

Blue Chip Partners: Quarterly Edge

Q1 2022



Market Outlook

In Michigan, the onset of wintery weather brings about a change in wardrobe. Instead of avoiding the outside world entirely, individuals bundle up accordingly. At Blue Chip Partners, we apply a similar approach to managing client allocations. As underlying market factors change, we dress portfolios appropriately instead of foregoing participation altogether. Whether it is in anticipation of financial markets' versions of sunshine and blue skies or seasonal precipitation, we maintain the belief that **time in the market** is more important than **timing the market**. As we digest the state of the investment climate today, we have identified three key themes to watch in the first quarter of 2022 and beyond:

At A Crossroads



Don't Panic!



Quality Checklist



U.S. markets find themselves at a crossroads as we begin 2022. The staying power of inflationary pressure, shifts in monetary policy at the Federal Reserve and central banks around the world, and the ensuing impact on consumer activity and balance sheets have potential to impact the direction of travel from an economic perspective.



The dynamics that currently underpin financial markets have led some to question the return potential of assets for the first quarter of 2022 and beyond. Interest rates may rise, albeit modestly, and the margin debt that has contributed to equity market appreciation could be scaled back. Now is not the time to panic, but a more normal level of volatility should be expected.



A focus on quality serves as the backbone of Blue Chip Partners' investment philosophy. Our approach is evergreen, but we also view increased scrutiny on allocations as prudent given elevated uncertainty as we enter Q1 2022. Health Care and pockets of Information Technology stand out as areas of interest.

Blue Chip Partners: Quarterly Edge

Q1 2022

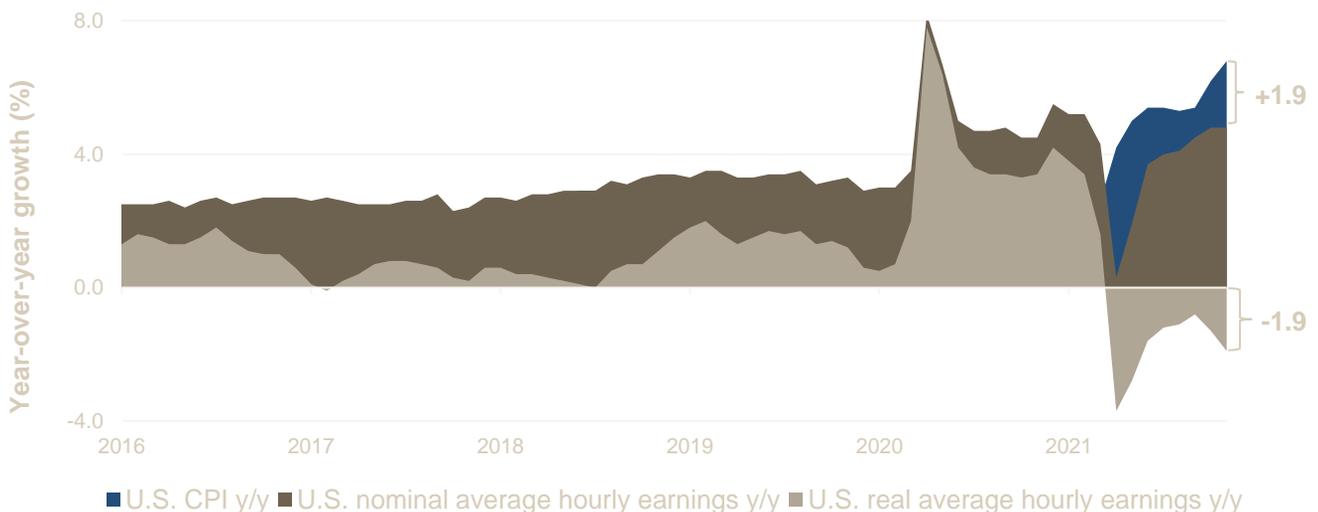


At A Crossroads

While 2022 will present fresh challenges from an investment perspective, concerns regarding inflationary pressure remain front and center as we set sail for 2022. While more cyclical items (think energy and automobiles) are primary contributors to the highest year-over-year increase in consumer prices since 1982, the staying power of these cost pressures could present consequences that reverberate throughout 2022.

U.S. consumers found themselves in an enviable position post-pandemic. A high savings rate, low level of debt service payments relative to personal disposable income, and a healthy level of pent-up demand fueled a robust rebound in spending. While growth in personal consumption expenditures remains significantly above the long-term average, the persistence of cost pressures may prove a hindrance to further strength in spending as individuals feel the heat. We feel as though we may be at a crossroads. The personal savings rate (7.3%, precisely where it was in December 2019) has returned to a more reasonable level, pandemic-era stimulus benefits have been removed, and thus consumers will be more reliant on wage growth for further spending. The problem: inflationary pressure has outpaced wage gains, **resulting in a decline in real wages**. We will be closely monitoring economic and company-level data in search of a “tipping point” in which consumers become unwilling (or unable) to stomach higher prices. This would have knock-on effects for the profitability of U.S. businesses.

