



Southern Capital Perspective

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Southern Capital Services, Inc.

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What's the View for 2022?

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STOCK MARKET INFLUENCES

In our view, there are four primary forces that will shape the stock market's performance in this new year. First is the direction that the virus will take and equally important, the reaction of the various government officials. Second, is inflation and how the Fed reacts. Third, is the strength of the economy and the market itself. Fourth, is the political environment including the midterm elections and the worrisome geo-political threats that our nation is facing. The path these forces take and how they interact with one another will determine the fate of investment portfolios in 2022.

Covid has wreaked havoc upon the economies of the world since making its appearance in early 2020. The International Monetary Fund (IMF) estimated in October 2020 that the cost in lost global output would be \$28 trillion and recently I have heard estimates as high as \$50 to \$60 trillion. The cost has been staggering, and the governments of the world as well as the central banks have pumped in trillions to soften the impact.

The enormous cost came about from two sources. The pandemic itself was extremely expensive, but the government responses were even more costly. The government-imposed shutdowns crippled the economy and put many small enterprises out of business. Then the politicians tried to pay those who were thrown out of work and in the process ran up huge deficits and debt. That is a recap on how we got here. Now we are faced with an evolving new set of circumstances.

The health experts say, Covid has produced a number of variants (versions) that vary in terms of being transmissible (contagious) and virulent (deadly). The current version is called Omicron and is considered to be very transmissible but less virulent. A growing number of doctors believe that the rapid spread of Omicron with lesser health consequences will bring about what they call "herd immunity" which means that enough of the herd (the population) has become immune by vaccination

or having had the disease. If this is accurate, then the Covid pandemic will transform into what is called an endemic which means something that is very common and can be dealt with by conventional means and not emergency measures. It should, in turn, lessen the government response and be more beneficial to the economy and the markets.

INFLATION

In the year 2021, the inflation genie escaped from the bottle. Until then it had been running at or below the Fed's target of two percent annually. The battle against the effects of Covid opened the floodgates and trillions of dollars flowed from the Fed and the Government with little regard for the consequences. As of November, the inflation rate hit 6.8% and is not showing any signs of abating. Unfortunately, some politicians are unfazed by the impact of rising prices on the public and keep pushing for more and larger spending bills.

The Fed, however, has decided that it is time to slow the money creation. The minutes of the Fed's December meeting were released; they revealed that the Fed intends to stop the monthly additions to the money supply and, in fact, may begin to



reduce its balance sheet - which means actually reducing the money supply. Also, they anticipate increasing interest rates three times in 2022. The market did not like the prospect of ending easy money and sold off for a few days, but it is better to take some discomfort now rather than a major disruption after

more excess. To put things into a proper perspective - three one-quarter percent rate increases will still leave the short-term rates between .75% and 1%. So, if the resolve by the Fed to take a firm stand against inflation and the politicians can be restrained, then more drastic measures may be avoided, and the market will not have to suffer too much disruption.

ECONOMY

The state of the economy presents a slightly more optimistic picture. In spite of supply chain disruptions and difficulty in finding workers, corporate profits have remained firm. According to the Wall Street Journal: "Companies are paying higher wages, spending more for materials and absorbing record freight costs, pushing up economic inflation gauges. They are also reporting some of their best profitability in years. Executives are seizing a once in a generation opportunity to raise prices to match and in some cases outpace their own higher expenses." The early stages of inflation can be very favorable for profitability, but if it is not checked it could result in stagflation as we experienced in the 1970's.

Another favorable factor for the economy and the markets is the trillions of dollars on the sidelines. As of January 6, according to the Investment Company Institute, there was \$4.7 trillion invested in money market funds. This money represents future fuel for market rallies. Also, as inflation continues to destroy the value of the dollar, people will be increasingly unwilling to leave their money in low yielding investments, like money market funds.

POLITICAL ENVIRONMENT

The current political environment has the potential to have a large impact on the direction of the markets. Domestic politics includes the mid-term congressional elections. This could

change the balance of power in Washington and bring about gridlock in DC. The markets usually respond favorably to gridlock because it limits the ability of the politicians in either party to make substantive changes that could be harmful to business interests. The possibility of a major legislative change before the mid-terms involves substantial tax increases and large increases in government spending. Thus far this legislation has been blocked but if it gets approved it will have a negative effect on stock values.

The greater danger is from a geo-political mistake or a foolish and reckless action. Russia's designs on the Ukraine, China's stated intent to take Taiwan and the belligerence of Iran are potential areas of actual armed conflict which would be very disruptive to markets.

Hopefully these confrontations can be limited to diplomatic skirmishes and not open hostilities. We are not predicting conflict, but we feel that we must remain aware of the possible danger.

TAX INFORMATION FOR 2021

Early in 2021, we felt fairly certain that the tax consequences from our trading activity would be significantly less than in 2020. We were correct; however, the internal trading activity generated by the fund managers realized big gains from their stock holdings. This was a byproduct of the enormous gains from the March 2020 lows. Therefore, realized capital gains for non-retirement accounts came in greater than anticipated. The one benefit of being taxed currently is that it adds to your basis and reduces future tax liability. If there is a "silver-lining," this is it, aside from the money that was made.

Reminder

Please remember to notify us if you have had any material changes in your financial circumstances.

OUTLOOK

2021 was the third strong-market year in a row, although the high-growth tech and bio-tech sectors entered a corrective phase during the fourth quarter. Nevertheless, the stock market was a rewarding place to have had your money in the year just ended.

2022 is likely to be more challenging due to the uncertainty arising from the four factors mentioned above. Although the potential for very negative outcomes is certainly possible, we are somewhat cautiously optimistic. Our thinking is that Omicron will likely go the way of an endemic. Also, the Fed will stand its ground and raise interest rates; inflation's rise will be contained but not returned to the Fed's two percent target. Additionally, we are hopeful that the politicians will not be able to pass another massive spending bill.

The positive trend of corporate earnings and the massive amount of cash on the sidelines will help to offset the negative influences. Finally, we are hopeful that the international situations can be dealt with diplomatically. If we are correct, this year, unlike the past three strong up years, will turn out to be modestly positive and subject to more volatility. This is how it looks now but as always it is subject to change.

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