ClarkCapital MANAGEMENT GROUP

Cliff Notes on the Economy

Economic Review & Outlook

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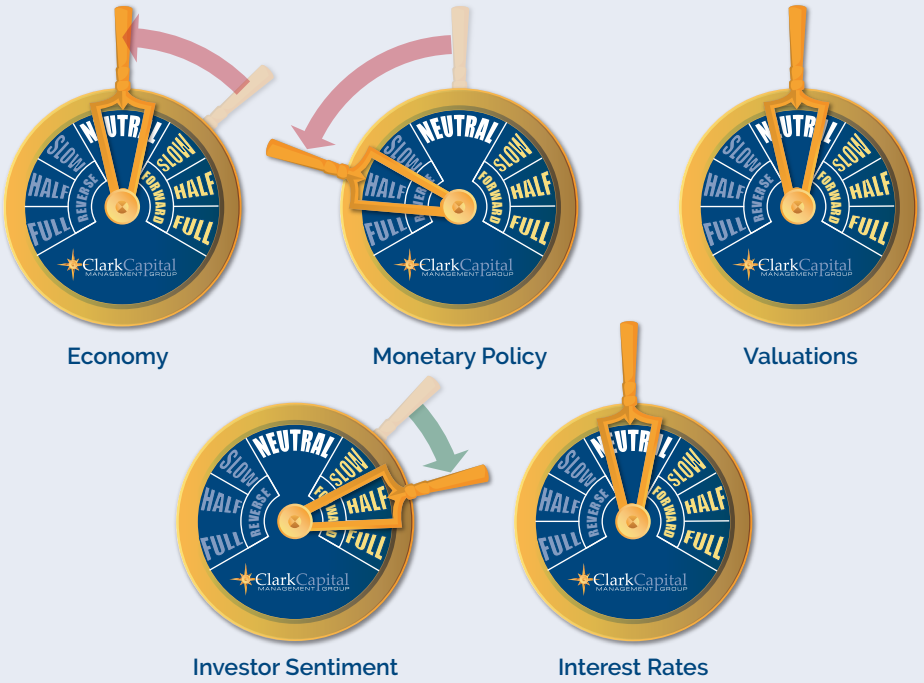
Second Quarter 2022

These five gauges drive our expectations for the stock market. Recall 12:00 is neutral, anything to the right of 12:00 is positive for stocks, anything to the left of 12:00 is negative.

Moving into the second half of 2022, we are adjusting three of our five gauges – we are reducing the Economy Gauge one step, putting it in neutral territory. We continue to reduce the Monetary Policy gauge bringing it back two notches into the half backward position. Finally, we are increasing the Investor Sentiment gauge by one step to the half forward position. Valuations and Interest Rates remain the same in the neutral position. As we start the 3rd quarter, we have three neutral gauges, one positive gauge, and one negative gauge. Let's recap the gauges and review why we have them in their current positions.



U.S. Economy

The first gauge covers the U.S. economy, and we move this back to neutral territory. Coming on the heels of a very strong final quarter of last year, negative first quarter GDP and tighter monetary conditions in the second quarter led us to put this gauge into a neutral position. With the Fed singularly focused on reining in inflation, it has raised interest rates and created tighter financial conditions in the economy.

We believe this will be a headwind to economic growth. We also still believe that second quarter GDP will be positive, but we acknowledge that growth will likely be subdued. The reopening from the pandemic exposed issues in areas like the labor market and the global supply chain as part shortages, hiring issues and inflation became dominant themes in 2021 – those themes continue to create challenges in

