MALVERN CAPITAL MANAGEMENT

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Quarterly Commentary and 2022 Market Outlook

January 2022

4th Quarter and Full Year 2021 Review

2021 was the third year in a row of double digit returns for the S&P 500 Index. Liquidity in the form of low interest rates and quantitative easing by the Federal Reserve helped to propel all of the major indices forward for the year. In the 4th quarter 2021, the S&P 500 Index advanced by over 11%. Growth stocks led value stocks in the quarter by nearly four percentage points. However, increasing interest rates in 2021 woke up value stocks which had impressive returns overall for the year although they lagged growth stocks. Value stocks have trailed growth stocks for many years prior to 2021. The technology heavy Nasdaq had another impressive quarter. Small and mid-cap stocks were laggards in the quarter although they were still positive.

We saw terrible inflation numbers reported in the 4th quarter, numbers we have not seen since 1982. One would expect commodities to fare better as they are usually considered a "hedge" against inflation. But the Bloomberg Commodity Index was negative in the quarter although it did post double digit returns for the year. Real Estate, another inflation hedge, performed well, with the Wilshire U.S. REIT Index rising 17.14% the last three months of the year.

The yield on the bellwether 10-year U.S. Treasury note was virtually unchanged in the 4th quarter but did rise over the course of the year. As such, high quality bonds were flat for the quarter but fell during the year as measured by the Bloomberg Barclays U.S. Aggregate Bond Index. Lower quality bonds had a positive quarter and year.

We move into a new year with a set of risks with which to be concerned. Will we make it to a fourth year of double digit returns in the equity markets or will the markets finally pause? We examine various issues and concerns as follows.

Index Performance

Category	Representative Index	Dec. 2021	4th Qtr 2021	2021	3 yr*	5 Yr*	10 Yr*
Mature US Large Companies	DJ Industrial Average	5.53	7.87	20.95	18.49	15.51	14.21
Broad US Large Companies	S&P 500 Index	4.48	11.03	28.71	26.07	18.47	16.55
US Small Cap Companies	Russell 2000 Index	2.23	2.14	14.82	20.02	12.02	13.23
US Mid Cap Companies	Russell Mid Cap Index	4.08	6.44	22.58	23.29	15.10	14.91
Largest 100 NASDAQ Companies	NASDAQ 100 Index	1.19	11.28	27.51	38.34	28.63	23.15
Large "Value" Stocks	Russell 1000 Value Index	6.31	7.77	25.16	17.64	11.16	12.97
Large "Growth" Stocks	Russell 1000 Growth Index	2.11	11.64	27.60	34.08	25.32	19.79
Developed International	MSCI EAFE Index	5.12	2.69	11.26	13.54	9.55	8.03
Emerging Markets	FTSE All Emerging Markets	1.66	-1.02	-0.24	11.32	9.56	5.62
Broad US Bonds	Bloomberg Barclays US Aggregate Bond	-0.26	0.01	-1.54	4.79	3.57	2.90
High Yield Bonds	Bloomberg Barclays US Corporate High Yld	1.87	0.71	5.28	8.83	6.30	6.83
Commodities	Bloomberg Commodity	3.53	-1.56	27.11	9.86	3.66	-2.85
Total US Market (all cap stocks)	Russell 3000 Index	3.94	9.28	25.66	25.79	17.97	16.30
Real Estate Investment Trusts	Wilshire US REIT Index	8.82	17.14	46.18	19.19	10.92	11.47
Cash	US T-Bill 90 Day	0.01	0.01	0.04	0.82	1.06	0.59

** 3 year, 5 year and 10 year returns are annualized. All periods ending December 31, 2021.*
All returns include the reinvestment of dividends.

Risks as We Transition Into the New Year, 2022

There are a number of global macro issues which may move markets in 2022. Such issues will likely contribute to increased market volatility this year.

China real estate developer Evergrande defaulted on its debt in December. Rating service Fitch Ratings says that as many as one-third of China's Real Estate developers could default on their debt if residential sales continue falling. Also, we need to be aware of the tensions developing between China and Taiwan. Tensions may accelerate with Taiwan after the Beijing Olympics this winter.

