Palacios' Perspectives

Week ending December 31st, 2021

XCEL WEALTH MANAGEMENT
A REGISTERED INVESTMENT ADVISORY FIRM

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From Wall Street to Main Street

Market / Macro Economic Summary

As we ended trading for 2021, I figured this week's edition will serve as both a recap of 2021 and a look forward to my thoughts for 2022. For starters, below is the performance for the three indexes for 2021:

S&P 500 -- 26.89%
Dow Jones Industrial Average -- 18.73%
Nasdaq 100 -- 21.39%

Now, each year I try to explain to readers certain items that I cover in each of the newsletters, so I might as well take the time now to explain the three indexes and their significance. In essence, the three indexes cover different parts of the economy with some overlaps. Let me start with the S&P 500. As the name implies, there are five hundred different stocks that are included in this index. More specifically, these are the largest five hundred U.S. based companies and names who most investors (even novices) would recognize: Amazon, Walmart, Apple, Microsoft, Deere, Google, Bank of America to name a few. By numeric contrast the Dow Jones only has 30 stocks, so it's a little more selective. It tries to accurately reflect the US economy, so it's a little more industrial related as the name implies. Names in the thirty include Salesforce, IBM, McDonalds's, Disney, Microsoft, Nike. The last index is the Nasdaq which is more of a technology-based index and avoids financials (commercial and investment banks). 56% of stocks in this sector deal with technology and innovation. Names here include Apple, Microsoft, Amazon, Tesla, Google, Nvidia, Paypal and Adobe.

There is one more index that I want to cover that I don't normally speak about, but I believe is relevant to the current discussion. The Russell 2000 is an index that, as the name implies, covers over 2000 publicly traded stocks. The reason I bring it up is because although there are close to 6,000 publicly traded stocks, the Russell can give an investor access to smaller companies that haven't quite made it to be the largest of stocks in the U.S.

This time last year I thought 2021 was supposed to be an 8%-10% growth year. The actual performance far exceeded my expectations. What I did not anticipate was the Federal Reserve and Federal Government's continued support of the economy from the effects of Covid. Even with current variants still in play, the economy is now fending more and more for itself. The Federal Reserve is now turning its attention towards inflation, which is more of a pressing issue as prices across the board seem to be increasing. As I have mentioned before, the Fed's main response to fight inflation is to increase interest rates; this would cause the economy to slow a bit and minimize those price hikes. By definition, though, these higher interest rates should affect the stock markets a bit, so it is important to keep this background in mind when discussing how I see things playing out in 2022.

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Expectations for 2022

So, we know several things going into the new year. The Federal Reserve will be motivated to do their part to decrease inflation and the Federal government is clearly gridlocked for additional stimulus, which we can agree is less and less needed by our economy. I will say this, there are certain parts of the inflation formula that regardless of what the Fed does, it will not be able to control. Labor inflation is here to stay; there no such thing as hiring someone for $15 per hour today and then telling them 6 months later that their pay is $10 per hour. Fuel prices, milk, corn, lumber are all things that can be impacted and have seen rises and declines. Remember when lumber went from $800 per thousand board feet and rose to over $1,686 on May 7th? Now it's down to $1,163. So, there can be drastic rises and declines.

What I want to focus on is why higher interest rates affect stock prices. For starters, we must realize that stock prices (while measured daily) are really a "net present value" of future cash flows for each company. This is why when a company reports earnings and says, for example, "we expect revenues to increase" ...a stock goes higher. The market acknowledges there will be more income in the future and as it re-runs the net present value of the "now known" higher cash flows, current stock price should be higher. Lastly, part of this calculation is a "discount rate" that is used in calculating the net present value. As interest rates rise, so does the discount rate. I'll give you an example: $100 given to me in one year, and having a 3% discount rate, would mean the net present value is $97.09. This means it's the same thing if I were given $97.09 today or $100 in one year from now. If the discount rate goes up to 5%, it would be equal to accepting $95.24 today or $100 a year from now. I hope this helps to explain how analyst use the new numbers that are reported each quarter and adjust their calculations for their projected stock prices or targets.

Finally, let's discuss implication to 2022 returns. Higher interest rates mean banks should do better, especially those that have high amounts of variable interest rate loans. Credit card companies would also benefit. Companies that can increase prices due to inflation, such as consumer products companies and oil companies, will also do well. The difficulty is that higher rates will impact growth stocks, but in the same way across the board. There are specific areas of technology that will still be able to do well… think companies that help drive costs down, help protect company information (cyber security), etc.

I believe 2020 is shaping up to be more of what I had initially expected last year, 8%-10% should be the expected market returns. This isn't an exact science, so who knows if I will be correct. But I will insist on one thing……it is BEST to be selective with investments and pick and choose where to place money. This year will be critical for active money managers, like ourselves, because it is easier for us to avoid stocks that we know would have a hard time during a rising interest rate environment and focus on those that will tend to do well.

Regards,

E. Palacios

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