10 Charts for the New Year

Quick Look

1. Strong equity performance led to all but the most conservative of portfolios finishing the year with satisfying returns.
2. Inflation (PCE) opened the year at just above 1%, but by year end, its 5.7% reading was its highest since 1982.
3. Fed policy pivoted towards a more hawkish stance in November, and three rate hikes next year are a near certainty.
4. The real Fed funds rate curently stands at -4.5%, its lowest reading since the mid 1970s.
5. U.S. stocks have averaged annualized inflation-adjusted returns of over 14% over the past 10 years, well above historical returns of 6.5% for stocks.
6. S&P 500 profit margins are currently at all-time highs despite rising labor costs.
7. Inflation has not interfered with stock returns thus far, but historical data suggests it will eventually become a headwind if inflation persists at its current level.
8. Although inflation has weakened purchasing power, the dollar actually appreciated compared to foreign currencies in 2021.
9. While the unemployment rate has fallen faster than expected (now at 4.2%), a number of factors are keeping a lid on the labor force.
10. Despite strong economic data, 70% of Americans view the economy as "bad" - citing high inflation as the primary concern.

Contacts

KEVIN P. WHELAN, CFA
President and CEO
kwhelan@opusinc.com

NATHAN A. BISHOP, CFA
Principal and CIO
nbishop@opusinc.com

NATHAN M. BAILEY, CFA, CFP®
Principal and Portfolio Manager
nbailey@opusinc.com

221 East Fourth Street, Suite 2850
Cincinnati, Ohio 45202
P (513) 621-6787

www.opusinc.com

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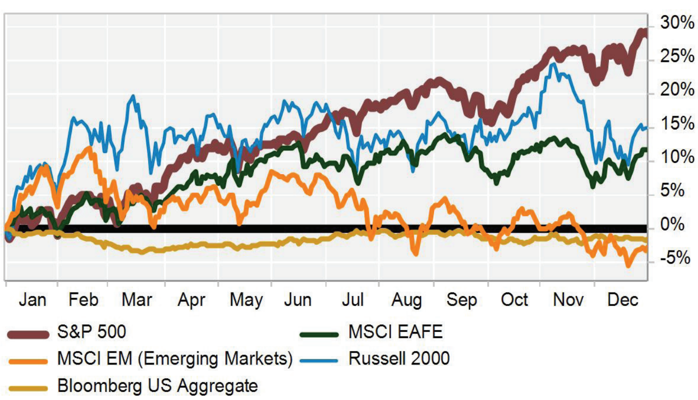
Quarterly Investment Letter, Q4 2021

Looking back from a year ago, some things remain the same – stocks at all-time highs amid another COVID spike, while some things have changed a great deal – inflation tops that list. Here are 10 charts that encapsulate 2021 and provide clues on what could be in store for the coming year.

1 Let's start with **MAJOR ASSET CLASS RETURNS**. Bonds (as represented in the chart below by the gold line) struggled in the first quarter with rising rates and posted modest losses of -1.5% for the year. U.S. Small Caps (blue line, 15% gain) were the best performing asset class in the first half, riding the wave of the strong economic reopening, but its second half was marked by slumps stemming from the Delta and Omicron outbreaks. COVID also stalled the progress of stocks outside of the U.S., causing Developed International stocks (green line, 11% gain) to trade sideways since June and Emerging Markets (orange line, -2.5% loss) to drift lower since their peak in February. U.S. Large Caps (maroon line) continued to show resilience in the face of the COVID strains and closed with gains of 29%, leading all major asset classes. In summary, all but the most conservative of portfolios finished the year with satisfying returns, especially those with higher allocations to stocks.

2021 Asset Class Returns



Source: Factset

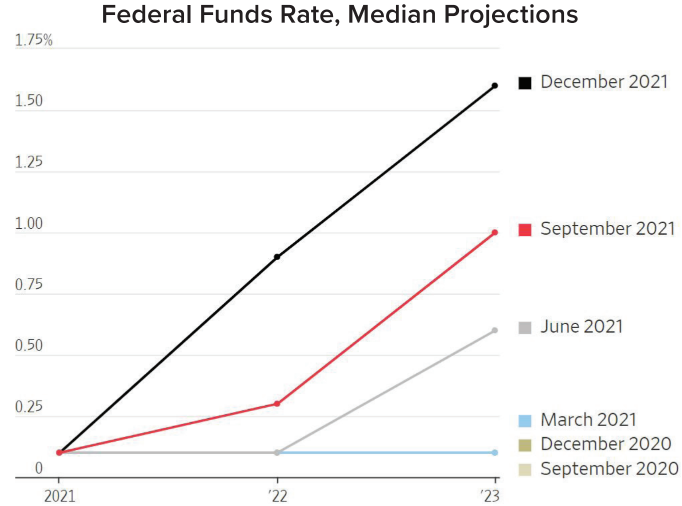
2 The sharp rise in **INFLATION** was arguably the story of the year in 2021. Inflation (as measured by PCE) measured just above 1% at the beginning of the year, but by year end, its 5.7% reading was its highest since 1982. Food costs are up 6%, while energy costs are up 33%. The Fed's preferred measure of inflation is Core Personal Consumption Expenditures, which strips out both food and energy costs, but even that measure was up 4.7% over the past year, more than twice their 2% target. For U.S. investors under the age of 50, 2021 marked their first meaningful test of investing in an inflationary environment.

