FVCM

U.S. MARKET REPORT

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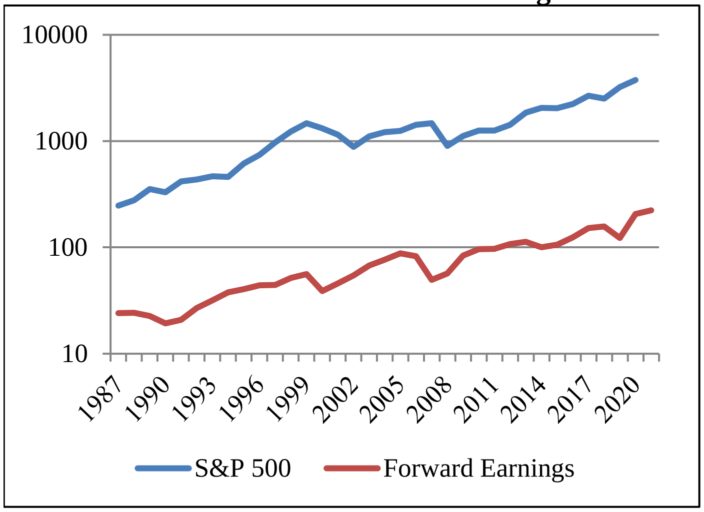
Stocks Still the Place to Invest

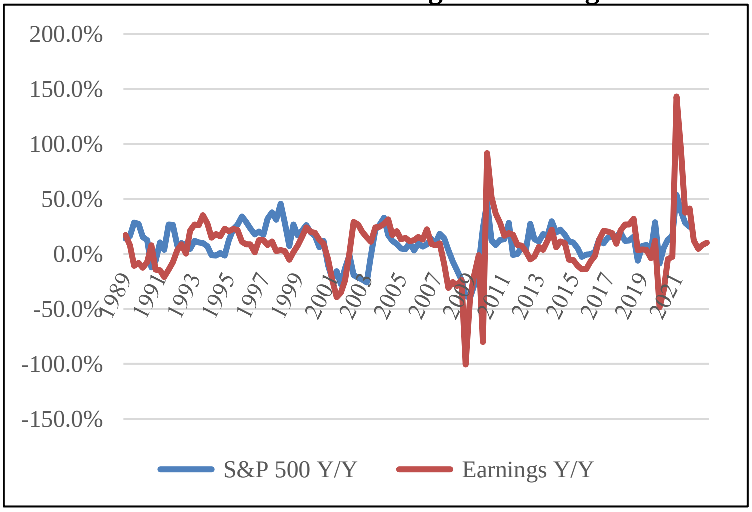
There are now, as always, many areas of investor concern about the stock market. But we remain bullish and suspect that a Bear Market is still at least a year or two away. The issues that seem to most concern clients and other investors we have spoken to are 1. Stock valuations; 2. The negative effects that politicians inflict on business in their reaction to the latest Covid-19 scare; 3. The Fed shifting to a less accommodative monetary policy; and, 4. Inflation. These things do merit concern, and we will briefly discuss them, but the most important factor that drives stock prices is corporate profitability. And the data still mostly points to ongoing economic growth, increasing sales, and expanding profit margins.

