# 2022 Outlook

*Rebuilding To Meet Demand*

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# Year of Transition for Economy

The U.S. economy fully recovered from 2020's pandemic-induced recession by mid-year 2021, and continues forward with solid momentum as we head into 2022. We expect economic growth to be close to 4% in 2022 (see Figure 1), down slightly from 2021's 5% plus pace.

This forward progress has been spurred along (with demand outstripping supply) by ultra-low interest rates, massive fiscal stimulus, rapid employment growth, pent-up consumer savings, strong financial markets, and an ongoing global vaccine distribution. The U.S. stock market, as measured by the S&P 500, surged in the first half of 2021, struggled a bit in the 3rd Quarter as the Delta variant took hold, then rebounded to tally a remarkable 25% gain through late November.

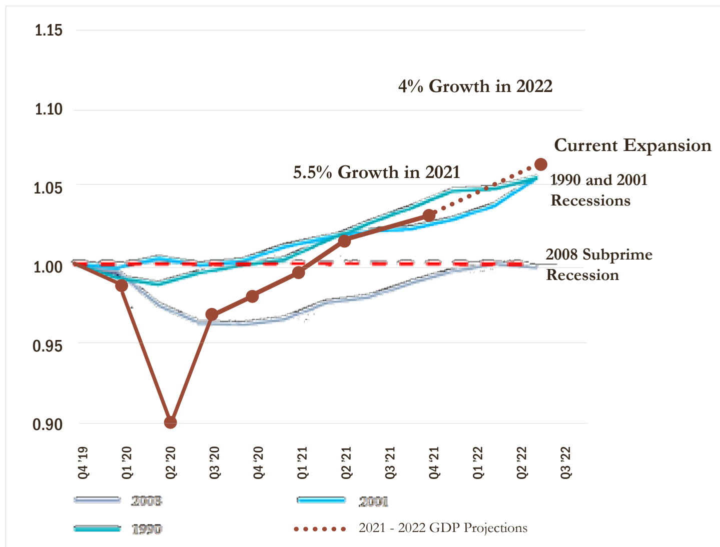
Large International developed stocks have fared about half as well as U.S. stocks, while emerging markets, driven by negative returns in China, have posted a nearly zero return. In the bond market, rates have slowly risen most of the year as predicted, leading to very minimal or slightly negative returns over the course of the year (see Figure 2).

On a macro front, all of this accelerating growth led to elevated inflation rates (headline CPI up to 6.2% in October) as pandemic-related supply chain disruptions and reduced labor supply acted to constrict economic capacity just as more was needed (see Figure 3). Fortunately, wages and salaries are growing at close to a 5% pace, helping to somewhat offset sharply higher food, shelter, and transportation costs.

## Market Summary

- **We expect corporate earnings to increase 10% to 15%**
- **The Federal Reserve (Fed) will likely raise interest rates over the second half of 2022**
- **A rising interest rate scenario does not necessarily mean the end of the equity bull market**
- **Inflation rises before it slowly falls**

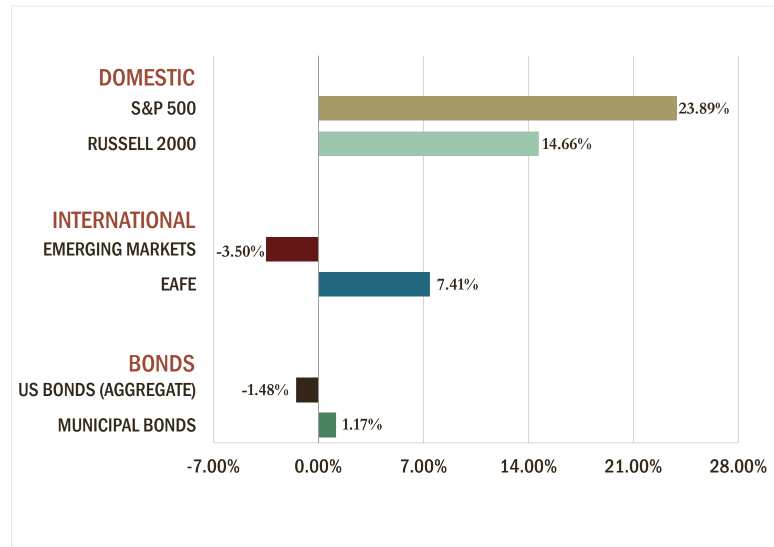
## U.S. GDP Plunged, But Will Recover More Quickly (Much Faster Than Last Three Recessions) *Figure 1*




