Investment Environment & Outlook

January 2022

Volume 9, Issue 1

Sabal Trust

Market & Economic Environment

2022 will bring with it change. The spectacular earnings growth since the brief, yet severe, COVID-induced recession in 2020 will downshift to a more normal positive trajectory. Synchronized central bank policies will decouple as markets confront the reality of higher interest rates. November's mid-term elections will bring the potential for another leadership change. We view this shifting paradigm as opportunistic. High quality businesses will out-perform lower quality franchises. Our clients will be rewarded by owning companies that pay growing dividends, which will act as a buffer against the inevitable periods of volatility that any adjustment period is likely to bring.

FISCAL POLICY

The philosophical gulf between moderate and progressive Democrats was evident when Senator Manchin refused to support the $1.8T Build Back Better bill. While negotiations continue, markets remain focused on the surging Omicron variant and a more hawkish Federal Reserve. Some corners of the market view scaled back spending favorably because unchecked deficit spending can be inflationary and cause the Federal Reserve to adjust interest rates more aggressively.

RETAIL SALES

Stimulus payments, savings, and rising wages supported consumer spending last year. November retail sales growth slowed to +0.3%. However, demand remains robust even as companies charge higher prices to combat inflationary inputs. We own companies in our clients' portfolios that continue to demonstrate the ability to pass along higher input costs and protect their profit margins.

LEADING ECONOMIC INDICATORS

Leading Economic Indicators, including the Purchasing Managers Index, durable goods orders and consumer confidence, are highly correlated to the economic cycle. The latest LEI readings indicated healthy economic activity. However, the Omicron variant's impact was not reflected in the data. The greater distribution of vaccines and renewed mobility after the current COVID wave should positively influence future LEI data and the overall economy.

CONSUMER PRICE INDEX (CPI)

November's Consumer Price Index (CPI) increased +0.8% reaching y/y growth of +6.8%, the fastest growth rate since 1982. Companies across a wide range of industries continue to report higher input costs from labor, transportation and raw materials. The Producer Price Index (PPI) rose +0.9% and is now +9.2% y/y, a record high. These readings reinforce the prospects of higher interest rates.

SUPPLY CHAINS

Shortages of available goods for purchase, the inability to adequately stock inventory, and upward pressure on prices continue to create headaches for consumers, companies and policy makers. The surge of pent-up global demand and pre-holiday purchasing placed additional pressures on already stressed supply chains. Now, the Omicron variant has the potential to create further disruptions that will take more time to work themselves out.

VALUATION

P/E is a valuation ratio measuring a company's price relative to its earnings. Today, the S&P 500 P/E is 24.4x compared to an average P/E of 16.1x since 1950. Elevated stock valuations offer less margin for error and are "vulnerable" in an environment of rightsizing economic growth, less accommodative monetary policy and the surging Omicron variant. We remain sensitive to valuation measures against a rising interest rate backdrop.

Fixed Income Observations

The widely anticipated Federal Reserve meeting resulted in policy makers adopting a more hawkish tone with three projected rate increases in 2022 and an acceleration of asset purchase tapering. However, their more dovish press conference pleased the markets. While Fed officials remain upbeat about strong economic growth and a firming labor market, they are monitoring the potential impact of the surging Omicron variant.   Policy makers believe that inflation pressures will abate as supply chain bottlenecks ease. We will continue to protect our clients' fixed income exposure by using shorter duration bonds that are less sensitive to upward moves in interest rates.