Chart 1 **S&P 500 Absolute Price vs Earnings**



Source: S&P Global, FVCM

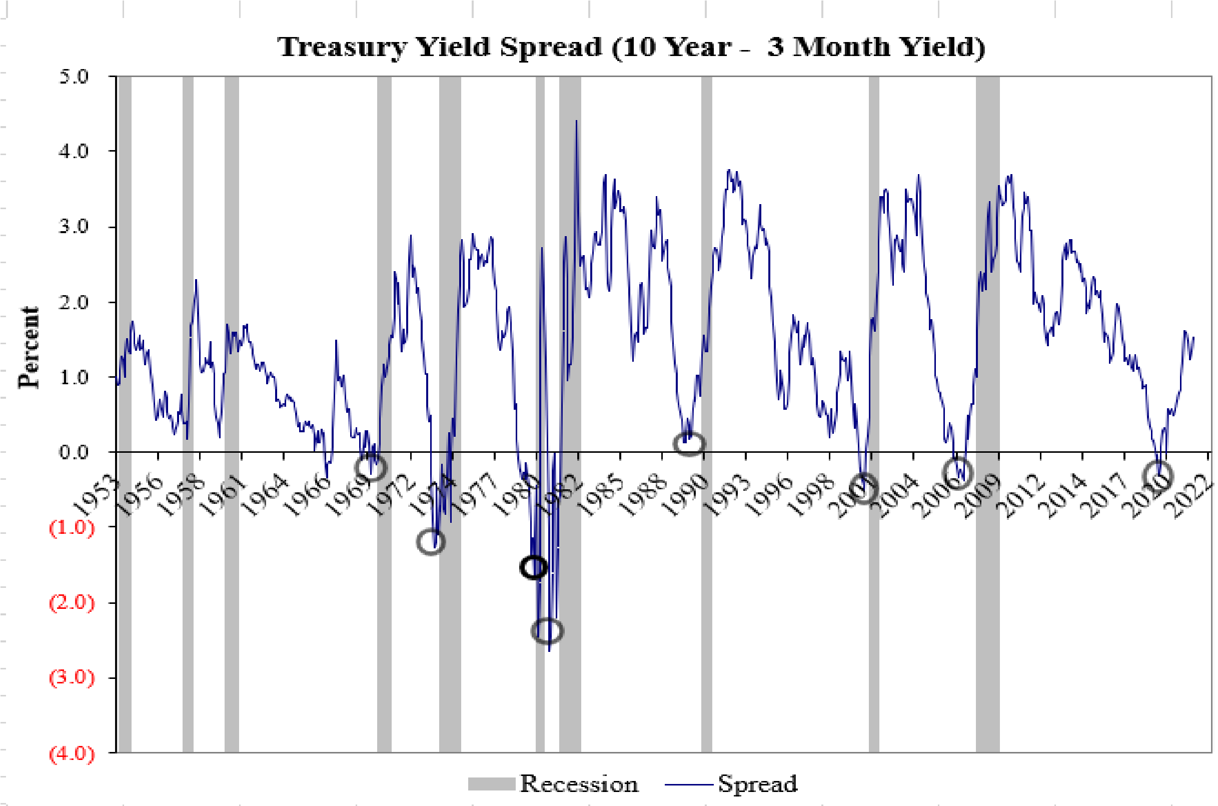
Chart 2 **S&P 500 % Price Change vs Earnings**



Source: S&P Global, FVCM Note: 4Q'09 earnings truncated at -80%.

Especially over long periods, stock prices go up because corporate profits go up. Chart 1 above, which is on a logarithmic scale, reveals that simple truth. Over periods measured in days and months, stock prices are volatile as investors react, and sometimes over-react, to current events. Short term traders often find themselves getting whipsawed because such movements, often prompted by emotion, are not predictable. In contrast, investors who stay in the market for long periods benefit from innovation, increasing production, and greater business revenues and profitability to ensure investment success. Even great recessions like 2008-9 don't last forever and are followed by expansion. Also, in periods measured in quarters (Chart 2), the ups and downs of the S&P 500 also closely resemble the ups and downs of corporate earnings. Consequently, our first line of thought about the market's prospects for the year ahead center on the economy and profitability. On that count things still look mostly positive.

Chart 3



There are several useful indicators of future economic activity, and the outlook is good. One of the best indicators is the shape of the yield curve. As economic growth accelerates, long term interest rates tend to rise for many reasons, including increasing demand for loanable funds. The spread between short and long-term rates widen. Conversely, toward the end of a business expansion, the central bank has typically been increasing short term rates for years and the spread narrows. Thus far in this expansion, long term yields have not yet risen as much as they typically would, evidently due to ongoing concerns about the pandemic and aggressive Fed bond purchases. But the spread between the 10-year US Treasury bond and the 3-month Treasury bill is still a healthy 1.5%. Other good leading indicators, like the ISM Manufacturing Purchasing Managers Index (PMI) stayed at a very strong 61.1 in November (greater than 50 signals expansion), while new orders were at 61.5 and the backlog of orders was 61.9. In November, the Services PMI reached an all-time high of 69.1, up from October's reading of 66.7. These figures are not telling us there are problems on the horizon. To the contrary, the outlook for 2022 remains very good. Below are consensus estimates for real GDP growth. These figures are consistent with our estimates of S&P earnings growth of 68% in 2021 to 205.55, and 9% in 2022 to 223.22. Even with wages rising, many businesses will achieve record earnings as rising sales and operating leverage that comes with fixed costs combine to boost profit margins.