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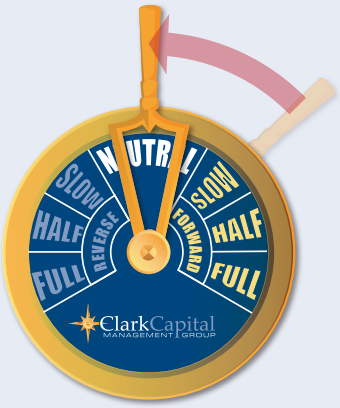
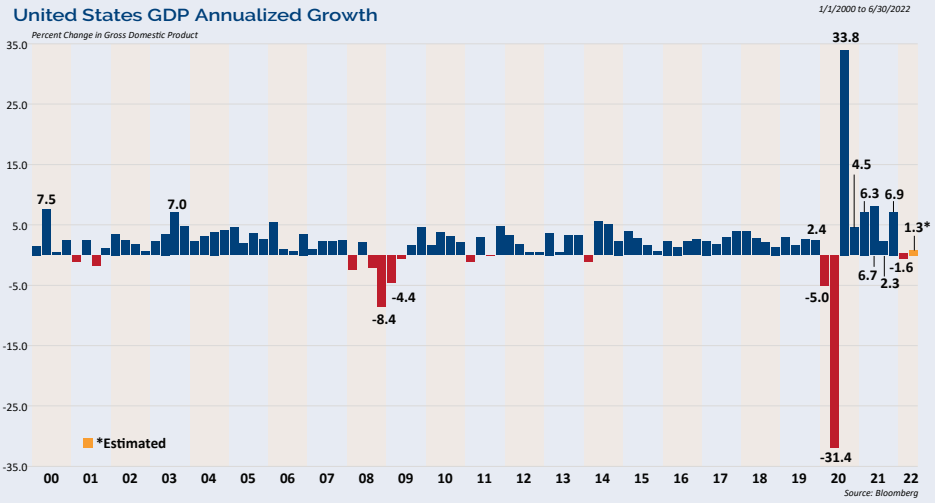


Economy

2022. The "V-shaped" portion of this economic recovery has changed to a square root as we have moved past peak economic growth. As the recovery matures, we expect economic growth to move toward its long-term trend around 2%.



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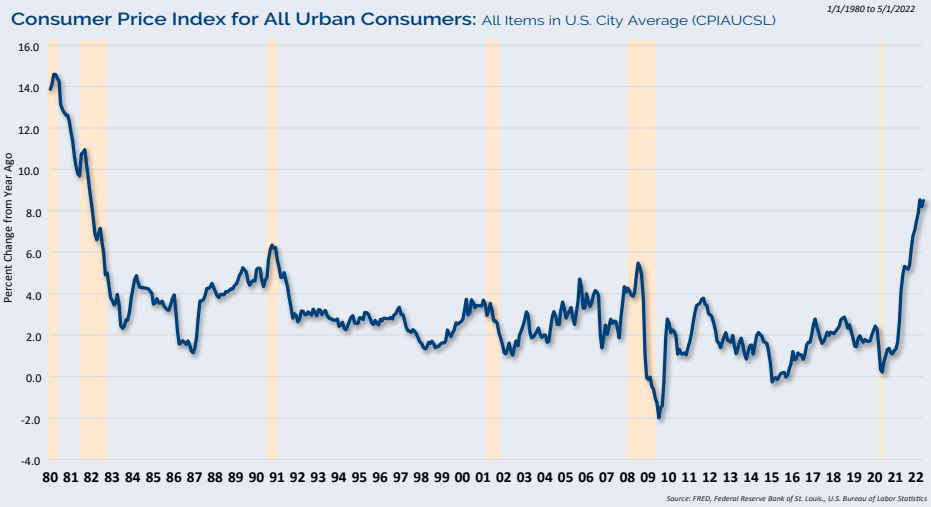
One of the big shifts in 2022 has been the change in Fed policy as it begins a new rate hike cycle with its full attention on curtailing inflation. This year has seen several price indices hit their highest levels since the early 1980s. For example, the latest Consumer Price Index (CPI) reading for May hit 8.6% – the largest increase in prices since 1981. Containing inflation has become the clear focus of the Fed.



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When the pandemic hit, the Fed was focused on the full employment side of its dual mandate as unemployment exploded to just below 15%. This focus has been at the expense of its second mandate, which is price stability or inflation control. With the unemployment rate now at 3.6% (compared to the 3.5% rate in February 2020 prior to the pandemic), the Fed has steered its attention toward inflation. Now, the Fed is tasked with trying to slow inflation, but without derailing the economy – achieving the much-heralded soft landing. We actually stand at a point where there are millions more job openings (based on the JOLTS job opening report) than those seeking em-