Source: Citi Research, Commerce Trust Company

## YTD Index Returns (as of 11/26/2021)

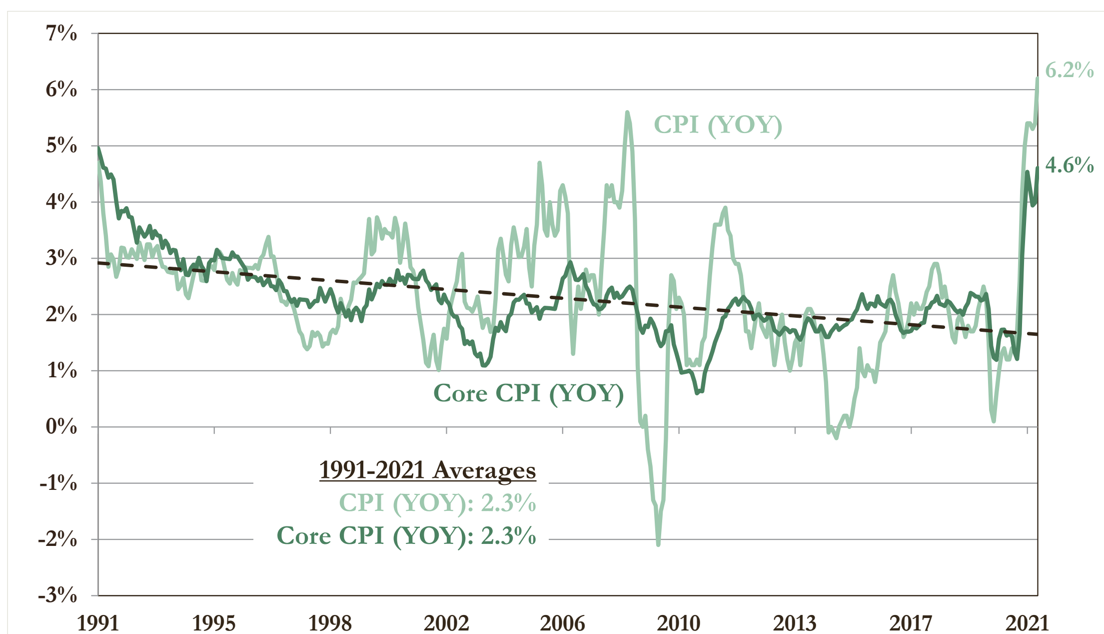
*Figure 2*




Source: Bloomberg

## Inflation – Aggressively Turning Up

*Figure 3*



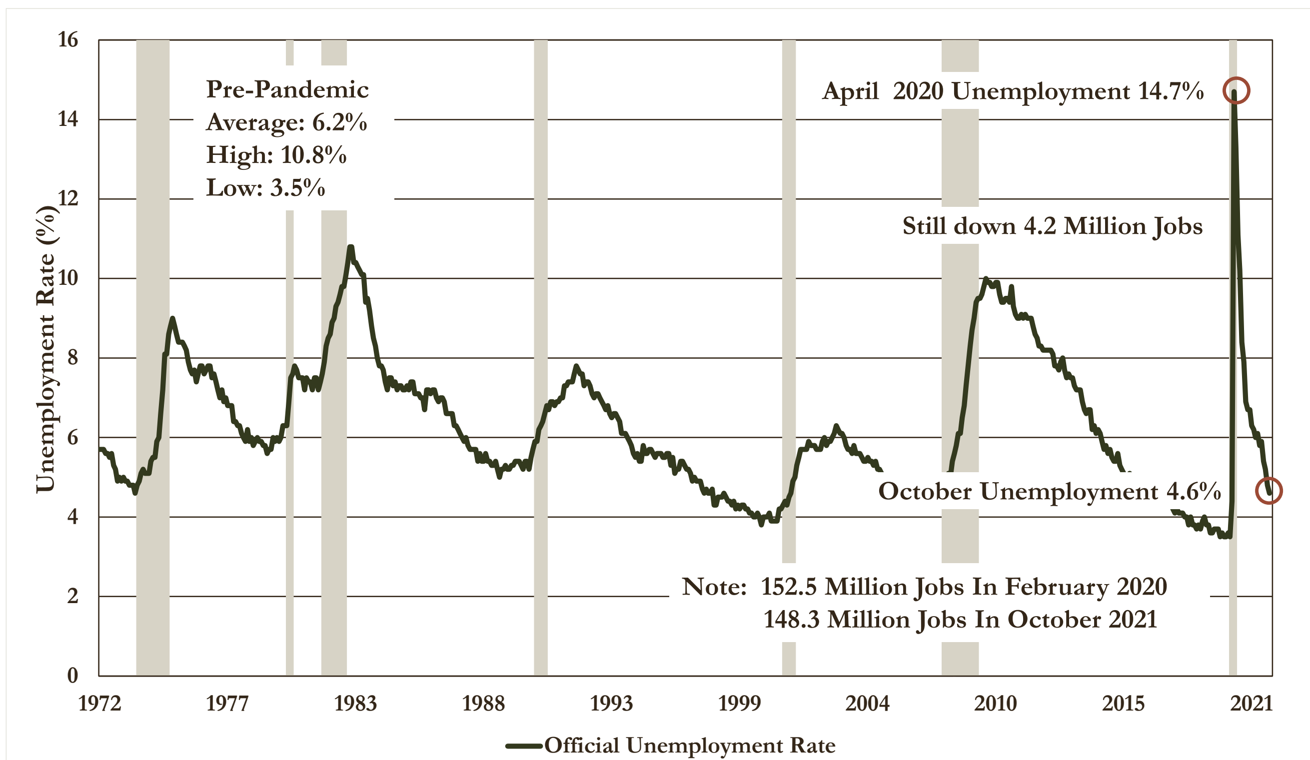

Source: Bloomberg

# Economic Outlook

With help wanted at record levels, employment and salaries should continue to grow next year, offsetting waning government stimulus and a more hawkish Federal Reserve that likely starts to raise interest rates over the second half of 2022. Following a slowdown in August and September, the labor market improvement accelerated with the retreat of the Delta variant and the expiration of augmented unemployment benefits in September. While the unemployment rate fell from 6.7% to 4.6% in 2021 (see Figure 4), approximately 4.5 million potential eligible employees chose to not yet look for a paying job. Hopefully, more people will reenter the workforce this year to help fill the labor gap. However, our healthcare crisis is slowly transitioning into a mini childcare crisis as many continue to stay home to juggle household duties. Families confront uncertain school policies, expensive or inaccessible childcare and another potential wave of the coronavirus as we enter the winter months. Still, macroeconomic fundamentals remain in good shape and will continue to support the U.S. economy as it moves toward "maximum employment." An unemployment rate below 4% is possible in 2022.

## Official Unemployment Rate

*Figure 4*




Source: Bloomberg

We see some other promising news as well. As our "economic pipeline" eventually expands and bottlenecks slowly recede, we expect inflation to peak early next year and then gradually decline. With inventories at record lows, economic growth will be spurred along as we restock our shelves, add cars to depleted dealer showrooms and continue to replenish our housing stock. While home prices have surged, affordability remains reasonable with mortgage rates so low. We expect home prices to continue to increase, driving household wealth next year, despite the record run-up in prices we saw this past year.