Further, evidence is building that Russia will invade Ukraine with Russia deploying troops along the Russia-Ukraine border. If an invasion should occur, much of the developed world including the United States will impose sanctions on Russia. While these sanctions have the potential to hurt Russia, they can also have a negative impact on the countries imposing such sanctions as well.

Lastly, Covid and its new strain Omicron, has the potential to negatively affect global economies. The new strain seems to be more contagious but less harmful than the original virus. Eventually, we all will learn to live with Covid and it will be treated much like the flu.

Other major issues can certainly come about such as global unrest, country credit defaults or some other "black swan" event and it will certainly be a year of caution in the financial markets.

Inflation; It Is More Than Transitory

Federal Reserve Chairman Jerome Powell said for months that inflation was transitory caused by supply chain disruptions. Powell claimed such supply chain disruptions would work themselves out and inflation would soon no longer be a problem. Inflation, the chairman has now conceded, has become more persistent as we are experiencing an inflation rate not seen since the early 1980's.

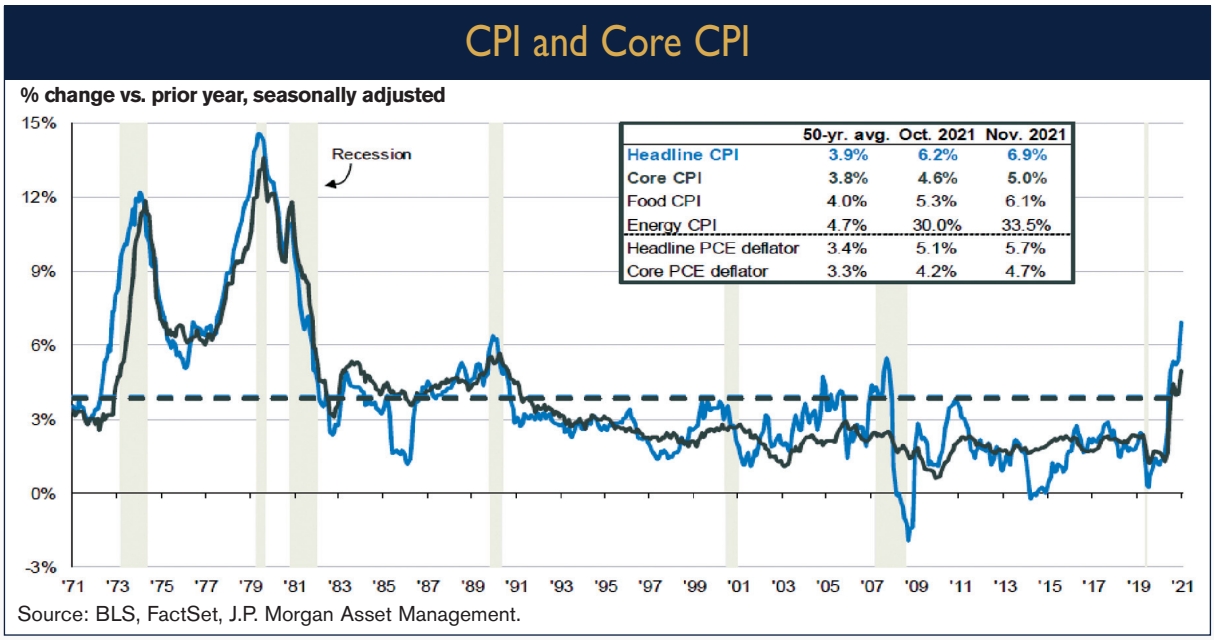
Goods still sit on ships waiting for weeks to get into the ports of Long Beach, California or Los Angeles. A large part of the problem is a lack of truckers to transport the goods once the goods are offloaded from the ships. As a result, goods are not getting to their final destinations creating a shortage and ultimately causing prices to increase sharply. This is an illustration of the supply chain. Although it has contributed to inflation, we believe that there are other factors which are causing inflation to be more persistent. These include the very accommodative Federal Reserve and the massive government spending that has occurred in the past year.

