

EQUITY MARKET UPDATE

As of 01/31/22 | Volume 11, Issue 1 | FFTAM.com

Stocks started the new year on a negative note. The sell-off was fueled by investor concerns that the two largest factors for economic growth in the past two years—stimulus checks from Congress and loose monetary policies from the Fed—are fading. Economists responded by lowering their growth forecasts for 2022 and beyond. Inflation data and Fed commentary have taken on heightened importance. Shortages in labor, parts, and energy persist. Economic data was negatively impacted by another wave of COVID-19 infections as Omicron swept across the globe. The market continues to believe a fully open economy will lead to a moderation in both inflation and supply chain disruption. Conditions remain very accommodative for a growing economy, but hawkish commentary from Fed Chairman Powell amplified volatility.

Stocks Sell-Off Briskly On Fed Worries

The S&P 500 fell 5.17% in January. Returns were hurt by a large sell-off in big tech companies. Microsoft, Amazon, NVIDIA, Tesla, Netflix, Meta Platforms, Alphabet, and Apple accounted for 42% of the losses. Despite that move, the decline was broad based. Energy was the only positive sector for the month, gaining 19.10%! Conditions were calm until mid-month when inflation data sparked concern about the upcoming Fed meeting. At its lowest point on January 24th, the S&P 500 was down 11.95% before staging a rally to end the month.

The Dow Jones Industrial Average did slightly better, falling 3.48%. A lower allocation to technology aided results. Large gains in Chevron, American Express, and Visa also helped.

The NASDAQ was the worst performer among major indexes, dropping 8.95%. For the fourth straight month, investors shied away from high valuation stocks as they contemplate tighter financial conditions in 2022. A lackluster earnings report from Netflix also negatively impacted the index. The NASDAQ trailed the S&P 500 by 550 bps in 2021, and the underperformance widened further in January.

Large monthly losses were also seen in mid-to-small sized companies. The S&P 400 Mid-Cap Index fell 7.27%, while the S&P 600 Small-Cap Index declined 7.31%. Like the NASDAQ, these two indexes trailed the S&P 500 in 2021. Small and medium sized companies serve as a barometer for investor sentiment about future economic activity. Enthusiasm for these indexes has dampened since they have a higher percentage of unprofitable companies than the S&P 500. Despite this, both indexes trade at relative PE valuations versus the S&P 500 that are usually seen during recessions or mid-cycle economic slowdowns.

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International & Emerging Market Stocks Fall on COVID, Inflation, and Russia Concerns

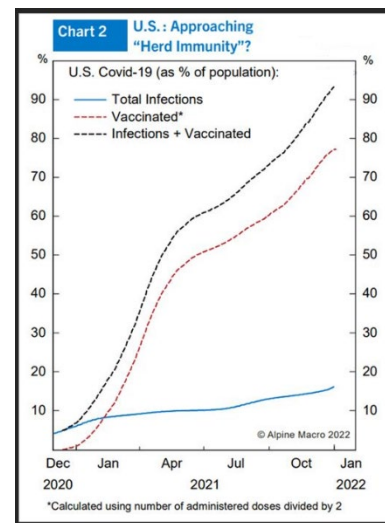
Eurozone GDP grew by an annualized rate of 1.6% in the final quarter of 2021. This was down sharply from the previous quarter's 9.1% pace. The deceleration was mainly due to high energy prices, supply chain disruptions, and new social distancing policies to combat the surge in COVID-19 cases. Growth in the Eurozone severely lagged both the US and China which grew 6.9% and 4%, respectively. Inflation hit a new record high of 5.1% on a year-over-year basis. The Bank of England responded with a second 0.25% interest rate hike. ECB President Christine Lagarde admitted that some of the inflationary pressures may not be short-lived. The euro rallied versus the US dollar on bets the ECB will lift interest rates later in 2022. The MSCI EAFE Index fell 4.86% for the month.

The MSCI Emerging Markets Index declined 1.93% as Chinese economic activity slowed once again due to strict COVID-19 restrictions and worries about the real estate market. Retail sales in China grew just 1.7% in the past year, far below expectations. Exports jumped 20.9% year-over-year, but that figure was also below street forecasts and the 31.7% pace reported the previous month. Collectively, the Chinese economy expanded by only 4% in the final three months of 2021, the slowest pace since the start of the pandemic. Weak data caused the People's Bank of China to cut two key interest rates to stimulate the economy.