Consumer Price Index (CPI) vs. Wages (year-over-year)



Sources: Blue Chip Partners with data from Bloomberg and the Bureau of Labor Statistics. Data shown from 12/31/16 – 11/30/21.

Along with the potential for a less rosy consumer spending environment, we do believe that price increases will close in on a more normal growth rate as we progress through 2022. Keep in mind that the current inflation shock has been primarily demand-driven but exacerbated by unique pandemic-related consequences. We have already seen some easing in supply chain issues at the company-level, and we expect the disruption to further abate through the back half of the upcoming year. Further, the Federal Reserve has become comfortable with scaling back its accommodative monetary policy. While a coordinated removal of stimulus efforts from central banks around the world leaves market participants in territory that is unfamiliar to the last decade, monetary authorities will be taking cues from the data as they set policies. For example, if GDP readings come in light on the back of weaker consumer spending or prices naturally moderate due to supply chain resolution, the Fed may not be rushing towards the three rate hikes that many expect in 2022.

Blue Chip Partners: Quarterly Edge

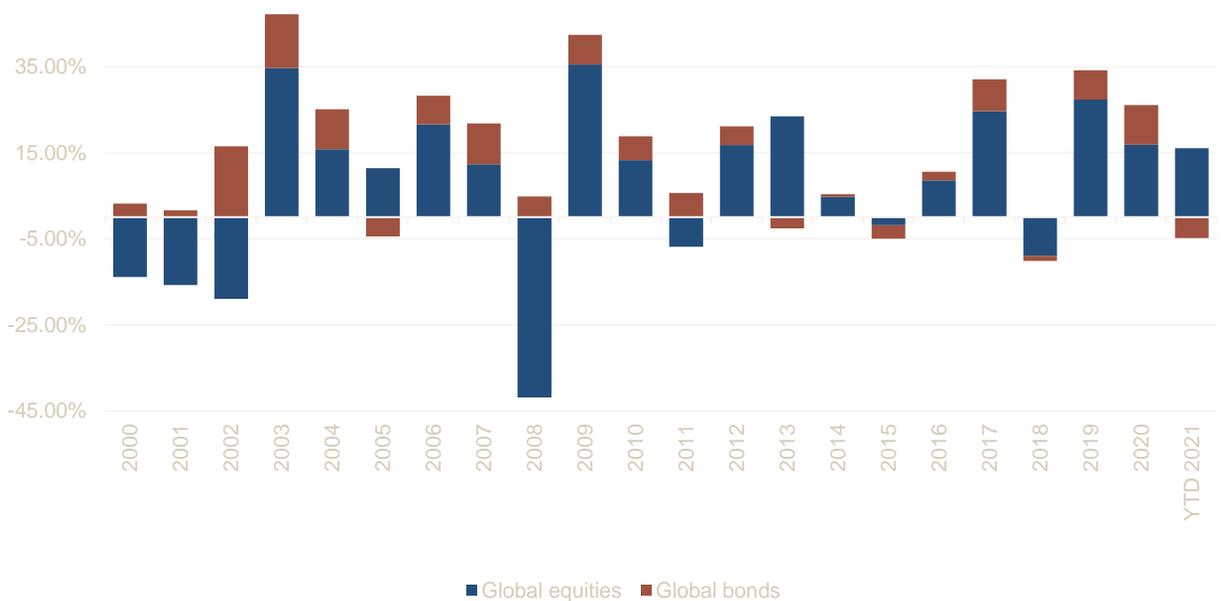
Q1 2022



Don't Panic!

As a testament to its unique qualities, calendar year 2021 bore witness to a rare occasion in which global equities appreciated in value while global bonds lost value (only seen twice since 2000, excluding 2021). The rapid rebound in economic activity coming out of the pandemic resulted in the previously outlined inflationary pressure and supply chain disruption. With booming demand and rising inflation, corporate profits swelled and real bond yields remained historically low (negative in some cases) without central bank intervention. These factors supported stocks, and investors allocated as such.

Annual Returns For Stocks And Bonds



Sources: Blue Chip Partners with data from Bloomberg. Global equities represented by the MSCI ACWI Index, Global Bonds represented by the Bloomberg Global-Aggregate Total Return Index. Data shown from 1/1/00 – 12/22/21.

For 2022, the Federal Reserve and other central banks are likely to put forth an uptick in policy rates – the post-pandemic recovery no longer requires ultra-supportive monetary policy. That being said, the Fed has shown an affinity for patience, especially given a challenged labor market and the dynamic nature of coronavirus variants. Even when the Fed initiates monetary tightening (raising interest rates), it will be in small increments, and we are coming off a low base. A likely scenario appears to be that real bond yields tick up modestly, but remain low as inflation remains a burden. Such an environment would continue to be supportive for U.S. equities relative to fixed income – see our discussion regarding the Equity Risk Premium in the [3Q 2021 Quarterly Edge](#). In fact, the 10-year treasury **would have to approach 3%** for U.S. stocks to appear overly risky relative to government bonds. Equities have also proven to be one of the better markets to play in when inflation is a concern, with companies that display pricing power standing out as premier options.

