HORAN Capital Advisors

Quarterly Investor Letter

WINTER 2021

"If you can't explain it simply, you don't understand it well enough."
- Albert Einstein

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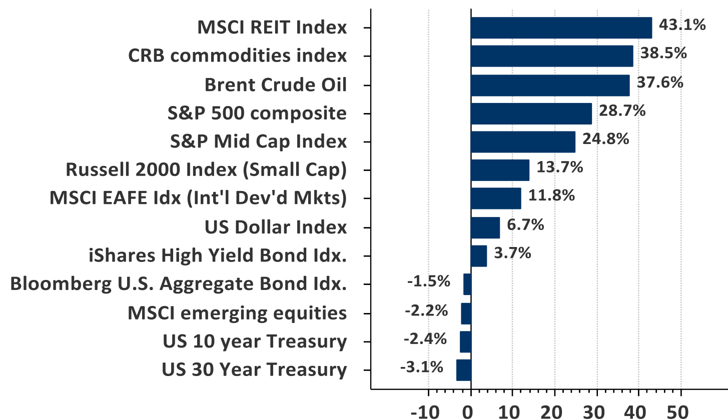
Seven Positive Quarters

The U.S. large cap equity market, as measured by the S&P 500 Index, showed its resilience in the fourth quarter by returning 11.0%. This marked the seventh consecutive positive quarter for the index since the pandemic lows. As the near chart shows, this seven quarter positive streak is not that uncommon of late as there have been two nine quarter streaks since 2013. Since 1950 there have only been six of these seven-quarter winning streaks for the S&P 500 Index. According to LPL Research, two quarters later the S&P 500 Index was up 100% of the time with an average return of 8.5% and up 83% of the time four quarters later with an average gain of 14.1%. For the 2021 calendar year, the S&P 500 Index was up 28.7% after an 18.4% return in 2020 and a 31.5% return in 2019. This has been the best three year return since the late 1990s. Further resilience is seen in the S&P 500's largest decline in 2021 was just over 5% while the average intra-year decline since 1980 is 14.0%.

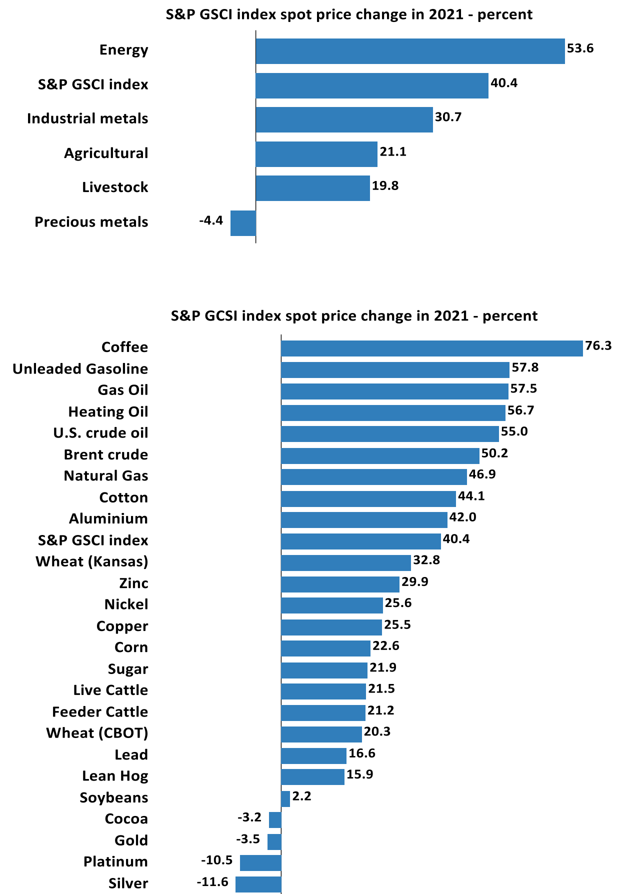
The second chart to the right highlights the return achieved in various asset classes last year. The MSCI REIT Index is the standout on the list generating a return of 43.1% in 2021, followed by the CRB Commmodity Index return of 38.5%, and Oil up 37.6%.

The U.S. equity market categories were the best equity markets with the large cap S&P 500 Index up 28.7%, followed by U.S. mid cap and small cap asset classes. At the bottom of the list are 10-year and 30-year U.S. Treasury Bonds. Bonds overall were a difficult asset class for investors. The Bloomberg Aggregate Bond Index was down 1.5% in 2021. This was only the fourth calendar year negative return since the Aggregate Index's inception in 1977.