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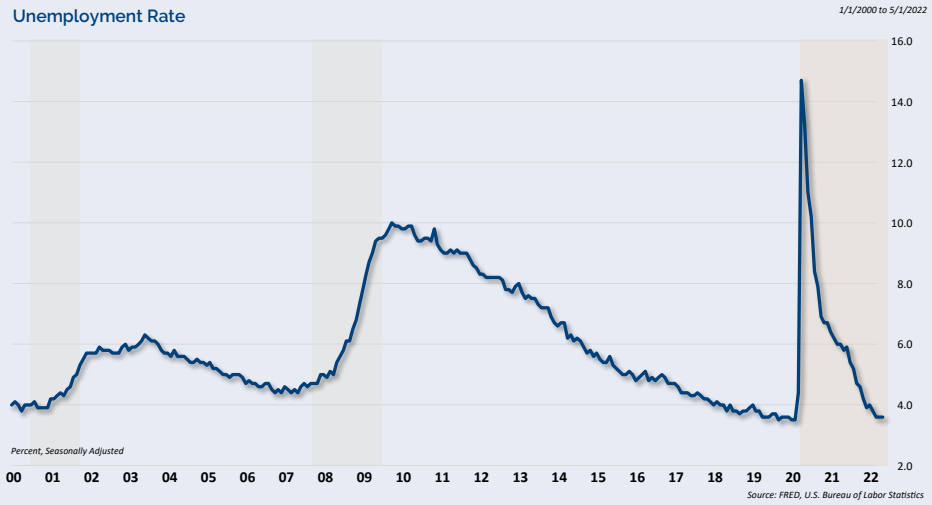
ployment. This is not typically a condition you see in a recession. From our observation a decrease in the labor participation rate has not helped the situation, but that has improved from the lows following the pandemic.

This mismatch in job openings and job seekers has driven wage levels higher, further exacerbating inflation concerns. The Fed enjoyed success in getting Americans back to work following the shutdown of the economy in the spring of 2020, but distortions exist in the labor market that are still being worked out today.



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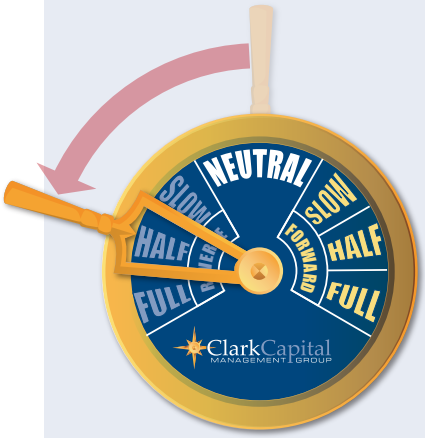
We believe the economic recovery will continue through 2022, but we recognize the Fed raising rates could result in slower growth, or even a mild recession at some point. Consumers, who represent about 70% of the U.S. economy, have been in good shape, but persistent inflation could begin to curtail their purchases. Currently, unemployment is low, consumer debt levels are low, and homeowners have seen the equity in their home grow as prices have increased. These factors help lead us to the conclusion that we do expect the economy to grow through 2022. We understand, however, that areas like the housing market will likely cool moving forward as mortgage rates have doubled, but we still expect positive overall economic growth this year.



Monetary Policy

Monetary Policy

The rate hike cycle is in full swing and we therefore reduce the Monetary Policy gauge to a half backward position. Several more rate hikes are expected in 2022 and into 2023, but the market seems to have priced in much of this rate hike cycle already. Interest rates are still low from a historical perspective, but they have gone up dramatically over the last two years. The Fed has progressively increased the Fed Funds rate at the last three meetings – moving rates up 25, then 50, and then 75 basis points as it tries to contain inflation. The 75 basis point increase was the largest increase by the Fed since 1994.

The Fed's balance sheet, which stood below $4 trillion prior to the pandemic, expanded to nearly $9 trillion driven by the Fed's actions during the pandemic. This aided the economy and capital markets to get back on track after the pandemic hit, including significant improvement in the job market. We have seen over the past

