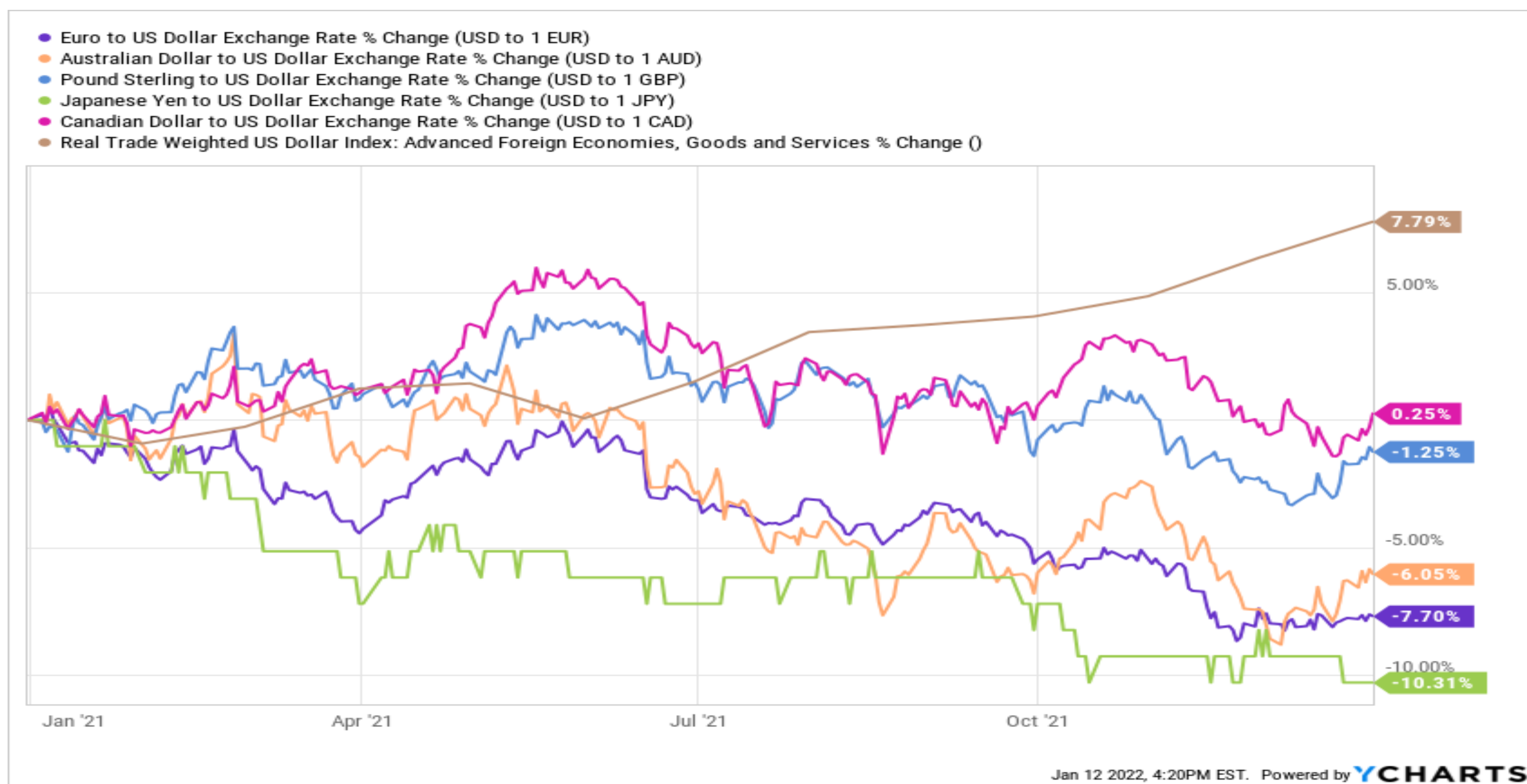
The chart below shows a number of developed market currencies vs. the US Dollar and also the USD trade-weighted index, which shows USD strength compared to a composite of currencies of countries with which the US trades. The US Dollar strengthened against most developed market currencies in 2021 as interest rates started to rise in the USA in response to inflationary pressures. This also supported US equity market returns compared to those valued in other currencies. The upward trend of the trade-weighted index indicates dollar strength – an increase of almost 8% in 2021 vs. trading partner currencies. The downward trend of most of the other lines shows weakness in the other currencies compared to the USD.



