Cliff Notes on the Economy

Economic Review & Outlook

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Fourth Quarter 2021

These five gauges drive our expectations for the stock market. Recall 12:00 is neutral, anything to the right of 12:00 is positive for stocks, anything to the left of 12:00 is negative.

Moving into the first quarter of 2022, we are adjusting three of our 5 gauges – reducing the Economy, Monetary Policy and Interest Rate gauges by one step each, which puts all three of those at a slow forward position. The Valuation and Investor Sentiment gauges remain unchanged. Despite these changes, four gauges remain in positive territory. Let's recap the gauges and review why we have them in their current positions.

U.S. Economy

The first gauge covers the U.S. economy. We reduced this gauge by one position to slow forward heading into the New Year and acknowledge that economic growth will likely slow in 2022 compared to 2021. Last year was dominated by the rebound in economic activity as the U.S. economy recovered from the pandemic shutdown.

We know the reopening exposed issues in areas like the labor market and in the global supply chain as part shortages, hiring issues, and higher prices became dominant themes in 2021. Despite economic challenges, the first half of 2021 still grew around 6.5% and following a pandemic-period low of 2.3% GDP growth in the third quarter, the fourth quarter was expected to bounce back strongly.

The Atlanta Fed's GDPNow gauge (as of 12/23/21) was estimating 7.6% annualized growth for Q4. We still expect economic growth to be above 3% in 2022, which is

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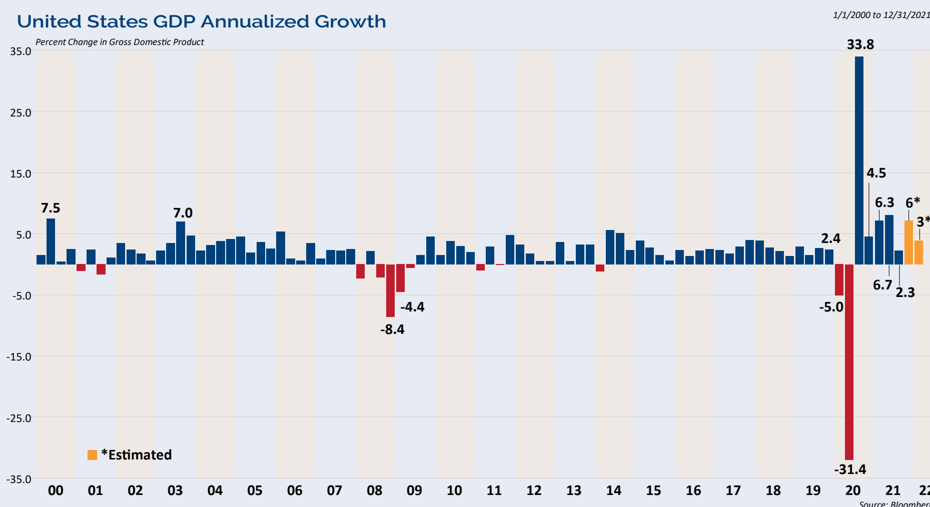
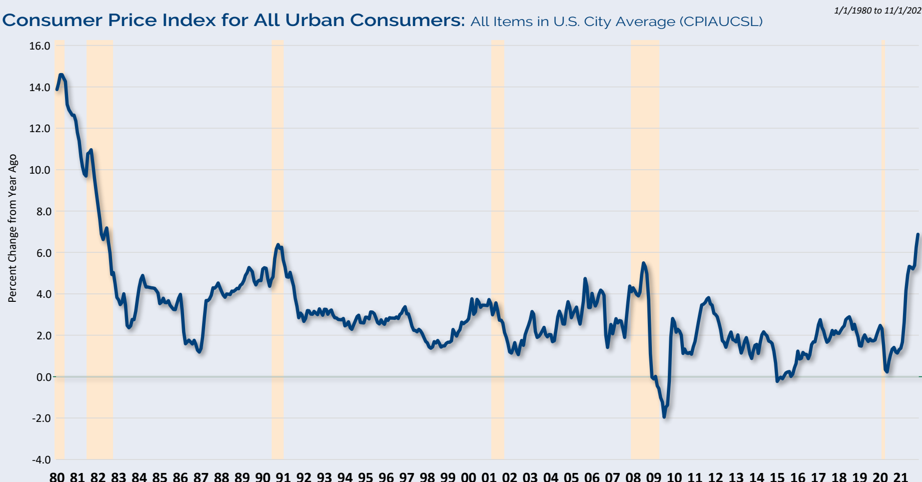
above longer-term trend levels estimated to be in the low 2% area. As the recovery matures, we expect the economy to move toward those long-term averages.