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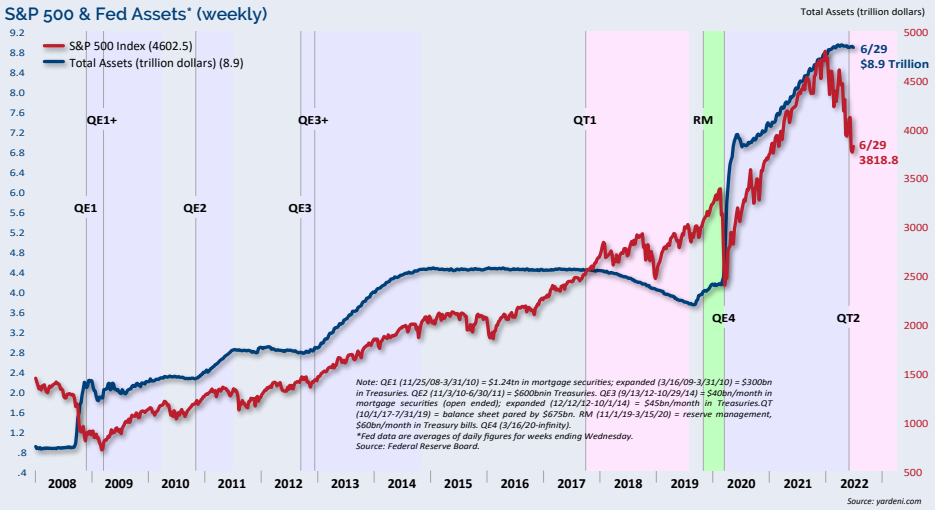
several years that when the Fed is increasing its balance sheet, stocks have reacted favorably. That same formula played out from the March 2020 lows through 2021.



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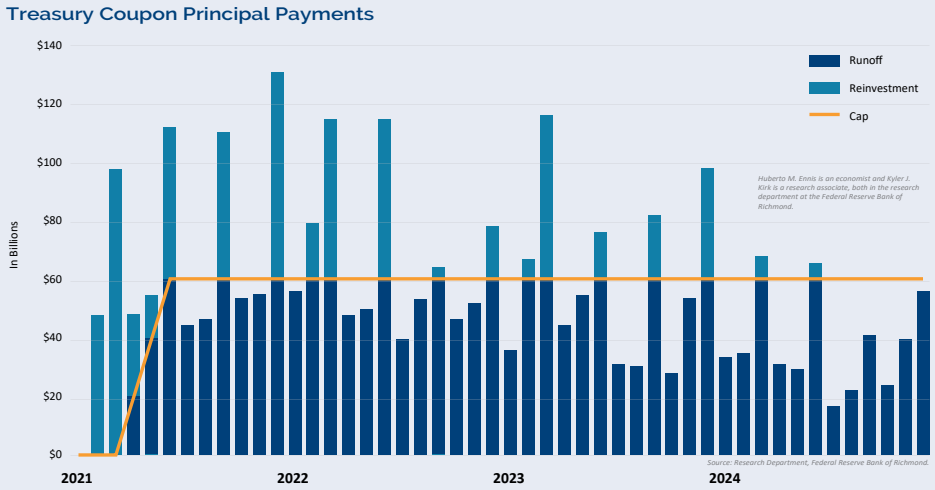
The next move by the Fed will be to start reducing the size of its balance sheet, and that just began in June. The Fed will be measured in this balance sheet reduction due to caps it has implemented. We can see that at times when too many bonds will be rolling off the balance sheet, the Fed has indicated it will actually buy bonds on the open market above this cap limit.



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Due in part to this change in Fed policy, the market environment will likely remain volatile as we have seen thus far in 2022. We know that one of the primary tools to deal with inflation is raising interest rates, but that will likely have a negative impact on economic growth as well as financial conditions tighten. This balancing act, slowing inflation but not pushing the economy into a recession, will be the primary challenge that the Fed faces moving through 2022. The market and the economy will

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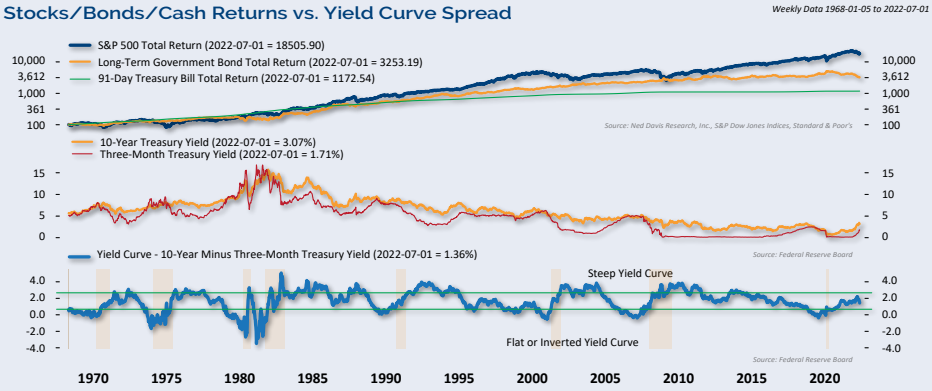
likely continue to face more volatility as this tightening cycle progresses. Due to this shift in monetary policy, we reduced this gauge to a half backward position.

