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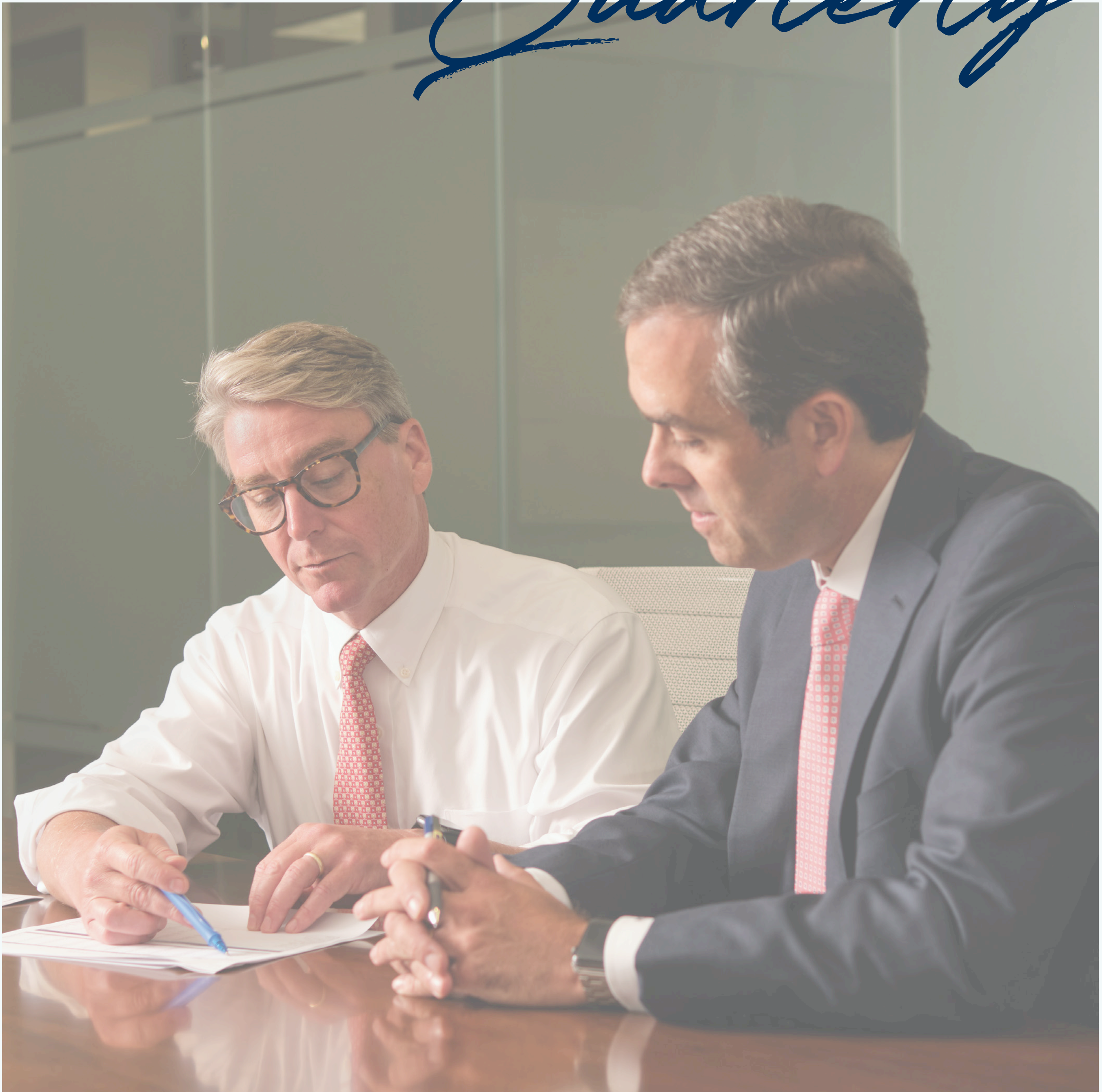
COLONIAL TRUST
COMPANY