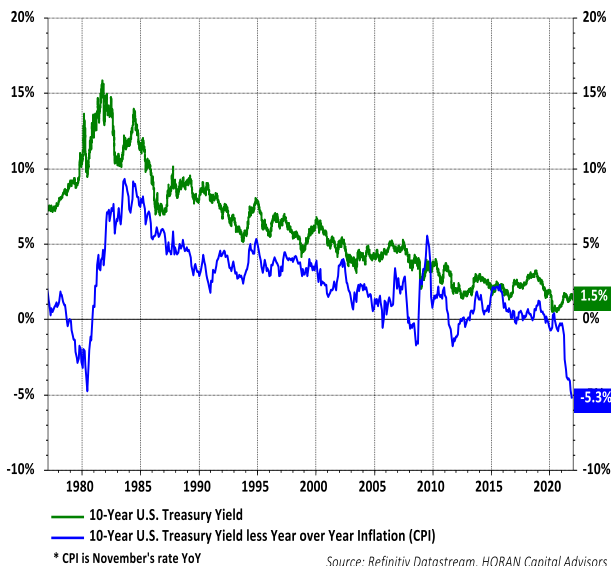


Inflation and The Fed

A headline topic throughout this past year has been the increase in inflation. The most hotly debated thought is whether this inflation is "transitory." In prior Investor Letters we discussed factors contributing to the increased inflationary pressure, such as clogged supply chains, near-term product shortages and elevated energy prices. Some of these near-term pressures have translated into rising labor costs which are more systemic. The inflation issue can be a double-edged sword. When the pandemic hit the U.S. in early 2020, the Federal Reserve and U.S. government pursued extrordinary stimulative policies. Interest rates were slashed to near zero percent and stimulus was injected into the economy. At that time, the Fed indicated rates could remain pegged near zero percent until 2023. On a year over year basis, inflation is now running at 6.9% as of the latest November report. The higher level of inflation has garnered the attention of the Federal Reserve, and now the Fed is indicating higher rates in 2022. Expectations are the Fed will raise rates three times. We believe overall inflation, and the rate of change in prices, will likely subside later this year as economic growth slows. Despite a slowing of growth and inflation, the Fed will likely increase rates to reduce stimulus to the economy and provide room for rate decreases in the future (i.e., at the next recession).



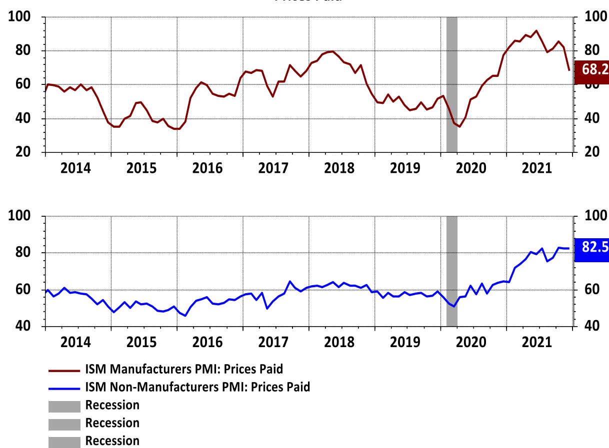
The unprecedented stimulus both in the U.S. and worldwide significantly reduced the negative impact of the economic shutdown. The fiscal and monetary support in the U.S. alone totaled $12 trillion or 54% of U.S. GDP. On one hand, stimulus provided through the pandemic served as support for families negatively impacted by business shutdowns. On the other hand, the extra funds allowed for spending to continue during the shutdown which led to reduced inventories in a number of segments of the economy. The rebuilding of inventories has contributed to the well publicized port backlogs. Also, with manufacturing businesses shuttered during the pandemic, companies were unable to purchase product and materials to rebuild inventories. With depleted inventories, and more dollars chasing fewer goods, prices have risen. This is seen in the broad commodity price inflation detailed in the chart above.

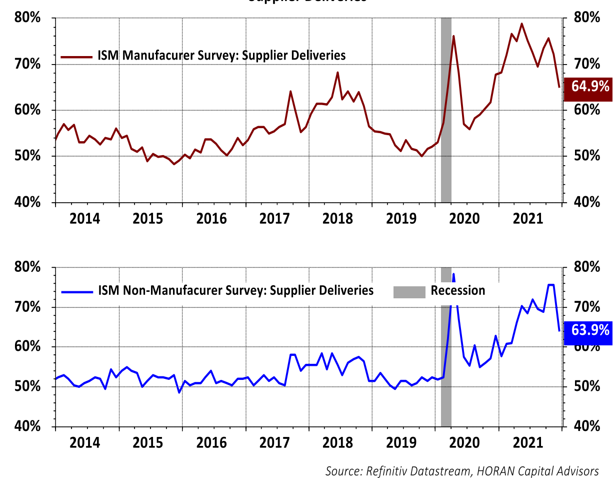


For the bond market, inflation is detrimental to returns, especially fixed rate bonds. As noted earlier, the Bloomberg Aggregate Index generated a negative return in 2021 for only the fourth time since its inception in 1977. For bond investors looking for income, most bond yields are far below the level necessary to beat inflation. The near chart shows the yield on a 10-Year U.S. Treasury Bond was around 1.5% at the end of 2021. Real returns were much worse when factoring in inflation, resulting in an after-inflation or real yield of negative 5.3%. Inflation is not nearly as bad for equities as companies generally are able to pass on increased product costs via higher selling prices.

