WILKINS
INVESTMENT COUNSEL

2022 INVESTMENT OUTLOOK

Another exceptional year for common stock prices has gone into the record books with domestic stock indices expanding by 20% or more while global markets, excluding the U.S., gaining roughly half that amount. The headline S&P 500 Index led the way with a total return of nearly 29%, driven by five large and widely held stocks which contributed 32% of that gain. Real GDP growth expanded by some 5.9% in 2021 (notably above the 2.2% average growth rate from 2000-2019) while profits of the S&P 500 are expected to advance 46%. The three-year S&P 500 total return is 100%, outpacing the 26% S&P 500 earnings gain for the same period. This remarkable stock market showing makes the short two-month bear market of February-March 2020 (when the COVID-19 pandemic commenced) a distant image in the rear-view mirror.

Massive and unprecedented federal government fiscal and monetary stimulus has been a key driver of the strong 2021 showing. With COVID-19 a grim reality in the spring of 2020, the federal government first passed the $2.2 trillion Cares Act; a December 2020 $900 billion stimulus package; the March 2021 $1.9 trillion American Rescue Plan; and then a fall 2021 infrastructure bill with $550 billion in new spending for total stimulus spending of more than $5.5 trillion. The Federal Reserve supported this policy by lowering the federal funds rate to 0.25% and expanding its balance sheet by open market bond purchases of $120 billion per month, thereby providing a ready buyer for the increasing U.S. Treasury debt while also supporting the mortgage market. In effect, the government transfers replaced jobs and wages lost in the pandemic with a "government income" stream, allowing households to continue reasonably normal consumption activity while upping their savings. This allowed the country to avoid the normal contraction and strains of a recession period as the economy reopened rather quickly thereafter.

The downside to these policies in addition to the now record public debt of some $28 trillion (roughly 125% of GDP), a bloated Federal Reserve balance sheet of $9 trillion, and large ongoing federal deficits as a percentage of GDP, has been the reemergence of inflation. Headline inflation, which averaged 2% for the last 20 years, rose significantly in 2021, reflecting consumers having enhanced savings to spend on the demand side of the economy while the supply of goods was constrained by COVID-related production limitations and international supply chain disruptions. The Consumer Price Index (CPI) rose 6.8% year-over-year in November for the largest increase in 39 years while the core personal consumption expenditure (PCE) price index, closely watched by the Federal Reserve, gained 4.7% when food and energy are excluded. These levels are far greater than the 2% target the Fed aims to achieve on a long-term basis. Economic sectors experiencing above average inflation included household energy (up 12.2% y/y), new vehicles (up 11.1% y/y), and residential homes (up 18% y/y). Corporate America is also reporting profit margin pressure from both materials and labor components.

On the positive side, the vast majority of jobs lost during the pandemic have now been regained, unemployment claims are back to pre-pandemic levels, and the unemployment rate has fallen to 4.6%. In addition, the growth of the digital economy continues at a robust pace with strong demand for productivity

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solutions like software and rapid job creation. However, the emergence of the Omicron variant in the closing months of 2021 has brought new uncertainty to the pace and durability of the recovery.

The 2021 market returns below show the widely followed domestic stock indices closing near record levels.

2021 Total Returns

	12/31/21	% Change
Dow 30 Industrials	36,338	+20.9%
S&P 500	4,766	+28.7%
NASDAQ Composite	15,645	+22.2%
MSCI All Country World Index ex-USA	344	+8.3%

Outlook

Economists are once again readjusting models for 2022 given the growing infection rate, hospitalizations, and deaths associated with Omicron. The pre-Omicron thinking had called for a solid 4% real GDP growth and a 10-12% gain in corporate profits with solid consumer and business spending. These figures, plus an expected slowdown in inflation by mid-year, would generally be well received by stock investors.

The hoped-for outlook would be for the fast-spreading Omicron variant to peak early in the year and decline rapidly, leaving the general population closer to herd immunity. It also appears to be a scientific fact that human T-cells are enhanced by vaccinations, which make Omicron and perhaps future COVID variants less severe than previously experienced. In any event, economic activity, to whatever extent slowed by Omicron, will likely pick up as the year progresses, making full year corporate profit expectations attainable.

Inflation prospects and the government response are also key variables to the outlook. The Federal Reserve has already announced that recent inflation levels are more than just transitory and that it is tapering its monthly bond purchases with a phase out of such easing likely completed by March. Simultaneously, the central bank is signaling three 25 basis point interest rate hikes, which would push short term interest rates to nearly 1% by year-end. Similar rate increases could follow along the yield curve in longer maturities. These increases would be moderate at best and unlikely to dampen economic activity or impede capital flows. The Federal Reserve will need to take stronger action in tightening monetary policy if inflation moderates less than it anticipates.

On the fiscal side of government activity, President Biden's Build Back Better $1.7 trillion program appears stalled and, with mid-term elections now pending, may very well remain an unattainable policy objective. If so, the economy will need to stand more on its own two feet with less reliance on government funding. Normal consumer behavior, given the savings on hand, should make this possible. Job growth, a higher labor participation rate, and the emergence of new technologies buttress this position.

Longer term issues do remain and will impact results beyond 2022. Geopolitical uncertainties exist as always. Russia and China appear to be expanding their spheres of influence as the lengthy American involvement in Afghanistan ended badly, traditional free world alliances are being questioned, and the Middle East continues to be a challenge. Nuclear proliferation, be it Iran or North Korea, should also be taken seriously.

Domestic politics can be expected to heat up in the new year as bipartisanship and the civility necessary for problem solving are unlikely to reemerge any time soon. The wounds and scars of last year's insurrection and assault on our nation's legislative branch remain open with closure yet to be achieved. The unprecedented fiscal and monetary response due to the emergence of the COVID-19 pandemic used many of the government levers available to end that recession. Our nation will require new and innovative thinking during periods of future economic challenge.

Investment Conclusion

The exceptional stock market gains of the last three years are well above historic returns and reasonable long-term expectations. Investor enthusiasm, laced with some speculative elements, is likely to recede to more normal levels this year as fundamentals regain investor attention. Higher interest rates, which are needed this year to temper inflation, are not at this point considered overly material to the outlook, but investors will logically pay a lower price for future earnings as rates eventually increase. Hence, stocks trading with normalized valuation criteria should be favored for purchase. The key criteria of this firm in stock selection is to pay a reasonable price for a piece of a superior enterprise which is well managed, adequately financed, and equipped with distinctive competence features which can sustain progress over the long term.

Many bond investments remain unattractive and, even with somewhat higher interest rates expected this year, real returns remain negative when inflation is considered. Hence, only investment grade and short maturities should be contemplated.

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