



Cliff Notes on the Economy

Economic Review & Outlook

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First Quarter 2022

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 second quarter of 2022, we are adjusting three of our five gauges – reducing the Monetary Policy and Interest Rate gauges by one, but increasing the Valuations gauge by one as well. The Economy and Investor Sentiment gauges remain unchanged in the slow forward position. The three changes we made result in those gauges moving to neutral positions. 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 keep this gauge in a slow forward position heading into the second quarter acknowledging that economic growth will likely be slower 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 inflation became dominant themes in 2021. Despite those challenges in 2021, GDP growth came in around 5.7% for the entire year.

While slower than 2021, we still expect economic growth to be above 3% in 2022, which is 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 aver-



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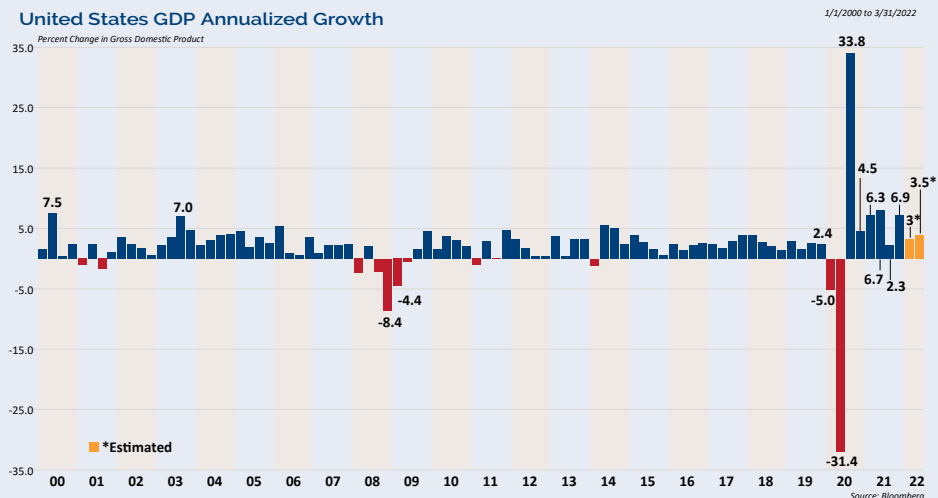
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ages. Regardless, the “V-shaped” portion of this economic recovery is changing to a square root as we have moved past peak economic growth and head toward the longer-term trend.

United States GDP Annualized Growth

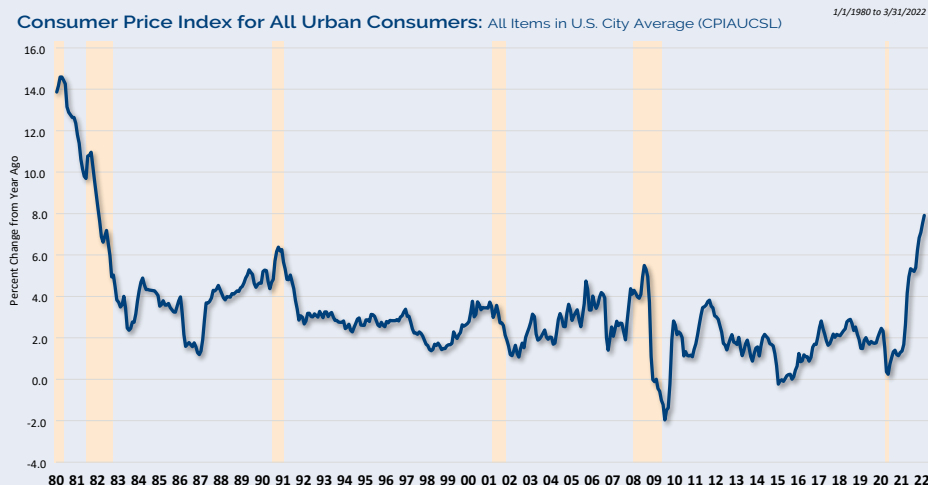


Projections or other forward looking statements regarding future financial performance of markets are only predictions and actual events or results may differ materially.