The Federal Reserve has been very accommodative through its quantitative easing or bond buying program and also through its near zero interest rate policy since the start of Covid in March 2020. The bond buying program has flooded the markets and economy with liquidity along with the near zero interest rate policy. Low interest rates have fueled the housing market pushing housing prices up to record highs.

There has also been massive government spending in the past year and earlier. Early in 2021, the president signed a Covid relief bill also referred to as the American Rescue Plan into law pumping $1.9 trillion into the economy.

This was on top of two previous pandemic-era stimulus bills that were passed during the Trump Administration. In addition, the president signed the $1.2 trillion infrastructure bill into law last year.

Inflation is often referred to as "too much money chasing too few goods."



	50-yr. avg.	Oct. 2021	Nov. 2021
Headline CPI	3.9%	6.2%	6.9%
Core CPI	3.8%	4.6%	5.0%
Food CPI	4.0%	5.3%	6.1%
Energy CPI	4.7%	30.0%	33.5%
Headline PCE deflator	3.4%	5.1%	5.7%
Core PCE deflator	3.3%	4.2%	4.7%

The Federal Reserve; Going In a New Direction

The Federal Reserve embarked on its current quantitative easing program right after Covid hit in March 2020. In that program the Fed would buy $120 billion of U.S. Treasury securities and mortgage-backed securities. After the Fed's November 2021 meeting it announced that it would begin unwinding the bond purchase program or "taper" its purchases. The taper would begin in November 2021 with the Fed gradually buying fewer bonds per month until it completely stopped buying bonds. Tapering was originally targeted to conclude by June 2022. It has since revised the pace of the taper so that it should complete its bond purchasing by March 2022.

In addition to the bond purchasing program, the Fed cut the Fed Funds rate to near zero back in March 2020. With the bond purchasing program driving down longer-term interest rates and the Fed's cutting of the Fed Funds rate or short-term interest rates, the yield curve "flattened" or became less steep.

The intended effect of the bond purchasing program and the near zero Fed Funds rate policy was to drive down interest rates and create liquidity in the economy. The purpose was to avert or end a Covid induced recession. We did experience a brief recession but it came and went so perhaps the quantitative easing and low interest rates were responsible or at least partly responsible.

In addition to ending quantitative easing, the Fed will be increasing the Fed Funds rate most likely starting after it completes its tapering. We believe there is a high probability of three rate hikes in 2022 and a lower probability that there will be a fourth rate hike this year. The Fed is changing its policy now in order to help tamp down inflation. The Fed's tightening stance reduces liquidity in the economy so that there is less money chasing fewer goods.

The implications for the stock market during a tightening phase is generally positive if the Fed does not move too quickly or raise rates too high. The problem we see is that the Fed is both unwinding quantitative easing, with which there is not a lot of historical precedence for doing, and it is going to subsequently raise interest rates. We are not entirely sure how the stock market will react to this policy shift.

As for the bond market, the 10-year U.S. Treasury note yield at the end of 2021 stood at 1.512%. It is often said that the 10-year U.S. Treasury Note yield should equal the nominal Gross Domestic Product rate. Historically there has been a high correlation between the 10-year yield and nominal GDP. That implied yield would be about 8.4% at the end of 2021. Given the inverse relationship between bond prices and yields, the 8.4% implied yield would suggest that the treasury bond market is very expensive and extremely over-valued right now. In other words, yields should rise causing bond prices to fall.

The "Build Back Better" Plan is On Hold for Now

In addition to the American Rescue Plan and the Infrastructure Spending bill, the Biden administration has proposed a rather ambitious spending program referred to as "Build Back Better." The bill has lots of benefits which include child care, the child care tax credit to families with children, "green new deal spending" to slow down climate change and much more. The problem with the bill is its potential inflationary impact. Again, more money chasing too few goods. The bill originally would spend upwards of $3.5 trillion over 10 years. It had since been pared down to about $1.8 trillion but still has been met with opposition by 52 of 100 senators including two Democrats, Joe Manchin and Kyrsten Sinema. The bill is currently on hold because it does not have the votes to pass.

