HAMRICK INVESTMENT COUNSEL LLC

POLITICAL, ECONOMIC AND CAPITAL MARKETS
REVIEW & OUTLOOK FOR 2022

- We expect that political relationships with China and Russia will remain challenging and in the headlines throughout the coming year. Domestically, tensions among the electorate will increase as we approach the 2022 mid-term elections. Each of these dynamics will create volatility in the markets with rapid advances and declines driven by headline events.
- Investors will face volatile investment returns as the markets adjust to an inflationary environment and uncertainty on the global stage.

Political Considerations

2021 was a year once again dominated by the COVID-19 pandemic, political division in the United States, and a mix of crises on the international stage including our withdrawal from Afghanistan after more than 20 years of conflict. We enter the new year with continued challenges with respect to Russia and an anticipated action against Ukraine, as well as our ongoing geopolitical and economic rivalry with China.

Disappointing as it is to many, based on our collective hope of vaccines being the answer towards normalcy, COVID-19 continues to evade our attempts to move beyond the pandemic. The introduction of several vaccines had been received with great relief throughout the world, yet successive variants have undermined attempts to reach an endemic state for COVID-19. The pandemic continues to be a major part of each of our lives and driver of economic, social, and geopolitical issues here and abroad.

We are still dealing with the ramifications of the 2020 election and its aftermath represented by the January 6th commission and the discourse among our citizens. The upcoming 2022 mid-term elections are certain to elevate the divide among Americans, and there is no doubt that many of the outcomes will be contested yet again. As we remarked in our 2021 outlook, we are a deeply divided nation and consensus will continue to prove challenging. In hindsight, that seems an understatement. Another data point for the state of our nation is presented in the Economist's 2020 Democracy Index. The United States falls into the category of a "flawed democracy" and 25th overall in its rankings.

Efforts by the Biden Administration to be the leader of the free world and rebuild confidence in our leadership role has not translated into actual successes. In a matter of months, the massing of Russian troops on the border with Ukraine has become the dominant foreign-policy story, with talk of a major conflict. Russia wants to keep Ukraine out of Western alliances or prevent the U.S. from building up a military relationship with Ukraine. NATO exercises in the Black Sea and ships sailing though territorial waters in Crimea heightens these concerns for Russia.

The response from the United States, Britain, and Western Europe has been uncoordinated. There is much in the news about economic sanctions, yet many question to what extent they would work and whether they would hurt Europe, particularly Germany in equal measure. The 8,500 U.S. troops for the Baltic states, Poland, and the others, seem irrelevant. We are engaged in high-stakes diplomacy throughout the region without a visible path to resolve the issues.

China's growth as a world power continues to influence and dominate politics in the region and with the United States. A top concern among U.S. analysts is that China's growing military capabilities and assertiveness, as well as the deterioration in cross-strait relations with Taiwan, could spark a conflict. Such a conflict has the potential to lead to a U.S.-China confrontation. That is because China has not ruled out using force to achieve Taiwan's "reunification" and the United States has not ruled out defending Taiwan if China attacks. While experts disagree about the likelihood and timing of a Chinese invasion, it does create uncertainty for the global community and equity markets around the world.

In 2021 the investment markets climbed the proverbial "wall of worry" as global markets continued an economic recovery from the 2020 nadir. We are cautious for 2022 with the challenges we face on the geopolitical front. The items of highest concern to us include an escalation of events in Ukraine, the slowing of the Chinese economy, and challenges between Taiwan and China. Here at home, we are concerned about the rise of populism and the threat to our elections and democracy.

Economic Review and Outlook

2021 was a year for robust economic growth rebounding from the depths of the economic contraction due to the pandemic. Annualized global GDP growth reached 5.5%, which was its highest mark in over three decades. Economic performance varied widely among countries, dependent upon both the level of COVID transmission within a country and the severity and length of public health edicts limiting economic activity.

Our outlook for 2022 is highly dependent upon the path of the Pandemic. Our baseline assumption is that most advanced countries will transition into an endemic phase, but the transition will occur unequally in both time and geography. From an economic standpoint, the global economy will be transitioning from running on monetary and fiscal support, though contained by the pandemic, to running on its own accord while government support eases. Overall, we anticipate global GDP to still expand at a healthy 4.2% as the global deficit spending boost eases. Though GDP will expand more slowly, the quality of economic growth will be improved.

Perhaps one of the largest surprises of the pandemic was the strength of the economy and corresponding inflation that was created. Inflation is due either to a scarcity of goods being chased by the same amount of money or to a surplus of money chasing the same amount of goods (or a mixture of both). We see most of the high inflation that has transpired, and likely to continue into 2022, caused from a scarcity of goods. When combined with the temporary influx of cash – via government transfers both here in the U.S. and in Europe – the result is a burst of inflation. With our assumption of the pandemic easing, we expect that inflation from a scarcity of goods will ease. Easing will come from a lowering of demand for goods due to more opportunities to spend on services, as well as from easing supply chain issues, which will increase the supply of goods. Lastly, the built-up savings accounts from government transfers should soon be exhausted as well.