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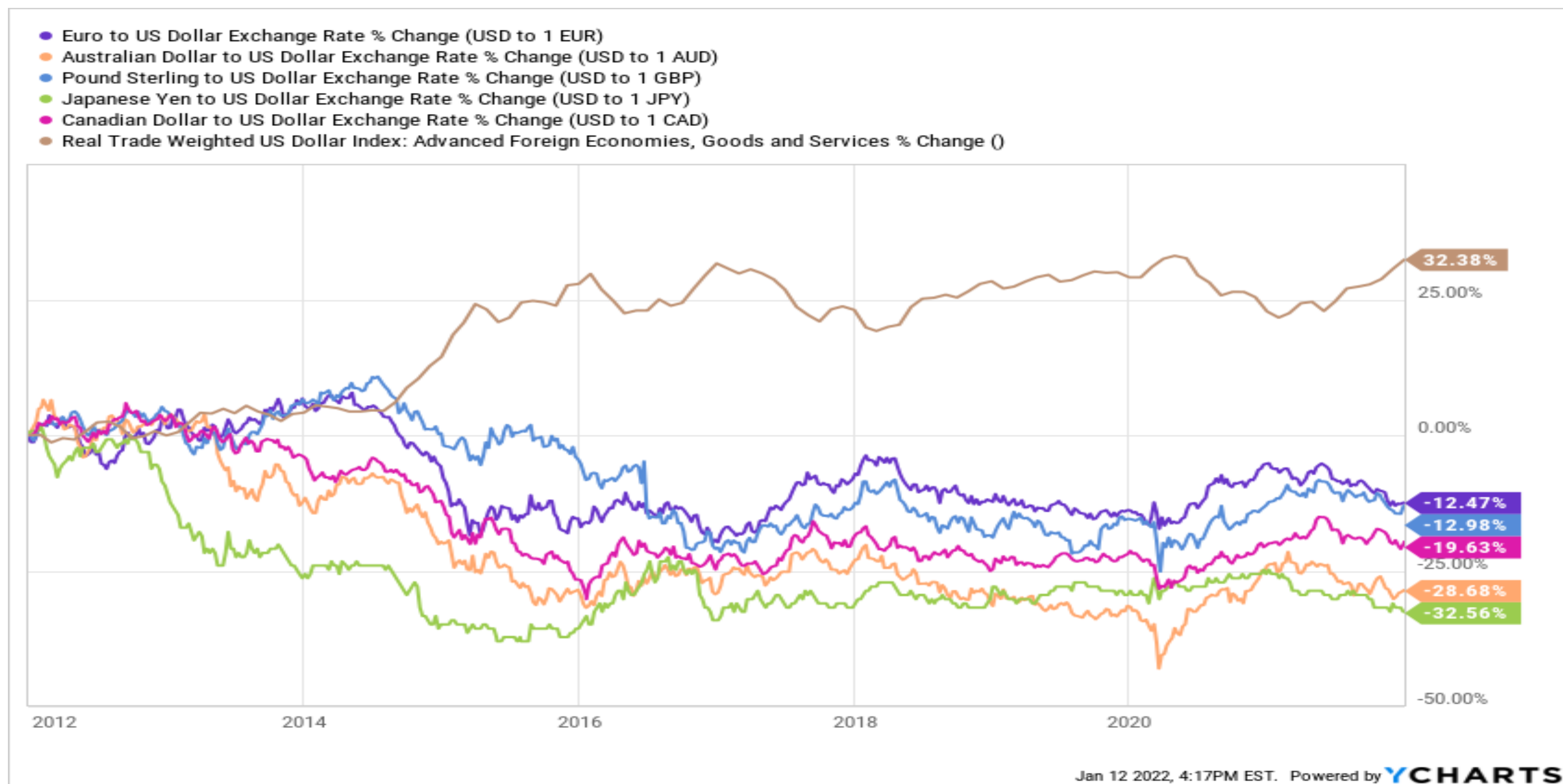
It is actually interesting to look at a longer-term chart of the US Dollar vs. other currencies, like the one below for the latest ten-year period. This shows a dramatic increase in the USD vs. a number of developed market currencies and in the trade-weighted USD.



But look at the chart below for the previous five-year period 2006-2011. There are a couple of things to note on this chart: First of all, the USD strengthens in times of stress, like during the 2008 financial crisis. Secondly, look at the dramatic weakening of the USD before and after the financial crisis, as compared to the substantial strengthening in USD over the next ten years shown above. The takeaway from this

