Inside Views From an Investment Management Leader

UPDATE

January 2022

About our Company

Company Profile:

Mitchell Anthony Capital Management is a private, boutique investment firm who has helped our clients grow and protect their wealth since 1991.

Key Offerings:

- *Personal wealth management*
- *Proactive investment strategies*
- *Proprietary research*
- *A professional team*
- *Fee-only services*

Distinguishing Values:

- *Passion for excellence*
- *Strategic focus*
- *A disciplined process*
- *Prudent risk management*
- *Comprehensive client care*
- *Superior long-term performance*
- *Sound judgment*
- *Objective Analysis*

MITCHELL ANTHONY
CAPITAL MANAGEMENT

9259 Research Drive
Irvine, CA 92618
Phone: 949-852-4100 or 800-497-9400
Fax: 949-852-4106
www.MitchellAnthonyCapital.com

In the News

Check out the MACM Team's New Blogs

If you have't already, check out the MACM team's new blogs. You'll find them full of up-to-date commentary on everything from finance and economics to politics and current events.

The Intuitive View
by Mitchell Pletcher
macmblog.com

Long Story Short
by Kyle Aron
thelongstoryshortblog.com

The Starving Market
by Dane May
thestarvingmarket.com

Economic Review & Outlook

Will Inflation Wreck this Economic Recovery?

Mitchell Anthony
President
Chief Investment Officer

2021 was a great year of economic recovery from one of the worst events that ever took hold of the global economy. The pandemic! Unfortunately there was some collateral damage and an inflationary cycle began that is difficult to understand. More importantly expectations for inflation have risen dramatically. Inflationary expectations have been anchored for over a decade at very low levels of 2-3%. However the CPI is currently measuring 6% inflation and the PCE (personal consumption expenditure index) is at 4.7%. (pg. 5, figs 1,2). These high levels of inflation have not been seen in decades and many believe they will not be sustainable because they have been achieved through strong demand that followed a long period of deprivation. These high levels of inflation has caused corporate leaders, business owners, and consumers to fear and worry that there is nothing ahead but significantly higher prices for the next few years. As a result business leaders are acting in a defensive manner to prepare for this inflation by putting plans in place to raise prices for their products. Likewise workers are demanding more wages to offset the inflation they believe lies on the horizon. This sort of thinking has caused inflationary expectations to become unanchored. As this occurs it becomes challenging to re-anchor expectations for inflation back at low levels that are consistent with healthy economic growth without a recession and/or a sharp correction in asset prices.

Inflation expectations have become unanchored resulting in fear driven behavior causing higher demand for labor and price hikes on raw materials, services, and goods. The actual Current Trends with inflation have been high and are still concerning. We are experiencing acceleration in prices for oil, lumber, housing, and autos. Every major category in the CPI was up year-over-year except airline prices in the November 2021 report. In the commodity area corn, coffee, cattle, cotton, and soybeans, are all higher. Conversely we have had some deceleration or lower prices for industrial commodities like steel and copper as well as precious metals. Even some Ag commodities like wheat have fallen. The Baltic Dry Index (shipping price for raw materials) reveals a decline in shipping prices while containers for finished goods still remain at a premium.

We worry about this as well but believe that the financial system is healthy and sound and that the higher probability is for inflation to calm down as supply chain bottlenecks in the economy are resolved and modest hikes in interest rates are used by the Fed to push down exuberant demand, as I will explain further below.

Market Review

2021 was another great year for risk assets! Real estate in general did quite well and stocks had an amazing year driven by over 48% earnings growth for the S&P 500. Single-family homes were up 14.5% on top of an over 20% gain in 2020, REITs were up 39%. US Equities were up 20-30%, with the SP500 gaining about 27%, and the QQQ gaining 27%. However the second largest economy in the globe had trouble and Chinese equity markets fell over 20% (FXI) as investors were caught by surprise by drastic change in economic policy by China's ultimate leader Xi.

(continued on pg. 2)

Economic Review & Outlook (continued)

(continued from pg. 1)

The MACM DYNAMIC GROWTH portfolio had great absolute return and was up over 22%. This performance unfortunately lagged our bogey which was up 26%. Our positions in Facebook, Apple, Netflix, and Google produced strong positive alpha for the portfolio along with positions in housing, restaurants and healthcare. That 400 basis point underperformance versus the bogey (negative alpha or NA) occurred because Amazon unfortunately had an unexpected flat year of earnings growth because of tremendous expenses they incurred to add new capacity to their e-commerce division without notice to shareholders. Further, investments in China and casinos held the MACM portfolio back as unexpected china driven problems occurred for Pro China investors.