1ST QUARTER
2022

COLONIAL TRUST *Quarterly*



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4TH QUARTER OVERVIEW

4TH QUARTER MARKET RETURNS

We saw a return to a bullish tone in the fourth quarter after a muted third quarter. The S&P 500 returned 11.0% for the fourth quarter and 28.7% for the year. The market moved swiftly from October 1st through Black Friday, climbing 7.9%. The WHO announcement that Omicron was a "Variant of Concern" caused the market to fall 2.3% on Black Friday. During the first two weeks of December, the market digested the reality that Omicron is more transmissible, but much less severe than prior variants. This caused markets to regain their bullish footing and return 4.4% for December.

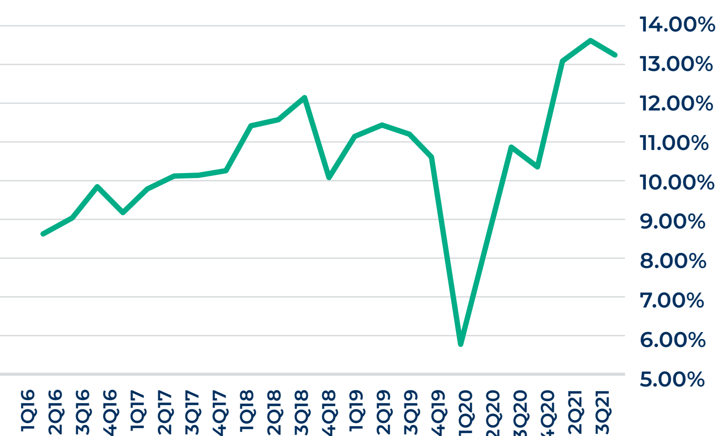
The S&P outperformed other domestic and international indices for the quarter and the year. Large cap domestic indices (DJIA and Nasdaq) had strong returns for the quarter, while the small cap Russell 2000 underperformed. International indices continue to lag the US markets, with emerging markets negative for the quarter and the year. The bond market, as measured by the US Agg Bond Index, was flat for the quarter and negative for the year.

Index	4Q%	YTD%
S&P 500	11.0%	28.7%
Nasdaq Composite	8.5%	22.2%
DJIA	7.9%	20.9%
Russell 2000	2.1%	14.8%
MSCI EAFE	2.7%	11.9%
MSCI Emerging Markets	-1.4%	-2.5%
US Agg Bond Index	0.0%	-1.5%

Source: Bloomberg

The strength in the S&P was broad based, with all 11 sectors in the green. Real estate was the best performing sector in the market, up 16.8%, followed by technology (16.7%), materials (15.2%), and consumer staples (13.3%). The market strength was driven by several factors: strong earnings, expectations of strong reopening growth, and the interest rate environment.

S&P 500 PROFIT MARGIN Source: Standard & Poor's

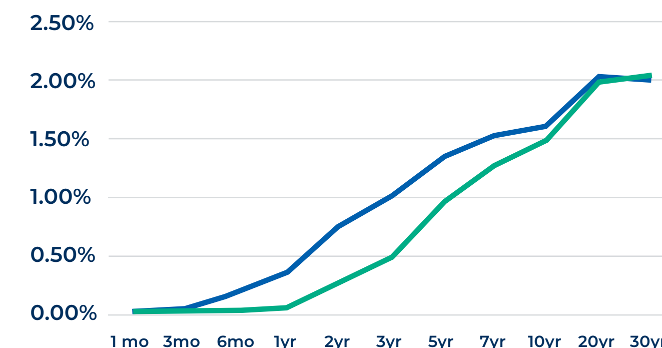


4TH QUARTER ECONOMIC CLIMATE

This fall's third quarter earnings season was impressive. According to S&P, 80.2% of companies beat analyst expectations for quarterly earnings. This is below the level of 2Q, but above the average for the last 38 quarters of 71.9%. For the quarter, earnings grew 37.3% year over year, which is down from the 91.0% earnings growth in 2Q. Perhaps a more instructive metric is trailing twelve month earnings which are now 20.7% higher than prepandemic levels. This increased profitability has led companies to reinstate or increase dividends, with S&P dividends per share surpassing the prepandemic levels in 3Q.