One of the big shifts in 2022 is the change in Fed policy as it begins a new rate hike cycle. One of the driving forces for this Fed U-turn has been persistent inflation, which the Fed has finally acknowledged as not being transitory and it is now keenly focused on arresting the rise in inflation.

2022 has begun with several price indices hitting their highest levels since the early 1980s. For example, the latest Consumer Price Index (CPI) reading for February 2022 showed a 7.9% year-over-year increase in prices on a headline basis – that is the largest increase in prices since 1982. Even on a core basis, which excludes food and energy prices, the CPI was up 6.4% on an annual basis.

Consumer Price Index for All Urban Consumers: All Items in U.S. City Average (CPIAUCSL)



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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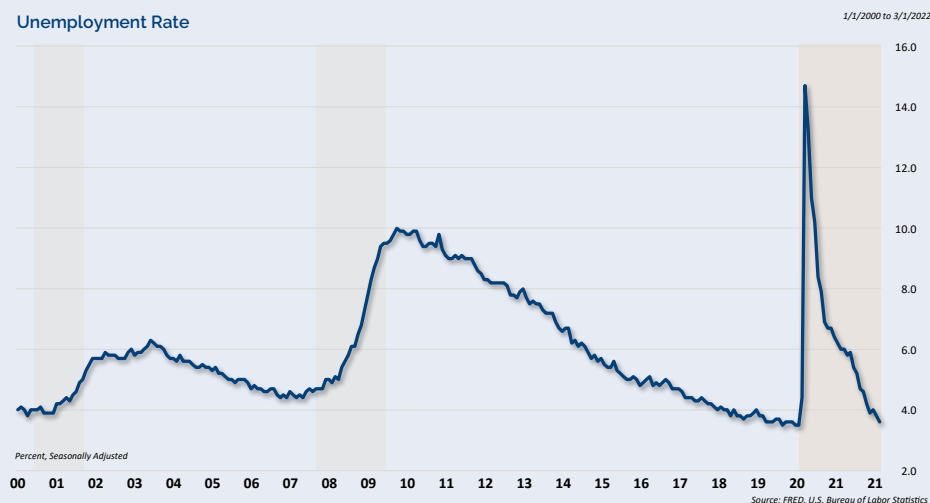
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When the pandemic hit, the Fed was focused on the full employment side of its dual mandate as unemployment exploded to over 14%. This focus has been at the expense of its second mandate, which is price stability or inflation control. With the unemployment rate now at 3.6% (compared to the 3.5% rate in February 2020 prior to the pandemic), the Fed has steered its attention to reigning in inflation.

Now, the Fed appears more determined to try to slow inflation, but without derailing the economic recovery – a challenging task indeed. We actually stand at an interesting juncture where there are millions 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, but that has started to improve in recent months.

This mismatch in job openings and job seekers has driven wage levels higher, further exacerbating inflation concerns. The Fed 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.

Unemployment Rate

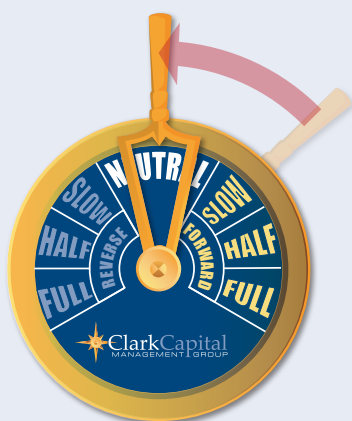


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We believe the economic recovery will continue through 2022 and well into 2023. We anticipate the recovery will continue to encounter bumps along the way, but we believe the U.S. economy is headed in the right direction. Consumers, who represent about 70% of the U.S. economy, are in good shape. Unemployment is low, consumer debt levels are low, and homeowners have seen the equity in their home grow as prices have increased. These factors help lead us to the conclusion that the economy should enjoy above trend growth.

