Demming
Financial Services Corp.

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4TH QUARTER 2021

Special Notes:

Please be sure to send your 2021 Taxes to info@demmingfinancial.com once they are completed.

As a friendly reminder, for your protection, it is our ongoing policy that any requests for funds sent to us via email will also be confirmed by phone.

We are planning on hosting future events, so if you would be interested in attending, please send an email to Sandy.

Demming Dispatch

We hope that everyone had a wonderful holiday season, and a happy new year! Here are some things to look forward to at the start of 2022

- We have officially launched our first blog post! You can view it by clicking this link, or you can visit demmingfinancial.com and go to our 'Demming This Week' page.

- We are continuing to improve our technology and internal processes to provide the best service and information to our clients.

- Follow us on LinkedIn to stay up to date with blog posts, news, and more.

- You can access the Client Portal via our website. This is the easiest way to access the Vault to upload documentation securely, as well as view your accounts. If you still need assistance setting up your account, please contact sandy@demmingfinancial.com.

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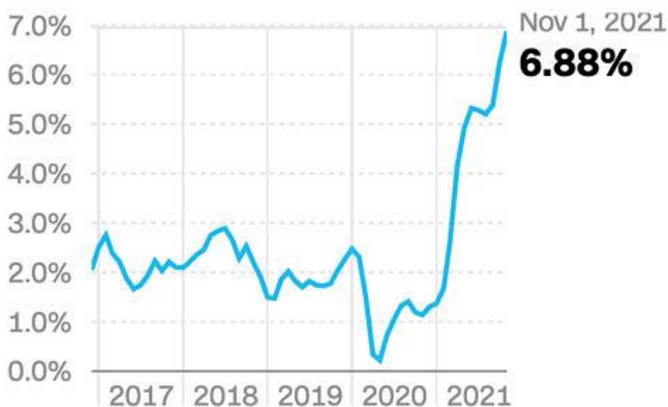
Food Inflation on the Uptick

If you haven't been to a grocery store in the past year, you might not be aware that the cost of groceries has gone up an aggregate 5.4% in the past year, and the prices of staples like meat, dairy, eggs, sugar and coffee have surged even faster. In just under a year, the average cost of a pound of bacon has gone up from $5.72 to $7.32, while a dozen eggs now cost, on average, $1.82, up from $1.41. That's a 28% and 29% rise in price, respectively. The U.S. economy hasn't seen that kind of food inflation in 31 years.

Consumer price index (CPI)

What's the value of a US dollar? The Consumer Price Index is helpful in answering that question because it measures how prices change over time. It's a key measure of inflation, calculated to include housing, food, gas, transportation and a wide range of other goods and services.



Note: Percent change from year ago, seasonally adjusted
Source: US Bureau of Labor Statistics via FRED
Data as of December 10, 2021

Of course, food tends to be the most visible indicator of inflation for most Americans, since most of us buy groceries every week and sometimes every day. The dramatic rises have made it harder for the U.S. government to argue that inflation is 'transitory,' especially when there are reports that meat processors are struggling to attract and retain workers, and there is stiff competition for workers and rising wages in the manufacturing sector overall.

It's still possible that labor and supply shortages will moderate, and supply chain problems will eventually be resolved whenever we finally get Covid under control. But with food production workers receiving higher wages, we also can't expect food prices to go back to where they were last year.

The End of the Buying Spree?

You might be reading about the internal debate at the Federal Reserve Board about when and how to 'shrink its balance sheet,' which will (articles tell us) have some mysteriously negative impact on the U.S. investment markets. But what are they actually talking about?

The Fed is, of course, the U.S. central bank, which is granted unlimited purchasing power, and which also can make unlimited funds available to banks in the form of (generally low-interest) loans. These powers were fully deployed during the market downturn in 2008-9, when the reckless real estate bets by the major brokerage firms very nearly toppled the global economy. Then came Covid. The Fed acted as the major buyer of U.S. Treasury securities, which effectively held down their rates (it bid competitively on the low end) and also purchased massive amounts of mortgage-backed securities from Freddie Mac and Fannie Mae, which, in turn, buy loans from banks, which makes housing credit more readily available and has had the effect of driving down mortgage rates.