The surge in the Omicron variant certainly poses challenges for the economy and its impact is yet to be seen, but it would not be surprising if it has a negative near-term impact. Regardless, the "V-shaped" portion of this economic recovery is changing to a square root as we have moved past peak economic growth and head toward the longer-term trend.



Projections or other forward looking statements regarding future financial performance of markets are only predictions and actual events or results may differ materially.

The infrastructure spending bill (estimated to be about $1 trillion) finally passed and should be a tailwind to economic activity moving through 2022. However, this fiscal measure is not being matched on the monetary side as the Fed rapidly reduces stimulus. One of the driving forces for this Fed U-turn has been persistent inflation, which the Fed has finally acknowledged as not being transitory. Indeed, the latest Consumer Price Index reading for November 2021 showed a 6.8% year-over-year increase in prices on a headline basis – the largest increase in prices since 1982.



The Consumer Price Index (CPI) measures the change in prices paid by consumers for goods and services. The CPI reflects spending patterns for each of two population groups: all urban consumers and urban wage earners and clerical workers.

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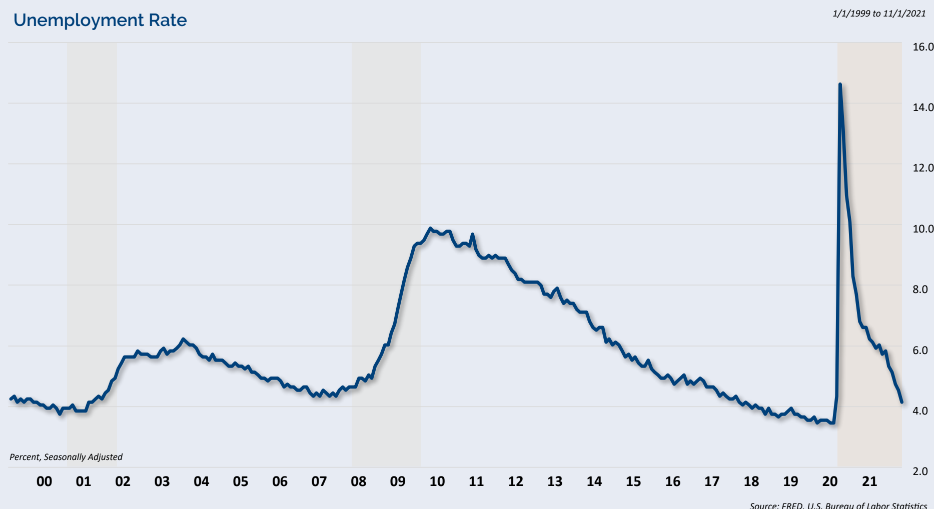
Since the pandemic hit, the Fed appeared to be much more focused on the full employment side of its dual mandate, which has seen strong gains. This focus has been at the expense of its second mandate, price stability or inflation control. Now, the Fed appears more determined to try to slow inflation, but without derailing the economic recovery – a challenging task indeed.

However, looking at the job market, the unemployment rate is down to 4.2% (as of November 2021), which is still above the pre-pandemic level of 3.5% in February of 2020, but significantly lower than the 14.8% rate seen in April 2020 at the pandemic's zenith. We actually stand at an interesting juncture where there are more job openings (based on the JOLTS job opening report) than those seeking employment.

