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ECONOMIC UDATE

Key economic inputs coming across our desk since publishing our December Statement of Investment Policy showed a pronounced slump in consumer demand and economic output largely traceable to the spike in Omicron. Consider the following: Retail sales fell 1.9% in December, industrial production was weaker than forecast, and consumer sentiment in the January preliminary survey fell to its second-lowest level since the pandemic began. Forward looking surveys also weakened. The headline composite for the ISM services survey declined from 62.3 in December to 59.9 in January and the ISM manufacturing survey fell from 58.8 in December to 57.6 in January. While the indices themselves continued to signal strong expansion ahead, the declines stemmed from falling supplier delivery times (which points to easing supply chain bottlenecks in the second half of this year) and from lower readings of new orders and production (which likely reflect Omicron-related issues). Recall that readings of the ISM indices above 50 signal expansion. Other measures which incorporate a wide range of macroeconomic data have also weakened, pointing toward a sharp slowdown in real GDP in the current quarter to 1.5% from 7.0% in the fourth quarter of last year. Overall though, we expect the economic drag from Omicron will be relatively short-lived, concentrated in weakened consumer demand and some production disruptions as people contract the virus and need to quarantine. Much of the business lost in the first quarter will be recouped in the second and third quarters. Forecasts for full year 2022 real GDP growth remain unchanged at 4.0%.

The reduced virulence of the Omicron strain has suggested to us the labor market slowdown should be less pronounced than during the earlier surges as firms and workers look through to the other side of Omicron. On cue, last Friday's nonfarm employment report on *businesses* from the Bureau of Labor Statistics (BLS) detailed an unexpected increase of 467,000 jobs in January and record-high upward revisions to November and December jobs numbers totaling 709,000. The BLS report was a massive upside surprise to the consensus forecast of a more modest 150,000 gain in January nonfarm payrolls. Some forecasts we saw had called for a 300,000 decline in jobs. Another survey of *households* showed the unemployment rate ticked up to 4.0% in January from 3.9% in December, a level that will still give the Fed cover to proceed with raising interest rates beginning next month and to commence shrinking its balance sheet soon thereafter. In addition, the official labor force participation rate rose by 0.3% as some workers decided

to go back to work after their generous unemployment benefits had run out, and others found their savings depleted.

On net, the BLS report showed that despite the Omicron surge, we are experiencing a much stronger labor market than was apparent in the earlier vintage of releases. Nevertheless, while the employment recovery has made great progress in the past year, the job market remains far from fully healed. Payrolls are 2.9 million short of where they were in February 2020 and are not expected to return to pre-COVID levels until the second half of this year. The number of people not in the labor force and who did not look for work due to COVID jumped by about 600,000 to 1.8 million in January, the highest this measure has been since May 2021. And the number of workers with a job but not at work due to illness jumped to 3.6 million, easily surpassing the prior record of 2.0 million set in April 2020. There were also large increases in full-time workers putting in reduced hours because of childcare issues or due to illness. Interestingly, the number of people teleworking last month due to the pandemic rose by 6.6 million to 23.9 million. These observations indicate that participation is likely to increase further in coming months, reducing the pressure on inflation from higher wages, as the public health crisis dissipates and COVID cases continue to fall.

THE OUTLOOK

Looking ahead, the US economy has reopened and is regaining its footing. We are learning to live with a pandemic that is more than likely to persist in one form or another for the foreseeable future. Underlying economic growth continues to be strong despite the recent temporary slowdown in consumption occasioned by this winter's spike in Omicron infections. We see real GDP, as well as corporate profit growth above trend for 2022 and 2023. Fiscal and monetary stimulus, although diminished from 2021, will continue to underpin the expansion. Consumers are flush with cash and willing to spend. While headline CPI inflation is running hot at 7%+, well above the Fed's 2% target, price increases should begin to moderate as the year progresses; supply chain issues will recede and labor shortages will ease, restoring a better balance between the supply of goods and demand for them. We do not believe inflation will kill this expansion as the Fed is likely to withdraw liquidity only slowly. High frequency leading economic indicators including the ISM surveys, our firm's proprietary Economic Model and the Leading Economic Indicators (LEI), signal expansion. Open market indicators we monitor, including credit spreads, remain favorable. The Treasury yield curve is steep, implying no threat to the expansion from an inversion despite the almost certainty of the Fed beginning a tightening cycle in March and gradually trimming its balance sheet once rate hikes have begun. The banking system is well capitalized. Unprecedented liquidity amounting to over $9.2 trillion globally, and excess savings of $2.0 trillion in the US, along with strong corporate balance sheets, augur well for future expansion absent an exogeneous shock such as an armed conflict.

