

January 12, 2022

As we reflect on the events of 2021, it's hard to not be astonished with the pace of equity market gains. Carderock's Quality Growth strategy remained in favor, with the average Carderock Client Stock Portfolio<sup>1</sup> gaining 28.99% versus 28.71% for the S&P 500 on a one-year basis, and a five-year total return of 181% for Carderock Stocks versus 133% for the S&P 500.

And while we celebrate another great year, we recognize the path was not always smooth. Investors rotated toward more cyclical sectors (Energy, Homebuilders, and Financials) in 2021 as commodity inflation and residential home-price appreciation dominated the headlines.

## Our View for 2022

### The Economy

- **Inflation** subsides as seasonality in transportation and home buying takes hold and services rebalance against over-heated demand for goods. The worst is likely behind us.
- **Economic Growth** decelerates but stays robust relative to pre-Pandemic trends.
- **Profit Margins** weather a temporary squeeze due to Labor and resource constraints but stay near record highs.
- **Capital Investment** - both public and corporate, restarts as part of a long-term effort to strengthen productivity, but its ultimate payoff will face interim risks by our decision-makers.
- **The Federal Reserve** has fully committed to "regime change" and will attempt to cool overheated Demand without killing it. This might be the second time in 100 years they succeed, as Houdini faced tougher challenges.

### Stocks

- **Quality Growth Stocks** should continue to see earnings and price growth, albeit at a slower pace compared to the astonishing gains of the last few years.
- **Value, Small Cap and Foreign Stocks** offer tempting prices on relative basis, but we believe over the course of a cycle our Quality Growth strategy will achieve better risk-adjusted returns.
- **Price Corrections** have become more commonplace in individual stocks but have been masked by growth in aggregate indices. We may see an aggregate correction in 2022.
- **Equity Rotation** toward slower growth sectors of the economy that have been neglected since the onset of the Covid-19 pandemic is expected.

### Fixed Income

- **Interest Rates** should rise as markets adjust to the Federal Reserve's announced policy change, with higher-than-expected issuance outpacing demand.
- **Buyer's Remorse and Overreaction** will present selective opportunities in fixed income, but as a rule fixed income markets continue to serve principally as a store of value as stock market volatility rises.
- **Higher Taxes** appear unlikely, but municipal markets nevertheless have priced in a substantial increase that severely limits their current appeal - particularly for MD and VA paper.

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<sup>1</sup> Includes all fee-paying accounts that have at least 1 stock purchase made by Carderock Capital

**Bottom Line:**

Stocks should run with higher volatility and cooler (but positive) returns, while Bond prices will continue to face challenges from both low supply and higher rates.

No doubt, the Omicron variant will continue to disrupt local economies across the globe, but we see diminishing consequences, and remain sanguine that the end is in sight. In summary, we are optimistic for another great year and see shades of “normalization” all around us, both in financial markets and our daily lives.

As always, feel free to give us a call to review your investment progress or ask any questions you may have.

Warmest Regards,

Carderock Capital Management Investment Committee

James W. Mersereau, CFA  
President

Daniel A. Kane, CFA  
Managing Director

Stephen F. Knapp, CFA  
Director of Research and Quantitative Strategies

### **Random Gleanings**

“The rally in Tesla’s shares has lifted the overall stock market value of Elon Musk’s carmaker to over \$1.1 trillion, making it one of the most valuable companies in the world. This year alone it added almost \$475 billion in market cap – equal to Procter & Gamble. Moreover, what some call the ‘Tesla-financial complex’ gives it an unrivaled, wider impact. ‘We don’t really have the language to describe Tesla anymore. It’s like explaining to a person in a two-dimensional world the concept of ‘up’.” Robin Wigglesworth, “The Big Read”, **Financial Times**, November 23<sup>rd</sup>.

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“Information asymmetry enables Big Tech to navigate the SEC’s disclosure rules to otherwise avoid disclosing far more financial detail. The point is that regulation hasn’t ‘scaled with company size’ as many giants now have entire divisions that would rank among the largest 100 companies in the US. Outdated regs are making it much harder for regulators, investors, customers, and citizens to really understand the tech giants. A recommended solution would rid management’s discretion and require standalone details on all product lines of \$5 billion or more.” Rana Foroohar, “Big Tech is Playing a Financial Shell Game”, **Financial Times**, December 12<sup>th</sup>.