A decrease in the labor participation rate has not helped the situation. This has driven wage levels higher, further exacerbating inflation concerns. The Fed clearly enjoyed success in getting Americans back to work following the shutdown of the economy in the spring of 2020, but distortions exist in the labor market that are still being worked out.



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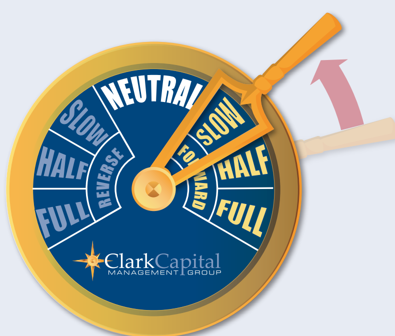
We believe the economic recovery will continue through 2022 and well into 2023. We anticipate the recovery will continue to encounter bumps along the way, but we believe the U.S. economy is headed in the right direction. As the reopening progresses and consumers feel more confident going back to some regular activities, the economy should enjoy above trend growth.

If the surge in Omicron cases slows the economic recovery, it could have the effect of extending the recovery as well – less strong growth in the near term, but more growth further down the line. The headwinds of the new Omicron variant might also influence the Federal Reserve and how it operates monetary policy, our next gauge, in the months ahead.



Monetary Policy

Monetary Policy

Monetary Policy remains stimulative, but it has clearly shifted gears in recent

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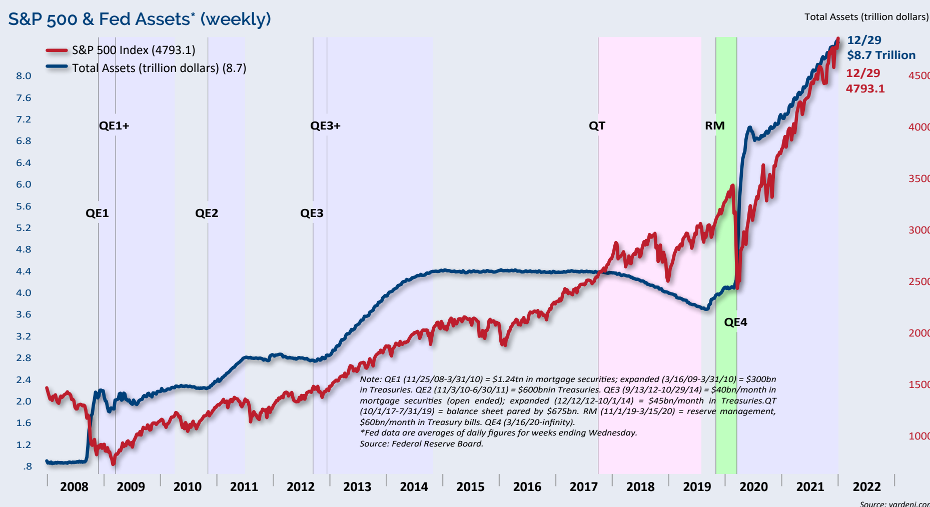
months. As of January 2022, the Fed will be buying only $60 billion of bonds for the month, when it had bought double that amount as recently as October. The tapering or slowing of the bond purchases has been ramped up and will likely end in the spring versus prior expectations of the summer of 2022. This has also pulled forward expectations of rate hikes occurring earlier and more often in 2022 than previously thought. We therefore decrease this gauge by one notch to a slow forward position to acknowledge this faster pace in the reduction of Fed stimulus.

As recently as September, Fed officials were split on whether there would be a rate hike at all in 2022 with half expecting no rate hike and most of the rest expecting only one increase in policy rates. In December, the economic projections by these same policy officials showed that more than half now expect three rate hikes in 2022. That is a dramatic shift in expectations and the market must adapt to a Fed that is clearly on the path of rapidly reducing monetary stimulus.

