STRATIGRAPHIC ASSET MANAGEMENT, INC.

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Investment Outlook

Equity investors were very well rewarded in 2021. The total return on the S&P 500 Index including dividends was 28.5%. Who would have thought that common stocks would record such a high return in a period when the economy remained under assault by COVID-19? Market performance wasn't entirely irrational — big-cap earnings that dominate the Index were exceptionally strong last year, and interest rates that affect valuations remained at historically low levels. This is the third year of outsized performance by the S&P 500 Index. Between 2019 and 2021, the Index experienced a compounded return of more than 25% per annum. In the last 50 years, there was only one other period of such outperformance. In the five years from 1995 through 1999, the compounded return of the S&P 500 Index exceeded 27% per annum. The two periods are not comparable. The 1990s were a favorable time of steady economic growth and stability, conducive to a rising stock market. The performance of equity markets over the last three years, however, was remarkable, given decelerating economic growth and the massive disruption caused by the pandemic.

Interest rates rose in 2021. The benchmark 10-Year Treasury Bond yield increased from 0.91% at the end of 2020 to 1.62% as of December 31. The rise in interest rates depressed fixed-income returns. The total return on the Bloomberg Barclays U.S. Aggregate Bond Index in 2021 was -1.5%.

Here are our major conclusions regarding the investment outlook:

- The outlook for the U.S. economy over the next two years is expected to be favorable. While the recovery has been pushed back somewhat by the upsurge of the COVID-19 Omicron variant in the last quarter, the economy is on track to regain the economic growth lost during the pandemic.

- Despite pandemic headwinds, corporate profits in the aggregate have been stellar. S&P 500 Index earnings recovered sharply in 2021 to above 2019 levels, which is evidence of the strength of the recovery underway. The big question in the current year is the extent to which corporate profits will be impacted by rising labor costs, supply-chain bottlenecks, and related factors. The outlook in 2022, while positive, is for more modest earnings growth.

- Our biggest concern is current price increases. We believe inflation will peak at higher rates than generally projected and will last longer. The Federal Reserve and the consensus of economists hold that rising inflation is largely attributable to temporary factors and will abate during 2022 and 2023. The Fed has been slow to respond. We anticipate the Fed will have to raise short-term rates more aggressively than generally expected in 2022 and 2023. While the hike in interest rates will be deadly for bond investors, we believe that pricing power and productivity gains will enable corporate profits to continue to grow.

- While the median expectation of leading market strategists is for the market to appreciate from year-end levels by around 5% in 2022, we caution that decelerating economic growth, a more

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moderate outlook for corporate profits, the general uncertainty over the magnitude and threat of inflation, rising interest rates, and currently high equity valuations could result in a bumpy market in 2022.

The economic backdrop for U.S. investors is moderately favorable.

The U.S. economy will experience rapid growth in 2022 as the recovery from the pandemic continues. Table 1 provides forecasts for real GDP growth made by institutional economists surveyed by Bloomberg and by Federal Reserve Board members and Federal Reserve Bank presidents. The economy took a hit in 2020 when GDP contracted by 3.4% and the unemployment rate rose to 5.5%. Owing largely to the stimulus provided by federal programs as well as progress made through vaccines and other measures to control the virus, the economy roared back in 2021. Because of the impact of the Omicron variant, it is possible that some of the growth anticipated in 2022 will be pushed out to 2023. However, if the forecasts are generally correct, the economy from 2019 through 2023 will have expanded at a compounded growth rate of around 2.1% per annum, which astonishingly is a bit higher than the original forecasts in this period prior to the pandemic. This unexpected achievement reflects the massive federal support during this period.

One way of assessing the economic cost of the pandemic is to estimate the incremental increase in federal debt above the level it would have been had there been no pandemic. Based on the current and pre-pandemic forecasts of the Congressional Budget Office, the five-year cumulative deficits and the federal debt are projected to be $3.5 trillion higher, an amount equal to around 15% of the country's total GDP.[1] How many countries can issue sovereign bonds of this magnitude without destabilizing their bond markets? The Treasury experienced no problems in 2021 with bond placement. The rise in Treasury rates last year was linked more to inflation expectations and anticipated tightening monetary policy than to any weakness in the creditworthiness of the United States Government.