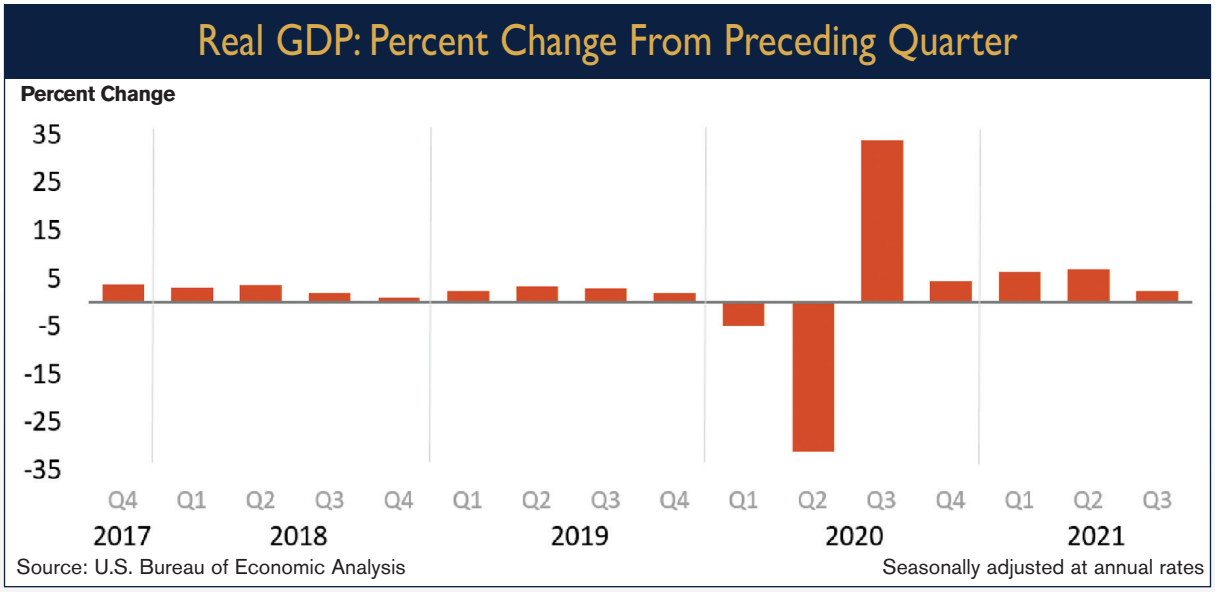
Our position on this bill is that it is best reserved until a recession hits. The president does not have a mandate from the voters as evidenced by the fairly even split in the House and Senate in order to pass such an ambitious plan. However, some version of a stripped down Build Back Better bill will likely get through the Senate in the 1st half of 2022.