The Fed's balance sheet, which stood below $4 trillion prior to the pandemic, has expanded to nearly $9 trillion by the end of 2021. This massive amount of stimulus over the last (almost) two years clearly aided the economy and capital markets to get back on track after the pandemic hit. We are now heading toward an economy that gets less lift from monetary policy and needs to stand more on its own, and the transition to this environment will likely be bumpy.



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Ultimately, this massive stimulus by the Fed helped support capital markets and the economy from the early days of the pandemic crisis. The economy and capital markets have responded accordingly with strong growth. We have seen over the past several years that when the Fed is increasing its balance sheet, stocks have reacted favorably. That same formula played out from the March 2020 lows through 2021.

Inflation has become a bigger topic of late driven in part by the massive increase in public debt and spending in response to the pandemic. Furthermore, the reopening of the economy has led to some supply/demand imbalances, which has caused prices to rise sharply in some areas. The FOMC seems to have shifted gears from focusing on full employment to now focusing on price stability given the persistently higher inflation readings.

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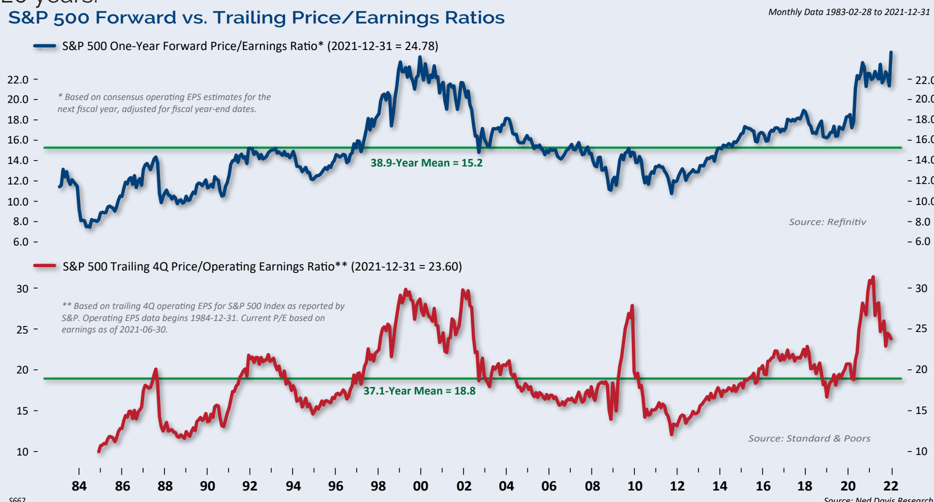
We know that one of the primary tools to deal with inflation is raising interest rates, but that could have a negative impact on economic growth as well. This balancing act will be a primary challenge that the Fed faces moving through 2022 and the market and the economy might face more volatility as this transition period occurs. Due to this shift in monetary policy, we reduce this gauge to a slow forward position. Even while this transition takes place, there tends to be a delayed impact due to rate changes, so rate hikes in 2022 might not be felt in the economy until 2023.

Valuations

Valuations

The next gauge is Valuations, which we keep in a slow reverse position. Needless to say, the rally in the stock market from the lows in March has been strong with new highs recorded for the major U.S. equity indices in late 2021. The forward price to earnings or P/E ratio of the S&P 500 continues to hover near its highest level in about 20 years.



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Although valuations remain elevated, the P/E ratio of the S&P 500 did not change much in 2021. Stock prices have clearly moved higher, but earnings have been strong and the primary driver of stock market progress. This rally in the stock market has not been driven by stocks getting more expensive or valuation expansion, but by strong earnings themselves.

Earnings have bounced back since the shutdown period last Spring. In fact, operating earnings for the S&P 500 grew by over 140% in Q1 2021 compared to the pandemic low earnings level in Q1 2020, but this will be the peak earnings growth period from a year-over-year perspective. The second quarter saw earnings grow more than 90% on a year-over-year basis and the third quarter saw a further slowdown to just shy of 40%. Growth rates will continue to come down in the quarters ahead and consensus estimates are looking for about 9% growth for 2022.