As the Fed raises rates, it has the impact of flattening the yield curve as well. Since the late 1960s, every recession the U.S. economy has gone through has been preceded by an inverted yield curve. (For the record, we have also had during this time 2 inverted yield curves that did not lead to a recession.) This year, parts of the yield curve inverted (primarily 2-year and 10-year Treasuries), but the measure we look at, the 3-month T-bill compared to the 10-year U.S. Treasury, has stayed in positively sloped territory. We will watch closely how rate hikes affect this relationship, but even once the yield curve goes inverted, it is usually about another year before the economy goes into a recession.



Stocks/Bonds/Cash Performance (1968-01-05 - 2022-07-01)

10-Yr/T-Bill Yield Spread:	S&P 500 TR Gain/Annum	LT Bonds TR Gain/Annum	Cash Gain/Annum	% of Time
Above 2.6	6.0	10.7	3.7	24.7
Between 0.6 and 2.6	15.9	5.0	4.0	51.7
0.6 and Below	2.0	5.9	6.9	23.6
Buy/Hold	10.0	6.6	4.6	100.0

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Source: Ned Davis Research

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Valuations

The price-to-earnings or P/E ratio of the S&P 500 rose close to its highest level in about 20 years during the period following the market low in March 2020. However, as equity markets have declined this year and earnings have continued to grow, valuations have improved. After increasing the Valuation gauge last quarter, we keep it in a neutral position moving into the third quarter.

Valuations

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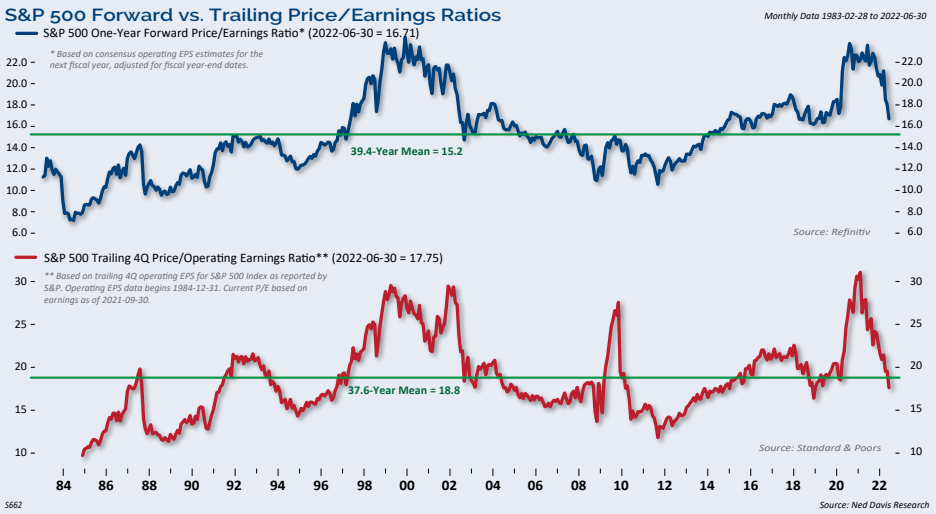

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Earnings are still expected to grow in 2022, however expectations have only modestly come down at this point. Currently, earnings growth is expected to be around 7.5% down from the just below 10% estimate at the start of the year. It is likely that earnings estimates will be revised lower in the months ahead and we will keep a close eye on those developments.

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Low interest rates tend to drive stock valuations higher, and as rates have moved up in 2022, it is natural to see stock valuations come down. This has been particularly true for growth stocks, which are more interest rate sensitive, as growth stocks have struggled more dramatically than value stocks in 2022. From a longer-term perspective, rates are still at low levels. When we compare the earnings yield of the S&P 500 (which is the inverse of the P/E ratio) to the yield on the 10-year Treasury, it shows that on a relative basis, stocks are still more attractive than bonds, but that differential has declined this year.

