GREAT OAK
INVESTMENT MANAGEMENT
OF
RAYMOND JAMES

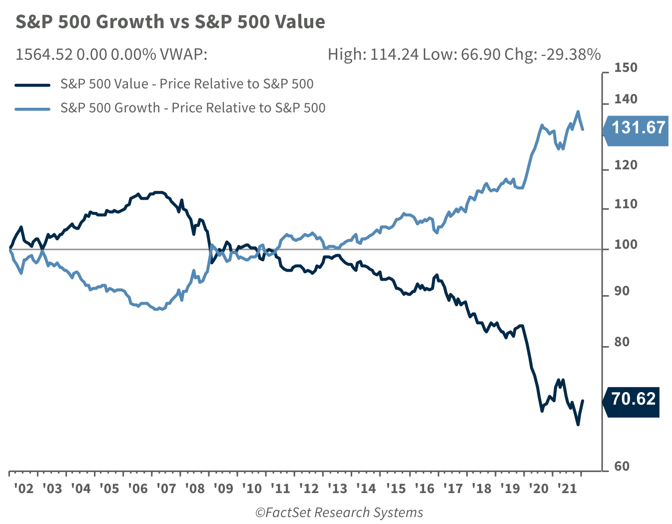
Outlook: 2022

As we end one year and start another, we first would like to thank our clients and friends for joining Great Oak Investment Management of Raymond James. We finish every Economic and Market Outlook with, "Thank you for entrusting us with your hard-earned capital." Perhaps that statement is more important than ever. We believe our relationship with Raymond James will allow Great Oak Investment Management to enhance our ability to manage your hard-earned capital, as well as refocus our commitment to quality financial planning and quality client service.

Before we look forward into 2022, let's take some time to review the last 12 months. The country grew at a strong pace in 2021 on the back of an ultra-accommodative Federal Reserve, robust consumer spending, and an improving labor market. Both consumer and investor sentiment seemed to be buoyed by a recovering and reopening economy. Through the end of the third quarter of 2021, Gross Domestic Product (GDP) grew north of 5%. Much of the growth came from purchases of durable goods, as auto sale prices grew by 17.8% year-over-year (YOY) and clothing/footwear by over 13% YOY. The labor market continued its remarkable recovery, as we saw the U-6 unemployment rate (the U-6 rate covers all persons who are still looking for work, part-time and marginally attached due to economic reasons) fall from 12% in January to 7.4% in November. Throughout 2021, personal consumption expenditures (PCE) jumped as the cost of goods rose. This price increase was due to supply shortages, growing consumer demand, government spending, and the abundance of money in the economy.

After over a decade of hiding in the shadows of a slow growing economy, price inflation grabbed the headlines in 2021. In the first half of the year, "Transitory" inflation morphed into the Federal Reserve acknowledging the risk of persistent inflation effects on the economy. Inflation was evident in nearly every part of the economy as consumers had to burden the increased costs in commodities, food, clothing, residential real estate, and automobiles. For example, lumber and gasoline prices rose to levels not seen for many years. In May of 2021, the price of lumber shot up 251% year over year due to building demand with the lack of supply due to lockdowns. These prices have fallen back to normal levels, but this type of price volatility creates uncertainty for businesses and consumers. Gas prices rose from $2.53/gallon on December 6th 2020 to current levels hovering around $3.50/gallon. The increase in gas prices affects 96% of Americans (4% of Americans drive electric vehicles)[1] leaving them with less money to spend on other needs. There are some indications that commodity price inflation has started to dampen as consumers saw their buying power shrink.

Equity markets had a strong year supported by easy monetary policy, strong consumer spending and corporate earning expansion. Growth stocks continued to outpace value stocks; the S&P 500 Growth (light blue line) vs S&P 500 Value (dark blue line) is the widest price return margin we in the past 20 years.