Chart 3

Country/Region	CY '18	CY '19	CY '20	CY '21	CY '22	CY '23
G7						
Canada	2.8	1.9	-5.2	4.8	4.0	2.9
France	1.8	1.8	-8.0	6.7	4.0	2.2
Germany	1.1	1.1	-4.9	2.8	4.4	2.0
Italy	1.0	0.4	-9.0	6.1	4.3	2.1
Japan	0.6	-0.2	-4.5	2.3	2.5	1.5
United Kingdom	1.7	1.7	-9.7	6.9	5.0	2.0
United States	2.9	2.3	-3.4	5.6	4.1	2.5

Source: Factset

Comments on the Four Major Concerns

1. Stock valuations - Buying individual stocks that are grossly overvalued is a recipe for failure. Buying a broad basket of stocks, like the S&P500, that is "overvalued," won't necessarily result in negative returns, but it will likely result in low returns. Valuations are high (see below) just as interest rates are low. Because of the high valuation levels, investors should have moderate expectations of average returns of perhaps the 5% to 8% range in the years ahead. This may not be the super exciting returns we've had in recent years, but we still expect stocks to outperform fixed income and other liquid assets. Even returns on illiquid assets like real estate are likely to be muted going forward because of the recent rise in prices. As of the end of the 2021 third quarter, home prices were up a record 19.5% year over year thanks partly to unsustainable demand prompted by the pandemic. This is unlikely to last, especially as mortgage rates rise. Lastly, our strategy is to avoid the overvalued momentum stocks. We may avoid some exiting gains on the way up, but our goal is to control risk and avoid the losses that will likely hit some of these stocks.

Chart 4: S&P 500 Next Twelve Months P/E

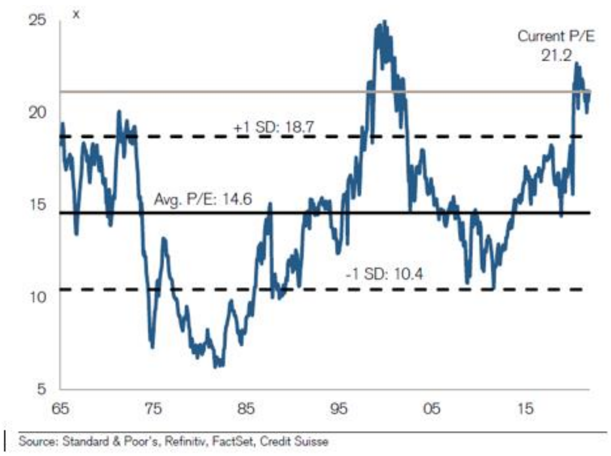
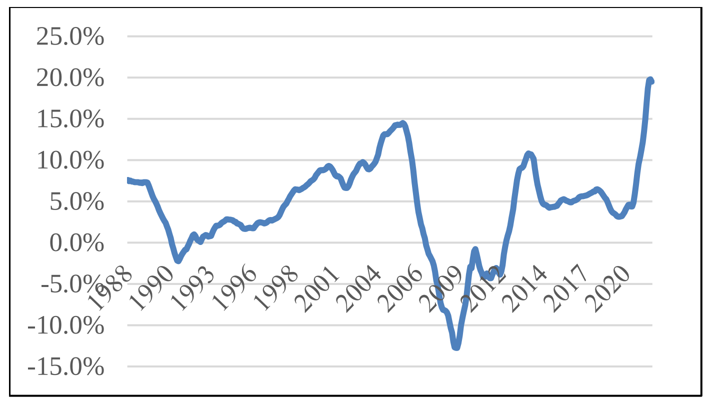


Chart 5 S&P/Case Shiller U.S. Home Prices Y/Y



Source: Federal Reserve of St. Louis

2. The negative effects that politicians inflict on business in their reaction to the latest Omicron Covid-19 scare – It is becoming increasingly apparent that the Covid-19 virus will be with the world for a long time. There is an end game in sight, however. An ever-increasing percentage of the population has gained some natural immunity by having had Covid, or through vaccination, or both. Covid may continue to circulate through the globe but increasing levels of immunity will result in manageable levels of hospitalizations. We will manage Covid just as we have long managed hospitalizations due to the Flu. The political response to Covid is likely to be more damaging to the economy than the disease itself. Both China and parts of Europe are taking strong measures that limit commerce and economic activity. This will not be helpful at relieving the supply side problems that are exacerbating inflation. However, as it becomes increasingly evident that Omicron is not as severe as past variants, the government controls should lessen again.