Volatility in both international and emerging markets remains high given the developing situation between Russia and Ukraine. President Vladimir Putin has amassed troops and supplies to the border signaling a potential invasion. This has set-off a diplomatic firestorm. President Biden and many European nations have vowed stiff economic sanctions against Russia should Putin proceed with military action. Troops and weapons are being sent to Ukraine by NATO members. The stakes are high for Europe since the region gets 46% of their gas from Russia, and supplies are already critically low. An adverse outcome threatens to make the inflation situation worse. Of the major European countries, Germany is in the most precarious situation since they get 27% of their total energy needs from Russia. To complicate matters, Mr. Putin appeared at the Opening Ceremony of the Olympics with President Xi. Speculation is China would like to woo additional energy supplies from Russia to alleviate their own energy concerns.

Omicron Cases Skyrocket

Just three months after Omicron was identified in South Africa, the variant has become the dominate strain in new infections worldwide. The highly contagious illness spread rapidly in January. At mid-month, more than 800,000 Americans were infected every day. This put tremendous strain on the economy as millions of people missed work, and numerous businesses closed or curtailed hours of operation. Fortunately, the variant was more mild than previous versions; however, the sheer volume of people infected placed enormous stress on hospitals. Currently, over 124,000 people remain in the hospital and 2,400 Americans are dying daily. Although these numbers are elevated, they are far less than what was seen just two weeks ago. With 64% of the population fully vaccinated and millions more recently infected, many are wondering if the US has reached the point of "herd immunity" where society can transition to an endemic stage.



US Economy Grows Briskly, Inflation Hits Multi-Decade High, Fed Prepares for Rate Hike

US GDP grew by an annualized rate of 6.9% in the fourth quarter, well above expectations. Much of the gain came from companies rebuilding depleted inventories after a torrid pace of consumer spending left shelves bare for most of the year. PMI

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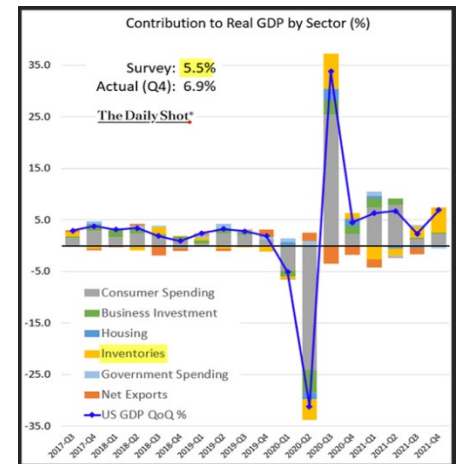
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reports in the past quarter produced the first signs that supply chain disruptions are beginning to ease. Despite the additional products, overall inventory levels remain critically low in several categories, especially autos. For the full year, GDP advanced 5.5%, the strongest growth in almost 40 years.

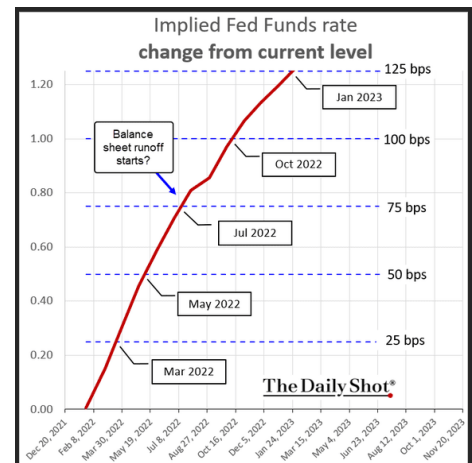
Employers added 467,000 jobs last month. This was well above expectations. Unemployment was 4%, and average hourly wages climbed 5.7% from one year ago—the fastest growth in compensation in decades. Labor force participation was 62.2%, still below the pre-COVID level of 63.4%. As I have discussed in previous months, part of that shortfall is due to the large number of people over age 55 electing to retire. To make matters worse, the Census Bureau showed the US population grew by its lowest level in history in 2021, and the size of the working age pool continues to shrink.



Consumer prices as measured by the CPI index rose 7%, the fastest jump since June 1982. The last three monthly inflation reports have exceeded 6%. Price increases are widespread as Core CPI, which excludes food and energy, climbed 5.5%. The personal consumption expenditures (PCE) index gained 6.5%, while the core index, which excludes food and energy, rose 4.9% from the previous year. These were the sharpest increases since September 1983. The PCE core index is the Fed’s preferred measurement of inflation. More troubling, wages when adjusted for inflation fell by 0.2% last month. They have decreased for five straight months and in eight of the past nine months. Higher prices, along with the spread of Omicron, are weighing on consumer spending which declined 0.6% last month. This was the first monthly decrease in over a year.