## Key Takeaways: Economic

- **Employment and salaries should grow in 2022, partially offsetting effects of diminishing government stimulus**
- **Childcare costs are holding many out of the workforce as families struggle to balance household duties**
- **Omicron and other variants likely to throw wildcards into the economic mix**

We also expect positive equity markets, even though valuations are elevated. Corporate earnings surged this past year and will likely continue to grow in 2022. Additionally, the $1.2 trillion bipartisan infrastructure package will deliver much-needed improvements to roads, bridges, etc., along with new funding for transportation, utilities and broadband. We doubt the Build Back Better Plan will be approved without serious negotiation and compromise.

In short, 2022 will be a year of transition, from an overheated, stimulus-driven economy to one that begins to cool but remains strong on a historical basis. From a supply-constrained world to one that begins to expand manufacturing capacity. From an inflationary environment to one that begins to wane. From an accommodative Fed to one that begins to tap the brake. From a surging stock market to one with modest gains. From what appeared to be a diminishing pandemic to one that may produce additional waves of new variants.

# Equity Outlook

Can the S&P 500 post another double-digit gain in 2022, following gains of 31.5% in 2019, 18.4% in 2020 and 26.0% YTD in 2021? Our answer is yes, at least at some point next year as the economy continues to post strong nominal growth, and inflation pushes revenue and profits higher for corporate America. Equities are not cheap, with valuation levels for the S&P 500 in the 22 times price/earnings (P/E) range, well above the long-term average of 16 times. (Figure 5) After a dismal year for earnings in 2020, earnings

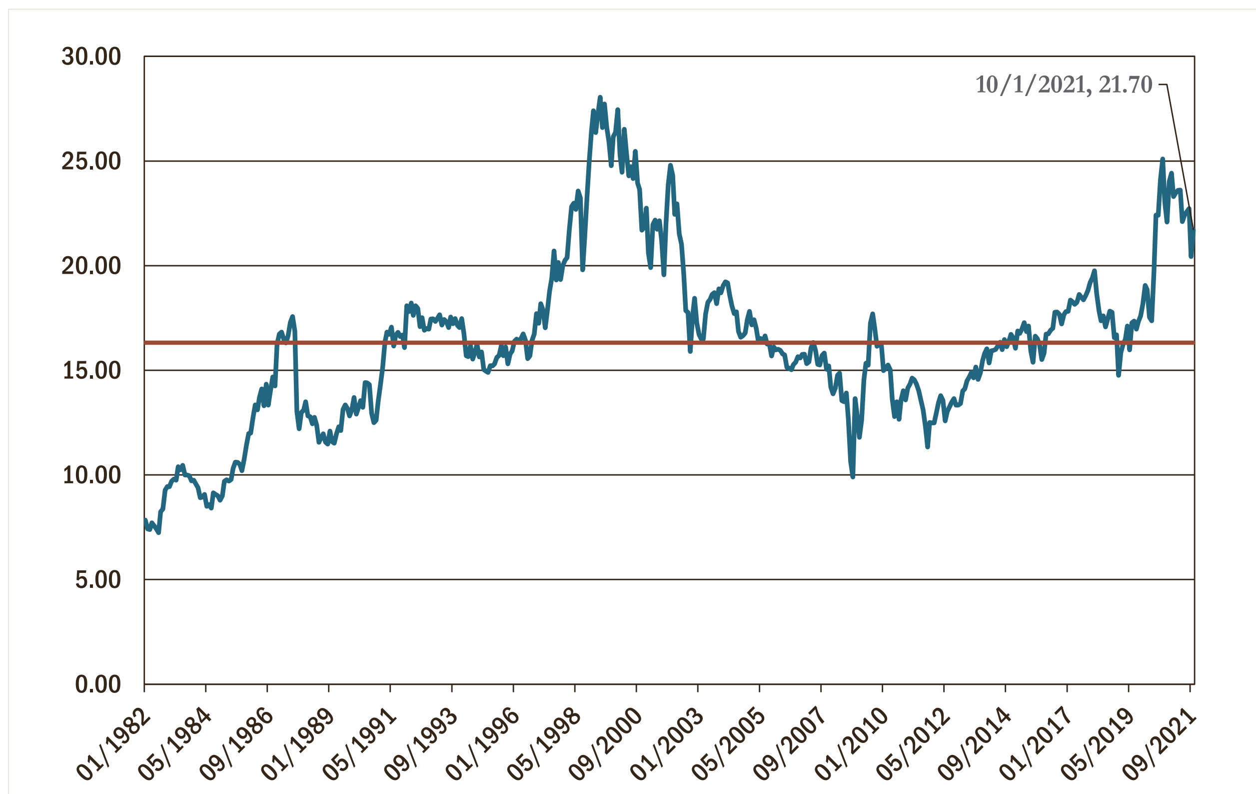
growth of 65-70% in 2021 supported higher equity prices and reduced the valuation level of the S&P 500 as earnings rose more than stock prices. In 2022, we expect earnings to increase 10% to 15%. In early phases of rising inflation, inflation acts as a tailwind to profit growth, as cost increases are easily passed on to the end user. Historically, inflation and rising interest rates have put a damper on P/E ratios, and this could happen later in 2022 if inflation does not moderate.

