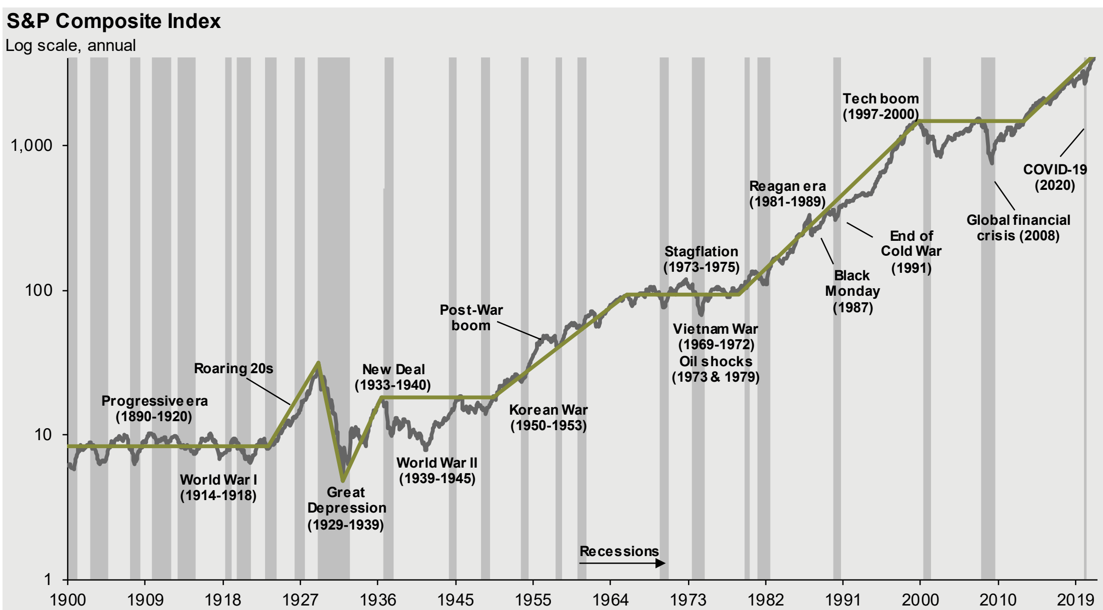
40 YEARS

NOTTINGHAM ADVISORS
ASSET MANAGEMENT

2021 Q4 Outlook

The Wall of Worry

It's often said that bull markets climb a "wall of worry". Despite investor tendencies to wring our hands and discount every imaginable issue into stock prices, markets tend to shrug off short-term noise, after all, that's what most of the "worry" is, and trend generally higher. (This corollary is a close cousin to Keynes' oft-repeated quip that markets can stay irrational longer than one can remain solvent.) In this letter, we'll discuss a few of today's worries and offer our take on them. Some of these fall under the category of 'problems for another day, but for others, that day may be soon approaching. First, however, let's give this discussion some context. Does anyone really want to bet against this chart?