Monetary Policy

Quantitative easing, or the Fed buying bonds in the open market, has concluded and March ushered in the first rate hike by the Fed since December 2018. As inflation readings continue to come in at high levels, several more rate hikes are expected in 2022 and into 2023. We therefore decrease this gauge by one notch to a neutral position to acknowledge this change in Fed direction. Despite rates moving up in the first quarter, we are still in a low interest rate environment, and it would be hard to argue



Monetary Policy



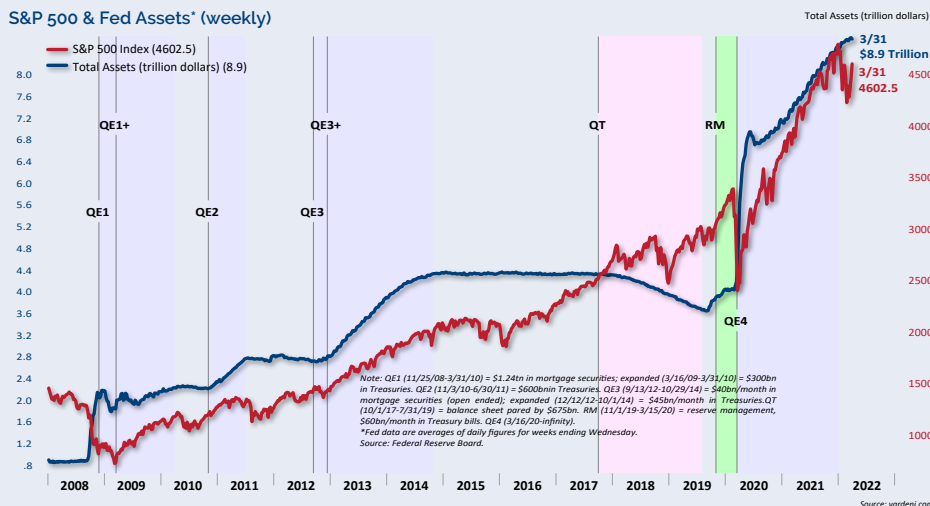
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that the Fed is "restrictive" at this point. The Fed is starting the path of raising interest rates, but that cycle has only just begun.

The Fed's balance sheet, which stood below \$4 trillion prior to the pandemic, expanded to nearly \$9 trillion driven by the Fed's actions during the pandemic. This aided the economy and capital markets to get back on track after the pandemic hit including significant improvement in the job market. 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.

S&P 500 & Fed Assets* (weekly)



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With the economy standing more on its own and less stimulus coming from the Fed, the market environment will likely be more volatile. We saw periods of elevated volatility in the first quarter and we will discuss that further with the Investor Sentiment gauge.

Among other factors like increased government debt and spending, the reopening of the economy has led to some supply/demand imbalances, which has caused prices to rise sharply in some areas. 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 neutral 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.