Additionally, large cap companies have performed well in the recovery, outperforming their smaller counterparts. Much of this performance has been attributed to the growth of corporate earnings and the ability for larger corporations to access historically low borrowing rates in debt markets. This in turn, has enabled larger companies to borrow and refinance their balance sheets – lowering their cost of capital. One very interesting note has been the lack of performance in small cap names as the small cap growth sector only returning 5%. Could this be a canary in the coal mine for the coming year, as small cap growth companies tend to have the weakest fundamentals?

[1] "Americans are buying Teslas, not EVs, but experts say that's about to change" – Michael Wayland

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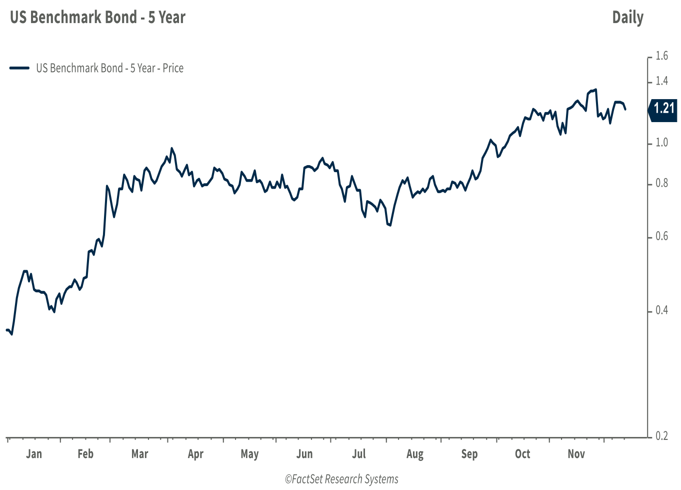
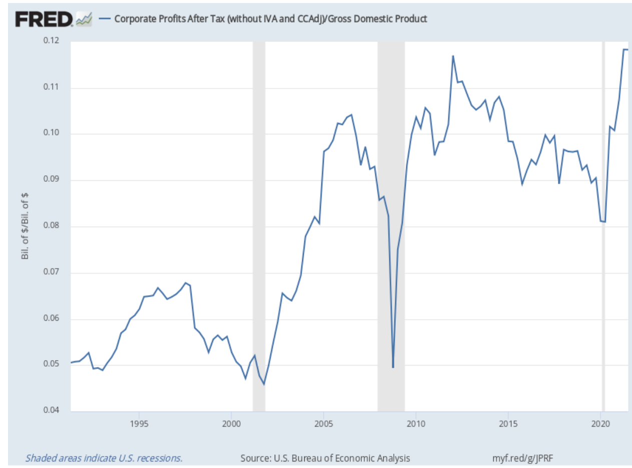
The bond market faced many headwinds in 2021; the Federal Reserve began reducing asset purchases, the emergence of inflation, and surprising domestic growth. The result was the yield on the 5-year US Treasury moving from 0.35% in late January to 1.26% by year end.



This 1% increase in yields pushed bond prices lower, as bond yields and bond prices have an inverse relationship. The best performing bond sector was the Treasury Inflation Protected Securities (TIPS) as market participants looked to hedge against inflationary concerns. Municipal bonds outperformed investment grade corporate bonds as investors demanded tax-efficient income. Much of the demand for tax efficient income came from echoes of higher tax rates, as new proposed legislation worried investors about the potential of increases in government spending.