The combination of higher inflation, supply chain disruptions, and Omicron have caused economists to trim their economic growth forecasts for 2022 to 3.3% according to a recent survey from *The Wall Street Journal*. Economists believe inflation will moderate by mid-year and abate further as we end 2022; however, inflation is believed to still be above the Fed’s 2% target.

The Fed responded to the tight labor market and hot inflation data by making a series of announcements at their most recent meeting. They claimed the economy is near full employment, so the need for highly accommodative monetary policy is ending. They confirmed that monthly bond purchases will stop after March. They also plan to initiate their first interest rate hike at the next meeting. During his press conference, Chairman Powell said it is important for the Fed to be nimble at combating inflation, and he refused to provide a definitive timetable for lifting rates, a major departure from previous rate hiking cycles. According to *The Wall Street Journal*, this will be the first time since the 1980s in which inflation is above the Fed’s target at the start of the rate hiking campaign. This means faster and larger rate increases may be needed. Markets are pricing-in four or five rate hikes in 2022. Mr. Powell still believes inflation will decelerate later this year as supply chain issues get resolved, but he admitted that certain areas of inflation, like employment, energy, and housing, are likely not transitory.



Elevated Valuation Remains Despite Earnings Growth & Sell-Off

We are in the thick of earnings season. According to FactSet, 56% of the S&P 500 have reported fourth quarter results. Three-

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quarters of those companies beat expectations. This is in-line with the 5-year average, but the size of the beat is lower. The largest growth in earnings has come from energy and industrials. Collectively, earnings have grown by 29.2% on a year-over-year basis. If this holds, it will mark the fourth straight quarter for earnings growth above 25%. Forward guidance has been disappointing. For the first time since the second quarter of 2020, analysts are decreasing their quarterly earnings estimate. They now forecast first quarter earnings growth of 5.6% and full-year profit gains of 8.6%. This is a sharp deceleration from the previous year's results.

Currently, the S&P 500 trades at 19.72x 2022 EPS estimates. This is far better than the 23.61x trailing earnings reading, and it shows that corporate profitability is expected to improve. However, stock valuations remain pricey despite the recent sell-off. The current valuation is well above the 5-year average of 18.62x and the 10-year average of 16.71x.

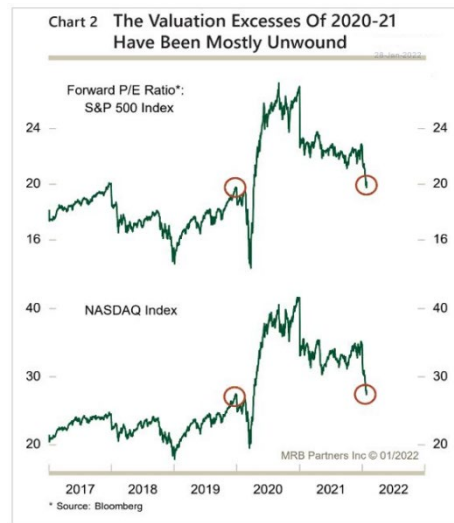
The valuation can be justified by low interest rates and the enormous amount of liquidity in the system. However, the Fed and other global central banks have begun to remove stimulus as the global economy reopens and inflation readings remain elevated. This makes stocks ripe for increased volatility, especially among the higher valuation growth names.

Our Outlook & Strategy

The biggest challenge for stocks in 2022 is central banks navigating how to remove emergency stimulus policies needed during the depths of the pandemic without significantly slowing growth. The prospect of higher interest rates reduces the PE multiples investors are willing to assign to stocks. This places outsized stress on stocks trading at lofty valuations, especially those that cannot clear the earnings growth hurdles investors have forecasted.

Historically, the early innings of Fed rate hikes are positive for stocks in general. The areas that experience the best results are cyclical sectors such as energy, industrials, and financials. This is due to a still growing economy and the low PE ratios assigned to those sectors. We have responded by increasing our overweight positions in both energy and financials.

As monetary conditions tighten further, investors tend to rotate towards more defensive areas of the market like utilities, consumer staples, and big pharma. The shape of the yield curve can be monitored as a harbinger for a potential mistake by the Fed. The treasury curve continues to flatten at the longer end signaling the proposed rate hikes will slow economic growth from current levels. Interest rate spreads are not forecasting a recession for 2022; however, we are closely monitoring this situation given Mr. Powell's comments about the need to potentially raise rates higher and faster than previous economic cycles. We are currently overweight consumer staples and big pharmaceutical companies.



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