Businesses faced challenges of Covid, inflation, and supply chain issues in the second half of the year. However, third quarter earnings and guidance for the fourth quarter demonstrated the ability of corporate America to manage through these challenges. This allowed Wall Street to increase their earnings expectations for the fourth quarter and 2022. Since this time last year, analysts have increased their expectations for 4Q earnings by 13.8% and full year 2022 earnings by 22.8%.

US TREASURY YIELD CURVE



EARNINGS ARE PROJECTED TO GROW 32.0% IN 4Q AND 9.0% IN FY22.

The cornerstone of these strong expectations is an uptick in profitability. S&P margins have expanded to new highs in 2021 as companies have learned lessons about productivity during the pandemic. Large companies have navigated higher inflation by investing in productivity and raising prices to maintain elevated margins. Continued growth and higher profitability have raised expectations for earnings growth for 2022.

The interest rate environment has remained largely constructive, but the direction of rates remains a point of contention for markets. During the quarter there was a steady flow of news about inflation and Fed policy changes. The November headline CPI was 6.8%, the highest level since March 1982. CPI was 1.4% one year ago and has risen to multi-decade highs. This has caused the Fed to accelerate the tapering of bond purchases, which we expect to end in March. The Fed has also signaled it will raise the Fed Funds rate to at least 0.75% in 2022. Higher inflation and a change in Fed policy have pushed short-end rates higher, with longer term rates either flat or up modestly. The 1yr through 5yr treasury rates have increased noticeably in the last three months, while the 10yr treasury is 0.13% higher and the 30yr is 0.04% lower. The structure of the yield curve implies that the market expects the Fed to raise short-term rates modestly, as evidenced by the increase in intermediate term rates. However, the muted move in long-term rates suggests the market believes the Fed's actions will be limited and the economy will eventually return to lower growth and lower inflation in the future. The equity markets are influenced by the level and direction of interest rates. The direction is a moderate headwind for the equity market, but the absolute level remains constructive.

2021 FORECAST SCORECARD

First, we will review our expectations from last January's newsletter. Our forecast for 2021 was optimistic with verbal hedges littered throughout regarding the path of the virus. We expected slower growth in 1Q, followed by a rebound in the remainder of the year. We expected the consumer to be a catalyst as strong balance sheets and pent-up demand caused consumer to spend on travel and entertainment. We expected some of the learned behaviors of 2020 to persist with continued share gains from e-commerce. Our forecast called for continued accommodative monetary policy, with less certainty on the passage of big fiscal policy. We expected inflation to increase during 2021 but believed it would be transitory due to the forces of demographics and high debt levels. The take-away from that newsletter was we expected the economy to outperform the markets in 2021.

Our general view of the 2021 economy was correct, with the jury still out on the transitory nature of inflation. With 4Q GDP estimates at 6.0% growth, full year GDP growth would be 5.6%. This would be the highest level of growth since 1984. Estimates for S&P 500 revenue growth for 2021 is 16.5% and earnings growth of 65.0% according to S&P. The S&P 500 return of 28.7% was greater than we expected for 2021; however, the economy and certain companies performed better than the markets.

THE YEAR AHEAD

As we forecast 2022, we do not expect another year of 20% plus returns in the equity markets. We will outline our expectations for the drivers of market returns and then provide expectations for market performance in the coming year.

