CONGRESS ASSET
MANAGEMENT COMPANY

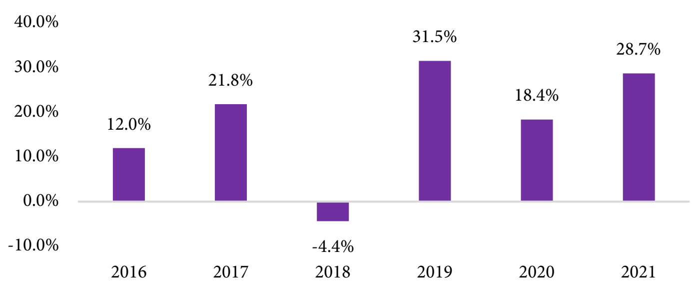
Economic and Market Outlook

First Quarter 2022

We ended 2021 seemingly how it began, mired in another COVID wave. This one driven by the new Omicron variant. Pandemic fatigue is spreading as fast as the new variant itself. Is it different this time? Probably. Omicron appears to spread faster but with less severity. Still, after almost two years, it remains tempting to apply fantastic headlines designed to lure readers to an unfavorable economic view. This would be a mistake as economic momentum remains strong. Omicron tempered economic activity post-Thanksgiving, but this is likely a stumble, not a fall.

Financial asset returns for 2021 reflected both the strong recovery from the initial pandemic lockdowns and increased inflation. The S&P 500 returned over 28%, driven in large part by big technology companies. While not reflected in broader market returns, many other companies reported strong operating results bolstered by pricing power. In contrast to stocks, the bond market displayed more volatility. Yields on the bellwether 10-year U.S. Treasury Note rose as inflation expectations increased, then fell with the onset of Omicron and the Federal Reserve Bank's (Fed) plan to end bond purchases in March rather than June. The 10-year U.S. Treasury Note ended the year with a 1.5% yield.

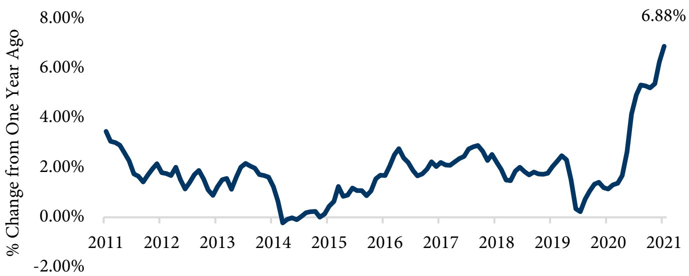
S&P 500 Calendar Year Returns
2016 to 2021



Source: Morningstar Direct

We expect the economy to maintain its current pace or strengthen as 2022 progresses. The outlook for the financial markets is more nuanced. Much depends on whether and how much inflation recedes from an elevated 7% November CPI report. Much also depends on growth outside the U.S. The growth/inflation paradigm is arguably more complex than at any time since the end of World War II.

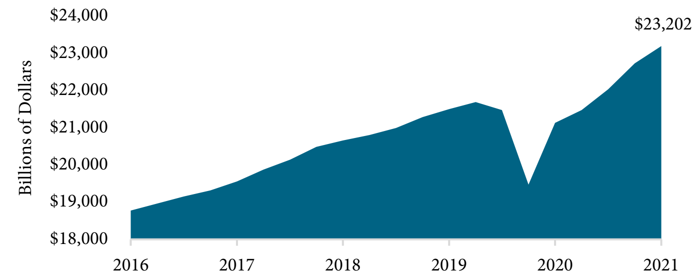
Consumer Price Index
November 2011 to November 2021



Source: U.S. Bureau of Labor Statistics

The economic resurgence that started in the spring of 2020 has been remarkable. Domestic GDP registered $23.2 trillion at an annual rate in the third quarter, $1.7 trillion above the 2019 level, the pre-COVID high. Economic activity has slowed with the spread of Omicron, but this likely represents a blip, nothing more. The domestic economy has a solid foundation, led by the consumer but bolstered by both businesses spending to satiate demand and also augmented by government stimulus plans.

