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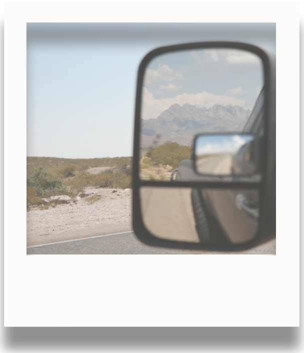
2022 Economic & Market Outlook

Six things to watch in the new year

Advice-driven financial service.

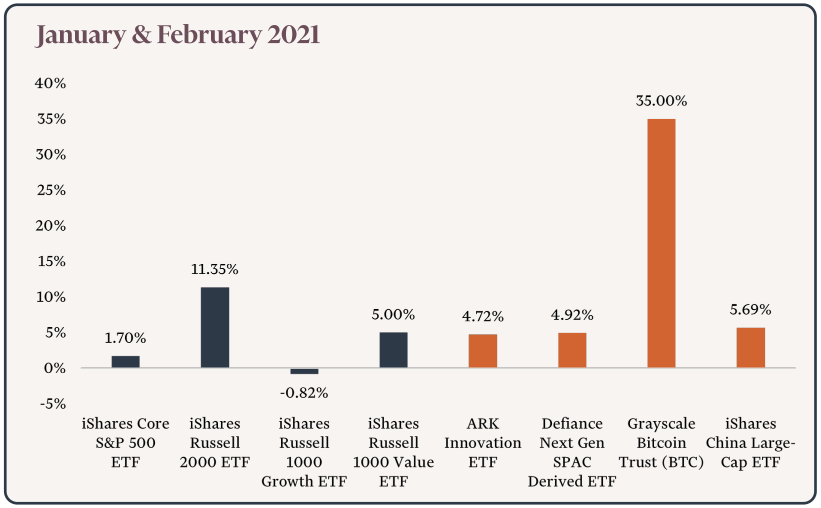
A QUICK REVIEW OF 2021

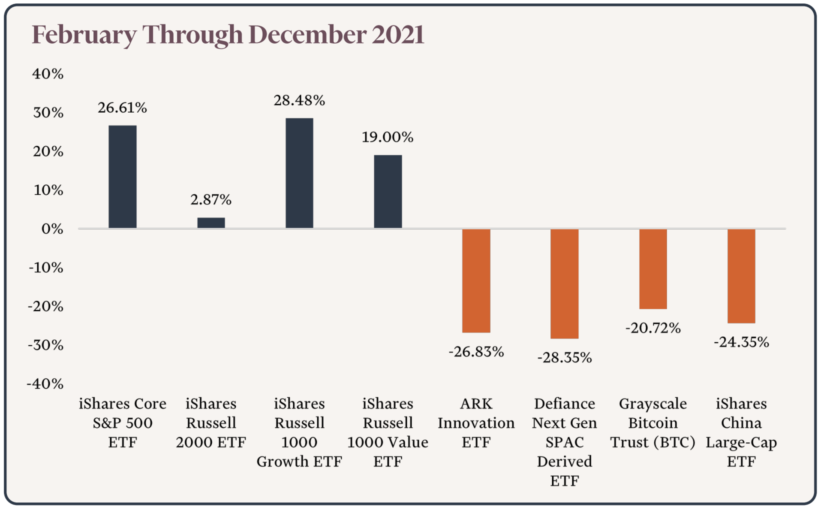


Last year wrapped with both the economy and equity markets in healthy shape. Another round of government relief checks drove consumer spending in 2021 to ever greater levels while an expansive monetary policy unleashed the animal spirits of institutional, and particularly retail, investors.

The first quarter of the year likely marked a period of peak exuberance in financial assets as the market for SPACs, renewable energy, technology, and so-called "meme" stocks exploded and then faltered as the year progressed. However, U.S. large cap equities surprised everyone by returning nearly 30% in one of the best years in the last 20. This was led by the mega cap stocks in the technology and communication services space, with help from the more cyclical energy, real estate and financial sectors. The result comfortably exceeded the performance of smaller and mid-sized U.S. companies while swamping the returns generated by developed and emerging international equities.