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“‘Common prosperity’ will be one of China’s most important objectives over the next 15 years as it intends to narrow the country’s stubbornly large gap between rich and poor. Xi made clear he does not want China to suffer the same fate as the US where “...the rich and the poor are polarized with the collapse of the middle class, leading to social disintegration, political polarization and rampant populism.” He says, wealthy people should “give back more to society” so that pensions and welfare benefits can be raised, but without falling into ‘the welfarist trap of encouraging the lazy’.” James Kynge, “Common Prosperity”, **Financial Times**, December 28<sup>th</sup>.

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“Inflation is what the financialized investor fears most, and now that ogre has arrived, it’s the dematerialization of money itself that may prolong its unwelcome stay. As Jason Zweig of The Wall Street Journal noted in July: “Dozens of studies have shown that consumers using credit cards rather than cash are less likely to remember how much they spend, take less time deciding what to buy, are more willing to pay high prices and make a greater number of purchases. They also exert less self-control, buying more junk food, luxury goods and other impulsive items.” James Grant, “Money’s out of touch”, **Grant’s Interest Rate Observer**, October 29<sup>th</sup>.

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“Big central banks are still largely locked into the peak panic, Covid policies established back in March 2020. In the US, this seems wildly inappropriate. Today’s problems are much more with supply than demand, and the Fed’s delay in normalization risks the danger that negative outcomes subsequently push the Fed to play catch-up with higher costs than would ensue in adjusting its ultra-loose policy now.” Martin Wolf, “Fed Policy Must Adjust for Inflation”, **Financial Times**, November 16<sup>th</sup>.

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“Let me start with the inflation issue. Sixty percent of inflation last month in June was due to cars. Another significant chunk was what we’re calling pandemic-related services, airfare, hotels – things related to people being like, ‘Hey, we’re back.’ When you take those out of the equation, inflation only increased by 0.2 percent last month, which is well within the bounds of normal.” Rana Foroohar, “Heather Boushey: The Guardrails Have Come Off the US Economy”, **Financial Times**, July 21<sup>st</sup>.

“With stocks hammered since the release of hawkish Fed minutes, it is clear ‘don’t fight the Fed’ works in both directions. Today’s Wall Street requires the central bank to have investors backs when the going gets rough, but this doesn’t preclude missteps, or a temporal need to raise cash. And as much as most investors treat the Fed’s word as gospel, the record shows otherwise: the Fed’s interest rate forecasts err 63% of the time; core inflation forecasts 71% of the time; unemployment 76%; and Real GDP growth err 83% of the time. Traditionally these errors run higher than what we see, suggesting that if the Fed acts on its current concerns, we could see a 20% decline in home values and 30% slide in equity prices. This means that as much as inflation dominated everyone’s attention in 2021, recessionary pressures could prove the focal point in 2022.” David A. Rosenberg, “*Breakfast with Dave*”, **Rosenberg Research**, January 6<sup>th</sup>.

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“Our **Bond Market** outlook over the coming year is dependent on the market’s assessment of the timing and pace of Fed rate hikes. We recommend a short-duration stance but do not expect a very severe rise in yields. For **Stocks**, Shiller’s dataset indicates that today’s equity risk premium is in line with its long-term median. To the extent that the US P/E ratio is extremely high today, it is due to today’s very low interest rates. Based on 4-5% revenue growth, flat profit margins and a constant dividend yield, our return projections suggest 2-5% per year for stocks, favoring industrials, cyclicals, and small caps.” Jonathan LaBerge and Gabriel Di Lullo, *Outlook 2022*, **The Bank Credit Analyst**, December 2021.

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“The bidding frenzy for employable people resembles the stampede for houses or non-fungible tokens, The Wall Street Journal reports. You know the world has changed when striking Deere & Co. workers tell management what to do with its miserable, risible proffered 10% wage hike. Labor’s newfound bargaining power spells trouble for corporate profit margins and may serve to prolong the inflation that the bond market isn’t yet worried about. ‘Even if the short-term pressures abate, the longer-term outlook for labor supply is quite troubling. The global economy benefited from a huge surge in labor from the 1980’s on – well more than population growth – and various projections are now for that trend to reverse within the US as well as globally.’ James Grant, “*The World Turned Upside Down*”, **Grant’s Interest Rate Observer**, November 12<sup>th</sup>.

