NOESIS
Capital Management

A Global Perspective Focused on You

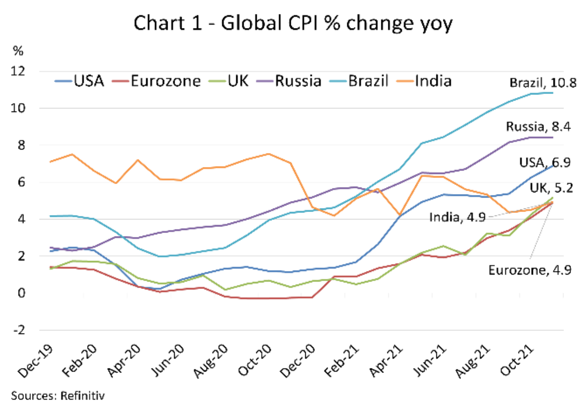
January 15, 2022

Outlook for 2022

Dear Friend:

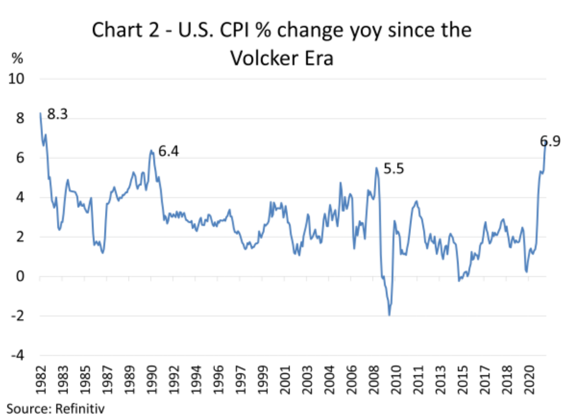
Review of 2021

We wrote the following at the beginning of 2021: "The tug of war between greed and fear was definitely on display in 2020." A similar situation occurred in 2021. The ample money supply in the financial system has raised the price of everything – including stocks, houses, cars, and daily consumable goods. Because of this, we are in a situation where reasonable-priced investments are difficult to find. The elevated value benefits existing investments but challenges disciplined investors looking for new ideas.



The concern over inflation could lead to further price increases. Globally, interest rates are at a historically low level. Some countries with a smaller economy and weaker balance sheet have already seen double-digit inflation and had to raise interest rates (see Chart 1 for inflation globally). For a while, the U.S. Federal Reserve Chairman kept his stance on inflation as transitory and suggested it would be relieved by the improvement of the global supply chain. However, several Asian countries, where most of the manufacturing capacity is located (such as Vietnam, Taiwan, and China), still have rigid "zero COVID cases" policies. On the U.S. front, we still see congestion on the transportation of goods. No infrastructure and labor market can handle such a surge in demand and supply squeeze. It will take more than just a few months to see significant relief.

The last reading of the U.S. Consumer Price Index (CPI) number was 6.9% compared to this time a year ago. We haven't seen a similar reading since the Volcker era in 1982 (see Chart 2 for the U.S. CPI data). People are used to the low-interest rate and low inflation environment since the Financial Crisis. It is beneficial for stable growth because the borrowing costs are cheap, and assets are not too expensive. However, it is a different situation now - elevated asset prices have started to impact affordability. With asset prices at this high level, any upward movement in interest rates will encourage a sell-off. In the U.S. stock markets, we see margin investors rushing to use their borrowed funds, while another group is pulling out of the markets thinking the bull run is over and doesn't mind paying the capital gain tax. The tug of war between greed and fear is in play again in the last quarter of 2021.