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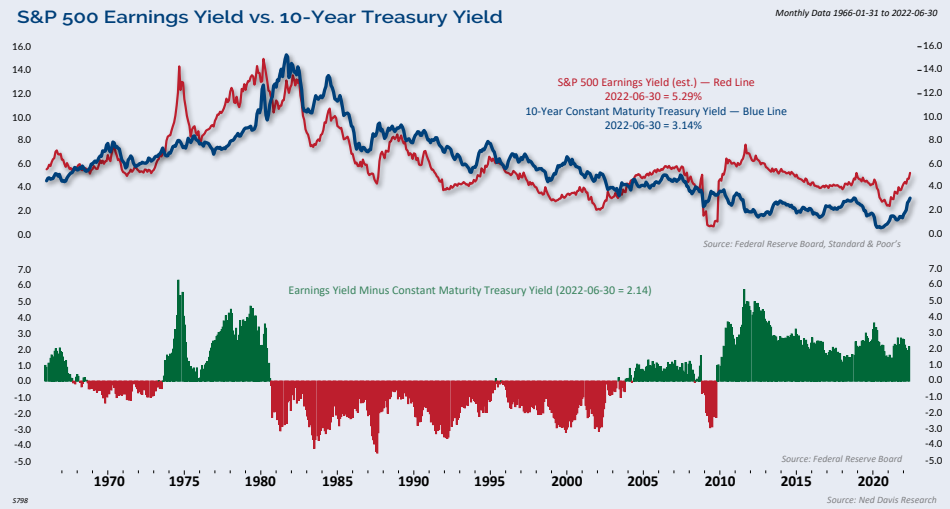

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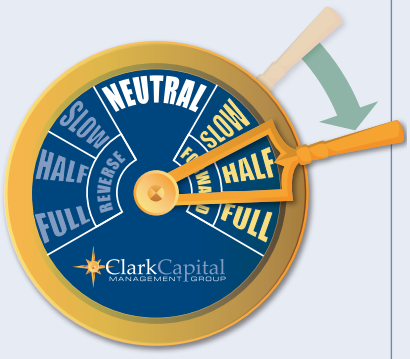
We decided to keep this gauge in a neutral position because stocks are still not cheap, but their valuations have improved and are reasonable given the current level of interest rates. As an active manager, we look at valuations on a company-by-company basis. The recent market volatility has provided us at Clark Capital an opportunity to seek out what we believe to be high quality companies at good prices and we continue to make very purposeful investments in both stocks and bonds



Investor Sentiment

Investor Sentiment

The next gauge is Investor Sentiment, which can be thought of as a measure of speculation or pessimism in the market. Recall, this gauge is a contrarian indicator, so extreme pessimism is a positive from a market perspective and extreme optimism is just the opposite. We move this measure further into positive territory to the half forward position as investors have become more pessimistic and fearful in recent months.

This gauge is very sensitive and can change quickly. Weakness in the stock market, inflation at generational highs and higher mortgage costs have led to consumers becoming more and more pessimistic. For example, the widely followed University of Michigan Consumer Confidence measure hit an all-time low in June.

Another important indicator, which we discuss often as a measure of fear in the market, is the CBOE Volatility Index or VIX Index. Volatility has been much higher in 2022 compared to 2021 and it has not been below 20 since April. The elevated level of the VIX Index does reflect higher levels of concern in the market, but we have not seen a spike higher in the number, which is often seen at market lows. Remember, as a contrarian indicator, the higher the VIX the more positive it is for the market as complacency has been replaced to some degree with some healthy market skepticism.