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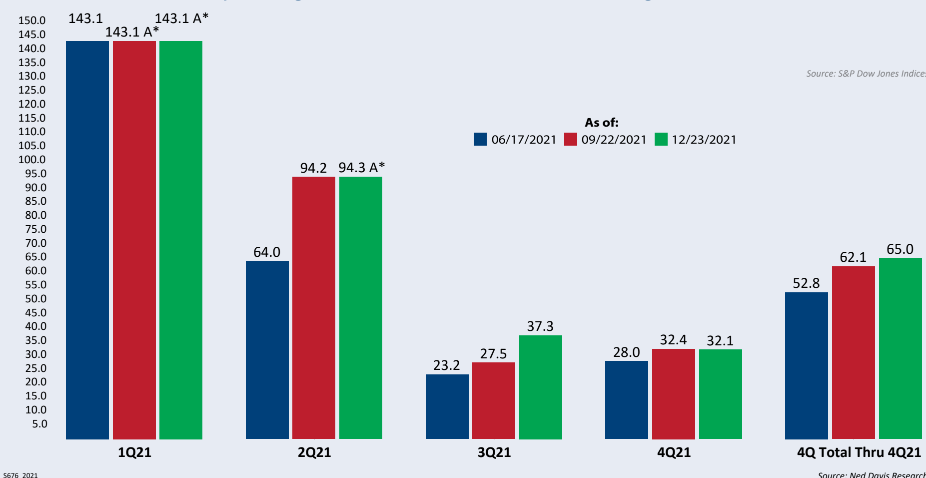

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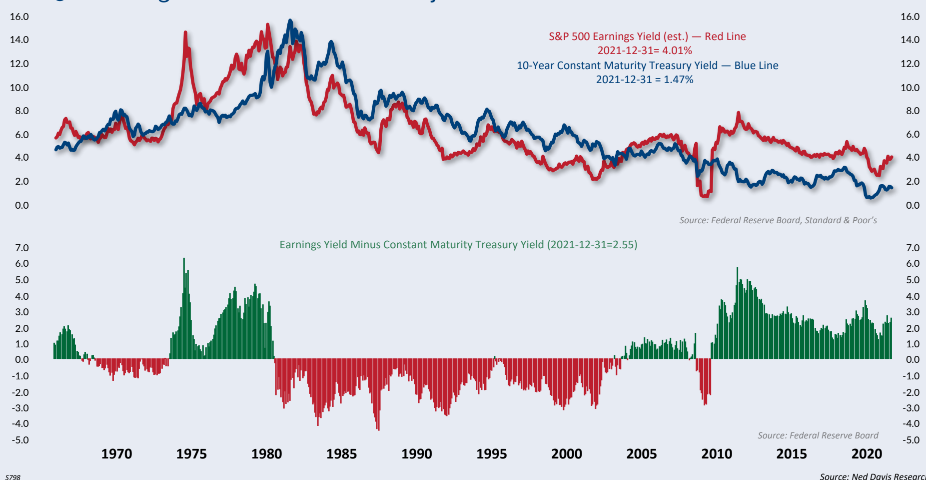
While valuation multiples are high, low interest rates help offset that. Interest rates moved sharply higher in the first quarter, but from a longer-term perspective, rates are still at low levels and the yield on the 10-year U.S. Treasury moved down from that March high. The 10-year U.S. Treasury yield was at 0.93% at the end of 2020, closed the first quarter at 1.74%, but came in from that point and it closed 2021 at 1.52%. We compare the earnings yield of the S&P 500 (which is the inverse of the P/E ratio) to the yield on the 10-year Treasury and it shows on a relative basis, stocks are still more attractive than bonds even with the move higher in rates in 2021.