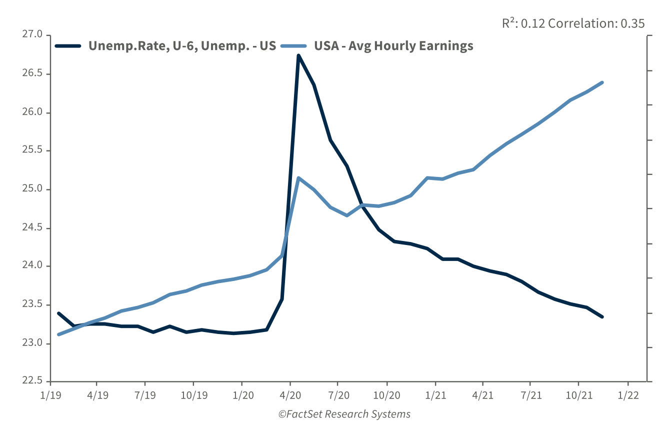
As we close the book on 2021, we look for US growth to continue in 2022. This growth should be supported by continued strength in US households, accommodative Federal Reserve monetary policy, and strong business investment due to a pick-up in capital expenditures.

We consistently focus on the US consumer as goods and services represents approximately 70% of the GDP calculation[2]. Understanding the health of other consumers can provide some insight on future growth prospects. Personal savings rate (as a percentage of disposable personal income) is back to pre-pandemic levels at 7.30%. This can be seen as an encouraging sign that the US consumer is reemerging from the COVID lockdowns and restrictions.



Real after-tax disposable personal income is back on the trajectory of pre-pandemic levels. Household debt service payments as a percent of disposable personal income is the lowest we have seen. This means the US consumer is making more money and spending more money, while maintaining the strongest financial health we have seen in sometime. We believe this bodes well for the economy. We think this should carry forward, as employees are starting to see their best bargaining power over their employers in 40 years.

The labor market remains tight. The unemployment rate has fallen dramatically from staggering levels seen in the early months of the pandemic (dark blue line). The labor force participation rate is starting to move higher as a reduction in government support and workers confidence re-energizes the workforce. The confidence in private sector workforce is apparent, as the private sector quit rate is the highest in 20 years. The NFIB (National Federation of Independ Businesses) November 2021 report shows 48% of small businesses have at least one unfilled position. The tight labor market is a key indicator for improving wages. We believe the increase in wages should put additional pressure on inflationary concerns (light blue line).



Economic growth should be bolstered by business fixed investment. Corporate profits continue to expand as

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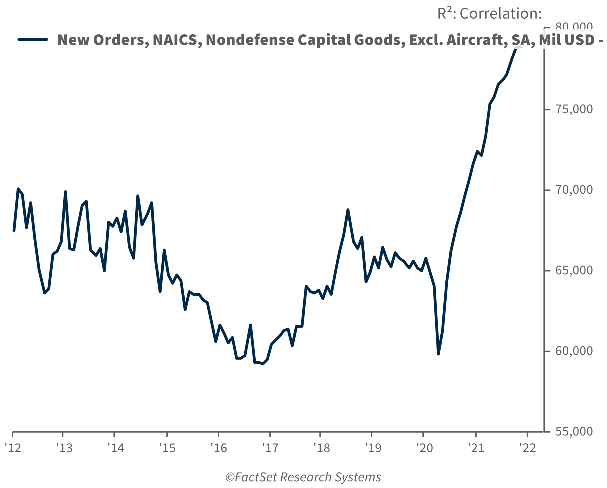
[2] U.S. Bureau of Economic Analysis, Shares of gross domestic product: Personal consumption expenditures [DPCERE1Q156NBEA]

uncertainty forces companies to adapt, innovate, and cut costs. Surprisingly, not only have corporate profits risen in the last year, but profit margins have improved in the face of higher wages and cost of goods. The strong profits create the potential for an increase in capital expenditures. Capital Expenditures are the money a company reinvests in its business (i.e., plant, property and equipment).



The strong growth in new orders (ex-aircraft) is just an example of the growth in capital expenditures. This creates more economic activity and overall growth for the economy.