Table 1						
U.S. Economic Data	Actual		Projected			
	2019	2020	2021	2022	2023	2024
Real GDP (YoY%)						
Economists (78)	2.3%	-3.4%	5.6%	3.9%	2.5%	NA
Federal Reserve	2.3%	-3.4%	5.5%	4.0%	2.2%	2.0%
Sources: Bloomberg as of January 4, 2022 and Federal Reserve, December 15, 2021						

Corporate profits have been astonishingly strong despite disruptions and higher operating costs.

The pandemic posed serious challenges to U.S. corporations, including the breakdown of overseas supply chains, rising energy costs, labor shortages, semiconductor shortages, and shutdowns. The virus especially affected travel, hotels, cruises, and entertainment, among other businesses. Notwithstanding the disruptions, the S&P 500 companies in the aggregate experienced a remarkable recovery in 2021. The consensus of analysts is that earnings will be reported at a significantly higher level than in 2019. One important driver of earnings last year was the excess savings of households — estimated at over

[1] These estimates are based on the actual and projected data published by the Congressional Budget Office in its 10-Year Budget Projections publications in January 2020 and July 2021. The CBO forecasts

$2 trillion — generated by federal support programs. Also important was the pricing power of the largest companies that enabled them to pass along the higher costs caused by the pandemic. While the earnings outlook for 2022 seems favorable, forecasts are less predictable owing to the virus and inflation. We are assuming that the impact of the Omicron variant will peak in the first quarter and operating margins will contract somewhat. On this basis, earnings growth in the mid-to-high single-digit range seems reasonable. Most earnings estimates do not provide for a corporate tax increase in 2022, although such legislation is still possible.

The biggest uncertainties looming over capital markets are inflation and the future level of interest rates.

For the first time in more than 30 years, the United States is experiencing elevated inflation as measured by major consumer price indices. In explaining the rise in prices and the outlook for inflation, there are two camps. One led by the Fed, including most economists, believes that the supply chain bottlenecks and labor shortages that gave rise to the current inflation will abate over the next two years. Table 2 shows the forecasts of the Fed and consensus of economists for inflation peaking in 2021 and gradually declining thereafter.

A second camp, represented by Harvard professor Lawrence Summers, believes pandemic-related stimulus legislation is creating excess demand that is driving inflation to higher levels.[2] In a December interview with Bloomberg, Summers stated, "We're going to entrench inflation way above 2% — perhaps in the 4% or even higher range."[3]

Table 2					
Inflation Forecasts, Personal Consumption Expenditures (PCE) Index					
	2021	2022	2023	2024	Longer Run
Federal Reserve Forecasts	5.3%	2.6%	2.3%	2.1%	2.0%
Consensus of Economists	3.8%	3.5%	3.2%	NA	
Sources: Federal Reserve Summary of Economic Projections, December 15, 2021					
https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20211215.pdf					
Bloomberg, January 6, 2022					

We have some difficulty with the forecasts of the Fed and the consensus of economists. The PCE Index is rising rapidly, from an annualized rate of 4.4% in September to 5.7% in November. The producer price index for goods and services in November rose at annualized rates of 13.3% and 7.0%, respectively, and will be reflected in consumer inflation indices over the next few months. Housing costs and rents, which together account for more than 20% of the PCE Index, are rising at annualized rates in the mid-teens. While special factors indicate that goods and housing inflation will not be sustained, we doubt future price increases in these areas will fall back to the 2% area that the Fed expects.

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[2] Summers, Lawrence H., "The Biden Stimulus Is Admirably Ambitious. But It Brings Some Big Risks Too," Washington Post, February 4, 2021.
[3] "Summers Says Policy Makers May Have Now Cemented Inflation at 4%," Chris Anstey, Bloomberg, December 10, 2021.