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When interest rates are low, it supports higher stock market valuations. Simply said, the low yields of bonds are not providing a lot of competition to stocks. So, ultimately, we decided to keep this gauge in the slow backward position with valuations still elevated and peak earnings growth behind us, but with interest rates low.

Furthermore, we know from experience that stock market valuations are poor timing

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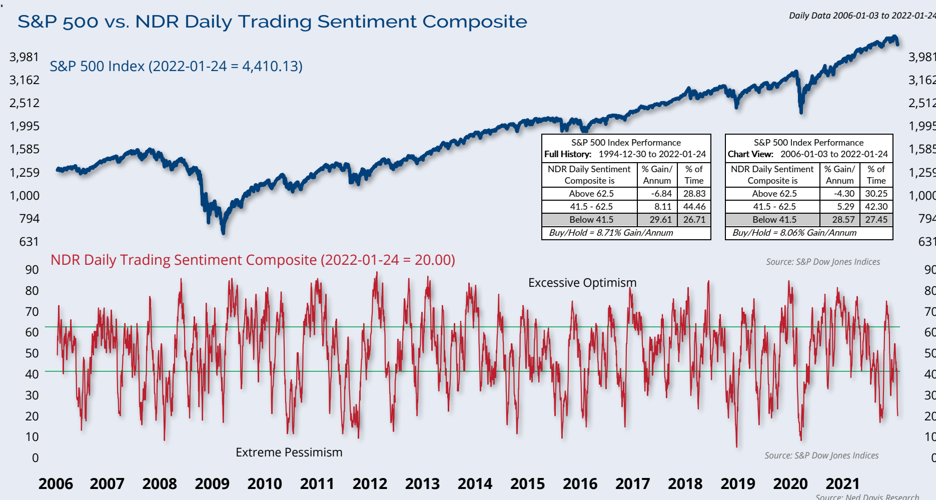
mechanisms. As an active manager, we look at valuations on a company-by-company basis. As the market rally has broadened, it has provided us at Clark Capital with an opportunity to seek out high quality companies at good prices and we continue to make very purposeful investments in both stocks and bonds.

Investor Sentiment

Investor Sentiment

The next gauge is Investor Sentiment, which can be thought of as a measure of speculation or pessimism in the market. Recall, this gauge is a contrarian indicator, so extreme pessimism is a positive from a market perspective and extreme optimism is just the opposite. After making the largest change to any gauge moving into the fourth quarter of 2021, we keep this gauge in its same slow forward position moving into 2022.

This gauge is very sensitive and can change quickly. After the market seemed a bit too optimistic and somewhat complacent during the first part of the year, some pessimism has crept back into the market, and we keep this gauge in its slightly positive position. Issues like the Omicron surge, higher inflation, and a Fed that has ramped up tapering and signaled coming rate increases have depressed investor sentiment. Also, trading sentiment has moved from optimism to pessimism, again a positive contrarian indicator.



S&P 500 Index Performance **Full History:** 1994-12-30 to 2022-01-24		
NDR Daily Sentiment Composite is	% Gain/ Annum	% of Time
Above 62.5	-6.84	28.83
41.5 - 62.5	8.11	44.46
Below 41.5	29.61	26.71
Buy/Hold = 8.71% Gain/Annum		

S&P 500 Index Performance **Chart View:** 2006-01-03 to 2022-01-24		
NDR Daily Sentiment Composite is	% Gain/ Annum	% of Time
Above 62.5	-4.30	30.25
41.5 - 62.5	5.29	42.30
Below 41.5	28.57	27.45
Buy/Hold = 8.06% Gain/Annum		

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Another indicator, which we discuss often as a measure of fear in the market, is the CBOE Volatility Index or VIX Index. Volatility returned with a vengeance in late November and early December. The VIX Index closed November above 31 and again posted a closing reading above 30 in early December – the highest levels since late January. However, that dropped dramatically to close the year at 17.22. Remember, as a contrarian indicator, the higher the VIX the more positive it is for the market as complacency has been replaced to some degree with some healthy market skepticism.