2022 DRIVERS OF MARKET RETURN

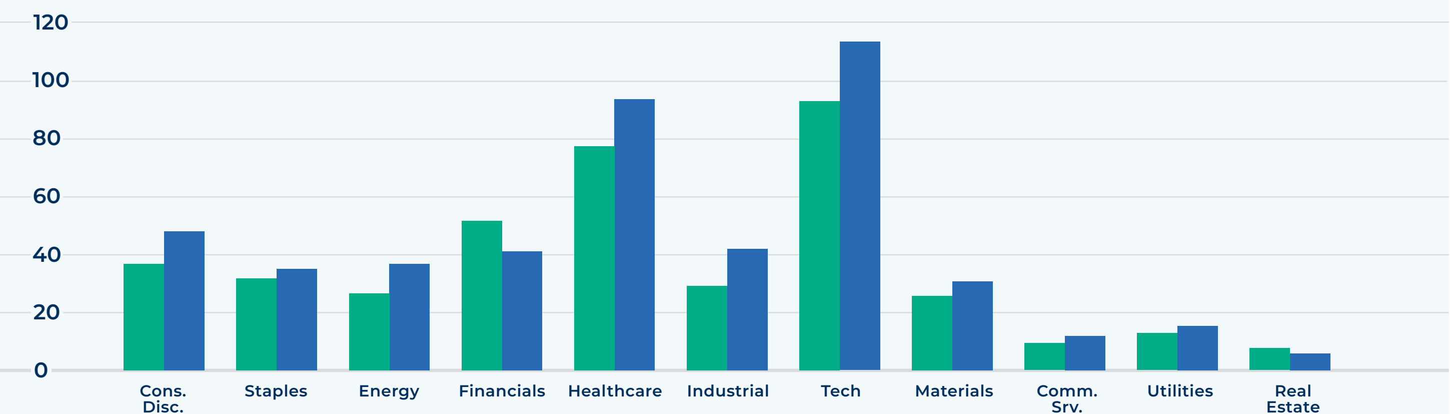
Expectations for economic growth in 2022 are lower than 2021. According to Bloomberg's composite of 57 Wall Street Houses, 2022 GDP growth is projected to be 3.9%, with the strongest quarter being 1Q at 4.0% and growth decelerating each quarter thereafter. We believe these are reasonable expectations after the snapback in activity in late 2020 and 2021 and that the economy will return to trend growth of 2.0% over time. We don't expect substantial additional fiscal support and monetary policy should turn from a tailwind to neutral and possibly a headwind in 2022.

Equity market valuations are elevated to begin 2022. The forward P/E ratio ended the year at 21.2x, which is down from 27.0x at the beginning of 2021. Strong earnings growth in 2021 reduced valuations, while still providing strong equity returns. We expect returns for 2022 to continue to be a function of earnings growth, with valuation ratios to continuing to fall to lower levels as interest rates increase.

Characteristics	3/24/2000	10/9/2007	2/19/2020	12/31/2021
Index Level	1527	1565	3386	4766
P/E Ration (Fwd.)	25.2x	15.1x	19.2x	21.2x
Div. Yield	1.4%	1.9%	1.9%	1.4%
10yr Treasury	6.2%	4.7	1.6%	1.5%

Source: Standard & Poor's

Naturally, stronger economic growth leads to stronger corporate revenue and earnings growth. Conversely, expectations for a deceleration in GDP growth leads to expectations for slower corporate revenue and earnings growth. Projections call for S&P revenues and earnings to increase 6.8% and 9.0%, respectively. It is noteworthy that expectations for margins remain elevated. Nine of the eleven S&P sectors are projected to see earnings growth in 2022, with financials and real estate stocks seeing a decline in earnings. The rate of compound earnings growth for the S&P 500 over the last decade is 7.4%, so a 9.0% growth rate is around average.



Perhaps the most important determinant for the economy, company performance, and market returns in 2022 is monetary policy. As mentioned, the Fed will cease quantitative easing in March and raise the Fed Funds rate later in 2022. Low interest rates have benefited all asset classes over the last decade. In the 13 years since quantitative easing began, the Fed's balance sheet has increased by nearly 900%, which is roughly ten times the increase in the prior 13 years. This chart illustrates the change in the S&P 500, the Fed's balance sheet, and the Fed Funds rate since 1995.