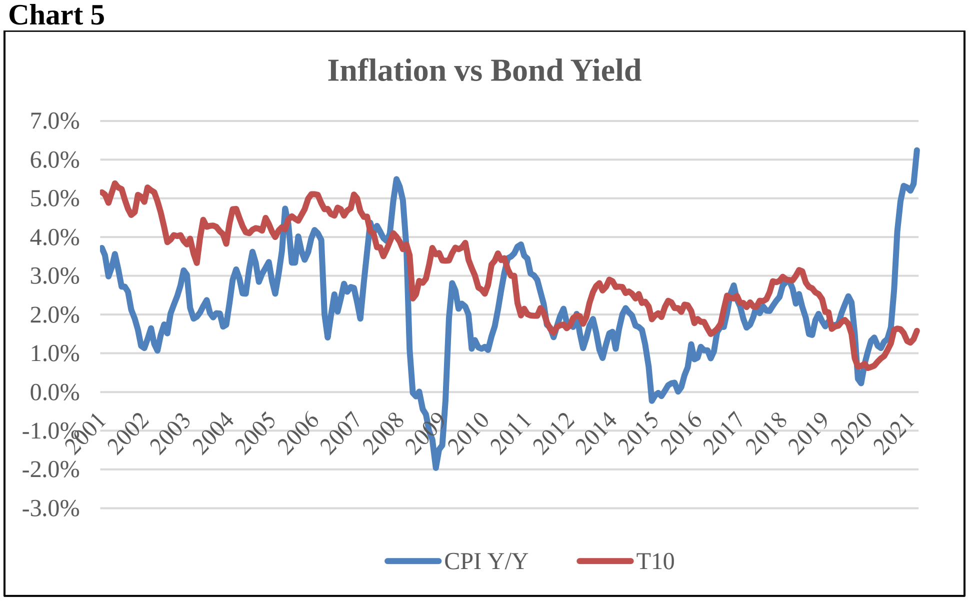
3. The Fed shifting to a less accommodative monetary policy – The Fed has been buying $120 billion in bonds per month ($80b in US Treasury bonds and $40b in mortgage-backed securities) in what is known as "quantitative easing." When a central bank buys bonds from a commercial bank it creates bank reserves. When the Fed buys bonds from the public, it creates a bank demand deposit (money). The Fed has effectively been buying from both. Because inflation has suddenly surged and unemployment is already back down to 4.2%, the Fed will this month begin reducing those purchases and expectations are that the program will end entirely in the first half of 2022. The end of QE is expected to be followed with the Fed raising short term interest rates. The current target on the Fed Funds rate, i.e., the overnight inter-bank lending rate, is 0.0% to

0.25%. It is quite possible that there will be two or three 0.25% rate increases in 2022. Whether this occurs will depend on actual spending and nominal GDP we think. Monetary policy works with long and variable lags and the economic impact may not be felt until late in the year or 2023. This is one explanation why stocks typically continue to rise during the early stages of a Fed tightening cycle.

4. Inflation – Inflation should disturb all investors because it distorts all commercial markets and can result in the misallocation of goods and capital. Inflation also erodes the present value of future business earnings. But the level of uncertainty about future inflation is very high. Our proprietary model, which is based on three years' worth of past spending growth, still shows inflation pressure heading back toward 2%. Also, it is unusual that the year-over-year change in the CPI is so high, and yet the 10-year US Treasury yield has barely moved. Bond investors seem not concerned about inflation.

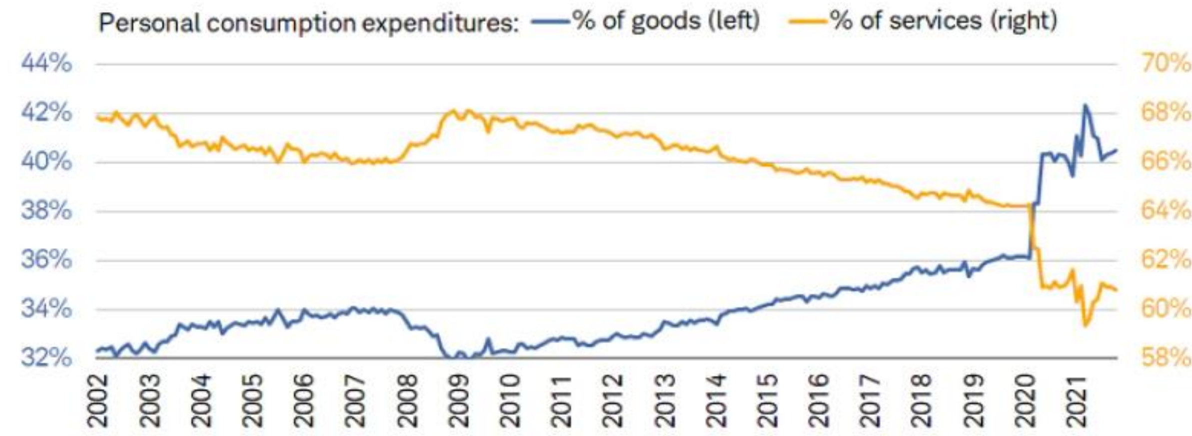
   The inflation numbers have been distorted not only by the widely discussed supply-chain issues, but also because consumers made a sudden and massive shift from buying services to buying goods during the pandemic (see Chart 6). If everyone suddenly stops traveling and instead spend spare money to buy a new car, cars will become scarce and prices will rise. However, airline ticket prices may not fall enough offset the rise in car prices. This may reverse as normal business resumes.