Mid-term Elections are This Year

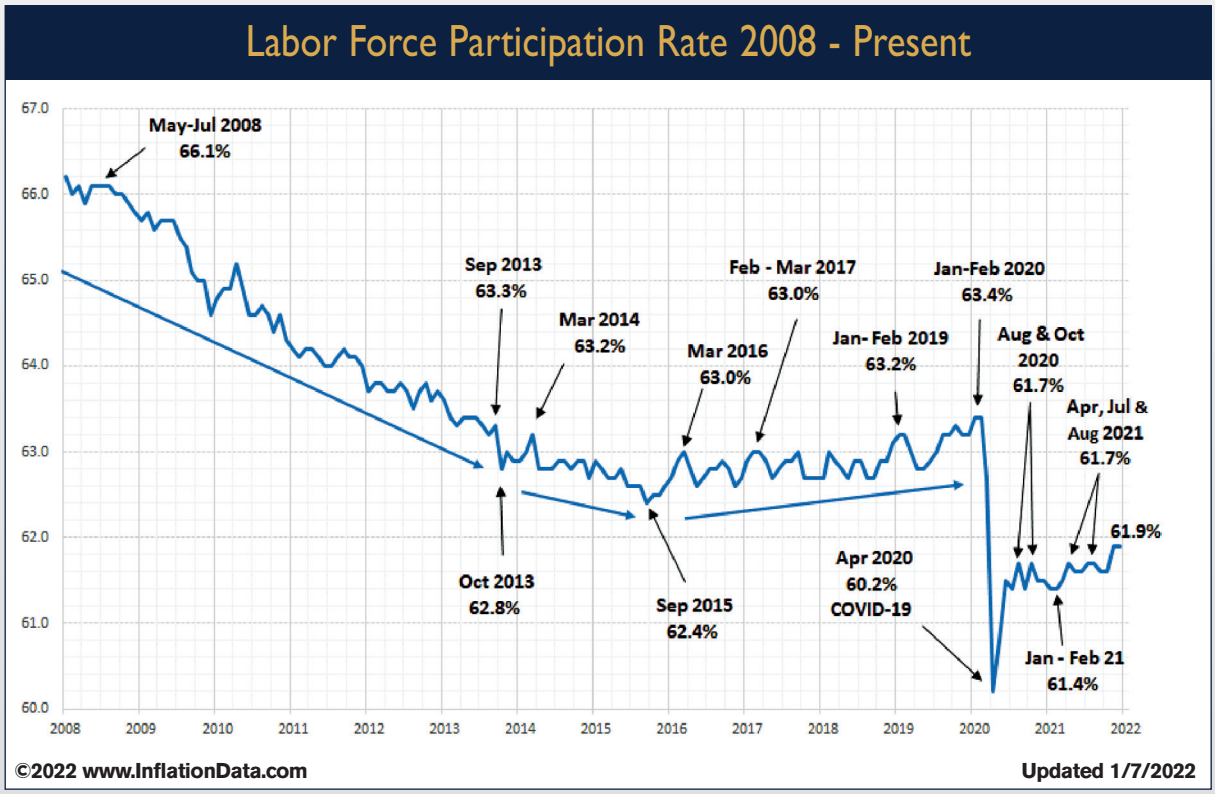
If the Biden Administration would like to pass the "Build Back Better" bill or any other major legislation, it will need to win elections. 2022 is a mid-term election year. All members of the House and 34 senators are up for re-election. As we stated, Biden does not currently have a mandate in order to pass any "bold" legislation. A mandate from Americans would be demonstrated by sending a commanding number of Democratic representatives to the house and Democratic senators to the senate. The bad news for President Biden is that sitting presidents usually lose House and Senate seats in mid-term elections. Currently the Real Clear Politics generic consensus poll (taken between 12/8/21 and 1/4/22) shows Republicans leading by 1.6% over Democrats in the upcoming mid-term elections. In November, the gap was 4.2% Republicans over Democrats. There is still a lot of time for the Democrats to over-take the Republicans.

The Economy

The third estimate of the 3rd quarter of 2021 real Gross Domestic Product (GDP) showed growth of 2.3%. We continued to see positive growth in GDP although the rate of growth has been slowing since the rebound after the initial Covid pandemic slump. The 3rd quarter GDP reflects the impact of Covid as many businesses remain closed or have disrupted operations. Currently, the economy is growing with no signs of slowing down despite the high inflation numbers. However, many Americans do not "feel" like the economy is doing well. A Pew Research Study conducted in September 2021 showed that just 26% of U.S. adults rate the economy positively. 74% rate the economy either fair or poor. Despite what people "feel" about the economy, it is growing at a steady rate.



A growing economy generally means an expanding workforce. The December jobs report showed that 199,000 jobs were created which was considered a "miss" by economists as 400,000 new jobs were expected. However, an average of 537,000 were added each month in 2021. In December, the unemployment rate fell to 3.9% better than the expected 4.1% rate. Encouragingly, wages grew by 4.7% as a sign that the jobs market is tightening. The labor force participation rate was 61.9% in December which is the highest rate since the pandemic started and showed the third straight month of increases. However, the rate is far from the 66.1% it was in summer of 2008. If more people would join the workforce, and increase the labor force participation rate, it would take some pressure off of inflation.