But the strange twist for investors is rising inflation has yet to push interest rates materially higher. This could change as the Fed starts to raise rates toward the second half of 2022. A rising interest rate scenario does not mean the end of a bull market, however. Typically, equity markets don't peak until a year or two after the first interest rate increase, postponing a top to perhaps sometime in 2024. The primary risk to our outlook is persistent inflation leading to higher interest rates and lower valuations for equities.

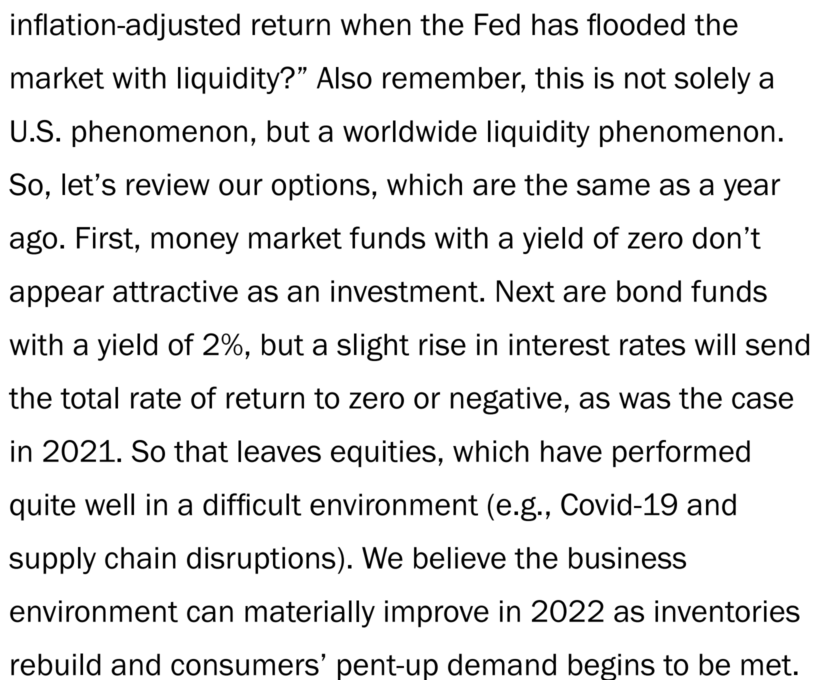
Investors enter 2022 with the same question they had a year ago: "Where can I invest to earn a decent

## Current Price/12 Month Forward Operating Earnings

*Figure 5*




Source: Morningstar, Factset, SPGlobal



inflation-adjusted return when the Fed has flooded the market with liquidity?" Also remember, this is not solely a U.S. phenomenon, but a worldwide liquidity phenomenon. So, let's review our options, which are the same as a year ago. First, money market funds with a yield of zero don't appear attractive as an investment. Next are bond funds with a yield of 2%, but a slight rise in interest rates will send the total rate of return to zero or negative, as was the case in 2021. So that leaves equities, which have performed quite well in a difficult environment (e.g., Covid-19 and supply chain disruptions). We believe the business environment can materially improve in 2022 as inventories rebuild and consumers' pent-up demand begins to be met. Yes, investors are currently overweighted in stocks versus historical measures, but in a world of zero percent interest rates, equity allocations can go higher. The rock-bottom rate outlook for the Fed Funds rate and, accordingly, money market rates could be changing as we move into the latter half of 2022. Nonetheless, we continue to see the momentum higher for equity prices, at least for the first six months.