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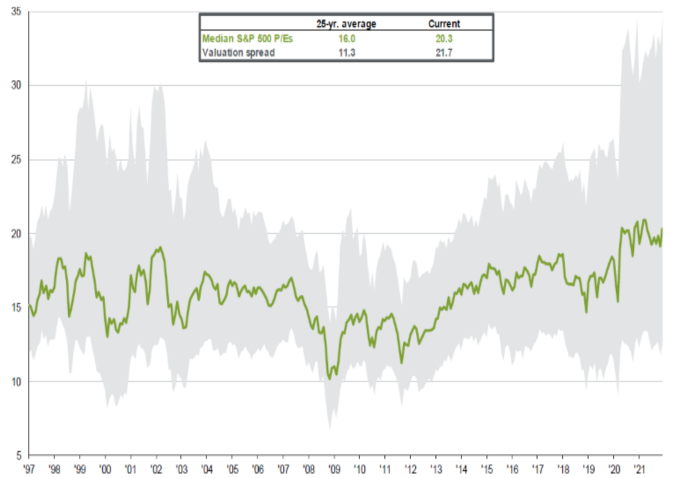
There is much attention on trends related to “working-from-home,” alternative-energy vehicles, cryptocurrencies, anything about semiconductors, and COVID treatments and vaccines. This scenario reminds us of a famous quote by Benjamin Graham: “In the short run, the market is a voting machine, but it is a weighing machine in the long run.” The market has been giving these names the popular vote, and when the pandemic is behind us, will the weighing machine vote for the same ideas? We know the answer is “no” because valuation is the ultimate factor that impacts the long-term return. Expensive purchases cannot always be sold at a higher value. Chart 3 demonstrates the valuation dispersion between expensive and cheap stocks. The height of the gray bar indicates how vast the difference is in valuation. The current dispersion is 92% more than the historical average.

Chart 3 – Valuation dispersion between the 20th and 80th percentile of S&P 500 stocks



Source: JPMorgan Asset Management

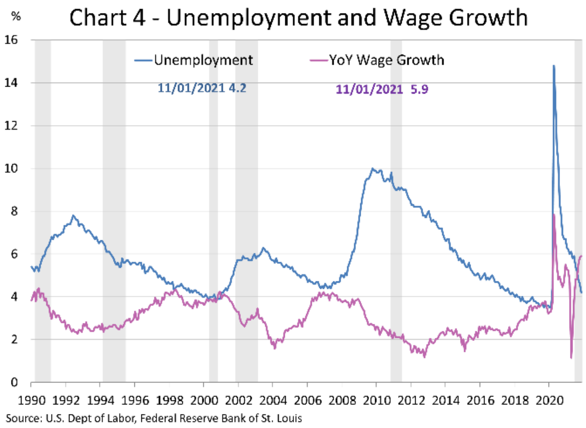
The highly anticipated U.S. infrastructure bill “Build Back Better” did not pass in the Senate, which suddenly reduced the short-term prospect of cyclical sectors. We all agree that the outdated U.S. infrastructure needs improvement, and such projects will create domestic job opportunities. These projects are more straightforward to execute than plans requiring the private sector’s mercy or a significant sum of incentives to move supply chains and factories back to the U.S. We hope a modified version will be discussed and passed.

China’s drastic changes in regulations, some of which were started in 2020, have altered the landscape of several industries: education, internet, the sharing economy, and property development. The news often came first without details, creating uncertainty and impacting investors’ confidence in China. We inevitably see a reduction in the growth prospect for the near future, even for the best operators. The Chinese government gave reasons for their actions – “Common Prosperity” in the coming decade. We won’t know if these new regulations will lead to that goal. But if the Chinese middle class does become richer and achieves a living standard comparable to those in the developed world, there will be plenty of investment opportunities.

Outlook of 2022 and beyond

We are still in the middle of a pandemic, so it seems impossible to see life going back to pre-pandemic conditions. However, we believe 2022 will surprise us on the upside, at least on the “return-to-normalcy” measurement and corporate profitability. First is the pandemic itself. Based on many scientists’ analyses and projections, we believe it is very probable that the pandemic will become an endemic eventually. We can have our daily routine back with regular vaccinations and effective medicines. Keeping that in mind, we believe the countries that maintain strict zero-case policies will start to open and allow normal cross-border traffic; hence, a significant relief for the supply-chain constraint, which is the main reason for the inflation pressure.

