MACRO MARKET UPDATE

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There was nothing ordinary about the year 2021. Whether it was the unprecedented global vaccine initiative or the epic rise and fall of the meme stocks, the year that started with the dramatic change of guard in Washington could only end with no change at all in your taxes.

While there are many things that the year 2021 will be remembered for in the history books, the story of the rise in inflation should matter the most to long-term investors. At the start of the year, inflation was at 1.36%. By the end of the year, inflation was at 7%. That is over a 500% change in the inflation rate over one year.

Cause of Current Inflation

In my opinion, three factors played a significant role in this inflation disaster.

1. **Excessive Demand** - unprecedented federal and monetary stimulus injected into the global economy to recover from the pandemic.
2. **Limited Supply** - supply chain and labor shortage issues caused by the forced economic shutdown.
3. **Denial by Central Banks** - the constant state of denial that the Federal Reserve and other central banks chose to be in for most of 2021 year.

Ray of hope

While the 500% rise in inflation rate shocked market participants and economists worldwide, a ray of hope started to emerge in the latter half of the year. In July of 2021, when inflation was at 5.6%, it was clear that the Federal Reserve was no longer confident to stand behind its "inflation being transitory stance" anymore. Slowly over the last two quarters, Federal Reserve chairman Powell did a remarkable 180-degree pivot that took the central bank into a completely different track of rate hikes and monetary tightening.

Other pressures on inflation have also started to show rays of hope. The Federal Reserve's recent pivot and Congress' general lack of appetite for new stimulus programs indicate that government interventions would no longer worsen the demand problem.

Pressures on the supply side of inflation are also starting to show hope. The labor market pressures are slowly showing signs of easing as people are more willing to return to work after vaccinations and the expiration of unemployment benefits. Governments worldwide have also started to show reluctance toward using an economic shutdown as a measure of dealing with the recent surge of the Omicron virus. Thus, there is more confidence in the market that supply chain disruption problems won't worsen anytime soon.

I purposely call these rays of hope because, until now, there has been no real improvement in the inflation or labor force participation levels. But with all these positive signs, the inflation pressure will likely start to ease into this year and beyond.

While no one believes that inflation levels will go back to the pre-pandemic rates anytime soon, a relief in inflation pressure does ease most of the concerns that market participants' had all through 2021. By the end of the year, almost everyone in the financial markets started taking a more defensive stance due to the uncertain inflationary problems.

Cost of the Fed Pivot

This corrective action by Fed is no small change. While I firmly believe that it will help us get off the course of the disastrous hyperinflation scenario, it also comes with a higher interest rate and thus higher levels of volatility in the near term.

Specifically, the market expects the Federal Reserve to increase interest rates three times next year and another two times in 2023. In addition, the Fed is expected to wind down its bond-buying program entirely by March of this year, much earlier than initially expected. Please see my detailed explanation of the bond buyback program in the last quarter's outlook video if you missed it.

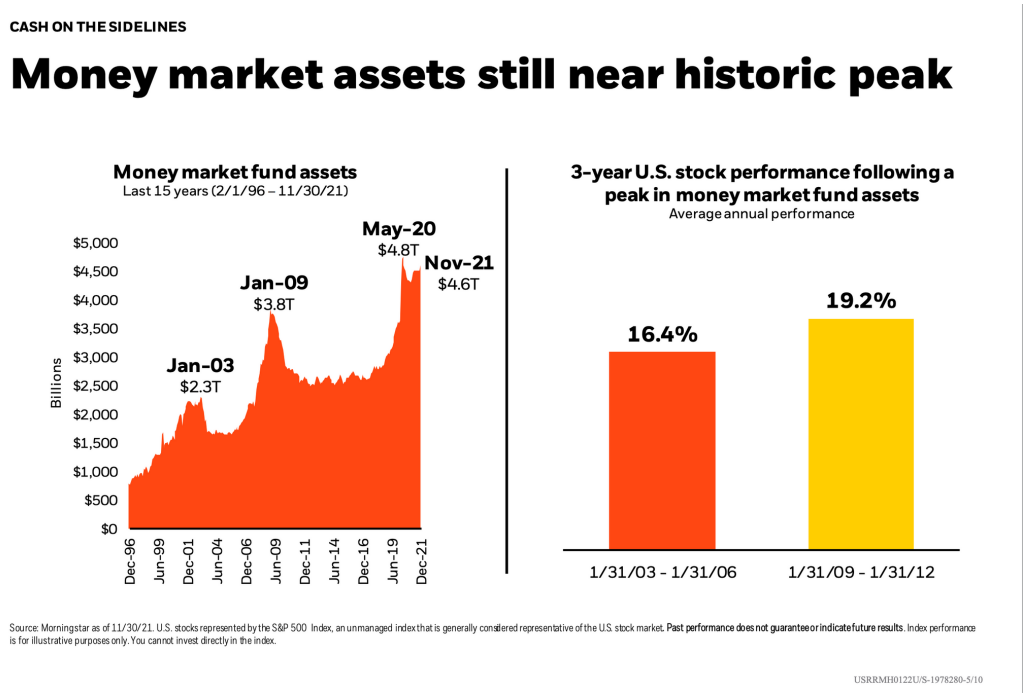
The normal effect of such tightening action by the central bank is a slowdown of the economy. As rates go up, money becomes more expensive, and thus, less money is spent on goods and services. Some market participants are currently raising concerns about such an economic slowdown due to the tightening of the fed.

A Bullish Case for Equities

These times are anything but normal. Those market participants taking the default negative outlook of the equity markets based on history are missing key distinguishing factors of our current times. Allow me to make my case of why the outcome could be very different this time.