Core Personal Consumption Expenditure (PCE)

Source: WSJ

3 It is hard to believe now, but **FED POLICY** early in the year was to let inflation "run a little hot", as their March interest rate forecast signaled their intention to keep rates at the zero percent emergency policy level through 2023. By year-end, the Fed was anticipating seven rate hikes by the end of 2023. This stark change in policy did not develop until the past quarter; the Fed only announced the tapering of their bond purchase program at their November meeting. The probability of three rate hikes in 2022 stood at just 25% in September. Now three rate hikes next year are a near certainty, with better-than-average odds that the first increase happens by March. This summer, the Fed's preferred word to describe inflation was "transitory", but that word was noticeably dropped from their latest policy statement.

Federal Funds Rate, Median Projections



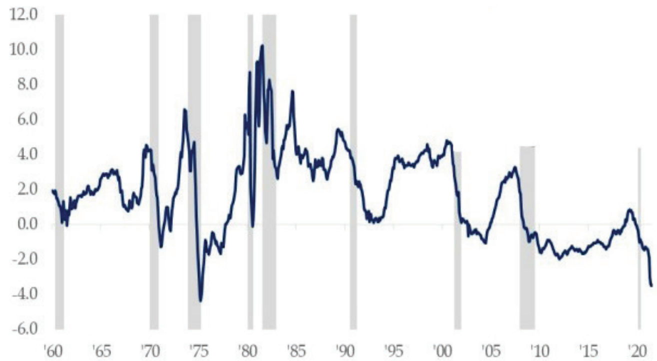
Source: Federal Reserve, WSJ

4 The latest Core PCE reading dropped the **REAL FED FUNDS RATE** to -4.5%, matching its mid-1970s nadir. These two time periods are a bit different though; the 1970s saw high Fed Funds rates and even higher inflation, while today's environment exhibits high inflation amid rock-bot tom Fed rates. Regardless, it has been a tough year for safe

Continued from page 2 . . .

assets. Historically, bonds have provided annualized real returns of 3%, while cash has been just under 1%. This year, real return losses have been -5% and -4%, respectively. You could see some improvement in 2022 through a combination of an increased Fed Funds rate and an eventual alleviation of supply-driven inflation.

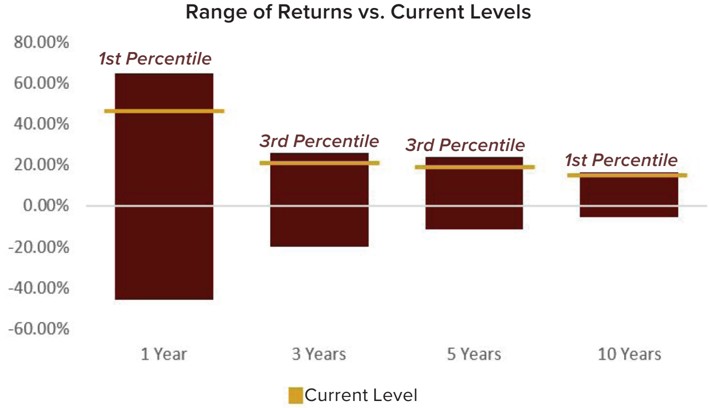
Real Fed Funds Rate (%)
(Effective Fed Funds Rate Less Inflation Core PCE)