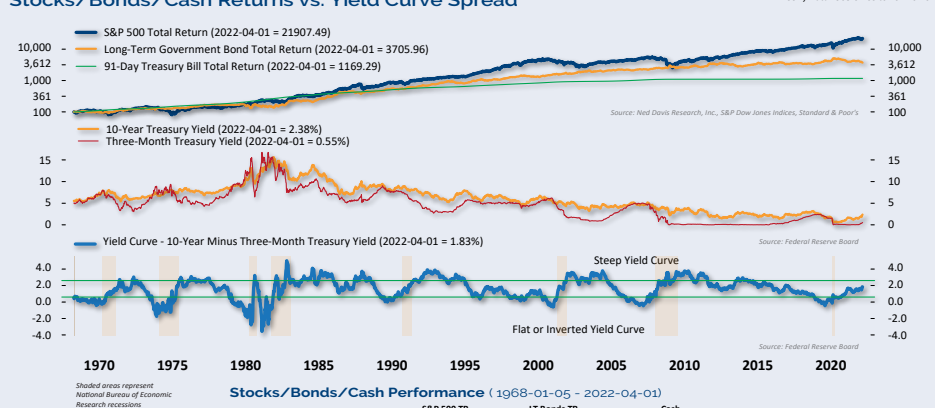
As the Fed raises rates, it has the impact of flattening the yield curve as well. Since the late 1960s, every recession the U.S. economy has gone through has been preceded by an inverted yield curve. (For the record, we have also had during this time 2 inverted yield curves that did not lead to a recession.) The second quarter saw parts of the yield curve invert, but the measure we look at, the 3-month T-bill compared to the 10-year U.S. Treasury, has stayed comfortably in positively sloped territory. We will watch closely how rate hikes affect this relationship, but even once the yield

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curve goes inverted, it is usually about another year before the economy has a recession.

Stocks/Bonds/Cash Returns vs. Yield Curve Spread



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Stocks/Bonds/Cash Performance (1968-01-05 - 2022-04-01)				
10-Yr/T-Bill Yield Spread:	S&P 500 TR Gain/Annum	LT Bonds TR Gain/Annum	Cash Gain/Annum	% of Time
Above 2.6	6.0	10.7	3.7	24.7
Between 0.6 and 2.6	16.8	5.5	4.0	51.7
0.6 and Below	2.0	5.9	6.9	23.6
Buy/Hold	10.4	6.9	4.6	100.0

Source: Ned Davis Research

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Valuations

Next are valuations, which improve by one position to neutral. Needless to say, the rally in the stock market from the lows in March 2020 has been strong with new highs recorded for the major U.S. equity indices in late 2021/early 2022. During that time, the forward price to earnings or P/E ratio of the S&P 500 hovered near its highest level in about 20 years. However, as markets saw some weakness in early 2022, the P/E ratio improved as prices declined and earnings have held up.

S&P 500 Forward vs. Trailing Price/Earnings Ratios



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Earnings have bounced back since the shutdown period during the Spring of 2020. Earnings for the S&P 500 grew by over 60% in 2021 and while more subdued, expect-



Valuations

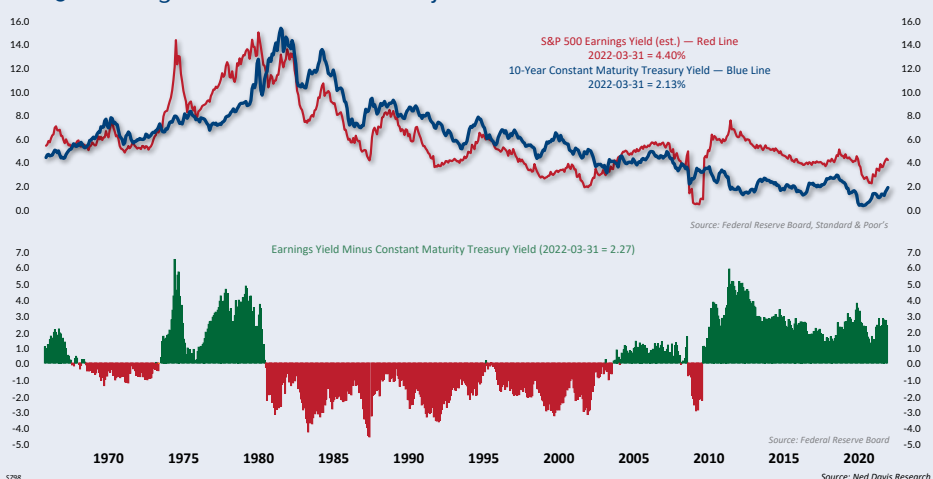


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tations are calling for solid earnings growth of 9% in 2022.