Chart 5



   Indeed, Chart 7 should make one wonder if there will be a reversal in the strength of durable goods sales. During the pandemic, many people delayed medical procedures, vacations and other activities that require human interaction. Those activities will certainly resume, and spending patterns will return to some greater similarity to the past. It's just a matter of when. And as spending shifts back to services, it could mean the start of a reversal in the inflation data. As a final thought on this subject, it should be noted that a reversal in spending patterns could also result in slower GDP growth. This was and is the Fed's concern. The current series of societal and economic developments have no modern precedent. In sum, we must recognize the extraordinarily unusual circumstances that has resulted in the recent high inflation numbers and recognize that we don't understand all the dynamics. We are trying to take a neutral, open-minded approach about forward inflation and will adjust our strategy as more is known.

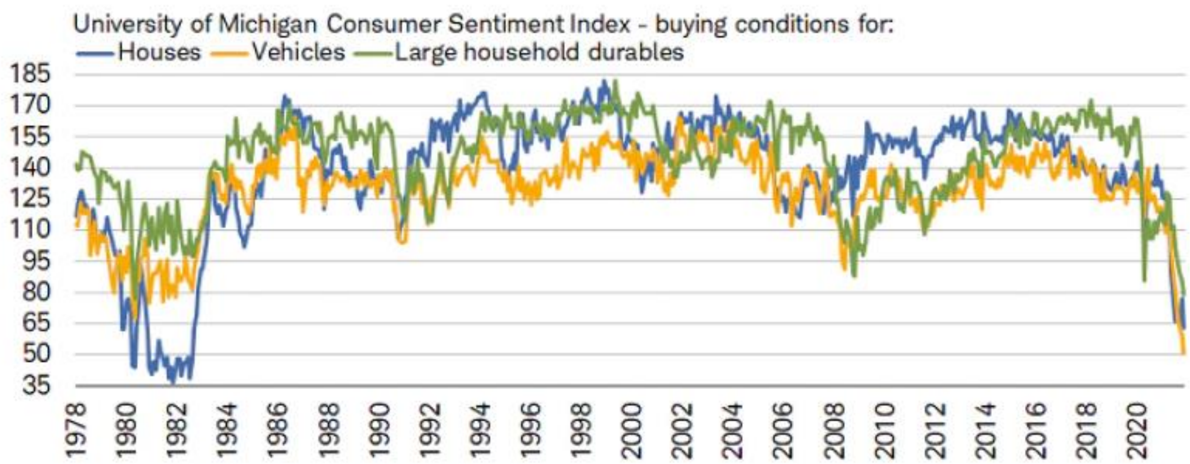
Chart 6



Source: Charles Schwab, Bloomberg, as of 10/31/2021.

Chart 7

Implosion in Buying Intentions



Source: Charles Schwab, Bloomberg, as of 11/30/2021.

Summary

We are in unprecedented times because of the pandemic, but we expect stocks to repeat history over the next ten years and for returns to exceed most other asset classes. Naturally, equity investors must be prepared for volatility. The very reason equity investors are rewarded with high returns is because of their willingness to tolerate volatility. Additionally, our strategy to emphasize "growth at a reasonable price" should continue to help limit volatility. Investors chasing some of the momentum names like Nvidia, which is a $750 billion market cap company that trades at 85 times forward earnings and 107 times cash flow, are surely taking a high level of risk because of the expectations built into a valuation like that. In contrast, our portfolio trades at 14.6 times forward earnings and 9.6 times cashflow. Managing risk is accomplished through traditional methods such as sector diversification, but valuation is also a prime factor that we consider. We hope to achieve superior results over time in this way.