Source: Strategas

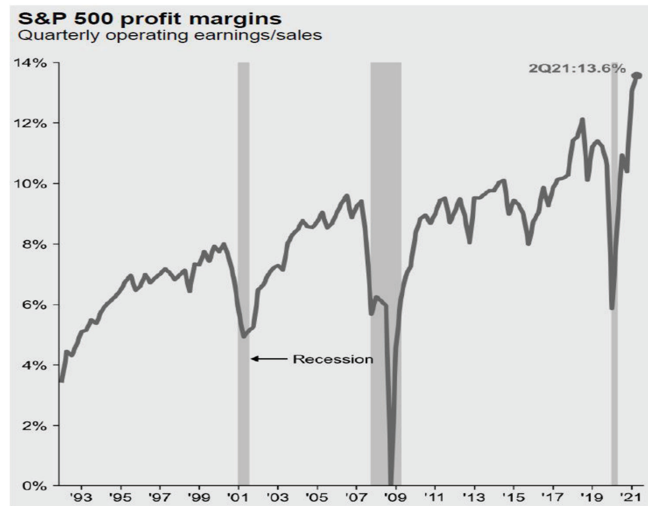
5 Conversely, The Fed's accommodative policy has been highly rewarding to stock investors. U.S. stocks have averaged annualized inflation-adjusted returns of 14% over the past ten years, well above historical real returns of 6.5% for stocks. **MARKET BETA**, which is return stocks provide above cash (the risk-free rate), is shown in the chart below. As you can see, market beta ranks in the 1st, 3rd, 3rd, and 1st percentile over the last one, three, five and ten years. Behaviorally, it is important that long-term investors consider a portion of these outsized returns "banked" as rolling returns eventually regress towards their historical mean.

Market Beta
Range of Returns vs. Current Levels



Source: Fama French
Data: 1963 - 2021

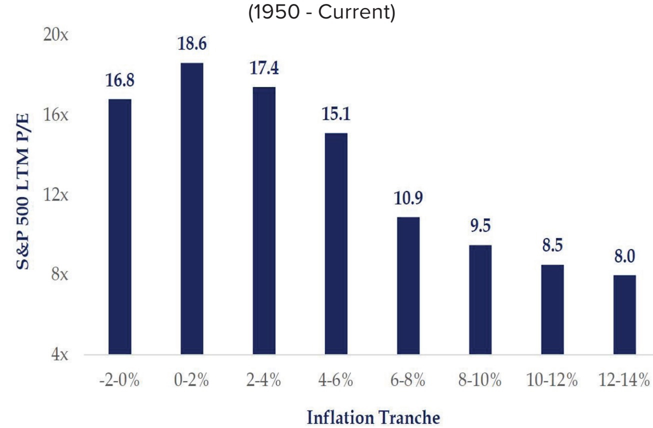
6 To this point, inflation pressures have had minimal impact on U.S. stocks, as companies have been able to pass these costs through to the end consumers. S&P 500 **PROFIT MARGINS** sit at all-time highs despite higher labor costs. S&P 500 operating earnings have not only fully recovered from the pandemic, but they are well above their pre-pandemic growth trend. With 45% EPS growth in 2021 off easy pandemic-comps, earnings growth exceeded market returns this year. As a result, despite 29% stock gains this year, the U.S. market valuation has declined versus one year ago (if measured by Trailing P/E).



Source: JP Morgan

7 While inflation thus far has not been an impediment to stock returns, historical data suggests that it will eventually become a headwind if it persists at its current level. Stock **VALUATIONS** tend to be highest when inflation ranges between 0-2%, which is the range inflation quietly drifted in for an extended period prior to this year. The sudden CPI surge puts inflation in the 6-8% bracket; current stock market valuations are more than twice as expensive as historical averages for that tranche. Stocks clearly fare much better at low levels of inflation and will likely require inflation pressures to recede to continue further gains.

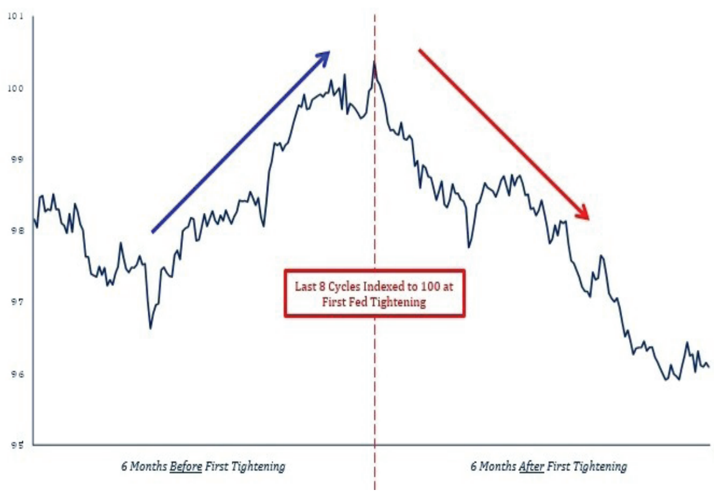
Average S&P 500 TTM P/E by CPI Y/Y Tranche
(1950 - Current)



Source: Strategas

8 We have heard people mistakenly assume that inflation has weakened **THE DOLLAR**. At the risk of being pedantic, inflation has weakened purchasing power, but the dollar has actually strengthened over the past six months compared to other major currencies. This helps, in part, explain the sluggish returns of international stocks over the past two quarters, as the currency translation has worked against U.S. based investors. Interestingly, the chart from Strategas below shows that over the last eight Fed tightening cycles, the U.S. dollar has strengthened heading into the first rate hike, and then weakened over the six-months following. Dollar weakness in 2022 would be a welcome reprieve for those serially-underperforming International and Emerging Market equities, at least relative to U.S. markets.