Corporate Earnings

Projected earnings (from the Standard & Poor's Corporation) for full year 2021 for the S&P 500 Index companies is $201.86 per share. Actual earnings for full year 2020 was $122.37 per share giving us an annual growth in earnings per share of 65%. Projected earnings for full year 2022 are $220.11 per share. This would represent a growth rate of 9% in 2022, reflecting a considerable slowdown in the growth of earnings between 2021 and 2022. Much of the growth in 2021 would be from a rebound in earnings which had slowed in 2020 due to Covid shutdowns.

Operating margins or return on sales is a measure of companies' profitability and those margins have been superior. The latest recorded operating margin for the S&P 500 Index is 13.17% (the estimate for the 3rd quarter, 2021). To put this in perspective, the average operating margin since the 1st quarter 1993 is 8.12%. Operating margins tell us how efficiently a company is managed and how profitable a company is. We would need to see these margins decline sharply before we would say that the strong corporate earnings were in trouble.

Contributing to these margins are steadily growing sales over the past few years, expense management and low corporate income taxes. The average quarterly corporate tax rate since 1993 has been 30.55%. The latest available quarterly tax rate (June, 2021) is 18.65% thanks to the 2017 tax reform law. There are proposals in Congress (part of the Build Back Better bill) to raise corporate income taxes to as high as 28%. Such an increase, if passed into law, will act as a headwind to continued high corporate operating margins which could ultimately impact stock prices.

Growing corporate earnings and increasing operating margins will be needed to see continued growing stock prices.

Market Valuations are Rich

Many market valuation indicators show that the U.S. equity markets are over-valued right now. The Q Ratio, Buffet Indicator, CAPE Ratio or the current Price/Earnings (P/E) Ratio relative to historic P/E ratios (all metrics we review), are all coming to the same conclusion; equity market prices are over-valued. Low interest rates and liquidity from the Federal Reserve have justified the high valuations in recent years as well as a strong growth in corporate earnings. But now the Fed is tightening and earnings growth may be slowing this year compared to last year.

Where do we see markets going this year? We have not seen a significant equity market correction since March 2020. A correction is defined as a decline in prices of between 10% and 20% with a bear market defined as a decline of over 20%. Deutsche Bank claims that market corrections occur on average every 357 days or about once per year. We are overdue for a correction.

Given the Fed tightening this year, and the growing chance that the Fed may be too aggressive, plus a slowdown in corporate earnings growth, we believe these factors will contribute greatly to equity market volatility this year. We also see a correction of over 10% at some point this year but not a bear market. All that being said, we still see the equity markets finishing the year positive with a total return from the S&P 500 Index of between 5% and 7%. If earnings estimates pan out with the S&P 500 Index earning the projected $220.11 per share in 2022, a 5% increase in the price would put the P/E ratio at around 22.7 which is lower than the current P/E Ratio of 23.6 (at the end of 2021). This represents a slight contraction in the P/E ratio which is warranted given the Fed tightening and slowing growth of earnings.

Conclusion

The year 2021 marked the culmination of three straight years of double digit returns for the U.S. equity markets. We enter 2022 facing potential global macro issues; China real estate developers' risks, China-Taiwan tensions, a Russia-Ukraine conflict and the continuation of the Covid pandemic.

Inflation is "too much money chasing too few goods." The Federal Reserve has been wrong over recent months as it has stated that inflation is "transitory." Inflation is more persistent and now the Fed is forced to become "hawkish." It not only has to taper its bond buying program, it has to raise interest rates to help slow down inflation. Recent Fed accommodative policy has contributed to the inflationary pressures as well as the massive government spending and supply chain disruptions. Absent inflation, the economy is doing pretty well growing at a steady rate. Unemployment continues to be low post the Covid lockdowns.

2022 is a mid-term election year. It is likely that Congress has about six months into the new year to pass any major legislation before senators and representatives focus on re-elections.

Corporate earnings continue to be good although Standard & Poor's projects a slowdown in earnings growth in 2022. Equity markets appear to be over-valued by various valuation measures. We project that we will see a great deal of market volatility in 2022 based on the "rich" valuations of the equity and bond markets as well as Federal Reserve policy shifts. As such, we are here to listen, counsel and provide direction to all of our clients.

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