## Key Takeaways: Equity

- **Despite markets being buffeted by uncertainty of the pandemic, the outlook for equities remains promising**
- **A combination of rising inflation and interest rates would be primary risk to stock valuations**
- **Until negative outlook for investing in China improves, emerging markets likely underperform**

As was the case in 2021, we continue to favor investing in domestic equities over international equities. As we have noted before, U.S. equity indexes are materially overweight technology companies versus international indexes. If technology issues continue to do well, domestic investing will win for yet another year over International. Emerging markets' outlook deteriorated considerably in 2021, led by the Chinese market being down 15% through 12/1/2021. The Chinese Communist Party (CCP) is exerting its power in many areas of the country, both politically and economically, in a move toward "common prosperity." As you can imagine, the CCP's move toward the common good isn't favorable for profits or equity markets. China represents over one-third of the emerging market index, and until the negative outlook for investment in China improves, emerging market indexes will likely continue to underperform. Additionally, many emerging markets are raising interest rates to combat inflation, which dampens their outlook.

## Key Takeaways: Fixed Income

- **Higher inflation levels proved to be much less "transitory" than the Fed anticipated**
- **The Fed also announced plans to taper its regular monthly purchases of Treasury and mortgage holdings**
- **Many fixed income sectors produced negative returns in 2021 and could continue to struggle in 2022**

# Fixed Income Outlook

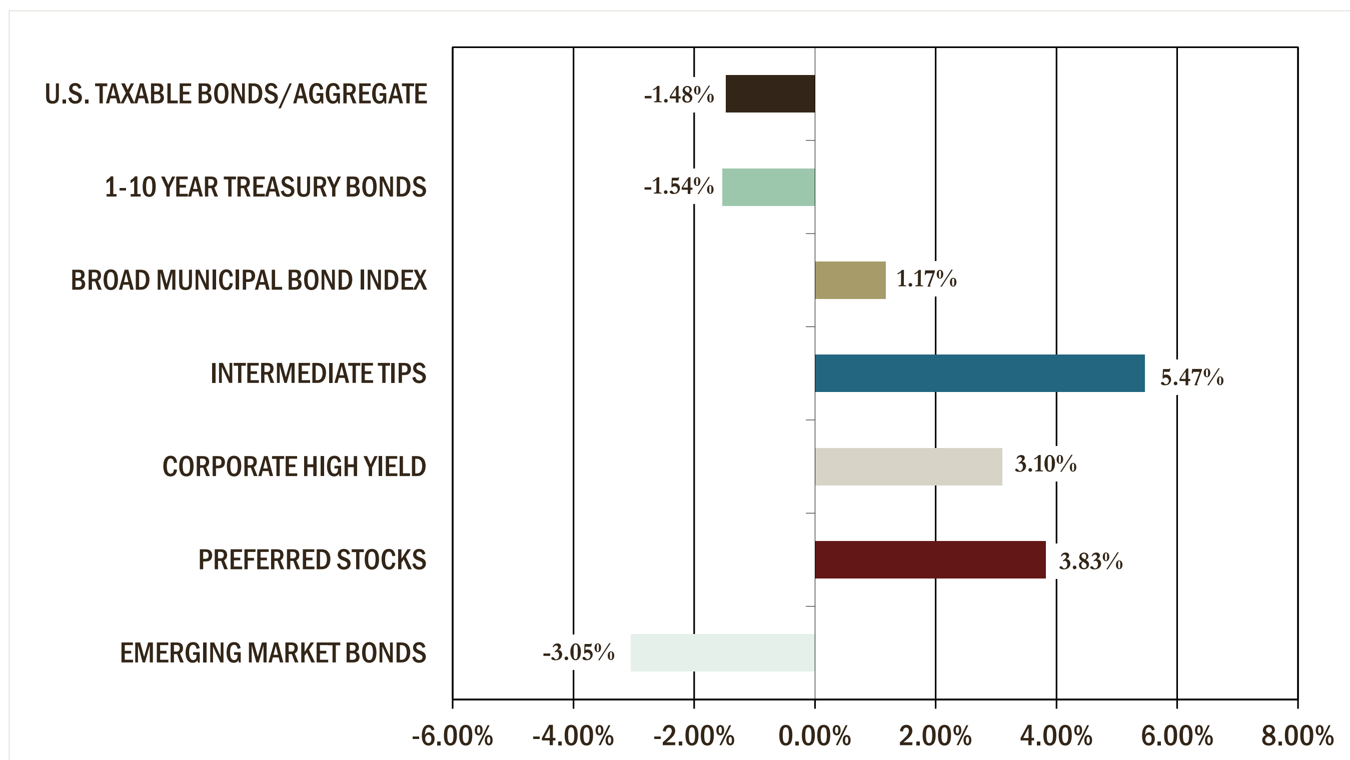
Covid-19, supply chain shocks, and rising inflation expectations loomed over the bond market during 2021 and will likely continue as an overarching theme as we enter 2022. After starting 2021 below 2.0%, the Core Consumer Price Index (excluding volatile food and energy prices) jumped to 4.6% in October, and we predict it will still climb a bit higher before it slows. These higher inflation levels proved to be much less transitory than our Federal Reserve had expected as U.S. demand recovered much faster than the world's disrupted manufacturing capacity. As vaccinations take hold, a diminishing Covid-19 impact and time should provide some resolution to supply-demand imbalances and help reinforce our forecast for above-trend economic growth.