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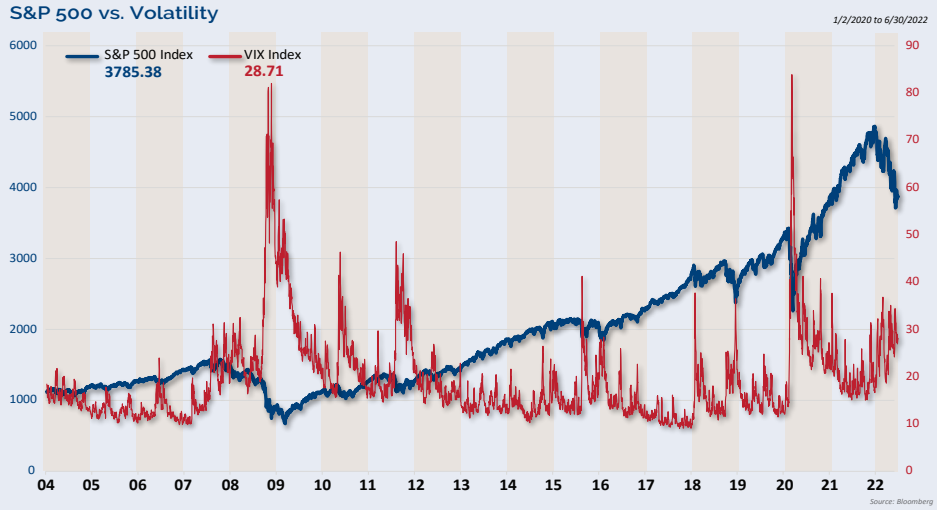

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Based on the cumulative data we analyze for investor sentiment, we believe it is appropriate to move the gauge to the Half Forward position due to increased levels of pessimism in the market. We had been anticipating a more volatile 2022 and 10%-15% first-half correction we expected occurred in the first quarter, but then the S&P 500 moved lower once again in the second quarter surpassing a 20% correction.

We continue to believe it is important for investors to be prepared for volatility to remain elevated moving into the second half of 2022 as the Fed continues to raise rates. As the market and the economy stand on their own in 2022, more normal levels of volatility should be expected after volatility was largely absent following the March 2020 sell-off in stocks. In fact, the market has already had 63 days in which it moved up or down by 1% or more compared to 55 such days for all of last year.

Interest Rates

Interest Rates

Interest rates are the final gauge, and we keep this in a neutral position. As we have already discussed, the Fed has begun shifting monetary policy. Parts of the yield curve have flattened (the curve is flat from about the 2-year to the 10-year), and the entire curve has shifted up with rates higher across all maturities.

For example, the 10-year rate moved from 1.52% at the end of 2021 to 2.98% by the end of the second quarter. (The 10-year yield had closed at 3.49% on June 14, so it was a rather dramatic drop in yields over the final two weeks of the quarter). The 30-year went from 1.90% to 3.14% over the same timeframe. Some yield moves on the front end of the curve are even more dramatic. For example, the yield on the 3-month T-bill closed 2021 at 0.06%, but it increased to 1.72% to end June – an increase of over 28x!

Once the Fed begins to raise interest rates, we typically see a flattening of the yield curve with short-term rates rising more rapidly than long-term rates. While the front end has seen a dramatic move higher reflecting tighter Fed policy, longer rates have moved up as well reflecting elevated inflation fears. We would expect the yield curve to continue to flatten as the Fed raises short-term interest rates (the Fed Funds rate is overnight lending).

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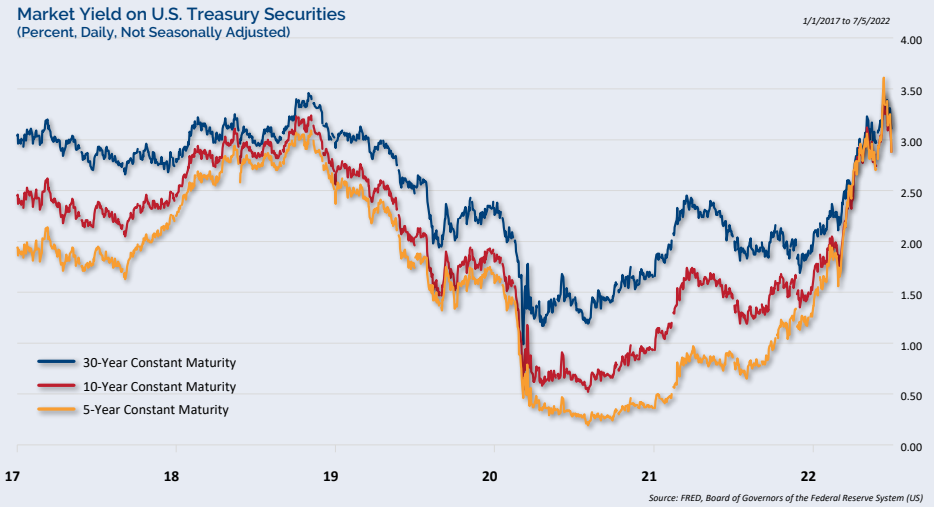