Two primary drivers of market returns are earnings growth and interest rates. This chart illustrates the influence of interest rates on market returns. Prior to 2009, the Fed's primary tool was the Fed Funds rate, and it is evident that rate increases can reach a tipping point as the economy overheats and puts downward pressure on markets. After 2009, the Fed Funds rate was anchored at 0.0%, and balance sheet expansion became an important tool of Fed policy. Beginning in 2010, a return to economic growth and an aggressive Fed policy caused markets to rebound. Returns became more muted in 2018 as the Fed raised rates and decreased the size of its balance sheet. Since March 2020, the Fed has aggressively expanded its balance sheet and lowered rates to 0.0% and markets have rallied.

2022 PROJECTED MARKET PERFORMANCE

It is too simplistic to draw a straight line between Fed policy and market returns. Expected economic and earnings growth, investor sentiment, and other factors influence market returns. However, monetary policy is an important determinant in interest rates and therefore returns in the equity and bond market. In 2022, monetary policy should be less accommodative than it has been in the last two years.

THE DEGREE OF THE FED'S PIVOT IS THE IMPORTANT QUESTION FOR 2022 AND THIS WILL BE DEPENDENT ON THE PATH OF INFLATION.

Inflation has been less transitory than we imagined in 2021 as large fiscal stimulus, aggressive monetary policy, and Covid supply chain issues combined to make inflation more persistent. We don't believe fiscal policy will be as inflationary in 2022, when compared to budget deficits of the last two years. We expect supply chain issues will improve as some idiosyncratic issues with semiconductors and the surge in demand for durable goods run their course. Monetary policy is slowly moving from accommodative to marginally restrictive. We believe inflation will persist into 2022, but that it will begin to moderate as the influence of fiscal policy diminishes and supply chains heal. For that reason, we believe the Fed's pivot will be limited and expect rates to increase in 2022 with a few rate increases and the end of quantitative easing. This should increase short-term rates to the 0.5%-1.0% range and the 10yr treasury to 1.75%-2.5% range during 2022. This should lead to higher volatility and lower returns for equity markets in 2022, as compared to the last two years.

The equity market has returned 31.5%, 18.4%, and 28.7% over the last three calendar years. We do not anticipate markets to post another year of strong double-digit returns. The economy should continue to heal from the pandemic and earnings growth should be slightly above average at 9.0%. This should provide moderate equity returns and allow valuations to moderate, after three years of above average gains. As we have said here before, it is a market of stocks and not a stock market. We will continue to seek out quality companies that we expect to grow their earnings and offer reasonable valuation for our clients.

As we begin another new year, we would like to thank our clients and friends for their support of our firm. We look back over the last two years and we have been through many unexpected events together. We know that unexpected events will surprise us in 2022, but we look forward to navigating them together. For now, we wish you all a Happy New Year.

IN THE SPOTLIGHT

Charles W. Clementson
Vice President - Financial Advisor & Trust Officer

CHARLES W. CLEMENTSON is a Vice President-Financial Advisor & Trust Officer in Colonial Trust Company's Spartanburg office. His professional investment background includes over 20 years of experience in investment services. Before joining Colonial Trust, Charles was a Vice President and Wealth Advisor with BB&T/Truist Wealth in Spartanburg.

Charles's responsibilities will include assisting in financial advisory, trust officer, and portfolio management roles. He will manage relationships and deliver the firm's services to those clients. Charles will also assist with business development and partner with existing advisors in the firm to develop best practices for investments, financial planning, and trust services.

He is a graduate of Wofford College, as is his wife Blair, a local dermatologist. Charles and Blair have three young children and are members of First Presbyterian Church. Charles has assisted with children's ministries and programs, Winter Warmth, and MorningSong Worship services. Both are active in the Spartanburg community. Charles has served on the Charles Lea Center Foundation for six years and is currently Vice-Chair. He has also delivered meals for Mobile Meals for over seven years.

We are glad that Charles has joined our Spartanburg team, and we are excited for him to represent our firm in the community. Charles will be an asset to our investment and trust team to support the continued personal relationships our clients have enjoyed in the Spartanburg office.

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