Interesting to note that stock valuations (PE ratios) actually fell in 2021 despite better than 20% growth in prices. This was due to the fact that earnings rose by over 48% for the S&P 500 resulting in a price-to-earnings ratio of 21 at the end of the year versus 23 at the beginning of the year. Growth has Outperformed Value in the Equity Market for 6+years and it doesn't seem like that will change despite the pundits forecast of strong cyclical growth, and cheap valuations in Value sectors. Cyclical industrial value oriented businesses have been challenged in the environment we have today that favors healthcare, technology, and consumer oriented companies with secular tailwinds driving strong demand. Real estate seems to be near all-time high valuations no matter how you measure it. Tremendous demand has been driven by life style choices, cheap credit, strong growth in wealth, as well as TINA (There Is No Alternative).

Risk assets have been highly valued because of Fed Policy, growth, and inflation fundamentals. Valuations could well break if inflationary expectations accelerate. However, we think not or this is not on the immediate horizon as central banks are still expanding credit, economic growth is in the ideal zone of modest to trend like growth, and inflation is explainable. However inflation is the wildcard and must calm down for risk assets to continue to rise.

Economic Review

• Some Past Trends Changed

We have had significant economic change in 2020 and 2021. The most notable is the fact that inflation and inflation expectations have heated up almost entirely due to the shut down and recovery of the Covid driven economy. Capacity bottlenecks started the problem and rising wealth has supported it. Further fiscal stimulus has brought about change in the labor force causing workers to quit at a record pace and they have been unwilling to get back to work without commanding higher wages. Workers are attempting to unionize more and hope to gain more power in the workplace as a result of Covid.

The Federal Reserve's policy of massive expansion of its balance sheet that came in response to Covid now seems to be over and the Fed's current thoughts are all about re-anchoring inflation expectations without pushing the economy into recession.

Obviously we must recognize that the world's second-largest economy has slowed dramatically over the last few years due to Covid but more importantly due to new policy of equality and socialism. China's supreme leader Xi has crushed a decade-long movement toward democracy and capitalism in China that enabled China to become an economic power. It seems like China's policy and goals for growth at all cost has been abandoned. China's growth has slowed dramatically affecting their trading partners and their demand for energy, raw materials, and finished goods. US exports to China have decelerated as well.

The energy sector has also embraced change. Carbon-based energy production has entered a managed decline that has enabled higher prices to exist as production has been minimalized by all players. OPEC is moving strategically and US players have been unable to increase output due to ESG (Environmental, Social and Governance) anti carbon pressure. Overall carbon-based usage is in decline by many relative measures while other energy sources are rising.

• Past Trends That Continued

The US economy has been growing slowly in an ebb and flow manner for over a decade. We have experienced slow global growth with no great cyclical demand for industrial goods or services. There has been no overriding significant consumption themes in America. Housing may well become a significant consumption theme going forward but it has yet to emerge into that.

The US economy has some Cyclical momentum from the rebound from the Covid 19 Shutdown. Retail sales are clearly in a strong uptrend mostly because of a rebound from Covid 19 deprivation as well as thick wallets because of higher wealth and stimulus money. Autos and housing are strong and have momentum but still have not reached historic highs. Travel and entertainment demand is high. The industrial sector is mixed with weak but improving global demand mostly due to the weakness in China. Stay at home demand has waned impacting demand for single-family homes, home entertainment, computers, and home networking equipment.

We have several secular consumption themes that remain in place but none are great consumption themes. The move to e-commerce continues but may be decelerating? Healthcare is still a priority and politically unobstructed. Artificial Intelligence demand is growing but still a modest consumption theme. Cloud computing and digitization of data continues to be the most robust secular consumption theme. The related demand for technology is still high and growing.

Economic Outlook

• Trends That Will Change.

The high level of expectations for inflation will likely moderate as inflation finds its anchor allowing actual inflation to moderate.

The reasons why include:

1. Bottlenecks ease.

2. Excess $$ in the hands of consumers from fiscal policy dries up, causing them to spend less and finally get back to work (wage + demand pressures ease).