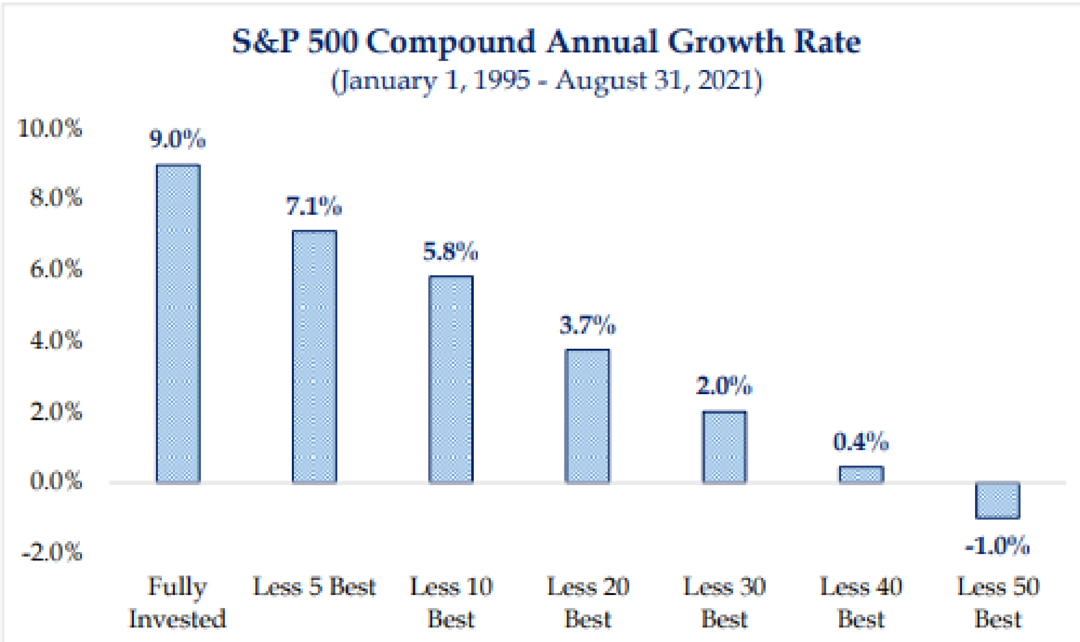


Source: JP Morgan, Guide to the Markets

Inflation would appear to be the latest entry on the worry list. Despite Fed Chair Powell's insistence that today's rising prices are transitory, and likely short-lived, it's tough not to feel the impact of $4+ gasoline, soaring home prices (the S&P CoreLogic CS 20-City home price index has risen +20% from a year ago!), and rising food costs (bought any milk or steak lately?). Not to mention the rising cost of labor, with $15+ minimum wage all but set in stone. We doubt these labor costs will be rolled back anytime soon (which is probably a good thing). The nature of today's price increases, the product of a global pandemic, supply-chain issues, federal stimulus, and historically loose monetary policy by the US Federal Reserve, may indeed prove anything but transitory, and this is not yet reflected in asset prices.

Further, historical parallels are being made with 1970's style "stagflation", as pandemic induced supply shocks result in slowing growth and surging prices. The ultimate outcome is neither clear nor decided at this point. It truly is a period of unprecedented events and challenges on numerous levels. While stagflation isn't our base case, we do feel today's inflationary pressures will be with us for some time. Equities, short-term bonds, and commodities are all reasonable assets to hedge inflation. Moreover, if our inflation outlook is wrong, these assets should perform well regardless.

Given this uncertainty, it's likely not the time to make sweeping changes to one's asset allocation. Beyond rebalancing on a periodic basis, timing swings in equities is a sucker's game. As the chart below reminds us, investors really are better off staying invested through periods of volatility, rather than trying to time exit and re-entry points. The difference in long-term return by missing the best few days is profound.

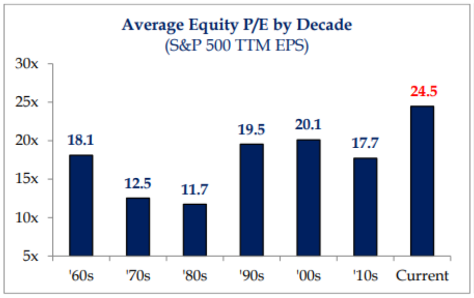


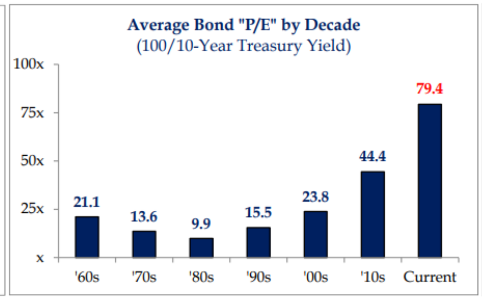
Source: Strategas Research Partners

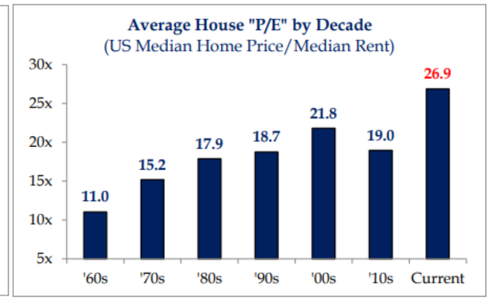
Politics and the legislative process in the U.S. has often been compared to sausage making – you don't really want to watch it happen, but the end product is occasionally decent. The latest whirlwind legislative session involves debt ceiling issues, a $3.5 trillion spending bill, and a $1.5 trillion infrastructure bill, all taken up at once. With real-time 24/7 media, it's hard to ignore the ups and downs and ongoing political infighting. Many things are at risk of change, not the least of which is tax policy, including both corporate and personal income tax rates, capital gains tax rates, and estate tax law. Nottingham regularly assists its clients with financial planning issues; however, the current policy debate in D.C. has us prefacing most comments with "…well, under today's tax structure….". Not optimal. Our hope is that our legislative representatives get things worked out sooner rather than later.