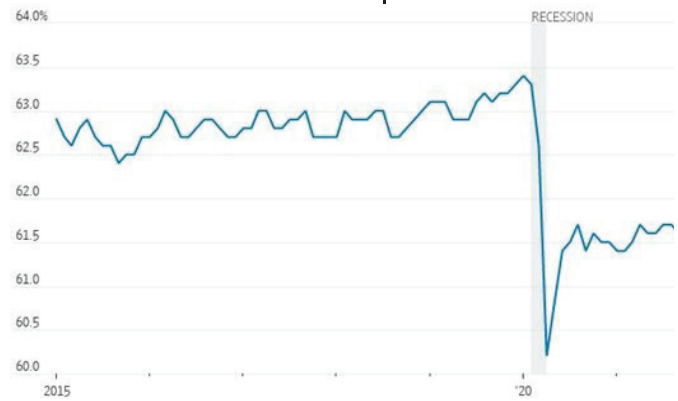
U.S. Dollar Performance Before & After Fed Tightening



Source: Strategas

9 While the unemployment rate has fallen much faster than expected (now at 4.2%), there are a number of factors keeping a lid on the **LABOR FORCE**. Concerns with COVID and child care were front and center last year, but the primary force now may be the jump in household wealth, discussed in our last letter. The combination of robust asset prices (stocks, home values, etc) and ample savings are likely leading people to stay home rather than go back to work, as the willingness to work often depends on financial health. Over the five quarters ending 9/30/21, households had built up a savings excess of $2.7 trillion. Retirements are at double the rate they were before the pandemic, and financial health will likely dictate whether people stay retired or re-enter the workforce. Pandemic-based stimulus fueled a record jump in the household savings rate, but as we enter 2022, the national savings rate has fallen back to pre-pandemic levels of 7%. Expect the participation rate to improve as excess savings is spent down over the coming months.

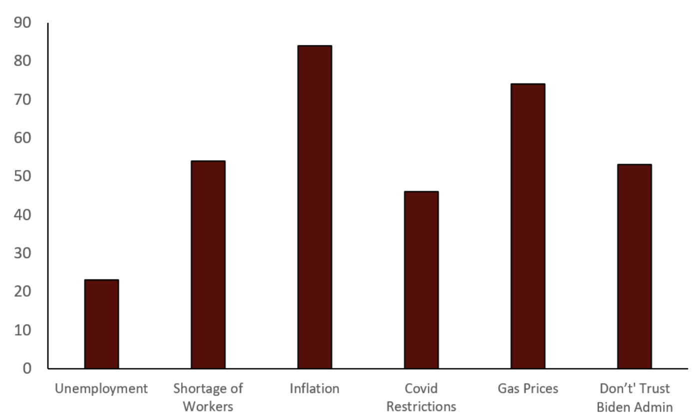
Labor Force Participation Rate



Source: WSJ

10 Taken at face value, current data suggests the **ECONOMY** is roaring. Yes, the comps are easy, but consumer spending growth is at a post-War high, ISM Non-Manufacturing is at an all-time high, and Real GDP could reach 7% in 2021 - its highest level in 40 years. Yet, a recent CBS News Poll showed that only 30% of Americans view the economy as good. When the 70% were asked why they viewed the economy as bad, inflation was cited as the primary reason. While acknowledging the existence of other non-economic factors, it is no coincidence that President Biden's approval rating has fallen precipitously as inflation has taken off. This year has provided a fresh reminder of inflation's deep unpopularity.

What Are the Reasons You View the Economy as Bad?



Source: CBS News

2022 As we turn the page to 2022, we anticipate the pivot to more restrictive policy, both from a monetary and fiscal perspective. This past quarter may have provided a sneak preview of what is in store, as stocks that underperformed were unprofitable, expensive, low-quality stocks, i.e., those that in theory could struggle as liquidity contracts. Value and Shareholder Yield were evidence-based factors that found their footing in 2021, and the Quality factor appears poised to join them. We appreciate your partnership with our firm and we wish everyone a happy and healthy New Year.

Opus CAPITAL MANAGEMENT
Opus Capital Management
221 East Fourth Street, Suite 2850
Cincinnati, OH 45202
(513) 621-6787 • www.opusinc.com