Schaper, Benz & Wise
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18 Jewelers Park Dr., Suite 200 | P.O. Box 628
Neenah, WI 54957-0628 | 920.727.1137

Economic & Market Summary
January 2022

The US economy and stock market had a strong year. Unemployment dropped from 6.4% in January to 3.9% in December. Real GDP grew mid-single digits for most of the year and surpassed 2019 levels. Driven by robust earnings growth, the S&P 500 returned 29% including dividends. Revenue recovered strongly for many businesses. Operating profit margins reached record highs as companies passed on cost increases and leveraged efficiencies gained during the pandemic.

Looking ahead, we expect economic growth to moderate. The economy is beyond the early stages of recovery when growth is fastest. COVID-19 is still an issue with the Omicron variant starting to disrupt economic activity. We could see less fiscal stimulus in 2022 relative to the last two years. Between the remaining COVID relief funds, the infrastructure bill, and the Build Back Better (BBB) social spending bill, there's about $3.75T in potential near-term stimulus. This is larger than the $3.5T in COVID stimulus spent as of September, but the fate of BBB is in doubt.

We have a positive view of 2022 but anticipate more modest equity returns. First, slower economic growth implies slower earnings growth. However, like the economy, earnings had a lot of ground to make up in 2021 so it's normal for growth to decelerate after a strong year. Additionally, corporate profit margins will face some headwinds. Wage growth has lagged inflation over the past year yet demand for labor far exceeds supply. Consequentially, labor costs will likely increase. Employees have bargaining power to negotiate higher compensation and employers are incentivized to be generous in order to meet demand. In addition to rising labor costs, supply costs could stay elevated if Omicron delays the untangling of global supply chains. Businesses will look to offset these costs by raising prices. However, it's uncertain how many more price increases consumers will tolerate.

Second, the Fed is finally tightening monetary policy to address high inflation. Bond purchases are being tapered more quickly and policy makers collectively expect three rate increases in 2022. This is a significant change in the Fed's thinking from just a few months ago and underscores how much inflation has outpaced their expectations. Equity investors tend to favor ultra-loose monetary policy so even a *modest* tightening could bring volatility. Still, the shift is warranted. The longer inflation stays above the soft 2% target, the more likely it is to become a long-term problem requiring more restrictive policy in the future. It's unclear why bond yields are so low in light of high inflation. Do bond investors believe the Fed's original view that inflation is "transitory"? Is there still significant risk aversion in the marketplace because COVID persists? Are central banks' bond purchases distorting bond market signals? Do bond investors believe the economy is still weak? These are a few of the questions we're asking ourselves.

Finally, the S&P 500 trades at an elevated valuation. The current price-to-earnings ratio is 21x this year's estimated earnings, well-above the 25 year upper-teens average. A high PE alone isn't worrisome but does mean the market is vulnerable to bad news. A few things on our minds to that end include continuing COVID disruptions that impact economic growth and supply chains, a disorderly rise in bond yields, a collapse in Chinese real estate, contagion from a downturn in popular high-risk assets, and geopolitical tension between the US and China over Taiwan. While we have a measured view of the year ahead, we remain positive long-term. For all its issues, we continue to believe the US economy is an engine of dynamism where high-quality, consistent growth companies can flourish and generate attractive, long-term returns for investors.

Mark J. Sprtel, CFA

If you're financial situation has materially changed or you would like to discuss your accounts in detail, please contact your investment manager. To request our SEC Form ADV Part II, please contact Mark J. Sprtel, Chief Compliance Officer, at the address above.