Perhaps the biggest risk to our outlook is the path of future interest rates, as the Fed attempts to smoothly transition monetary policy in the coming months. The Federal Open Market Committee (FOMC) has already announced plans to begin reducing its monthly purchases of Treasury and agency mortgage holdings. This so-called "tapering" process is expected to take eight months and end no later than June but could be accelerated if inflation continues to run hot. Since Fed rate hikes are not anticipated to commence until tapering is completed, the inflationary surge that is lasting longer than markets expected could even pull forward the timing to raise interest rates into the second quarter.

Of course, interest rates have already moved up during 2021 in response to these elevated inflation expectations. A bear market in bonds resulted, with most fixed income sectors producing negative returns year-to-date (YTD). The Bloomberg Aggregate Bond Index has generated a -1.48% YTD return as of 11/26/2021, with Treasuries being the worst-performing sector of the fixed income market (see Figure 6). High Yield and Treasury Inflation Protected Securities (TIPS) have been select taxable subsectors that generated positive returns as investors eagerly searched for more yield and protection from inflation. Municipal bonds have fared better this year than taxable investment grade bonds. Fund flows into

## Fixed Income YTD Returns (as of 11/26/2021)

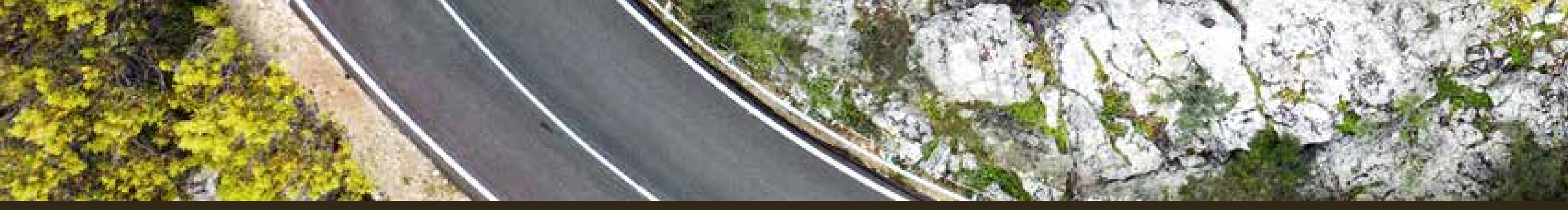
*Figure 6*




Source: Bloomberg

municipal bond funds have exhibited strong demand as flows continue to outpace 2019 (a record year). Municipal issuers' credit quality has been strengthened by better-than-expected tax revenue and fiscal stimulus. Despite the threat of higher inflation and expensive valuations, so far this year municipal bonds have outperformed taxable indexes by nearly 3%. The Bloomberg Municipal Bond Index has generated a YTD return of 1.17% as of 11/26/2021. Given our expectation for higher interest rates and growing new issuance related to the recently passed $1.2 trillion Infrastructure bill, municipal bonds are not likely to generate much relative outperformance next year.