You can see from the graphic that the Fed has ramped up its buying spree in the past couple of years, to the extent that it now owns an extraordinary $8.7 trillion worth of bonds overall, including more than 22% of all U.S. government bonds outstanding. But the interesting part is how this has disrupted the normal market forces of supply and demand.

Meaning? A normal bond buyer (that is, everyone except the Fed) wants to get the highest rate possible, so there is usually an equilibrium among greedy and less-greedy buyers where the auction ultimately delivers a fair price, usually some percentage over the current inflation rate. At today's 6.2% rate of inflation (over the last 12 months), that would imply a 10-year Treasury bond yield somewhere in the 7-8% range, which would allow for a small profit over inflation. But with the Fed putting in bids way below what most investors would be willing to accept, the actual yield, today, is below 1.5%. This is why you will hear dark muttering from some economists that the Fed is interfering with the natural workings of the marketplace.

So what does this have to do with the Fed 'shrinking its balance sheet?' If the U.S. central bank were to stop buying Treasuries altogether, it's possible—even probable—that government bond rates would jump many multiples of where they are today, to the point where investors were once again earning a fair return after inflation. If the Fed were to go further, and actually start selling off its massive bond holdings, it would flood the market with bonds, potentially creating a massive buyer's market where the buyers could set the prices—which could drive rates even higher.

But how would that affect the equities markets? In two ways. First, if investors could buy safe, totally secure returns of, say, 8% a year, wouldn't they be motivated to shift at least some of their holdings from volatile stocks to risk-free bonds? If that triggered a major selloff in stocks, it would create a new buyer's market, where stock buyers can wait for stocks to drop to more attractive prices before jumping in to buy the dip.

The other impact would be on the U.S. government debt, which currently stands at a record $28.43 trillion. What happens if the government is paying 7% on that debt instead of 1.5%? The debt would quickly spiral out of control, alarming taxpayers and potentially (certainly?) leading to higher tax rates.

Of course, Fed economists are highly aware of their potential impact on the government's debt and investment markets, and are motivated to tread very lightly. The most recent announcement unveiled plans to scale back purchases by a minuscule $30 billion a month Reducing the balance sheet, it seems, actually means increasing it less rapidly than in the recent past, gradually buying fewer and fewer government securities while holding what the Fed already owns to maturity. It's probably going to take a very long time to unwind an $8 trillion balance sheet, but it's not out of the question that even a modest step in that direction will spook investors who are carefully watching to see how this drama plays out.

2021 Investment Report

We've been seeing a lot of cartoons and jokes lately about how it has felt like Groundhog Day, with 2021 being basically a repeat of 2020. The reference, of course, is to the Covid pandemic, which raged through 2020 and then, when we all expected a return to normalcy, once again peaked (twice) during 2021 with the Delta and Omicron variants. But the Groundhog Day analogy could just as easily be applied to the investment markets.

A breakdown shows that just about every U.S. investment asset was up strongly for the second year in a row. The Wilshire 5000 Total Market Index—the broadest measure of U.S. stocks—gained 9.58% in the 4th quarter, finishing the year with a hefty 26.70% gain, similar to the 20.82% return we experienced in 2020. The comparable Russell 3000 index was up 25.66% for the year after posting a 20.89% in the previous year.

Looking at large cap stocks, the Wilshire U.S. 2500 Large Cap index was up 9.78% in the fourth quarter, paving the way for a 26.76% return for the year, after the previous year's 20+% return. The Russell 1000 large-cap index finished the year with a similar 26.45% gain, the second 20%+ gain in a row, while the widely-quoted S&P 500 index of large company stocks gained 10.65% during the year's final quarter and overall finished up 26.89% in calendar 2021.

Meanwhile, the Russell Midcap Index finished the 2021 calendar year up 22.58%.

As measured by the Wilshire U.S. Small-Cap index, investors in smaller companies posted 19.24% gains for the most recent year. The comparable Russell 2000 Small-Cap Index posted a 14.82% gain in the past 12 months. The technology-heavy Nasdaq Composite Index 8.28% in the final three months of the year, to finish with a total return of 21.39%.

The foreign markets were not quite so generous to investors. The broad-based EAFE index of companies in developed foreign economies gained 2.40% in the final quarter of 2021, to finish up 8.26% in dollar terms for the year just ended. In aggregate, European stocks were up a healthy 12.72% in 2021, while EAFE's Far East Index was down 0.76%. Emerging market stocks of less developed countries, as represented by the EAFE EM index, lost 4.59% in dollar terms in the year.

