Hughes Investment Advisory Service LLC

January 1, 2022

Dear Clients and Investors,

For Q4 the S&P 500 was up 9.3% and rose 26.9% for the full year 2021. This was a second great year for equities following the onset of Covid-19 in January of 2020 and subsequent Bear Market.

Some additional key 2021 data points:

- Estimated final 2021 GDP growth will come in at 5.6%
- Estimated final 2021 Inflation +7% highest in 40 years.
- Estimated final 2021 S&P 500 Earnings will come in at $210 or +50% over 2020– to a new record.

The above data is, after all, what matters most in calculating how the economy is doing which directly effects corporate earnings and the performance of investment classes across the board.

I think we can all agree that despite Covid-19 and associated economic turmoil, the recovery over the last two years has been remarkable. In fact, despite the rampant pessimism naturally surrounding Covid-19 and what that has done to our country and the world for the last 2 years, I see many signs of American renaissance. Social strife, rising inflation, a disastrous withdrawal from Afghanistan, political strife and gridlock in Washington makes it seem like America is in decline but let's look at the larger landscape.

The US economy is poised for another strong year in 2022. This makes the Worlds authoritarian leaders nervous, as it should. From Beijing, Moscow, Istanbul, Tehran to Pyongyang excessive state control, in all its forms, is causing economic and social pain for the people in the grip of authoritarianism. Their international political isolation is growing as free market capitalism and our constitutional federal republic exhibits strengths despite the mudslinging it so often entails.

The challenges of continued US growth and continued global influence are not insignificant but when looking at the worlds other major players and the systemic problems inherent in their political and economic systems it brings to light the superior aspects of all that the US has to offer. This should continue to attract both FDI (foreign direct investment) and human talent in the foreseeable future. US corporations continue to be the superior engines of growth, technological progress, profits, and flat out solving the worlds problems whether it's Pfizer, Apple, Fedex etc. These companies solve the world's problems while paying taxes, creating jobs and wealth along the way.

Looking back at last year's two predictions, 1. that the S&P 500 would rise 8%, I was under the actual return of 27% and 2. that inflation would run much higher than predicted, proved correct with inflation exceeding the Fed's predictions and running at a 40 year high. How about the year ahead? I'm expecting:

- GDP growth of 3%
- PCE Inflation of 6%
- S&P 500 Earnings of $225 or +7%
- S&P 500 return of 6%
- Fed will raise Federal Funds rate 5 times to 1.5%

The Fed, finally fearful of rising inflation, said it would finish its pandemic-era bond buying (Quantitative-Easing) by spring 2022, several months earlier than previously planned. Thereafter, it's projection is to start raising the federal-funds rate target with three hikes in 2022. As stated above, I believe that 3 rate hikes may not be enough due to persistent supply chain bottlenecks and higher labor costs which will exacerbate the inflation problem beyond what the Fed currently expects. As I have been writing for a year, the Fed has been behind the inflation curve and remains so in my view. For the first time in decades, events, and policies, have conspired to create an inflation problem that may persist well into 2022 and beyond.

Covid-19 continues to be a clear and present danger but from everything that I read and absorb about this virus, the latest Omicron strain is precisely what we would hope for and expect, meaning more contagious but also less virulent. However, with the Omicron currently raging and the Fed planning to increase rates concurrently the result could be stagflation or slowing growth and higher inflation as warned in earlier letters. Is the Fed finally raising rates at perhaps exactly the wrong time? I believe the chances of that are quite high as their backs are against the wall with inflation and Omicron raging concurrently! Inflation requires the Fed to raise rates while Omicron requires stable/lower rates.

Having been an investor since 1984 I can say that 2021 was an unusual year in the markets for sure. Why? Zero interest rates, one-time covid related government payments, rent and student loan payment deferrals etc. all seemed to come together at once to create the year of the “risk asset”. Anywhere there was elevated risk and an opportunity for larger returns generated investor interest. Crypto’s, SPAC’s, IPO’s, Options, ARK funds and meme stocks all saw huge returns followed by large pullbacks. This action reminded me of 1999 (Internet Bubble) and 2007 (Real Estate Bubble) giving me pause regarding the markets overall since risky asset bubbles can spill over to less risky assets as we saw in both previous cases. Despite the great gains for the S&P 500 most of the risky investments mentioned above all fell precipitously. As of a month ago 49 out of 50 recent tech IPOs were all in the red for 2021. Despite my financial contagion concerns we have so far seen an orderly pullback in these assets without spill over into the more traditional assets that we own in our portfolio’s. Yet to be determined and one of my focus points going into 2022 is to see if these and other assets can continue to prosper under a scenario where the Fed is eliminating their asset purchases and raising the federal funds rate.

Specifically, given the above concerns where do I find attractive investments and companies today? I’m leaning more towards “real assets” which include equities with well-defined earnings prospects that can pass on higher input costs and prosper during periods of moderating economic growth, real estate, and some commodity exposure. Areas of focus include pharma, technology, defense, energy, infrastructure, and biotechnology. The Utility and Consumer Staples sectors stand out as income producers in a low-rate environment. I am still expecting the Utility sector to be a surprise winner from the EV and green energy revolution which require infrastructure investments needed throughout the power grid system.

Overall, I continue to favor large-cap, dividend paying, US based multi-national companies with strong balance sheets. We love businesses with irreplaceable brand names, wide moats, high margins, grow their dividends, and have modest debt. Risk/reward continues to favor equities over fixed income. A few select REIT's and specialized bond/income and alternative funds continue to look good as income producers. I believe that our portfolios are well positioned to produce consistently attractive long-term risk adjusted returns while preserving capital. Please do not hesitate to give me a call to discuss the above analysis.

Sincerely,

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