While a challenging environment awaits bond investors in 2022, an overhang of global liquidity and ultra-low interest rates abroad should provide ongoing support, keeping any upward thrust in rates in check as U.S. government bond yields remain attractive relative to those in Europe and Japan. Exceptional corporate earnings growth and very healthy balance sheets should also lessen the risk of wider credit



spreads, even though the incremental yield earned for taking on this credit risk is close to an all-time low. And it is possible that there will be some decline in fixed income supply (mostly due to surging tax receipts and less fiscal stimulus that offsets the Fed taper) to help provide technical support to the market.

Still, bond returns could be very close to zero again or even push negative, if rates continue to move higher as we anticipate. To hedge some of the potential risk, we are targeting shorter maturities than average and are still willing to take on credit risk to earn extra income, just as we did most of last year. Despite the unexceptional rate environment, bonds still serve their important role in an investment portfolio by offsetting volatility associated with other asset classes, essentially acting as an insurance policy against a falling stock market.

## Alternative Investments Outlook

Commodities performed strongly in 2021 but there are reasons to be more cautious going forward. While oil prices are far from their all-time high of $147 reached in 2008, there are other factors that may be more relevant in the future. Demand in the United States is about the same as 20 years ago and the growth of electric vehicles will only depress demand further. OPEC+ countries appear to be cautious regarding the expansion of production capacities amid uncertainty of economic growth caused by supply-chain problems. The price of gold peaked in 2020 and is down in price in 2021. Key risks to the outlook for gold are tighter central bank policies and competition from cryptocurrencies.

Real estate continues its transformation that was underway prior to the pandemic. Repurposing of traditional retail malls and industrial space continues. Office space needs are being reassessed as working from home and hybrid working arrangements continue. Warehouse, storage, cell towers and health care continue to experience growth. Residential real estate demand is supported by limited supply and low interest rates.

With our outlook for higher rates and a challenging 2022 for fixed income investments, we continue to allocate hedge funds for a portion of the fixed income allocation in portfolios. We expect the hedge fund strategies that we employ to outpace fixed income returns in 2022 as economic growth remains positive, interest rates increase, and inflation concerns persist.

## Conclusion

Simply put, as we continue to make progress both domestically and globally in combatting potential new variants of the coronavirus, we expect above-average U.S. economic growth, interest rates to rise gradually, inflation to peak and roll over, and employment to continue to climb at a solid clip. Even as corporate earnings growth decelerates from its breakneck pace, equity markets should continue to maintain their firm footing even as the Fed becomes less accommodative as we go into 2022. Fortunately, U.S. growth has led the world's recovery, and we expect some catch-up from most of the overseas economies. China, however, is likely to continue to slow as they confront an over-levered, overvalued property market and adjust to more government involvement in the business sector. All in all, even in this transitional phase, we anticipate another impressive year of recovery. As we gradually recoup the global economic capacity stunted by the pandemic, the world will steadily restock its empty shelves.

## Key Stats

**4%**
2022 U.S. GDP Growth Forecast

**26%**
S&P 500 YTD*

**4.6%**
2021 Unemployment (estimate)

**1.473%**
10-year U.S. Treasury Yield*

**-1.48%**
Bloomberg Barclays Aggregate Bond Index YTD Return*

**1.17%**
Bloomberg Barclays Municipal Bond Index YTD Return*

* As of 11/26/21

INVESTMENT POLICY TEAM - NOVEMBER 30, 2021

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# 2022 Outlook
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