Other investment categories produced some phenomenal gains, albeit for small portions of most investment portfolios. Real estate, as measured by the Wilshire U.S. REIT index, posted a 17.14% gain during the year's final quarter, finishing a strong recovery year up 46.18% after a 7.90% loss in 2020. The S&P GSCI index, which measures commodities returns, gained 1.51% in the 4th quarter, but ended the year up 40.35%.

In the bond markets, yields on 10-year Treasury bonds rose modestly during the year, from 0.95% a year ago to 1.51% currently. 30-year government bonds are yielding just 1.88%. Five-year municipal bonds are providing, on average, a meager 0.60% yield, while 30-year munis are yielding 1.54% on average.

By all accounts, we are in an extraordinary period of investment history. The markets, as measured by the S&P 500 index, have now doubled since New Year's 2018, and it is hard to find three years to match the three year record of 28.88% (2019), 16.26% (2020) and 26.89% (2021) returns that index investors have enjoyed during this remarkable stretch. The widely-quoted proxy for U.S. market returns closed at a record level 69 times in the past 12 months, which is a recipe for spoiled investors to expect more of the same. Yet few would suggest that stocks are cheap at the moment; by one measure, the Price/Earnings ratio of the S&P 500 index is just over 30, which is about 70% above the modern-era market average of 19.6.

With interest rates and bond yields at rock bottom, investors seem to have decided that stocks are the only way to make money in their investment portfolios. But the current valuations suggest that high returns won't last forever, even if there are few warning signs on the economic horizon. One concern is inflation, which—as you can see from the graph—has spiked over the last 12 months to levels not seen

since the old "stagflation" days of the 1980s. But if we look at the health of the economy, the U.S. real gross domestic product has largely recovered its former trajectory (see graph) after a steep decline in the spring months of 2020. The unemployment rate (third graph) is moving steadily down toward the record lows that the economy had reached before Covid reared its ugly head, and the US payroll numbers are clearly on the rise (fourth graph) as well. Growth forecasts for the fourth quarter of 2021 range as high as a 7.5% annualized rate, which is about as bullish a report as you will ever hear from the normally sober crowd of professional economists.

It is possible to wonder whether companies will be able to maintain their rising profit margin trajectory with the shortage of workers and the resulting higher salaries throughout the economy. Unit labor costs rose a remarkable 9.6% in the third quarter of 2021 (the most recent statistics we have), and productivity (which is a function of the cost of labor) accordingly dropped 5.2%. In manufacturing, unit labor costs were up 4.6% and productivity decreased 1.8%.

Another worry is whether the U.S. central bank's promise to reduce its stimulus measures in 2022 will cause interest rates to rise. Some economists believe that a global glut of saved cash will lead to a demand for longer-term bonds; by the laws of supply and demand, this could keep 10-year yields at or below 2% in the coming year. But these are tricky predictions; it is possible that bond investors will be able to demand higher yields once they are no longer negotiating against the Federal Reserve Board's unlimited deep pockets and indifference to returns.

Meanwhile, who knows what to expect from the wild cards that have so far had little impact on our financial landscape? Covid is peaking again, with the new Omicron variant potentially creating the largest spike in the pandemic to date; nobody knows what the economic impact will be when the final measurement comes back a few months hence. Billions of dollars are locked up in various cryptocurrencies (there are more than 700 of them currently), and the recent severe price downturn might cause some investors to cash out of their stock portfolios. Meme stocks are still trading at crazy valuations, which so far have had little impact on the broader market, and there are continuing worries about supply chain disruptions and the future health of the Chinese economy.

This is a long way of saying that the signs are mixed going into 2022, but when has it been otherwise? If there's one lesson for us to take from this long, extended period of market prosperity, it is that the future is unknown, and the surprises more often favor the upside than the downside. We might be heading into a mild recession, or we might experience more booming economic growth. The markets will certainly pull back at some point, but that prediction has been made for each of the years that have contributed to the recent 100% growth in stock values. A steady course has been surprisingly beneficial to investors in the face of many worries, but perhaps we shouldn't be surprised, since that has always, long-term, been the winning investment strategy.

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Cartoons by: *Harley Schwadron*

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