3. Lack of significant (if any) new fiscal policy to replenish this excess $$.

4. Surge in durables demand from covid slows as people have made all their desired purchases, this demand returns to trend.

5. Base effects recede (i.e. Will autos increase 50% again y/y? And oil? Not highly likely)

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Economic Review & Outlook (continued)

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6. Fed tightening causes borrowing costs generally to increase and slows demand, as well as decreases liquidity generally.

On the flip side, the primary risk to our outlook is that some or all of these changes in trends fail to materialize. This seems like the less probable but still possible outcome, and one which we'll be monitoring closely.

Fed policy will become less accommodative but remain accommodative or neutral?? Rates will likely rise on Mortgages and CC's by 100 bips or less. The 10 year treasury trading range will rise to (1.5-2%).

• Trends That Will Continue!
Carbon based energy production will remain in managed decline and will ultimately give way to lower prices, but higher prices may endure for a while as production is minimalized? We continue to see Slow Global growth with no great cyclical demand for industrial goods? China was the great consumer for the last decade but has overbuilt and future demand will likely be modest.

It's reasonable to believe that the US & Global economy will have cyclical momentum from the rebound from the Covid 19 Shutdown. Can this economic momentum be sustained? Seems unlikely to be significant. Retail Sales will moderate but stay in uptrend. Autos and Housing consumption in US will stay strong but likely to decelerate with the 100 bip expected rise in rates. Travel and Entertainment demand will accelerate as consumers want to get out and play. Stay at home demand will wane impacting demand for: Homes, Home entertainment, Computers, home networking. Secular consumption themes will remain in place as noted above.

Market Outlook
Equities and Real Estate likely to move to higher and establish new all-time high valuations. Real Estate demand will continue to be driven by Lifestyle choices, cheap credit, strong growth in Wealth, and TINA. The return on equities seems to hedge heavily on corporate America's ability to grow earnings again in 2022. Current estimates from street analyst call for earnings growth of 20% this year. To do this corporate America will have to grow revenue and increase margins further in a difficult labor environment. This could be challenging and remains the wildcard for stocks. Stock demand will also be driven by high liquidity, and strong growth in Wealth. Growth stocks will continue to outperform value stocks in the Equity Market as cyclical rebound hopes fade and rates stay moderate and tech earnings meet estimates. Cyclical Industrial Growth will remain modest making it challenging to own value companies that are growth challenged in the industrial, energy, and financial sector. This group may move for a while but the sustainability of this rally will require much higher rates, and stronger industrial growth, than is likely.

We remain cautiously optimistic for the economy and risk assets.

Table 1: Stock & Bond Market Returns — 12/31/2021

	Quarterly Change	Trailing 12 Mos		Quarterly Change	Trailing 12 Mos
Large Cap Growth (IWF)	11.7%	27.4%	Small Cap Value (IWN)	4.2%	28.0%
Large Cap Value (IWD)	7.8%	24.9%	Small Cap Growth (IWO)	-0.1%	2.5%
Europe Asia Far East (EFA)	2.8%	11.5%	Emerging Markets (EEM)	-1.6%	-3.6%
Invest Grade Bonds (LQD)	0.4%	-1.8%	High Yield Bonds (HYG)	0.8%	3.7%
Interm Treasurys (IEF)	0.1%	-3.3%	Mortgage Bonds (MBB)	-0.6%	-1.4%

Source: Bloomberg, Barclay's Global Investors ETFs. Actual performance including dividends.

Table 2: Real Estate & Commodity Returns — 12/31/2021

	Quarterly Change	Trailing 12 Mos		Quarterly Change	Trailing 12 Mos
DJ US Real Estate (IYR)	14.6%	38.7%	DJ Commodity Index (DJP)	-1.9%	31.1%
Int'l Real Estate (IFGL)	2.4%	8.3%	Goldman Commodity (GSG)	1.5%	38.8%
NAREIT Residential (REZ)	15.6%	47.8%	Gold (GLD)	4.1%	-4.1%

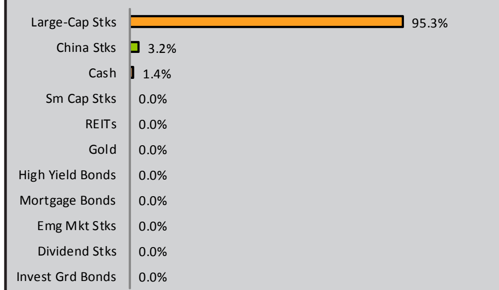
Source: Bloomberg, Barclay's Global Investors ETFs. Actual performance including dividends.