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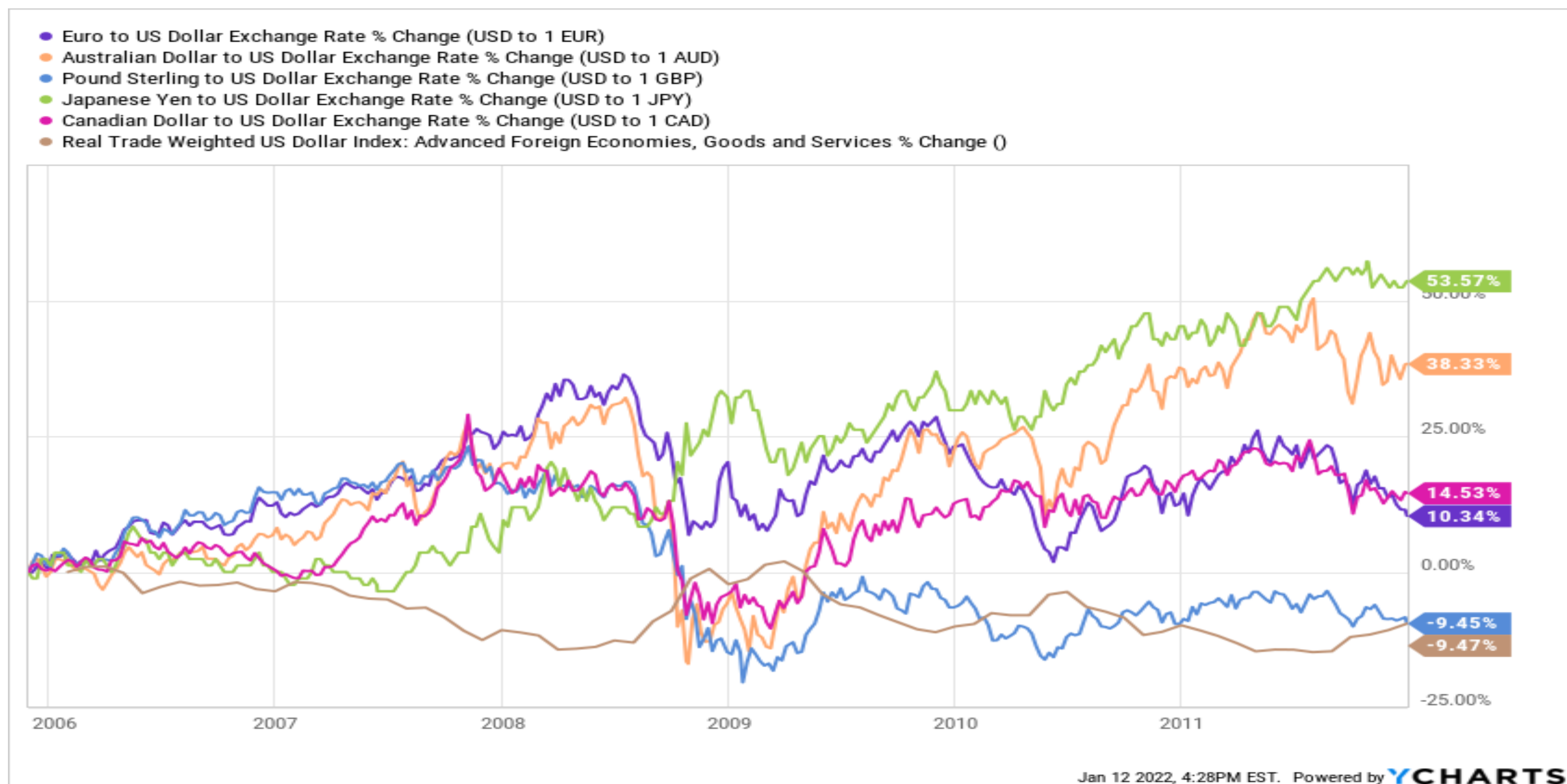
second point is that currencies tend to be mean-reverting, unlike the stock market for example, which generally goes up.



We are currently in a strengthening-USD trend due to increasing interest rates in the US and some uncertainty in investment markets. However, if inflationary pressures decrease and interest rates stabilize, and assuming we are not in a recession at that point, we might expect the US Dollar to change direction and start weakening. Given the outperformance of US investment markets over many years now compared to other developed markets, this could signal an inflection point where non-US markets

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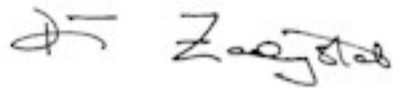
outperform for a number of years. So we are keeping an eye on this although I doubt 2022 will be the inflection year.

We are also keeping an eye on major Chinese companies such as Ali Baba, TenCent, XPEV, and others. These have been hit hard recently and I regret that we weren't smarter and faster to get out of them when the Chinese government clamped down. However at this point, unless these companies end up getting nationalized, I would think they may present a buying opportunity. I doubt the Chinese government would nationalize these companies because what a communist government needs more than anything else is stability and prosperity – otherwise the natives may get restless. I suspect the Chinese government wanted to show owners of these companies who is actually boss in China and slap them around a bit – now having done that I wouldn't be surprised if we got some news out of China in the near future that would be supportive of these companies and this would be the moment to rebalance back to China.

Finally, we continue to look at long-term trends as investment theses: The shift to renewable energy, 3D printing, an aging population, especially in the USA; and a new trend – more flexible workspaces as people and companies have become more comfortable with employees working remotely.

I am generally positive on equity markets for 2022, although I don't think we will see the returns we saw in 2021. I continue to believe that at some point value stocks must take leadership from growth companies and that non-US markets must get more traction, although a strengthening USD will not help this. We should continue to avoid bonds and live with the added volatility inherent in dividend-paying investments. Finally, I keep thinking the price of gold should take off – maybe this will be the year.



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