However, inflation of labor prices may very well prove to be more persistent. The pandemic has resulted in a large net-loss of workers in the U.S. and elsewhere. The labor participation rate dropped from 63.4% prior to the pandemic (which was still a multi-decade low) - to 61.9% in December of 2021. The 1.5% decline represents nearly 4 million missing workers in the United States. The loss of workers was from three distinct categories: uneducated men, highly educated and productive women, and near retirees. The combination has created an unprecedented level of unfilled jobs – sitting at 10.9M as of January 2022. Some of these changes in composition of the workforce may be permanent or "sticky", with workers not coming back in large numbers until wages are attractive enough, in real terms, which is exactly how a new labor dynamic may lead to inflation running in the 3-4% range for many years ahead.

After several decades of Capital increasing its share of distributions from corporate earnings relative to Labor, the pandemic may prove to be a tidal change if Labor begins a long-term trend of increasing its share of the pie. This could create substantial declines of corporate profit margins into the future, depressing stock valuations. Our judgment is that it is yet too early to tell whether the recent wage gains will be persistent or temporary, lasting just a few years until there is a new equilibrium.

The current economic environment is ripe for missteps by central banks. The cause and nature of the recent spike in inflation will likely only be realized in hindsight, making policy actions aimed at reigning in inflation difficult. Will easing of supply chains solve all the inflationary pressures? Will removing quantitative easing do it, or will a Fed Funds rate above 1% be the cure that is needed? All of these judgements are made even more difficult due to the unpredictability of the course of the pandemic.

To date, it has appeared that policy makers were very successful in ameliorating the worst effects of the pandemic through a combination of monetary and fiscal plans. We liken the challenge of navigating the pandemic to threading not one needle but threading two needles at the same time – it's very difficult to get it right. Our primary concern is that, by and large, monetary actions may be the wrong medicine to "cure" the rising inflation if inflation really is primarily due to supply chain disruptions from the pandemic. Instead of reigning in prices, tightening monetary policy may only subdue the economy and have negligible effect on inflation.

Investment Markets Outlook & Strategy

In our estimation, there are simply too many challenges ahead for 2022 to be a tranquil year in the markets. The course of inflation and interest rates will be the primary factor moving markets for the year ahead. Will inflation continue to rise? Will it abate from its January 7.5% peak, due supply chain normalization? Likewise, how fast will the Fed raise rates? Three-quarter-point rate increases were expected until the recent inflation report; now a full 1% rise for the remainder of the year is more than likely, based on futures markets. Will the longer-end of the yield curve rise substantially if markets lose faith in the Fed's long-term inflation outlook? Is the source of inflation even monetary in nature? Or is it from supply chain issues?

All the uncertainty sits on top of the uncomfortable familiar uncertainty surrounding the pandemic. Though it is true that the economy has become more resilient to increases in the disease's spread, we now live in a world where public health related economic contractions are a real and persistent threat.

The challenge in this environment will be achieving positive real returns, while taking acceptable amounts of risk. Fixed income markets certainly appear to be over-valued relative to inflation. The risk of a "taper-tantrum" is real – though it may be a buying opportunity. Likewise, cash investments still offer no return, though this should change early into 2022 as the Fed Funds rate rises.

Strategically, we do see some opportunities to navigate this difficult environment, including:

1) Within the fixed income allocation of client portfolios, increase the cash/money market holdings. In the face of likely further interest rate increases, a 10%-15% position of a client's bond holdings should be in cash. (For example, in a 60% stock / 40% bond, 10% to 15% of the 40% bonds (4%-6%) can be allocated to cash.) The

funds should be taken primarily from the current short-term bond allocation for clients.

2) Among equities, look to allocate an even greater proportion of stocks to foreign issuers. The MSCI All-Cap-World-Index ACWI has a 60% U.S. stock / 40% non-U.S. allocation. The current investment strategy we undertake has a 62% domestic equity and 34% "Global" equity allocation. Due to the use of several global funds (those that invest in the U.S. and abroad) the current underlying domestic/foreign breakdown is closer to 72% U.S. / 28% foreign, bringing our allocation closer to the ACWI index. However, due to geo-political risks, our goal is to move in gradual steps towards this goal to diversify the timing (or wait for a better opportunity in the event that non-U.S. stocks sell off more than U.S. ones). As part of this allocation change, we are purposefully reducing exposure to mega-cap tech stocks and investing in a more "value" approach by changing the geographic mix of holdings.

3) We anticipate there to be a greater amount of volatility in the financial markets this year. In response, we look to rebalance accounts more often, as well as more rigorously (to a tighter range of allowable variance from targets). We acknowledge this will create greater capital gains for many clients but believe the improved risk/return profile in rebalancing will offset any tax consequences.

We anticipate the year to be a volatile, though ultimately positive, one, driven by the strong economy. If there are declines in financial markets, we expect them to be offset by higher future returns, especially in the bond market. 2022 may require greater discipline for investors relative to the previous several years as markets uniformly rose sharply from their pandemic related lows.

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