Carderock Equity Target Allocation

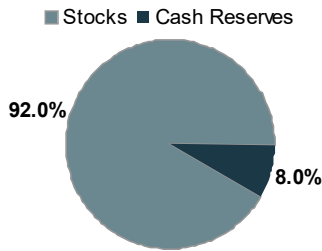


Chart 6: Inflow to equities exceeds combined inflow of past 19 years  
Rolling 12m flows to equities (\$bn)



Source: BofA Global Investment Strategy, EPFR

Table of Sorted Stock Indexes Returns

Stock Indexes Returns (Total) For time periods ending December 31, 2021			
1 year returns		2 year annualized returns	
Dow Jones Transportation Average	33.21%	Nasdaq 100	37.78%
S&P 500 Composite (Equal Weighted)	29.63%	Nasdaq Composite	33.06%
S&P 500 Composite (Capitalization Weighted)	28.71%	Dow Jones Transportation Average	24.59%
Nasdaq 100	27.51%	Russell 1000	23.68%
S&P 600 SmallCap	26.82%	S&P 500 Composite (Capitalization Weighted)	23.44%
Russell 1000	26.46%	Russell 3000	23.25%
Russell 3000	25.66%	Dow Jones Total Stock Market	23.20%
Dow Jones Total Stock Market	25.66%	S&P 500 Composite (Equal Weighted)	20.94%
S&P 400 MidCap	24.78%	S&P 400 MidCap	19.08%
Nasdaq Composite	22.18%	S&P 600 SmallCap	18.80%
Dow Jones Industrial Average	20.95%	Russell 2000	17.36%
Dow Jones Utilities Average	17.01%	Dow Jones Industrial Average	16.20%
Russell 2000	14.82%	Dow Jones Utilities Average	9.01%
5 year annualized returns		10 year annualized returns	
Nasdaq 100	28.63%	Nasdaq 100	23.15%
Nasdaq Composite	24.97%	Nasdaq Composite	20.96%
S&P 500 Composite (Capitalization Weighted)	18.47%	S&P 500 Composite (Capitalization Weighted)	16.56%
Russell 1000	18.43%	Russell 1000	16.54%
Russell 3000	17.97%	Russell 3000	16.30%
Dow Jones Total Stock Market	17.92%	Dow Jones Total Stock Market	16.24%
S&P 500 Composite (Equal Weighted)	15.73%	S&P 500 Composite (Equal Weighted)	15.64%
Dow Jones Industrial Average	15.61%	S&P 600 SmallCap	14.50%
Dow Jones Transportation Average	14.37%	Dow Jones Transportation Average	14.25%
S&P 400 MidCap	13.09%	Dow Jones Industrial Average	14.21%
S&P 600 SmallCap	12.42%	S&P 400 MidCap	14.20%
Russell 2000	12.02%	Russell 2000	13.23%
Dow Jones Utilities Average	11.82%	Dow Jones Utilities Average	11.60%

Table of Sorted Standard & Poor's 500 GICS Sectors Returns

GICS Sectors Returns (Total) For time periods ending December 31, 2021			
1 year returns		2 year annualized returns	
Energy	54.64%	Information Technology	39.13%
Real Estate	46.19%	Consumer Discretionary	28.79%
Financials	35.04%	Materials	23.96%
Information Technology	34.53%	Communication Services	22.59%
Materials	27.28%	Health Care	19.62%
Health Care	26.13%	Real Estate	19.59%
Consumer Discretionary	24.43%	Industrials	15.98%
Communication Services	21.57%	Financials	15.22%
Industrials	21.12%	Consumer Staples	14.62%
Consumer Staples	18.63%	Utilities	8.74%
Utilities	17.67%	Energy	1.27%
5 year annualized returns		10 year annualized returns	
Information Technology	32.13%	Information Technology	24.01%
Consumer Discretionary	21.35%	Consumer Discretionary	19.57%
Health Care	17.58%	Health Care	17.19%
Materials	15.12%	Financials	16.32%
Real Estate	14.87%	Industrials	14.19%
Financials	13.26%	Real Estate	13.11%
Industrials	12.80%	Materials	12.81%
Utilities	11.76%	Consumer Staples	12.24%
Consumer Staples	11.76%	Communication Services	11.56%
Communication Services	11.49%	Utilities	11.06%
Energy	-1.45%	Energy	1.20%