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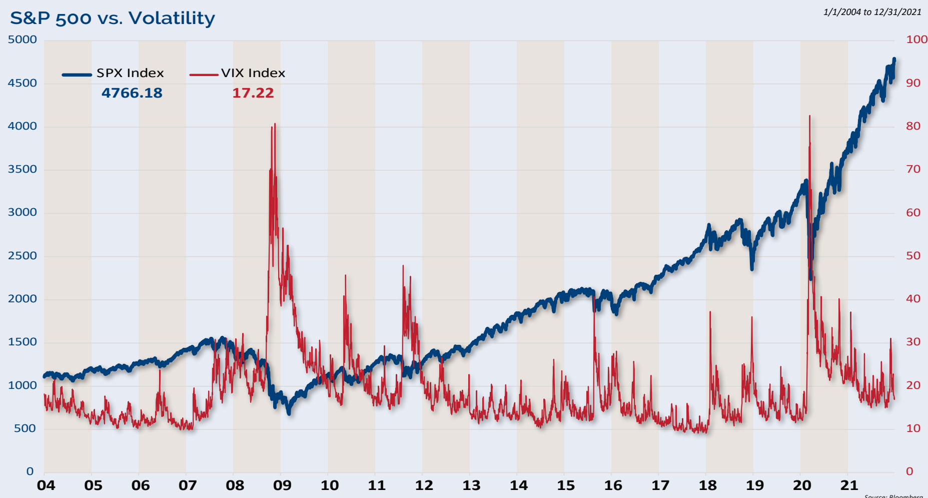

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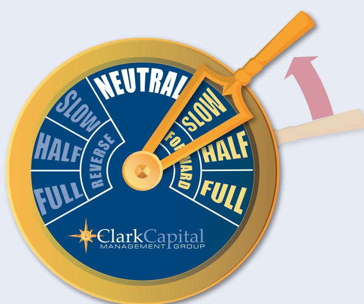
Based on the cumulative data we analyze for investor sentiment, we believe the gauge is positioned correctly as we move into 2022. We had been anticipating a more volatile second half of 2021 and that proved to be correct in the latter part of the year. We continue to believe it is important for investors to be prepared for volatility to remain elevated moving into the new year as Omicron cases surge and the Fed is shifting course away from the significant monetary accommodation it had provided the market since the pandemic began. As the market and the economy begin to stand on their own in 2022, it could usher in more normal levels of volatility, which have been largely absent following the March 2020 sell-off in stocks.

Interest Rates



Interest Rates

Interest rates are the final gauge, and we bring this back one step to a slow forward position. As we have already discussed, the Fed has begun shifting monetary policy and one result has been a flattening of the yield curve with shorter-term rates moving higher. We often reference the 10-year U.S. Treasury yield and it in many ways acts as a benchmark for what interest rates in general are doing.

However, as the market has started to anticipate the tapering and eventual raising of policy rates, rates at the front end of the yield curve have gone dramatically higher. For example, as of 6/30/21, the 1-year T-Bill and the 5-year T-Note were yielding a mere 0.07% and 0.87%, respectively. At the end of the year, those rates were at 0.39% and 1.26%, respectively, while at the same time, the 10-year rate barely moved from 1.45% to 1.52%. Once the Fed begins to raise interest rates, we historically see a flattening of that yield curve and that has already begun to happen as the market anticipates this eventuality.