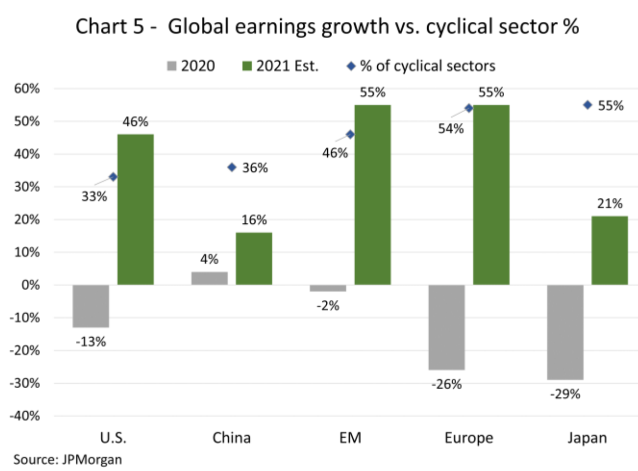
Second is a more balanced demand and supply situation in the labor market. We hear that job seekers are getting choosier during the pandemic with plenty of government support and a shortage in workers. Robots and automation cannot replace traditional labor rapidly without proper planning and investment. However, when things are normal again, companies will go back to the drawing boards to plan a sustainable solution. We believe the bargaining power between employers and the labor force will be more balanced, as shown in the past (see chart 4 for labor market data).



The pandemic severely impacted the healthcare industry, especially treatments requiring new patients to be tested and diagnosed with target diseases or illnesses. Hospitals are often over-run with COVID patients and face a shortage of staff. With COVID potentially more under control in 2022, we think patients will be more inclined to be tested and start their treatments. Many great healthcare companies haven't performed during the pandemic, and we believe they will gather more investors' attention in the coming years with their attractive valuation.

While the valuation of the information technology sector is expensive, there remain gems to be discovered. We like the new internet-centric economy due to its versatility and scalability. These companies attract the brightest minds from universities, and their products and services are not just evolutionary, but also revolutionary. We don't need to go far to find companies that can invest on our behalf. These well-capitalized IT companies can afford to invest for the future without worrying about the short-term industry or economic volatility. Contrary to investing in newly established companies with a price tag based on dream prospects, we believe our disciplined approach will bring similar results but less volatility.

We continue to like consumer-related sectors; these outstanding domestic operators and global brands have been delivering impressive returns for decades. As with everything in life, high-quality products are never cheap, so we need to expand and amplify our antenna in this area. Our investment in the material sector has been rewarding and is the proper strategy in an inflationary environment. These material companies also elevate our average ESG (Environmental, Social, Governance) scores due to their well-recognized efforts in reducing the impact on the environment, ethical practices, and social responsibilities.



As for the international markets, we are still optimistic about the recovery of the European region and the eventual opening of the Asian countries. These economies have higher cyclical sector exposure than the U.S (see chart 5 for the cyclical sector's contribution to the earnings growth in 2021). We believe the cyclical industries will continue to be a significant portion of the earnings growth in international markets since harsher COVID policies were hindering the economic activities. For example, Southern Europe and Southeast Asia, where tourism is a crucial industry and a significant labor employer, will benefit from the eventual border openings and the return of tourists. Furthermore, the cyclical names in these regions haven't enjoyed the same expansion on multiples as in the U.S., making their valuation attractive.

Fixed Income

In its latest meeting, the U.S. Federal Reserve (Fed) announced a faster reduction of its asset purchases, which should conclude by March 2022, and hinted to an earlier and faster increase of interest rates. It admitted that inflation is spreading beyond only goods shortened by the pandemic. In particular, signs of a strong labor market with record high quit numbers and job openings contributed to its decision. It is difficult to foresee for the short-term if people will change their behavior and reenter the labor force, thereby raising the participation rate back to pre-pandemic levels. Based on current Fed and market expectations, we might see three interest rate hikes in 2022 and another two to three hikes in 2023. Other central banks are on a similar path of monetary tightening; for example, the Bank of England recently announced its first interest rate increase and the European Central Bank a step-by-step reduction in asset purchases.

Rising short-term rates might offer better opportunities for fixed income, where valuations continue to be stretched with spreads close to historic low levels across almost every sector. Continuing to invest in shorter duration and variable/floating rate bonds is prudent for now until these higher rates will be realized. In addition, alternative sources of income such as real estate or infrastructure investments might offer better opportunities once higher rates are priced into their valuations.

News in Europe

We would like to congratulate our colleague Bruno Gomez in Spain. He recently earned the EFP (European Financial Planner) designation. Previously he earned the EFA (European Financial Advisor) designation. This is another step in improving our expertise and offering you more service.

Thank You

We appreciate your trust and efforts in introducing Noesis to your friends and families. We hope you and your family stay safe and have many years of happiness and prosperity to come. Please contact us with your questions.

Sincerely yours,

Shihfang Chuang

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