MACM Managed Accounts

Growth Portfolios

Dynamic Growth

(Qualified Accounts)
A dynamic blend of stocks, bonds, commodities, REITs, and cash for growth investors with a bias toward timely asset classes.

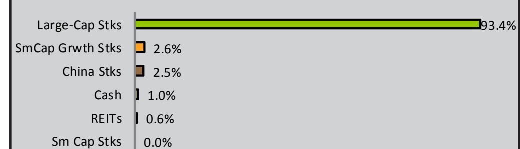


Growth

A portfolio of large- and mid-cap US stocks that are industry leaders with strong brands and timely products.

Diversified Equity

A global, all-cap equity portfolio following economic trends across capitalization and geographic ranges.



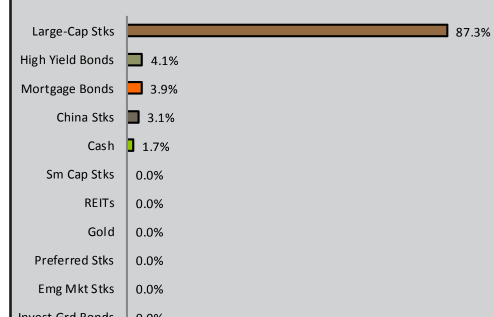
Focused REIT

A portfolio of companies whose primary business is owning and leasing real properties.

Balanced Portfolios

Dynamic Growth & Income

(Qualified Accounts)
A portfolio of stocks, bonds, and cash for moderately-conservative investors seeking income and growth with relative stability.



MACM Research Spotlight

Washington Update: Democrats Losing Faith

Politics seems to have taken a bit of a backseat these days. Perhaps understandably so, as our current president is a bit more reluctant to take the spotlight than his predecessor. It's a notable change from Trump's almost daily twitter rants.

This is not to say a lot hasn't been happening in Washington. Democratic infighting over multi-trillion dollar legislation, a proposed re-writing of the filibuster, unprecedented vaccine mandates on businesses and more have all been taking place. With 2021 coming to a close, and 2022 mid-terms elections upon us, let's take stock of what's happening in Washington, including the implications for our markets and economy. On both fronts, the outlook appears muted, if perhaps a bit encouraging.

Current State of Legislative Affairs

Biden's flagship legislative agenda – the Build Back Better plan – continues to wither on the vine. While the House has passed its version of this bill, Democrats need all 50 of their Senators to agree on the legislation to move it forward. Unfortunately, the hefty price tag, and means of paying it, continues to cause disagreement and stall the legislation.

Democratic Senator Kyrsten Sinema has staunchly opposed tax hikes on individuals or corporations, which are needed to pay for nearly the entirety of the bill. Meanwhile Democratic Senator Joe Manchin continues to balk at the massive overall size of the bill. For example, the bill is packed with billions of dollars in spending to both continue and expand monthly child tax credit payments to individuals. In light of the environment where businesses are struggling to hire workers and inflation is running its hottest in decades, it's not hard to see why Senator Manchin would prefer to dial back government handouts.

Unfortunately, as the disagreement has persisted among Democrats, the average consumer has become more and more disgruntled with the party and Biden's ability to deliver on promises. With hiring difficulties and inflation not seemingly on the cusp of immediate resolution, it is seemingly increasingly unlikely that Build Back Better will be enacted.

Democrats have further been unable to pass their promised overhaul to voting rights, which they claim will simply make it easier for people to vote. Republicans have voiced complete opposition, claiming the legislation leaves voting unregulated with laws that are far too loose. With clear disagreement from the opposing party, Democrats first hoped to include this legislation in their Build Back Back plan and pass it through filibuster-proof reconciliation. However, not only does Build Back Better appear doomed, but voting rights aren't particularly germane to budgetary matters – meaning they can't really be included in a bill set to be passed as budgetary bill like BBB.