Blue Chip Partners: Quarterly Edge

Q1 2022



Don't Panic!

Overall, we remain constructive on U.S. equities heading into the first quarter of 2022. Robust pent-up demand (although not as intense as seen in 2021) should buoy corporate revenues, and U.S. businesses have taken measures to insulate themselves from margin pressure where possible. However, we do see potential for volatility to emerge as we begin the new year.

The pivot in monetary policy, ongoing pandemic-related challenges, and lofty valuations in select sectors all point to a potentially bumpier ride ahead. Additionally, we have taken note of the possibility of a decline in a mountainous level of margin debt (**\$919bn** today vs. **\$579bn** in Dec. '19). Margin debt refers to additional dollars that investors borrow to buy new shares, using their stockholdings as collateral. When interest rates are low, the cost of utilizing margin debt is minimal, and this extra leverage can magnify returns if markets trend upwards. The opposite is true in a declining market, and if shares purchased on margin decline to a certain level, the investor must either deposit additional cash or sell shares. Given the substantial use of margin today, the latter could contribute a snowball effect in stock prices. More importantly, and a likely contributor to volatility experienced in 4Q 2021, investors are anticipating a rise in margin borrowing costs as rates tick up, and are paring back positions accordingly. We see room for further unwinding of margin debt which, although healthy for the market long-term, could contribute to pockets of short-term volatility. While it is not time to panic, selectivity in portfolio allocations will be key as we begin 2022.

Peaks In Margin Debt Have Historically Preceded Volatility



Sources: Blue Chip Partners with data from FINRA. Data shown from 1/31/97 – 11/30/21.

Blue Chip Partners: Quarterly Edge



Q1 2022



Quality Checklist

Given the confluence of factors that will contribute to the direction of financial markets in 2022, we submit that Blue Chip Partners' philosophical bias towards quality can aid in navigating uncertainty. Our interpretation of quality is evidenced by ownership of businesses that display healthy balance sheets, competitive advantages, proven management teams, and capacity for dividend growth. Within that framework, however, we see a need for selectivity as we enter the first quarter of 2022. Speculative, high-growth investments have dominated the market in recent years, but the crossroads the U.S. finds itself at today may prompt investors to require more than just pie in the sky future expectations. In addition to analyzing potential investments through the quality lens outlined above, employing tactical aspects in our checklist aligns with the selectivity we are calling for. How have various sectors performed in a rising interest rate environment? Which sectors have exhibited leadership when margin debt is being unwound? Two sectors that have our attention are Health Care and Information Technology.

Health Care

The Health Care sector provides a rare blend of growth, stability, and attractive valuations that few can match at this point in time. Health Care was front and center through 2020 and 2021, and the innovation displayed through the rapid development of vaccines and testing equipment is a testament to the imperative nature of the sector. It also highlights the staple-like characteristics of businesses in the sector, which fit the bill for the stability portion of portfolios. COVID-19 will not magically disappear, and thus companies that participate in the production of relevant testing equipment and therapeutics appear positioned to remain intertwined with the daily lives of individuals around the world. Elective procedures have been delayed by pandemic-related closures and labor shortages, which has caused an earnings hiccup for many providers of medical devices. The key is that these necessary procedures have been pushed down the road, not cancelled. As the world continues to re-open, an abundance of demand may contribute to above-trend earnings growth in the devices space. Lastly, health maintenance organizations reap benefits as an aging population results in greater need for health care. Additionally, these firms have become incredibly adept at predicting costs, resulting in reliable profitability. Despite the tailwinds, the Health Care sector looks like a bargain relative to the market.

Information Technology

To be clear, we are not as interested in the companies that have been beneficiaries of speculative froth. We view that subset as most likely to be impacted by rising rates and a lowered emphasis on leverage. Elsewhere in the sector, pockets of opportunity remain. We tend to lean towards structural growers who have proven themselves through market cycles and, at this point, exhibit more resilience than other sectors. Corporate spending on technology infrastructure has boomed on the back of COVID-19, and the new hybrid work environment would imply that the future holds much of the same. In the semiconductor space, we remain optimistic on both the providers of more widely used chips and the manufacturers of vital process control units. These companies trade at significant discounts to the high-performance chipmakers, and can continue to exhibit reliable growth as the prominence of semiconductors accelerates. Valuations seen in the sector at large are rich relative to the broad market, but among our areas of interest, multiples have been supported by continued profitability. The forward PEG ratio (forward price-to-earnings divided by long-term earnings growth estimates), shown below for Blue Chip's Core Model holdings in the sector, indicates that we don't necessarily have to pay up to participate in these structural growers.

Health Care Sector Valuation vs. S&P 500



Sources: Blue Chip Partners with data from Bloomberg. Data shown from 1/31/12 – 11/30/21.

Valuation Relative To est. Long-term Growth



Sources: Blue Chip Partners with data from Bloomberg. Data shown as of 12/23/21.

Blue Chip Partners: Quarterly Edge

Q1 2022



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