

Stimulus Deceleration

The US Federal Government deficit and the US Federal Reserve (the Fed) balance sheet both continue to grow from record levels; however, both of their growth rates are finally decelerating. Federal Government debt also continues to grow but at a slower pace.

This spring (as early as March), the Fed is expected to stop growing its balance sheet and might start shrinking its balance sheet by this summer.

What does this mean? Since the pandemic began, the Fed has grown its balance sheet by buying US Treasury debt (Treasury notes and bonds) and mortgage-backed securities (MBS), making it the world's largest buyer of these securities. As the Federal Government issues new Treasury debt (and reissues maturing debt), new buyers of US Treasuries must be found. A likely scenario is that bond interest rates will rise until enough buyers are attracted to these securities.

Similarly, there will need to be buyers for future MBS issuances. Conventional mortgage loan rates declined to record lows as the Fed purchased much of the loan volume in the last couple of years. Because of this, we expect mortgage interest rates to rise through 2022 and into 2023 in order to attract enough investment to replace its biggest buyer.

Bond prices will fall as interest rates rise. Some long and intermediate-term bonds could generate a negative total return in 2022 & 2023.

Broad-based Inflation Continues

Record levels of government spending and printing of money have ignited inflation. The consumer price index rose 7% in December from a year earlier – the fastest pace since June 1982.

Some have called the current inflation environment as “transitory” (i.e., short term). We believe it will continue this year.

KEY DATES

- 1.7 Unemployment Report
- 1.12 December CPI
- 1.17 Martin Luther King Jr. Day
Stock Market Closed
- 1.26 Federal Open Market Committee Press Conference
- 1.27 GDP 4Q and 2021 Advance Estimate
- 2.4 Unemployment Report
- 2.10 January CPI
- 2.21 Presidents' Day
Stock Market Closed
- 2.24 GDP 4Q and 2021 Second Estimate
- 3.4 Unemployment Report
- 3.10 February CPI
- 3.16 FOMC Press Conference
- 3.30 GDP 4Q and 2021 Third Estimate



Why? Twenty state minimum wage increases went into effect at the beginning of this year. Four additional states have scheduled an increase in the third quarter. As a result, many employers will offset higher wage expenses by raising product prices, including the food we buy at the grocery store.

All of us are paying more at the pump as well.

The reason is domestic energy production remains under pressure as limitations on emissions and industry lending have reduced exploration activity. Meanwhile, energy demand has increased due to the growing economy. Consequently, rising demand combined with limited domestic supplies will result in higher energy prices.



Oil and gas refineries are the largest producers of plastics and synthetic rubber. As energy prices rise, packaging and products using plastics or rubber will experience price increases. Moreover, items needing to be shipped from overseas, from production to distribution to retail, will incur increased transportation costs due to fuel, wages and congestion.

Though renewable energy is on the rise, it is not expected to offset electric utility electricity production from fossil fuels for decades. Thus, factories using energy for production and consumers heating their homes should experience cost increases.

Many companies either have started to or are planning to offset these cost increases. From food to bikes, we likely will experience rising prices in 2022.

Avoid “Long-Duration” Investments

Long-duration investments are securities expected to generate most of their cash flow in the distant future. As a result, “longer duration” assets are worth less in a rising interest rate and/or inflation environment as higher interest rates are used to discount future cash flows to present value.

Types of long-duration securities include:

- Long-term bonds
- Preferred stocks
- Royalty trusts
- Limited partnerships
- Common stocks of firms that have negative earnings or negative cash generation
- Investments with high valuation multiples (P/E, P/S)



What We See & Know

We often are asked if there will be a significant sell off of the market in the near future. Timing the market is not a prudent strategy. However, investing wisely in financially strong companies with excess cash, potentially combined with the right mix of bonds, has been and always will be a smart strategy.

In addition to “long-duration” assets, here’s what we know as 2022 begins.

- Stocks in firms that rely on cheap imports, cheap labor, cheap commodities, outsourced production and just-in-time inventory are concerning in a high inflationary environment.
- Many companies benefiting from trends during the pandemic appear overvalued. As their growth rates decelerate to pre-pandemic levels, their stock price valuation metrics should decline.
- The S&P 500 index is composed of more than 40% of large-cap, technology-centric companies, many of which fall into the “long-duration” asset class. Though their stock prices have pulled back some, they still are overvalued with prices at or near their all-time high.
- Over the last decade many smaller companies (having less than \$10 billion market capitalization) have been ignored by institutional investors. Moreover, many stable dividend-paying firms were considered too boring by those seeking exciting returns. After being overlooked for so long, investors can buy these growing firms at attractive entry prices.
- As rates rise, bond investors should shorten average portfolio maturities in order to limit price risk and benefit from reinvesting maturing bonds at higher interest rates.

Keep in mind: In a volatile market, normal human emotions can result in investors selling low, buying high, chasing short-term trends and joining the herd. When the herd runs off the cliff, the only comfort is knowing you are not alone.