S&P 500 Earnings Yield vs. 10-Year Treasury Yield



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Valuation multiples have now moved to more neutral territory in the upper teens for the S&P 500. Low interest rates tend to drive valuations higher, and the first quarter of 2022 has seen interest rates move up as well. From a longer-term perspective, rates are still at low levels. 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, but that differential has declined so far this year.



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. We keep this gauge in its same slow forward position moving into the second quarter of 2022.

This gauge is very sensitive and can change quickly. During parts of the first quarter, this gauge would likely have moved further into positive territory as pessimism was mounting with the equity market sell off and the Russian invasion of Ukraine. Not to mention the already ongoing issues of higher inflation, a Fed that turned more hawkish and pandemic concerns. However, as markets recovered somewhat in March, sentiment improved, and we believe we are starting the second quarter in a similar position to the first quarter and are therefore leaving this gauge in the slow forward position.

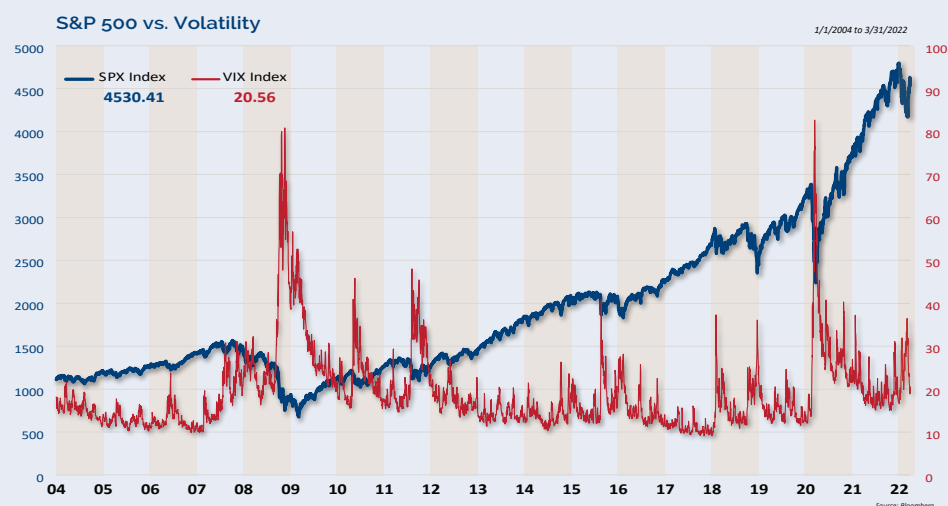
One important indicator, which we discuss often as a measure of fear in the market, is the CBOE Volatility Index or VIX Index. Volatility became more commonplace in the first quarter. Periods in late January, late February and early March saw the VIX go above 30 – a level we saw only a few times in 2021. After hitting an intra-day high above 37 in early March, it slipped lower and closed out the quarter at 20.56. That is still elevated compared to most of 2021, but it was improved from the late February/early March levels this year and only slight above its long-term average.



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Remember, as a contrarian indicator, the higher the VIX is the more positive it is for the market as complacency has been replaced to some degree with some healthy market skepticism. So, although the VIX did spike during the quarter, it came off those highs to close the month at an elevated, but more subdued level.



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Based on the cumulative data we analyze for investor sentiment, we believe the gauge is positioned correctly continuing further into 2022. We had been anticipating a more volatile start to 2022 and our expected 10%+ first-half correction actually occurred during the first quarter. We continue to believe it is important for investors to be prepared for volatility to remain elevated moving further into 2022 as the Fed is shifting course away from the significant monetary accommodation it had provided the market since the pandemic began.