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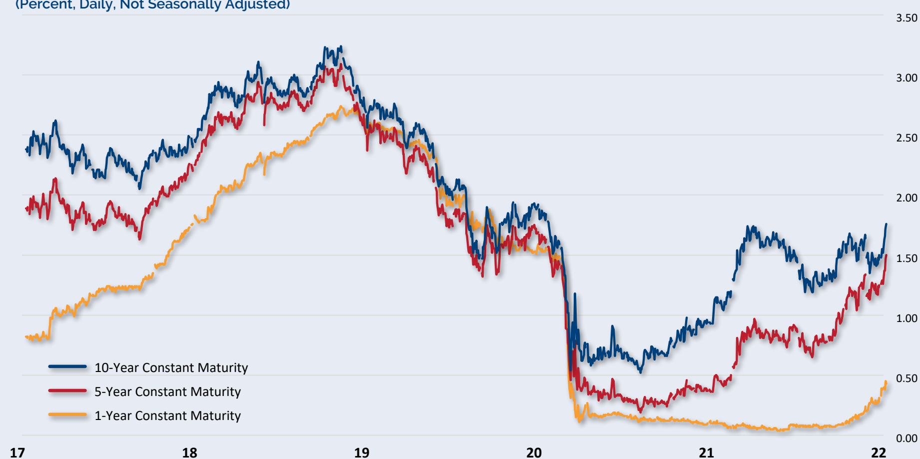

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Overall, interest rates are low, and they will likely remain that way for some time. However, we know the Fed is poised to begin an interest rate hike cycle in 2022 and more rate hikes are expected this year than many had anticipated just a couple of months ago. Higher rates on the front end of the yield curve and the Fed's messaging on rates moving into 2022 compel us to bring this gauge back one step to the slow forward position.

Remember that as the yield curve flattens it is a less positive signal for stocks and provides unique opportunities for active bond management. We believe we are positioned well at Clark Capital to navigate through this more dynamic time in the bond market.

Ultimately, low rates should be helpful to the economy as it reduces the cost of capital for both businesses and consumers. This gauge remains in the positive zone from our perspective, but not to the degree that it was during 2021.

Conclusion

We know these remain challenging times, but the good news is that the U.S. economy has rebounded strongly from the pandemic lows and earnings and equity markets have followed. Fed policy is starting to shift to reflect this stronger economy. Vaccines are available for those who want them and with the recent surge in the Delta and Omicron variants, more people seem to be willing to get the vaccine.

Booster shots have also been made available to help further protect individuals from a more serious outcome due to illness from the coronavirus. We believe the U.S. economy and corporate America will continue to fight through this crisis. We also acknowledge there will likely be more bumps on the road to recovery from both an economic and stock market perspective, but we think we are heading in the right direction.

The pandemic clearly persists, and the Omicron variant is surging, but it appears that despite its highly contagious nature, its severity is less than prior variants. We continue to urge clients to stick to their financial plans and not make decisions based

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on short-term movements in the market.

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Investing involves risk, including possible loss of principal. The value of investments, and the income from them, can go down as well as up and you may get back less than the amount invested.

Index returns include the reinvestment of income and dividends. The returns for these unmanaged indexes do not include any transaction costs, management fees or other costs. It is not possible to make an investment directly in any index.

Fixed income securities are subject to certain risks including, but not limited to: interest rate (changes in interest rates may cause a decline in market value or an investment), credit, prepayment, call (some bonds allow the issuer to call a bond for redemption before it matures), and extension (principal repayments may not occur as quickly as anticipated, causing the expected maturity of a security to increase).

The VIX Index is a popular measure of the stock market's expectation of volatility based on S&P 500 index options.

The 10-year U.S. Treasury yield is used as a proxy for mortgage rates. It's also seen as a sign of investor sentiment about the economy.

The NASDAQ Composite is a stock market index that includes almost all stocks listed on the Nasdaq stock Exchange.

The Dow Jones Industrial Average is a stock market index that measures the stock performance of 30 large companies listed on stock exchanges in the United States.

The Russell 2000 is a small-cap stock market index of the smallest 2,000 stocks in the Russell 3000 Index.

The S&P 500 is a stock market index that measures the stock performance of 500 large companies listed on stock exchanges in the United States.

The price-earnings ratio, also known as P/E ratio, P/E, or PER, is the ratio of a company's share price to the company's earnings per share.

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