U.S. Gross Domestic Product
Q3 2016 to Q3 2021

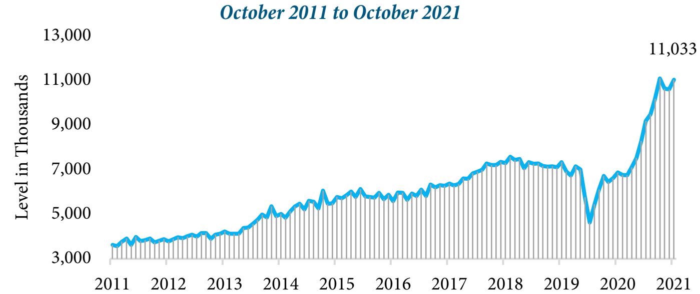


Source: U.S. Bureau of Economic Analysis

Borrowing from Newton's Three Laws of Motion, the economy will not change its expansionary trajectory without a force acting against it. The economy's velocity is supported by almost two years of embedded fiscal and monetary stimuli. Inflation and higher interest rates are forces that could hinder the trajectory but currently do not have enough mass to do so. Further, curtailment of some government transfer programs is unlikely to alter the expansionary trajectory.

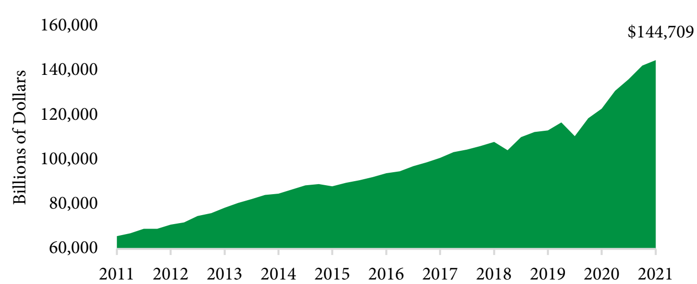
The most important force supporting the economy is the combination of jobs, wages, and personal income. The U.S. has a scarcity of labor. Employment surveys indicate 11 million open jobs with far fewer available workers. The shortage will only be partially solved by workers returning post-COVID. Scarcity is forcing employers to pay more, pushing up wages. Personal income was up 7.4% on a year-over-year basis in November 2021. Consumer Net Worth, a broader indicator of financial health, was up 18% over last year.

U.S. Job Openings: Total Nonfarm
October 2011 to October 2021



Source: U.S. Bureau of Labor Statistics

U.S. Household & Non-Profit Net Worth
Q3 2011 to Q3 2021



Source: Source: Board of Governors of the Federal Reserve System

Other forces continue to indicate continued growth into the New Year. Corporate profits were up 8.4% in the third quarter. Importantly, credit via the bond market and bank loans remains accessible, supporting investment in longer term, productive assets.

Rising wages may be reversing a decades-long secular decline in the labor share of economic output. Up to now, pricing power has mitigated increased labor costs, forestalling the deleterious effects on margins. The reversal of this trend may pose a challenge to profit margins in 2022 and beyond.

Finally, government stimulus should continue to support growth. The November passage of a $1 trillion infrastructure package should impact 2022/2023 with increased federal spending. Regardless as to whether President Biden's Build Back Better plan is passed or not, government and municipal spending will continue to increase.

The sanguine domestic economic outlook cannot be directly applied to the financial markets. As forward-looking instruments, both the stock and bond markets try to anticipate what is around the bend. Entering 2022, two risks appear more prominent now than at any time in the recent past: inflation and China's worrisome economic path.

On the domestic front, the Fed has acknowledged that the level of inflation experienced in 2021, if sustained, would be a detriment to the U.S. economy. Accordingly, it accelerated its plan to curb bond purchases and intimated it may raise short term interest rates as early as the spring. Whether that is enough to limit inflation to the Fed's preferred level of 2% or so remains to be seen. Sustained inflation above 2% would eventually crimp profit margins and would likely result in higher long term interest rates and would weigh on stock prices.

As the world's second largest economy, China has large coattails. China's third quarter GDP grew by only 4.9%, well below its historical average. A slew of Chinese real-estate developers declared bankruptcy. Real estate represents about 30% of China's economy, a far greater level than seen in the U.S. As such, it has outsized importance. With real-estate demand waning, China could be dragged into a recession while facing international sanctions on human rights abuses. China's lack of transparency is especially troubling when its economy is in flux, as it is now.

The New Year holds much promise, including the potential for COVID to be downgraded to endemic status. The U.S. economy and by extension the consumer should continue to do well. Stock investors are likely to experience more volatility with a focus on profit margins and a heightened interest in price-earnings multiples. Investment grade bonds should continue to be a modest source of current income and offer stability relative to other assets should interest rates rise.

Best wishes for a healthy and Happy New Year.

Investment Oversight Committee
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