Business Activity Cooling

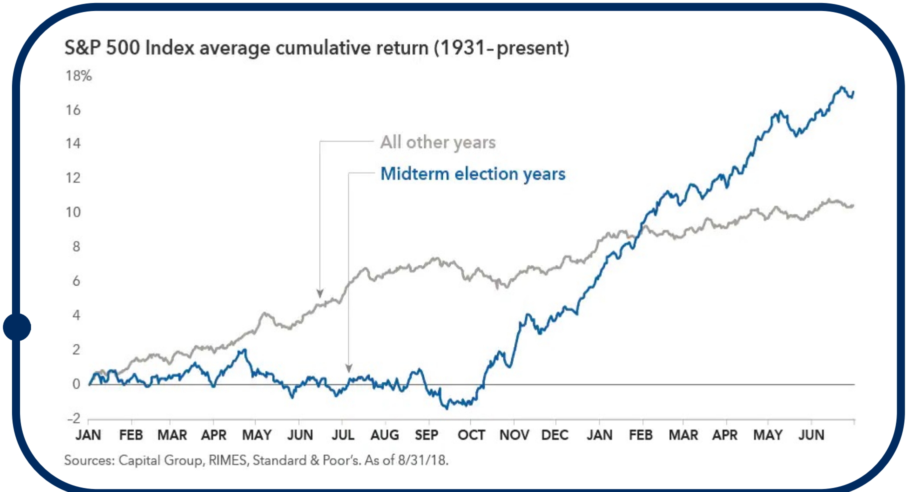
With consumer demand for goods remaining strong, it seems the supply side of the economy is where the inflation pressure is being created. Recent ISM (Institute For Supply Management) Purchasing Managers Index surveys are providing a glimpse of some inflation relief. The December ISM Manufacurers PMI survey on Prices Paid showed a smaller percentage of firms are paying higher prices for inputs. The survey asked whether firms are paying higher, the same, or lower prices. The survey showed 47% of the firms said higher, down from 67.9% in November, and 72.3% in October. On the services side, or non-manufacturer PMI Survey, prices paid remained elevated. Supplier deliveries remain elevated as well; however, manufacturer and services deliveries are trending down toward 50%, and readings below 50% indicate faster deliveries.





A Mid-Term Election Year

The coming year will represent a mid-term election year in the U.S. An undetermined outcome early in the year may lead to elevated equity market volatility. As the mid-term election approaches, the equity market tends to move higher as the uncertainty fades. The blue line on the near chart shows the average return going back to 1931 during mid-term election years. A choppy sideways market tends to be the result until mid-October after which the market enjoys a strong advance. According to a Capital Group report, the one year period following the mid-term election sees the market generate an average return of 15.1%, far above the 6.8% average return for all other years. As we have noted in the past, political outcomes have a limited long-term impact on equity market returns as markets are influenced more by company operating activities in the long run.



Long-Term Investors

The equity markets have been rewarding for investors over the last three years in spite of the significant headwinds from the pandemic. With massive stimulus, record amount of cash and liquidity in the system, and bond investments providing little competition for stocks, equity investors have been handsomely rewarded. Most client balanced accounts have seen an increase in value in the 45-55% range over the last three years.

As fourth quarter 2021 earnings are reported this quarter, earnings for S&P 500 companies are expected to be up 26% in 2021 versus 2020. The sizeable increase is not likely to be repeated in 2022. Earnings expectations in 2022 for S&P 500 companies are currently in the high single digits. The slowing earnings growth will be a factor companies and the market will contend with this year. Navigating cost pressures, labor availability, and supply chain issues will be a differentiator for companies. Those companies that effectively handle these issues could have another good year in 2022. Since the end of the Great Financial Crisis in 2009, the S&P 500 Index has only had one negative year and that was a single digit decline of 4.4% in 2018. Interest rate increases may result in short-term equity market volatility, but we believe a move higher in short-term rates to 1% – 1.5% should not be a long-term headwind for equities.

Thank you for your continued confidence and support in HORAN Capital Advisors. We are always available to answer your questions and discuss our outlook further. Please be sure to visit us for company news, reports, and our blog at https://horanassoc.com/insights/market-commentary-blog.

Respectfully,
HORAN Capital Advisors

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