Kyle Aron
Senior Analyst

This has left Democrats needing to overcome a filibuster to pass this legislation in an ordinary manner. With Republican opposition unwavering, Biden tried to pressure Democrats into re-writing filibuster rules to ease requirements to end one. Here, Biden was again met with opposition from within his own party. In opposing Biden's suggested rules change to the filibuster, Senator Manchin quipped "Allowing one party to exert complete control in the Senate with only a simple majority will only pour fuel onto the fire of political whiplash and dysfunction that is tearing this nation apart." Once again, Americans see their Democratic party unable to reach consensus and keep their promises. Even worse, they see Biden pushing his party members to forcibly rewrite the rules of our Democracy.

Democrats Losing Faith

Throw in the Supreme Court's recent rejection of Biden's vaccine mandate on businesses, general consumer dissatisfaction with current inflation trends (even if not Biden's fault), and you can see where this is going: enthusiasm in the Democratic camp is wavering. Indeed, Biden's approval rating recently set a new low at 33% in a major poll. At this point in his presidency, Biden's approval rating is lower than every other modern-era president apart from Donald Trump. So what does this mean? In short, it seems likely that change will be coming to Washington.

A Change in the Guard?

Precedent suggests that the tide will shift towards the out-of-power party – Republicans – to some degree in the midterms in 2022. However, Republicans need to pick up only 1 seat in the Senate and 5 seats in the House to retake the majorities. It seems entirely within the realm of possibility that we arrive back at divided government come 2023, with Republicans potentially controlling both the House & Senate. As far as the market is concerned, this may well be good news – gridlock in Washington, and the typical lack of surprises and new legislation that comes with it – is favored by markets. No new taxes, no massive spending bills – the odd calm of gridlock. This likewise means muted economic impact from Washington as well.

We'll see just how much Republicans can capitalize on the current Democratic weakness come mid-term election time this November. In the meantime, the Federal Reserve's policy shift is set to be far more influential on the economy and markets as the year progresses than any political goings-on. Should policy tightening end up taking us into a recession, Democrats may be set up to lose the presidency in the next few years as well, with a loss in the mid-terms all but guaranteed.

Equity Market Spotlight: Sector Performance

	Quarterly Change	Trailing 12-Months
Real Estate	15.6%	40.5%
Materials	14.4%	25.1%
Technology	14.2%	30.4%
Utilities	13.2%	17.6%
Cons Staples	12.7%	17.9%
Cons Discretionary	10.7%	21.6%
Healthcare	9.5%	24.3%
Industrials	8.2%	19.4%
Energy	7.7%	55.9%
Financials	4.9%	35.5%
Comm Services	-0.5%	18.7%

2021 Q4: Markets Rise to Cap Big Year

Markets ended the year up strongly, with the Fed not yet revealing the full extent of its hawkish pivot by year-end. Investors generally bought up more defensive market segments, however, including utilities, consumer staples, and secularly strong mega-cap technology. Overall, though, equity markets soared to cap an exceptionally strong year, supported by loose fiscal and monetary policy, as well as S&P earnings growth of nearly 50%. As we head into 2022, investors would be wise to keep an eye on the more defensive market segments, which may well remain appealing. Investors will now be grappling with the Fed unwinding its support and tightening financial conditions in an attempt to rein in inflation. It's not an easy process – indeed, one that might be bumpy and may even result in a crash landing if not handled properly.

Data based upon Russell 1000 Index and GICS sectors. Source: Bloomberg Financial

A Word from our Client Team

Dane May
Client Relations Manager
& Research Analyst

How Much Can They Tighten?

Back in October 2020 I wrote about how the Federal Reserve's (Fed) loose monetary policy was injecting a large amount of liquidity into the system, pushing investors out on the risk curve and increasing asset prices. Now, for the first time in a long time, due to inflationary pressures and what appears to be a recovering economy, the Fed is changing their posture and have announced their intentions to tighten financial conditions. In the same way the Fed used monetary policy to speed up a slowing economy through Covid-19, it seems they are now going to use it to tap the breaks on economic growth in an attempt to curb inflation.

How Do They Tighten Financial Conditions?

The two most common tools they use include raising interest rates and executing quantitative tightening (QT). When the Fed raises interest rates there is a downstream impact which results in higher borrowing costs for businesses and consumers. By increasing the cost of accessing money it becomes more expensive for a family to buy a house, a business to buy a new piece of equipment, and your everyday consumer to spend on their credit card. Eventually, this should result in a slow down in aggregate spending on goods and services as the incremental cost to borrow has increased. Additionally, the Fed can use QT to decrease the money supply which can discourage lending and investment. Both of these tools used by the Fed ultimately decrease the amount of liquidity within the economy. It is important to note this liquidity, which has been injected over the past two years, is a large portion of what has fueled asset inflation (equities, housing, crypto, etc).