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Overall, interest rates are low from a historical perspective, but they are moving higher. The Fed rate hike cycle has now begun and several more rate hikes are expected through 2022 and into 2023. Higher rates across the yield curve and continued rate increases expected by the Fed for the foreseeable future lead us to keep this gauge in the neutral position.

We do think the majority of the move higher in rates in 2022 has already occurred and we expect the 10-year yield to move lower over the balance of the year. Remember that as the yield curve ultimately flattens, it is a less positive signal for stocks and provides unique opportunities for active bond management. Although bonds have generally struggled to begin the year with rates moving higher, in our view it has also presented opportunities in the bond market that we have not seen in some time. We believe we are positioned well at Clark Capital to navigate through this more dynamic time in the bond market.

Conclusion

We know these are challenging times as the stock market just finished its worst first half of a year since 1970. But the good news is that the U.S. economy has rebounded strongly from the pandemic lows and earnings have been strong. We also have to acknowledge that we are coming off a very strong year of equity returns in 2021.

Fed policy has shifted reflecting a stronger economy, but unfortunately, it is also an economy with inflation at unsustainable levels that the Fed is determined to bring down. This means higher rates, a reduction in the Fed balance sheet, and tighter financial conditions. The U.S. economy is facing challenges from this change in Fed policy, but we still expect the economy to grow in 2022.

Corporate earnings have been strong since the pandemic lows, but we will need to be mindful of earnings revisions moving through the second half of 2022. We also acknowledge there will likely be volatility from both an economic and stock market perspective, but we think ultimately the fundamentals of the economy are still solid. We continue to urge clients to stick to their financial plans and not make decisions based on short-term movements in the market.

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Investing involves risk, including possible loss of principal. The value of investments, and the income from them, can go down as well as up and you may get back less than the amount invested.

Index returns include the reinvestment of income and dividends. The returns for these unmanaged indexes do not include any transaction costs, management fees or other costs. It is not possible to make an investment directly in any index.

Fixed income securities are subject to certain risks including, but not limited to: interest rate (changes in interest rates may cause a decline in market value or an investment), credit, prepayment, call (some bonds allow the issuer to call a bond for redemption before it matures), and extension (principal repayments may not occur as quickly as anticipated, causing the expected maturity of a security to increase).

The Consumer Price Index (CPI) measures the change in prices paid by consumers for goods and services. The CPI reflects spending patterns for each of two population groups: all urban consumers and urban wage earners and clerical workers.

The 3 Month Treasury Bill Rate is the yield received for investing in a government issued treasury security that has a maturity of 3 months. The 3 month treasury yield is included on the shorter end of the yield curve and is important when looking at the overall US economy.

The VIX Index is a popular measure of the stock market's expectation of volatility based on S&P 500 index options.

The 10-Year Treasury Rate is the yield received for investing in a US government issued treasury security that has a maturity of 10 years.

The S&P 500 measures the performance of the 500 leading companies in leading industries of the U.S. economy, capturing 80% of U.S. equities

The price-earnings ratio, also known as P/E ratio, P/E, or PER, is the ratio of a company's share price to the company's earnings per share.

Gross domestic product (GDP) is the total monetary or market value of all the finished goods and services produced within a country's borders in a specific time period. As a broad measure of overall domestic production, it functions as a comprehensive scorecard of a given country's economic health.

The University of Michigan Consumer Confidence Index reflects a monthly telephone survey of 500 or so US households. The survey consists of two components: sentiment (40% of the index) and expectations (60%). Participants are asked about the current economic climate, where they think the economy as a whole is heading, and what they think about their personal financial situation.

The 2 Year Treasury Rate is the yield received for investing in a US government issued treasury security that has a maturity of 2 years. The 2 year treasury yield is included on the shorter end of the yield curve and is important when looking at the overall US economy.

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