Furthermore, there are ongoing elevated inflation levels and a new geopolitical crisis with the Russian invasion of Ukraine. 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

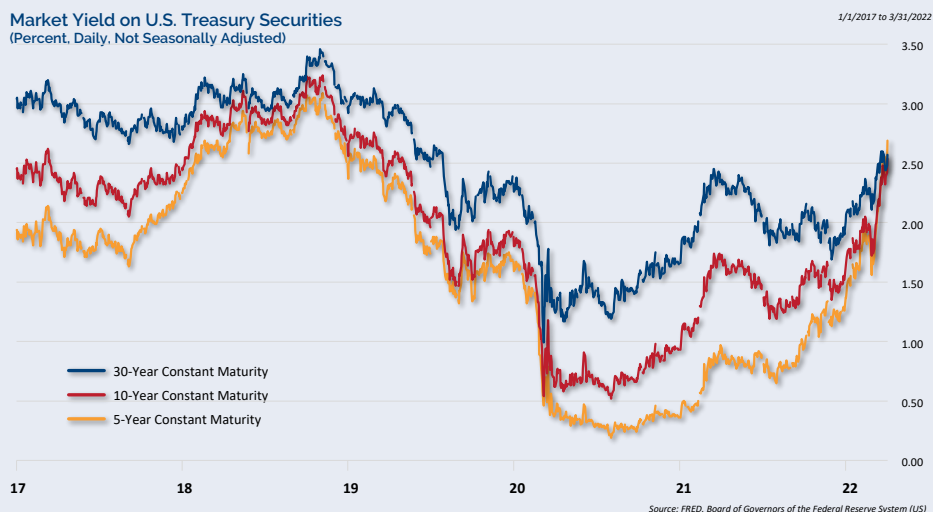
Interest rates are the final gauge, and we bring this back one step to a Neutral position. As we have already discussed, the Fed has begun shifting monetary policy. Oddly, while parts of the yield curve have flattened (the curve is flat from about two years on), the entire curve has shifted up with rates higher across all maturities.

For example, the 10-year rate moved from 1.52% to 2.38% during the first quarter and the 30-year yield has moved from 1.90% to 2.44% over the same timeframe. Not surprisingly, the yield on the 3-month bill also increased from 0.06% to 0.52% but the 3-month/10-year curve has actually steepened so far this year (146 basis points to 180 basis points). Once the Fed begins to raise interest rates, we typically see a flattening of the yield curve with short-term rates rising more rapidly than long-term rates. But so far, there has been a shift higher in the overall yield curve occurring as well with rates moving up across the board in the first quarter.



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Overall, interest rates are low from a historical perspective, but they are moving higher. The Fed interest rate hike cycle has now begun and several more rate hikes are expected through 2022 and into 2023. Higher rates across the yield curve and continued rate increases expected by the Fed for the foreseeable future compel us to bring this gauge back one step to the neutral position.

Remember that as the yield curve ultimately flattens it is a less positive signal for stocks and provides unique opportunities for active bond management. Although bonds have generally struggled to begin the new year with rates moving higher, it has also presented opportunities in the bond market that we have not seen in some time. We believe we are well-positioned to navigate through this more dynamic time in the bond market.

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 and that means less accommodation and a market standing more on its own two feet.

Vaccines and booster shots are available for those who want them, and the U.S. seems to be shifting to more of an endemic approach to COVID versus a pandemic, which will hopefully be less disruptive to everyday life. We believe the U.S. economy and corporate America will continue to be resilient in the face of higher inflation, a Russian invasion of Ukraine and ongoing issues with the coronavirus.

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. We continue to urge clients to stick to their financial plans and not make decisions based on short-term movements in the market.



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The 3 Month Treasury Bill Rate is the yield received for investing in a government issued treasury security that has a maturity of 3 months. The 3 month treasury yield is included on the shorter end of the yield curve and is important when looking at the overall US economy.

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 Treasury Rate is the yield received for investing in a US government issued treasury security that has a maturity of 10 years.

The S&P 500 measures the performance of the 500 leading companies in leading industries of the U.S. economy, capturing 80% of U.S. equities

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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