Here's our take:

- Price increases will not decelerate markedly in 2022 as the Fed believes. Our view is that inflation will be higher than projected and will persist longer.
- Some unwinding of globalization leading to increased domestic investment and manufacturing will be good for the U.S. economy, but will lead to a rise in real wages and other cost pressures.
- Highly stimulative fiscal policy, including enacted as well as pending legislation, is inflationary.
- We believe the Fed's decision to end the purchase of Treasuries and mortgage-backed securities (tapering), coupled with the implied rate increases in the Federal Funds target rate over the next two years, may be too modest and will take too long to implement.
- Interest rates will rise, but not likely to a level that will greatly affect the bottom line. Many corporations have sufficient pricing power to increase prices, but operating margins will be impacted.
- It is axiomatic that when interest rates rise, equity markets will come under pressure. That is because bonds, a less risky asset class, become more attractive. In general, we would expect valuations (price/earnings ratios) to decline as the market will now discount future corporate earnings by a higher interest rate. Until fixed-income investments generate attractive real returns, the pressure on equity markets should be limited.

Here is a quandary: is it possible for the United States to be dysfunctional politically while the country's capital markets remain unaffected?

It can be argued that a major reason why our capital markets are strong is that political governance and the rule of law are considered rock solid. However, events over the past year, perhaps best symbolized by the insurrection on January 6, 2021, point to growing political risk, which potentially could infect the investment landscape. How do you process a former president who refuses to accept his defeat in the 2020 election given that the peaceful and orderly transfer of presidential power has been a keystone of our democracy? What does it mean that millions of Americans believe the election process was flawed and the 2020 results a fraud in the face of no supporting evidence? What are the implications of broadcasters and social media participants willingly and knowingly propagating falsehoods? We do not know the answers to these questions, but they are on our mind.

Our assessment of equity market performance in 2022 is neutral. Further near-term appreciation will be limited, and there are risks of negative returns.

Common stocks are expensive. While the market at the end of the year was significantly higher than at the beginning, the forward multiples of the S&P 500 Index earnings have not meaningfully changed.[4] That is because the price appreciation of the Index in 2021 was driven by a proportionate increase in earnings.

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[4] In our January 2021 report, the price/earnings ratios on estimated 2021 and 2022 earnings were calculated at 22.9x and 19.6x respectively.

Table 3					
S&P 500 Index Levels, Earnings and Price/Earnings					
Current Price Earnings Ratios	2019	2020	2021	2022	2023
S&P 500 Index (at December 31)	3,231	3,756	4,766		
S&P 500 Index Year-Over-Year Change (Price Appreciation)	28.9%	16.3%	26.9%		
S&P 500 Earnings, 2019& 2020 Actual, 2021 Estimated	$157	$122	$202		
S&P 500 Price/Earnings	20.6	29.9	23.6		
Forward Price Earnings Ratios					
S&P 500 Index (at December 31, 2021)				4,766	4,766
S&P 500 Earnings, Estimated, Standard & Poor's				$219.58	$241.43
S&P 500 Price/Earnings				21.7	19.7

In December 2021, Bloomberg surveyed 19 strategists for their views of where the S&P 500 Index would end up in 2022. The median forecast indicates that the market will appreciate around 5% this year. Bear in mind that these individuals do not have a crystal ball. Historically there has not been a market drop of 20% or more, except when the economy is headed for recession, which is not anticipated over the next 12-to-18-month period. The consensus probability of a U.S. recession beginning over the next 12 months is around 15%.

To sum up, we caution that a decelerating economy, more modest growth in corporate profits, the general uncertainty over the magnitude and threat of inflation, and rising interest rates coupled with currently high equity valuations could result in a down market in 2022. In the last 50 years, the market experienced 12 annual declines averaging around 14%. The three worst of these took place in the 1970s when the economy was experiencing high inflation and stagnation, in the early 2000s resulting from the technology bubble, and in the financial crisis of 2008–2009. Our view is that economic conditions are currently better than during those times and that our companies are stronger and more profitable. We are confident that the average returns over the long term will continue to be favorable and justify the risk of equity investment.

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