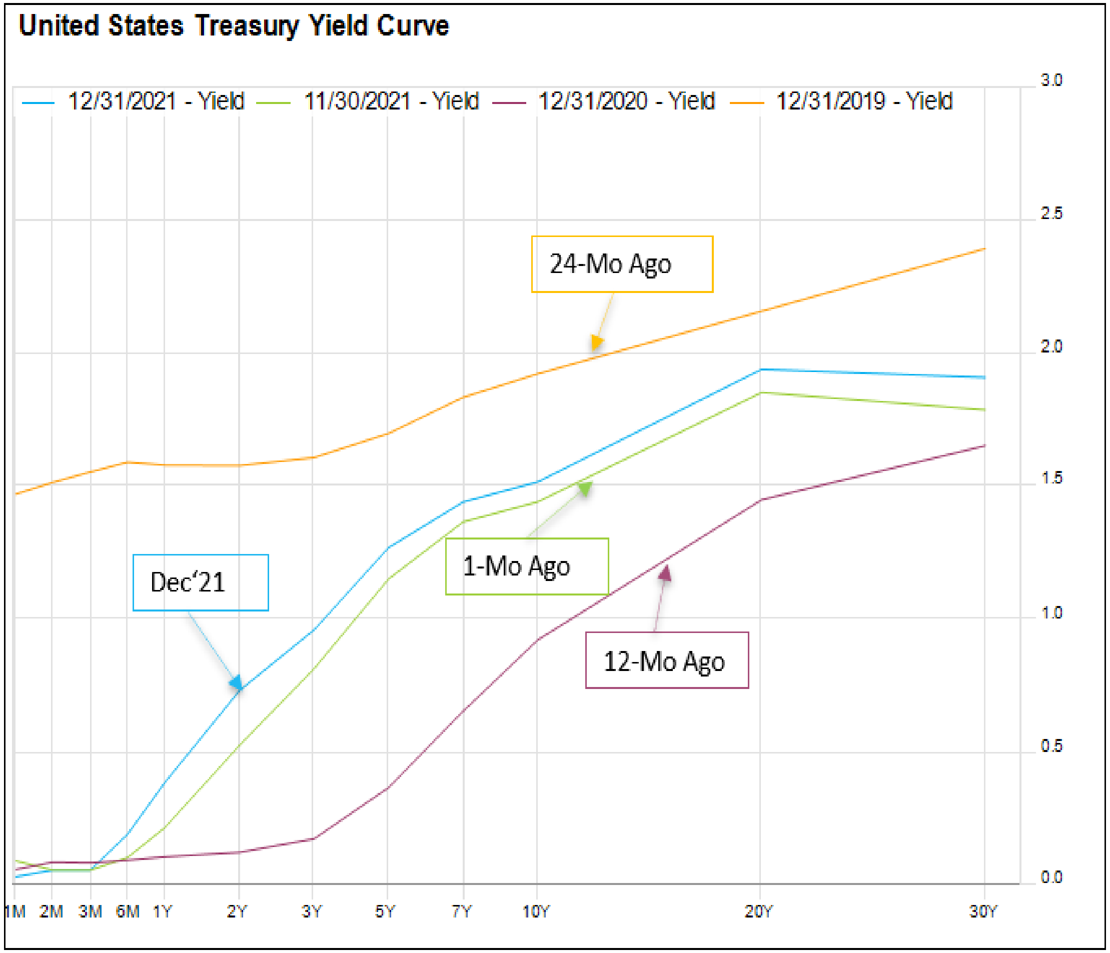
YIELD CURVE

- The Federal Reserve's dot plot projected a more aggressive path for rate hikes than investors originally anticipated. The markets reacted with choppy price action following the FOMC announcement and volatility continued for most of December.

- In anticipation of rate hikes, the belly of the curve remained sensitive, ending the month +17 bps higher. 2-yr hit recent highs and closed the month over ~30 bps. 30-yr yields rose about 10 bps and closed just over 1.9% while 10-yr broke just above 1.51%, up 7 bps in December.

- With the exception of junk credit, most taxable fixed income indices posted losses in 2021. As the Federal Reserve starts its tightening cycle, rising yields will continue to weigh on bond performance in 2022.

- The Federal Reserve's response to inflation, employment and economic growth, will determine the path of the credit markets and bond volatility will likely continue. In the current economic environment, we recommend sticking to low duration and high credit-quality credit.



Volume 9, Issue 1 January 2022

Sabal Trust

SABALTRUST.COM