Many investors and young money managers haven’t experienced an inflationary period like we are experiencing today. Our advice is to remain long-term, disciplined and diversified, investing in companies that have the following traits:

- Attractive current valuation
- Excess cash generation (both operating cash flow and free cash flow)
- Positive GAAP earnings
- Recurring cash dividend (preferably a growing cash dividend)
- Control of sourcing and input costs
- Ability to increase prices and maintain profit margins (pricing power)
- Leader in a growing, profitable niche with barriers-to-entry
- History of innovation

Companies with the above traits can continue to pay dividends and interest to investors even in a volatile market or market downturn.



CMC Strategy & Approach

Our portfolios are positioned to benefit from any environment, including an inflationary one. Many investment managers can cite an investment process but few adhere to those disciplines like CMC.

We will continue to use **our proprietary process** by sifting through thousands of stocks in a different way to find companies that dominate a growing profitable niche.

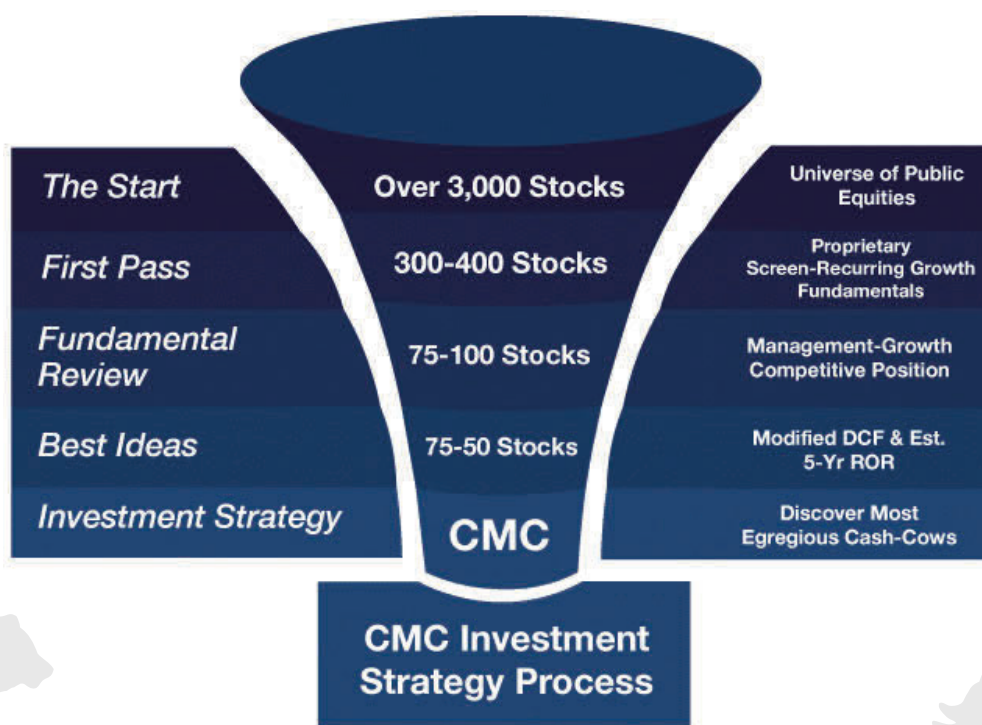
Central to the research process are our multifactor proprietary screens, designed to identify those companies that possess superior growth of cash flow and that earn high cash returns relative to their cost of capital.

We own a diverse set of growing firms which generate excessive amounts of cash. This recurring, growing stream of cash can be used for accretive acquisitions, debt retirement, share buybacks, dividend increases and cash reserves.

Our hurdles are high: approximately 150 companies survive the process from the original database of more than 3000 stocks. We then focus on the unique characteristics of each company, including competitive strengths and weaknesses. Solid growth can be determined by a company's competitive position, market share, pricing flexibility, innovation, low-cost production, and quality of management. This analysis leads to a judgment of the sustainability of a company's growth.

We then determine five-year price targets and expected total returns. Establishing the current valuation benchmark for a stock finalizes our process to avoid over-paying and to provide a "margin of safety." This leads to our approved list of less than 2% of the stock universe.

We own a select list of high-conviction holdings that should thrive in this environment. Our strong track record has weathered market cycles, extreme events, changing fashions and technological advances.



Last But Not Least

We thank you for having the confidence in us. We think of you as part of our family and friends and strive to be the absolute best advisors we can be to you and your loved ones. If you have any questions, we are only a phone call or email away. We're here to help!



We've had the good fortune of several clients referring us to other family and friends to achieve similar results for them. If you know of someone that would like to learn more about CMC, please feel free to have them reach out to us. We don't like to toot our horn per say; rather have our clients do that for us.

About: The Capital Management Corporation

Established in 1964, The Capital Management Corporation (CMC) is a SEC registered investment advisor (RIA) providing investment management services to institutions, foundations and high net worth individuals. Our singular purpose is managing long-term investment portfolios. We strive to maximize investor return and mitigate risk by applying a principled and disciplined process. Our firm holds itself to the highest standards of integrity and serves as a fiduciary for every managed account.

CMC is 100% employee owned and operated. We are one team, the same team; we are a family. This shared knowledge fosters camaraderie, communication and collaboration. We have a shared vision and passion for excellence. There is ownership over decisions, results and performance.

Together, we serve as our clients' fiduciary with a focus on growing wealth, preserving capital and generating rising, recurring streams of cash income. We greatly appreciate your confidence in our team, services and results.

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