EQUITY INVESTMENT POLICY

Following three consecutive years of double-digit annual returns approaching 15% for the broad US stock market averages, the S&P 500 has experienced a 5.7% pullback this year. The tech-heavy NASDAQ has fallen 9.9% through last Friday, while the S&P small cap index has declined 8.2% year-to-date. Many formerly outrageously-priced, speculative, small cap stocks without earnings or prospects of earnings anytime soon, darlings of speculators through last summer, have declined as much as 80% from their 2021 highs. Market volatility has been elevated. How far the drawdown in stock prices will go is anyone's guess; unforecastable market sentiment is an important driver of these pullbacks. Recall that corrections of 10%+ in the broad market indices are common even during periods of exceptional economic fundamentals and corporate profit growth. Corrections should be expected and considered in setting portfolio guidelines.

The recent bearishness in equities, in our view, importantly reflects concerns over rising inflation and the Fed's response thereto. Some fear a hawkish Fed will repeat its past policy mistakes by preemptively tightening monetary policy, plunging the economy, weakened by the pandemic, into recession. Until recent more hawkish Fed statements, others may have feared the Fed would not do enough to control rising prices, setting the stage for a 1970's style inflationary spiral which culminated in a deep recession. Many have voiced concerns that rising input cost pressures will eat into margins prompting reductions in profit forecasts. And, of course, there are some who trade the market from a technical view who have become more negative as the market has pulled back. For whatever the reasons, so long as the economic outlook is favorable, as it is currently, corrections, no matter how painful they may seem over the short term, eventually run their course and are beneficial to long term investors as they wash excesses out of the market, setting the stage for the next advance.

In our view, given the momentum in the economy, easing bottlenecks, the strong labor market, robust corporate profit growth, and a data-driven Fed that will tighten credit conditions as necessary, the economic fundamentals remain sound. We also expect profit margins to remain resilient for two reasons: They are strongly correlated to activity, and prices are outpacing wage inflation. *Consequently, there has been no change in our firm's investment policy since our December letter. Equity portfolios under our supervision remain fully invested within individual portfolio guidelines*, well balanced between domestic *growth* and *value* investments, tilted toward *growth* which is our long-term bias. Beyond large cap US core equities, our investment platform includes allocations to small cap US equities as well as international developed market and emerging market stocks. Additions to equity portfolios over the past several quarters have centered on *value* investments. Despite their inherent volatility, equities remain the investment of choice for clients given the lack of attractive fixed income alternatives which currently offer negative *real* returns.

Beyond the favorable fundamental outlook for the US economy, the case for investing in equities, despite their current high valuations, is supported by sound financial market conditions which include the narrow spreads in yields between high-quality corporate bonds and those of low-rated obligations. Banks are well capitalized and accordingly are permitted to increase their dividends and to fund buybacks. Corporate buybacks in aggregate are above historic levels. Merger and acquisition activity has been robust. Corporate balance sheets are strong and cash on the books of US corporations is at record levels.

Finally, as long-term investors, we are dedicated to building clients' wealth. We are neither market timers nor traders. We have no products to sell, and we have no marketing goals to reach. Instead, we focus all of our efforts on finding interesting new investment ideas and intensively monitoring the investments we hold in clients' portfolios. Maintaining an appropriate balance between *growth* and *value* investments is the never-ending challenge of our investment process.

FIXED INCOME INVESTMENT POLICY

The outlook for bonds with duration remains unfavorable. The multi-generation decline in interest rates is behind us. Already, the yield on the benchmark 10-year US Treasury bond has risen sharply from 0.53% on July 26, 2020, to 1.91% last Friday. Interest rates are forecast to rise further as the economic cycle plays out and the Fed works to normalize interest rates. Since preservation of principal is a primary objective of our fixed income management, along with maintaining liquidity, bond portfolios under our supervision are invested defensively in a short ladder of high-quality corporate bonds with a target duration of less than 1.

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