1. **Hyperinflation worries diminishing due to Fed intervention**
   As I have said before, coming into this fed pivot, the biggest market concern was the rising tide of inflation. I would argue that many participants were holding back on making investments into equity markets because of their concern around the negative effects of hyperinflation. That pressure is relieved by this move from the Federal Reserve. Thus, making it much easier to allocate cash into equities where valuations are still reasonable.

2. **High levels of cash in Money Market Fund**
   Assets parked in money market funds are a good barometer of future market trends. Historically if there are very high levels of cash parked in money market funds, eventually it makes its way back into the equity markets. Thanks to the unprecedented federal and monetary stimulus, there are 4.3 trillion dollars in the money market funds. Cash levels this high had only happened twice in recent history. Those times were January 2003 and January 2009. After both those times, the equity markets ran up 15 to 20% on average for the next three years. What makes this even more interesting is that the levels were elevated in those two previous times because the market was coming off a recession. This time, the economy is healthy, the equity markets are at all-time highs, and still, record levels of cash are available and can flow into the equities and move these markets higher.



3. **Possible flow of funds from abroad**
   While the U.S. Federal Reserve has made the necessary pivot to combat inflation, other central banks like the European Union have chosen to stay firm on keeping rates low and providing more liquidity into their economies. The other central banks' choices could have an interesting effect on money flow into the U.S. equity markets from abroad. Rates on U.S. sovereign bonds would rise compared to other sovereign debt, and funds would flow into our economy for stability and yield purposes.

4. **No place to hide: negative real return**
   There is no place to hide. With inflation running at 7% and the yield on bonds averaging 2%, it would take a long time for investors in bonds and other debt instruments to see an attractive positive return on their money. If our assumption that inflation is not going back to pre-covid levels anytime soon is correct, this scenario of low real yields will play out favorably for stocks in the near future. No one likes to earn a negative real return on their hard-earned money.

5. **Economic reopening trade is just getting started**
   The economic reopening recovery is just getting started. While we have made a lot of progress in the past year, the reopening process is still very much related to the fear of the pandemic. Slowly things are coming back to normal. I would say that many parts of the economy are just starting to open, things like travel and entertainment. This continued reopening should provide more catalysts to markets in the near future.

Short Term Turbulance

With all that said, there is no disputing that the ride from here will be turbulent. In fact, it has been turbulent for the past few months. But that is to be expected.

Think of it this way; if you have a heart problem, it is terrible for you in the long term. If you went through open-heart surgery to fix your problem, you would feel weak right after the surgery. You will not run a marathon right after open-heart surgery. But, in the long term, you will feel a whole lot better than before. What the Fed is doing with the pivot is no different from performing open-heart surgery on this economy that is suffering from the inflation problem. It is normal to be turbulent while this is happening, but it is much better for our financial lives in the long term.

Nothing here is normal; thus, turbulence is to be expected. The market is repricing this new information and events and thus gyrating in a sideways channel.

But as long-term investors, we need to keep our eye on the big picture and our emotions in check as we ride this turbulence to financial success.

The Noise

There is no hiding from the fact that, unfortunately, our country is going through a huge political divide which we have not seen for a very long time. It is natural to feel emotional and biased about your political beliefs and values. It's natural to be nervous about the outcome of elections or specific bills passing in Congress. It's natural to be scared in these times.

While we go through these emotional times, it is also important to remember that elections have no significant impact on the investment strategy of a long-term portfolio.

That's right, who is currently in power in Washington has no significant impact on your investment strategy. **The fear of the market impact of an upcoming midterm or presidential election belongs in the noise section.** It doesn't matter who wins or who losses from a long-term investment strategy point of view. It might matter in the short term, it might matter to us emotionally or politically, but from an investment strategy point of view, it has no significance whatsoever. It is just noise; thus, there is no point in worrying about it!

FORWARD-LOOKING STRATEGY

It is no secret that our view is that equities have a much stronger footing coming into this year. Our current strategy is to stay **cautiously bullish** and use this current market turbulence to invest in opportunities that would provide value in the long term.

The **bond market on an overall basis still looks weak**. Our strategy is to allocate funds in types of bonds and income-generating investments that would provide a positive real return for the portfolios and also diversify the portfolio at an adequate level.

Of course, our strategy has one primary goal. In the long term, when markets go down, our portfolios are designed to go down less than the market. Thus, **the strategy's primary focus is still risk aversion**.

To illustrate that fact, let me show one such instance where our strategy would start to get defensive.

The monthly chart of the small-cap index gives some insight. The markets have continued their sideways pattern that began in June of last year.

The support line seems to hold this market from falling any lower. If this line is broken significantly at any time, our strategy is designed to get more conservative on equities.

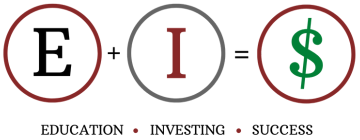
Similar support lines exist on other types of equity markets as well. These support lines keep us unbiased and on course for our long-term objective.

In closing

I want to remind you again the purpose of this update is not to predict the future. No one can do that. The purpose of this update is to inform you of what we are seeing and how we are preparing for it. If things were to change between now and the next update in 3 months, we would report those changes and how we adapted to them in the next update or our next conversation.

The above view of the markets & the narration of the events is a general view. You know that every portfolio in Parks Capital is managed based on who you are. Thus, they all look a bit different based on your risk tolerance and individual goals. Please keep that in mind.

We are looking forward to talking with you in your quarterly meeting. Remember, education plus investing equals success!



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