As to the impact of higher taxes on stocks, bonds, and real estate, there may be some near-term volatility as investors try and get ahead of some of the proposed changes, but in the long run, valuations are typically predicated more on cash flows and earnings as fundamentals more often win the day. In other words, it's usually not best to let the tax tail wag the dog, but if one has generated substantial long-term capital gains, there may be consideration given to expediting some gains capture while tax rates are lower, assuming the predicted tax hikes aren't made retroactive to an earlier date.

The last rung on the wall of worry that we want to highlight would be valuation. This might admittedly be the most challenging hurdle for us at Nottingham. We remain keenly sensitive to valuations, as these metrics remain a vital input in our investment models. With the S&P 500 trading at roughly 20x next year's estimated earnings and already sporting a historically low dividend yield, the equity market can't be described as cheap. Moreover, on a longer-term Shiller P/E basis, the S&P 500 was only more expensive at the height of the dot-com bubble in 1999. Against this backdrop of absolute richness, we would argue that on a relative basis, equities remain far more attractive than bonds, cash, and perhaps even real estate and commodities. Blame the Fed, we do!







Source: Strategas Research Partners

The Shiller PE Ratio

Source: multpl.com

Given what we feel are "full" valuations currently (we highlighted two measures, but there are many more supporting the case for expensive stocks), it's our bet that future 5-year returns will be markedly lower than the preceding 5-year return. We wouldn't be surprised to see low single-digit annual returns, though still in excess of inflation and most likely far better than bonds. The chart on page 2 should disabuse anyone of the notion that they can successfully side-step the inevitable pullback, will the chart on page one should encourage everyone to ride out the spike in volatility we're likely to see as the Fed attempts to remove the proverbial punch bowl. Regardless of the asset class, prices have benefitted materially from the artificial suppression of interest rates (coined quantitative easing), and in our estimation, few bargains remain on the shelves. We preached the importance of patience in prior missives, and now is the time for that.

Nottingham's diversified portfolios contain exposures that have performed incredibly well (US large-cap growth), so-so (US mid and small caps) and poorly (emerging markets). That said, on a purely valuation basis, we would rather invest $1 today in EM, then SMID, and lastly in the expensive US large-cap growth space. Mean reversion still exists for us, but sometimes those stretches of underperformance can last for a maddeningly long time. And for some, patience is wearing thin. We get it. Investing for the long run can be trying, especially during periods of time where a handful of mega-cap companies (i.e. FAANMG) are doing very well relative to nearly everything else. A decade-long period of underperformance by international markets relative to the US has even die-hard global allocators questioning the wisdom of their investment strategy. The glut of investor dollars chasing growth right now is truly reminiscent of the dot-com bubble. This too will end, and likely badly for many. Stay disciplined.

With inflation running hot and the Fed contemplating tapering, bond prices should fall and yields should trend higher. Maintaining exposure to short and intermediate-duration bonds as a hedge to equities makes sense. While you won't earn much yield, bond prices should rise given a severe equity correction. Credit spreads continue to grind near historic lows, which means the risk/reward trade-off for owning sub-investment grade debt skews the wrong way. We're cautious here, preferring the upper-end of the junk credit stack, namely BB-rated credits. If the Fed can manage the transition to market-based interest rates, we don't foresee too much trouble in the credit markets. On the other hand, should they misstep, it is likely that interest rate volatility will spike and numerous overly levered entities will face solvency challenges. China's credit woes notwithstanding, and we don't anticipate Evergrande Group's default to trigger global contagion, the world is awash with liquidity and central banks around the globe continue to expand the money supply.

Summary

In short, as long as the Federal Reserve keeps interest rates at or near 0%, the path for asset prices, volatility notwithstanding, is likely higher. The TINA thesis (There Is No Alternative), while overly simplistic, makes sense. What's the investor to do? Stay level-headed, intellectually flexible, remain focused on the long run, and be ready when the market hands us a bargain. A lot will change in the coming year, likely for better and for worse. As always, Nottingham is here to help our clients navigate a pathway through all the uncertainty. Our portfolios are built for weathering storms, and our 40 years of experience working for our clients financial well-being means that we've managed and invested through all sorts of market disruptions. Experience matters. Please reach out with your own worry list and we'll gladly try and help you make sense of today's ever-changing investment landscape.

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