RBC Wealth Management
The Crescent Group
Carsten Frederiksen, CFP®
Senior Vice President
Financial Advisor
Senior Portfolio Manager
Portfolio Focus
Direct: 214-775-6401
NMLS#: 1321563 City National Bank
The Crescent Group website

Paul Hendershot
Senior Vice President
Financial Advisor
Senior Portfolio Manager
Portfolio Focus
NMLS # 1370978 City National Bank

Lindsey Vickers, MBA
Client Service Associate
214-775-6458

Andrew Ielmini
Investment Associate
214-775-6448

December 2021 Crescent Commentary

"I consider this as being even crazier than the dot-com boom, which blew up in 2000". – Billionaire investor Charlie Munger, 12/3/21[1]

As with all years, 2021 had its share of unexpected twists and turns. The year began with the roll out of covid vaccines around the world. Societies reopened and economies recovered. By contrast, Covid variants emerged and still are emerging. Whether or not you agree with peoples' and governments' reactions to covid variants, react they did, and it caused turbulence in global economies and changes in expectations. Partly as a result of covid supply chain disruptions and stimulus, our country witnessed the emergence of inflation that we haven't seen in forty years. And to end the year, we've witnessed a major shift in financial and economic policies to combat inflation[2].

A common question investors ask financial professionals at the end of the year is what we expect for the upcoming year. The problem is that experts usually get it wrong with expectations. Take the Federal Reserve. They said for a year that they expected inflation to be transitory. But in November, the Fed admitted they were wrong about transitory inflation and said they would combat it by more quickly withdrawing financial stimulus. Central banks in other countries have already begun withdrawing financial stimulus by raising interest rates. This put an immediate damper on some financial assets that had been partying too hard for too long with help from government stimulus[3].

For the past thirteen years since the 2008 financial crisis, world governments have endlessly stimulated their economies even after they healed from the crisis. Until this year, there had been no apparent negative consequences from this over stimulation. In terms of our expectations for 2022, the main question as we sit here today is whether high inflation will persist and governments will be forced to withdraw economic stimulus more rapidly than expected in order to tame inflation. If that were to happen, it would mark a change in the status quo investment climate of the past thirteen years.

One consequence of chronic financial stimulus has been asset price inflation and financial bubbles. You can see it not just in certain segments of the stock market, but also in bidding wars for homes and excitement from the general public over assets with no fundamental underpinning. In a 1999 survey, individual investors said they expected stocks to return 16.6% a year going forward.

Instead, U.S. stocks generated a loss for the following decade. Today, individual investors as a whole expect an annual return of 14.5% above inflation, which comes out to a number higher than the 1999 expectation. The expectations in 1999 and the expectations today share something: they're too high. Since the year 1900, U.S. stocks have returned an average of 7% a year. Nothing has fundamentally changed with the global economy to where that 7% number should be different for the long-term future. Returns have been above-average over the past twelve years partly as a result of chronic economic stimulus[1][4][5][6].

Considering that governments may be forced to reduce chronic economic stimulus in order to fight inflation, how should an investor position themselves in an uncertain world? We think investors should approach that question with a heavy dose of humility. Our Group certainly does not expect to predict the future any better than anyone else. For that reason, we think the best course of action is to invest in a manner that gives you the best chance of a good outcome, no matter what happens.

What does that mean? It means owning assets likely to do well with or without continued stimulus. To figure out what that is, we need to look to history. How far back? It's been forty years since the U.S. battled the current level of inflation, so the 1970s are a good starting point.

During the 1970s, the U.S. experienced a period of high inflation, slow economic growth (known as stagflation), and rising interest rates (a reduction of economic stimulus). As a result of these challenges, the Dow Jones stock index was flat from 1972 to 1982. Yet investors who reinvested dividends over that time period earned a 69% return over that decade, rather than the zero percent return of the index. A more recent time period of economic challenge to look at would be the 1999 to 2009 decade. The withdrawal of financial stimulus by the Fed precipitated the bursting of the technology bubble in the late 1990's, and that was followed by a bursting of a home price bubble a few years later. Although U.S. stocks as a whole fell 7% over those ten years, individual sectors generated gains over that period, with Consumer Staples increasing 66%, Health Care increasing 30%, and Industrials increasing 8%. Most recently, during 2018, the Fed started withdrawing its interest rate stimulus and sparked a 34% decline in some of the stock market's most popular and overvalued investments, with U.S. stocks as a whole falling 20%. This market decline spooked the Fed, and they quickly back pedaled and came up with excuses for why they needed to resume unnecessary interest rate stimulus, which has fueled further continued speculation in financial assets to this day[7][8][9].

The main question now is whether persistent high inflation will force the Fed to reduce its economic stimulus. That would mark a stark change in the investment status quo of the past thirteen years. We believe our clients are positioned to do well in such a more challenged investment climate. As we've said before, we view the current stock market as a seesaw with the most popular and overvalued assets high and poised for challenges – and with high quality but unexciting investments low and reasonably priced and poised to do well over time.

And what if the opposite happens? What if inflation declines and the Fed can continue to stimulate the seemingly endless financial party of the past twelve years? Financial speculation will likely intensify. But our Group's investments will remain poised to do well. Although our core mundane investments don't generate a lot of excitement, they do generate high returns over time. They provide essential products and services that people clamor for all over the world. They are resistant to technological obsolescence, yet benefit from using new technology to operate their businesses more efficiently and profitably. They have strong brands with pricing power and have consistently raised prices 5% to 10% during the current inflationary period. Emerging markets are behind on the covid economic recovery curve, and the recovery of those markets will provide a tailwind to our core investments, which serve those markets. And finally, if the financial stimulus party continues, our core investments will continue with their trend of premiumization, offering the type of premium and luxury products consumers demand during a hot economy (to understand premiumization, take a look at your toothpaste tube – it's likely half the size and twice the price of the tubes you bought twenty years ago)[10].

Billionaire investor Charlie Munger celebrated his 97th birthday this year. He's seen more happen with investment markets than almost any living person. As we mentioned earlier, he recently described the current investment climate as "even crazier" than the 1990s bubble. As we look to the future, we know our nation will go through a period of hardship at some point. Our economy simply can't go on indefinitely in the current overheated state. But we remain steadfastly confident in the ability of our core investments to deliver the results you depend upon in order to protect and intelligently grow your irreplaceable wealth[1].

The Crescent Group
Carsten Frederiksen, CFP® | Paul Hendershot | Andrew Ielmini | Lindsey Vickers, MBA

Sources:

(1) Morningstar
(2) NPR
(3) Fortune
(4) Gallup
(5) Natixis
(6) S&P Dow Jones Indices LLC
(7) Roger Thomas
(8) Richard Bernstein Advisors
(9) Yahoo Finance
(10) Company reports

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