PETERSON FINANCIAL SERVICES

Limited Liability Company ◆ Registered Investment Advisory Firm

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WHEN BIG-GOVERNMENT POLITICIANS INTERVENE IN EFFCIENT MARKETS, SERIOUS DAMAGE IS DONE.

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QUARTERLY MARKET RECAP

The last quarter of 2021 was a replay of the previous quarter's index volatility ending with decent gains. The fourth quarter is historically the strongest, and this year it was a good one. The negative prospect of massive proposed government spending and taxes receded with a lack of agreement among Democrat politicians, and the Federal Reserve's belated realization that loose monetary policy has actually led to increased inflation, became the primary trading themes. For the last quarter, the DJIA added 7.37%, the S&P 500 rose 10.64%, the NASDAQ picked up 8.28%, but the small-cap Russell 2000 drifted to a 1.86% rise. Foreign equities gained 7.49%. Expected interest rate increases, which the Fed has now made clear will come sooner and perhaps occur more often in 2022, and an acceleration of the demise of their quantitative easing program, did little to sway the bond market, as the Barclay's Aggregate Bond Index barely fell by 0.14%. Expect fixed-income losses in 2022.

As has been consistent throughout 2021, which operated under the pro-growth policies of the previous administration, GDP gains continue, our economy is outpacing most others, and the labor markets are healing. At this juncture, the greatest risk to the markets is potential damage done out of Washington.

FREE MARKETS ARE QUICKLY SELF-CORRECTING, BUT BAD POLICY INTRUSION CAUSES ECONOMIC HARM

Congress has poured fuel on the Federal Reserve's easy-money conflagration by dumping trillions of dollars of stimulus money into the economy at levels it didn't need and couldn't digest, long past the point of it being useful. The predicable result is runaway inflation the likes of which we haven't seen in 40 years. So what do the politicians in power who created this mess propose we do about it? Add more fuel to their fire! Thankfully, one of them, Sen. Joe Manchin, is standing in the breach.

As we mentioned last quarter, President Biden recently said his Build Back Better program would cost zero dollars. He also said more massive government spending would *lower* inflation! Not since Jimmy Carter uttered his demand that the Federal Reserve lower interest rates during a surge of double-digit inflation, has there been such a stunning display of presidential economic illiteracy and ignorance.

Excessive inflation is one of the most damaging economic conditions because it adversely affects those at the lower end of the earnings scale the worst. It feeds on itself, as we're already seeing, when workers demand higher wages to fight off higher living costs. That creates wage inflation that must be covered by higher prices for goods and services, creating a viscous cycle.

Our current level of inflation, which has rapidly emerged in just the last year, is a result of getting hit from both directions at the same time: too loose monetary policy for far beyond when it was warranted, and too much government "stimulus" spending beyond any sense of need or reason. Combined, these policy mistakes have flooded the economy beyond its ability to absorb the money. This has caused overheated demand chasing too few goods and services, and has bid up prices. Just over the last year or so, the government has authorized enough spending to replace 13.5% of annual GDP, and over $1 trillion of it hasn't even been spent yet. But the Build Back Better plan wants to add over $5 trillion more to this. That 13.5% of GDP is more than the amount of GDP loss during the brief Covid recession. They're not just replacing what was lost; they're drowning the economy in excess, and most of it is with borrowed money. This is literally insane.

This is all being done under the auspices of a necessary response to the Covid crisis. But a new study by JAMA Internal Medicine based on serological testing showed that the number of Covid *infections* is likely 6 to 24 times the number of *cases* reported. Other analyses indicate similar under-reporting of infections based on antibodies found in individuals, asymptomatic cases, and those who get Covid and know it by home self-testing, but aren't seriously affected, so they don't see a doctor or report it to anyone. That last category is significant. If these estimates are applied to the most recent case fatality rate (CFR) of 3.6% (which we'll ignore is inflated by deaths attributed to Covid that aren't, which is also prevalent), that would yield an infection fatality rate (IFR) of 0.15% to 0.6%. The IFR is the meaningful value. The nine-year average IFR for seasonal flu in America is 0.13%, according to the CDC. The severe flu season of 2020-11 had an IFR of 0.176%.

The point is, we've created economic policy and spent trillions of dollars on flawed data and some false assumptions. This is not to say the pandemic isn't a serious issue, it is. But is the policy response proportional? We now know more. These policies have led to widespread economic damage we cannot go back and fix, such as lost output during severe lockdowns and bankrupted businesses. Fair enough – no one knew early on what this situation would develop into, or how severe it would ultimately be. But now we have almost two years of experience and more complete data to analyze and what we can do at this point is not continue these policy errors based on miscalculations. The economic data reveals that certain policies, such as severe lockdowns and overspending have done serious damage and have not even halted the spread of infection.

Worse, this pretense has been used by some politicians to seek to accomplish their desire to entrap more citizens into permanent dependence on government, forever eroding our liberties, and obligating us to crushing transfer payment costs. It is in this, that we find the greatest long-term risk to our standard of living. This economic structure is exactly what Europe burdens under.

These proposed spending programs come with controls that once enacted, will not be easily rolled back, if that is ever even attempted. One of Sen. Manchin's rational reasons for resisting this tax-and-spend blowout is that the proposal seeks to conceal the true cost by showing tax revenue for ten years, but limiting program life to just a few years. But he knows what we should all know as well: that the authors of this legislation have already gone on record as saying they intend for future Congresses to extend all of these programs indefinitely. These would become brand new *permanent* entitlements, all under the guise of responding to an unusual emergency, which is now well in hand. The pandemic is now endemic.

At this moment the markets are digesting the ramifications of these two issues: how interest rate and monetary policy will affect capital formation, and if this additional permanent government involvement in our lives will play out. The answers to these issues will drive 2022 markets.

"Nearly all men can stand adversity, but if you want to test a man's character, give him power."
- President Abraham Lincoln

CONTACT

1726 Clarkson Street
Denver, CO 80218

Phone: (303) 831-4800

E-Mail:
kirk@petersonfs.com

Hours of Operation
7:30am–5pm M-F

Visit us on the Web!

www.petersonfs.com

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