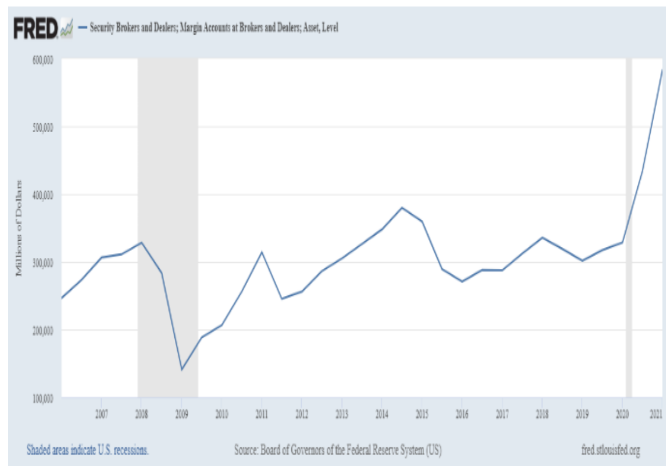
With the expected continued economic support and business investment, we look for equity markets to see a positive year. We see the equity markets as fully valued. Valuations have been driven by low interest rates reducing the cost of capital, with the result being healthy cash flows and elevated margins and profits. For example, free cash flow to total debt for the S&P 500 is the strongest in 10 years and coverage ratios for the index remain in a solid position. Some of the ratios we examine are out of balance due to the elevated current asset levels (assisted by stock prices). However, asset prices would have to fall dramatically to make a major impact on leverage ratios – especially when the cost of debt (interest expense) has risen about half the amount of net debt since 2011.

With that said, we remain focused on examining the stocks in our strategies, understanding each company's profitability, cash flow, and overall business projections. We believe the companies we hold are positioned well for a rising rate environment, as much of their debt has been refinanced and locked in at lower rates.

Bonds look to be under pressure as headwinds remain in 2022. With the Federal Reserve feeling pressure from continued inflation concerns and economic growth, we expect to see an elimination of asset purchases in March and three hikes in the Federal Fund rate from Chairman Jerome Powell. It's important to note, we welcome the prospects of higher rates for our strategies even though in the short term it might create price volatility. Higher interest rates allow us to purchase bonds at higher yields, providing opportunities for enhanced income and total return for bond investors over the long term. The core of our laddered fixed income strategy is designed for a rising rate environment.

Even though our base case is for continued economic growth and positive equity markets in 2022 – we see potential headwinds that keep us cautious.

Investor speculation is reaching concerning levels. The use of margin in accounts has reached concerning levels. Below shows the amount of margin in investment accounts held at security brokers and dealers.



In addition to equity account speculation, investors are pouring into speculative asset classes such as Special Purpose Acquisition Companies (SPAC), crypto currencies and non-fungible tokens (NFT). The willingness for investors to take on risk, adds concern for volatile markets heading into 2022.

Concern of higher-than-expected inflation remains an elevated risk. Persistent elevated inflation could push the Federal Reserve to act more hawkish, reducing the monetary accommodations and potentially stalling out economic growth and increasing borrowing rates.

The ability to borrow is at the heart of western capitalism. It fosters home ownership, asset purchases, education, etc. However, too much debt, i.e., overleveraging, is typically a driver in economic instability. Consumers and private sector leverage remain low to normal, however government debt is elevated. While the elevated government debt isn't an immediate concern, we expect borrowing costs to be higher in the next economic cycle increasing the debt service for governments. The Federal Governments needs tame in debt burden in the coming years. History has shown this is easier said than done.

Base Case for 2022:

1.) Continued economic growth should be supported by continued strength in US households, accommodative Federal Reserve and strong business investment due to a pick-up in capital expenditures
2.) Equities should see a positive year with an increase in volatility. Corporations should maintain impressive fundamentals, but profitability might tighten due to increases in labor costs.
3.) Bonds should face headwinds, but investors should remain diligent. Bond ladder strategies should help mitigate interest rate risk. With the potential of higher rates in years to come, investors should see the benefits of higher income and thus expecting greater return.

Have a safe and enjoyable 2022.

As always, thank you for entrusting us with your hard-earned capital.

Great Oak Investment Management

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