What Can We Expect If/When They Actually Go Through With Tightening?

First and foremost the market is always looking forward so we have already seen a negative reaction regarding their commentary on the potential tightening. From their recent highs, the SP500 is down 4%, the Nasdaq 100 is down 7% and riskier asset classes like bitcoin are down 20%+. Assets furthest out on the risk curve get hit the hardest when liquidity is removed from the system. Crypto, NFTs, and high-flying equities without earnings have all seen much larger drawdowns. We do know the Fed is very aware of how financial markets react to their policy decisions so it appears they are taking a cautious approach. But that cautious approach can only be taken so far due to the most recent inflation data coming in at 7% (highest in 40 years).

The reality is they are facing a different situation than they have before. In the past two decades, they have always been able to reverse course if they felt they tightened too much or too fast. This was because inflation was not a potential problem. They have always had to wrestle with their maximum employment mandate but rarely had to manage their other mandate, Price Stability (inflation). With inflation staying elevated longer than they expected they have put themselves in a difficult situation with some tough decisions to make in the near future.

What Does That Mean For Our Portfolio?

The past three years we have been in an environment where the Fed has been very accommodating to financial markets. That time may have come to an end. In the event the Fed can engineer a soft landing by getting us back to modest growth and re-anchor inflation expectations then we stay the course – heavy secular growth and continue to be tactical with well positioned cyclical names. In the event we see a potential storm on the horizon with negative outlooks to growth and inflation expectations we will get more defensive with the portfolio and see us hold more quality tech, staples, gold, treasuries and cash.

Economic & Financial Market Charts

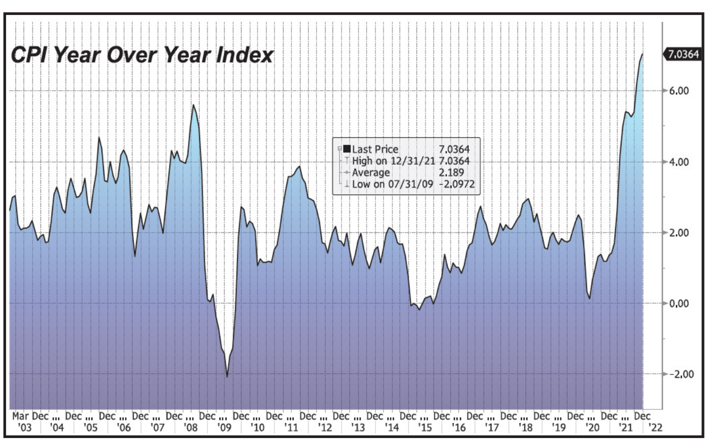


Figure 1 - Source: MACM / Bloomberg Financial
Graph of CPI year-over-year, reaching levels
not seen in decades

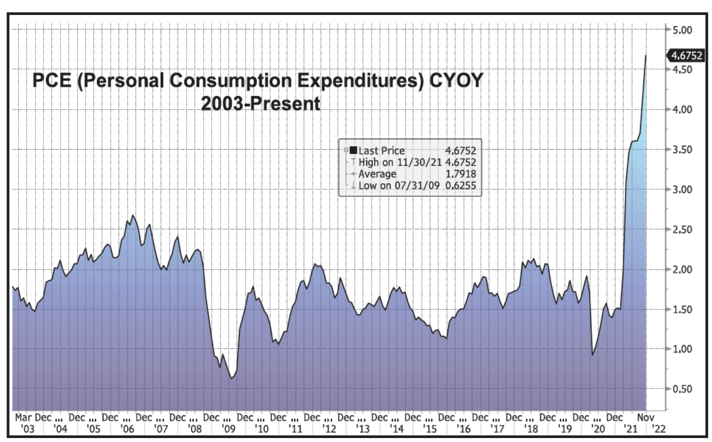


Figure 2 - Source: MACM / Bloomberg Financial
Graph of PCE year-over-year, the preferred inflation metric
of the Fed, also showing a sizeable run up