Like 2020, the outbreak and progression of Covid-19 and its variants dominated headlines. The summertime spread of the Delta variant stalled the transition of consumer spending from goods to services and meaningfully slowed third quarter GDP growth. Another factor contributing to the relatively weak quarter was ongoing supply chain disruptions, which impacted the big-ticket sectors of the economy, such as automobile purchases, the most.



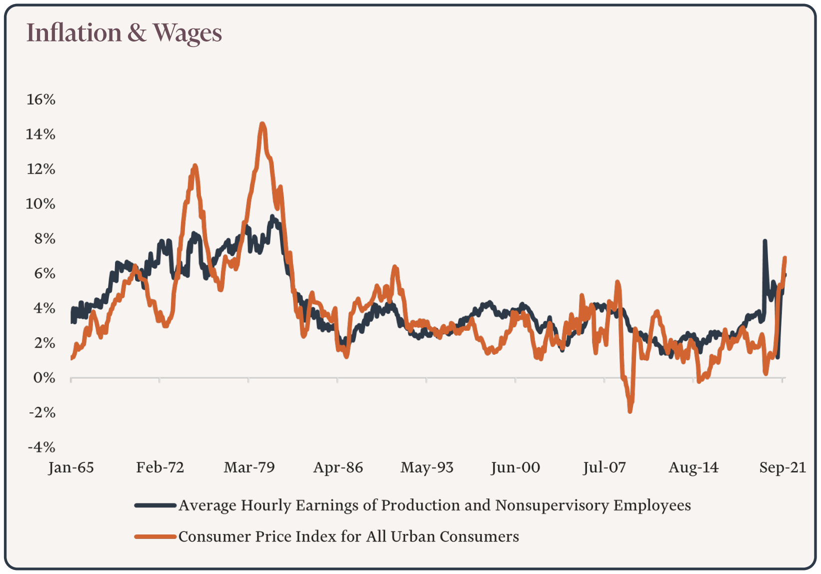


Source: Factset

The fourth quarter was recouping lost output from the third when the Omicron variant was discovered and quickly spread throughout the world. Holiday shopping is minimally affected although the leisure/hospitality sectors of the economy are again bearing an inordinate brunt of cancellations and increased consumer hesitancy. A potential silver lining to this continuous Covid cloud is the evidence that each variant, while more contagious, appears to be less virulent as measured by the hospitalization and mortality statistics. Continuation of this trend should prevent a recurrence of the widespread government-imposed lockdowns which were initially used to respond to a virus about which the medical and political communities knew little.

With Covid always lurking in the background, inflation became the biggest market risk with the year-over-year headline rate approaching 7% at year end. The concern was primarily about the size of price increases, but also the persistency of this inflation as the Fed had to deemphasize the original belief that the price increases would be "transitory." Market participants were initially leery of price increases negatively impacting demand, but the ultimate concern was the Fed making a policy mistake by tightening policy too quickly to battle an inflation rate that was more a function of supply constraints as opposed to excess demand.

Although the Fed was forced to respond by announcing an acceleration of the asset purchase tapering program, their messaging is so far effective in placating markets. This is evidenced not only by the strong equity returns, but also a relaxed bond market and the lackluster performance of traditional inflation hedges such as gold.



Source: Federal Reserve Bank of New York Liberty Street Economics and FRED

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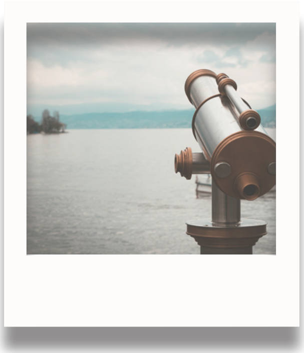
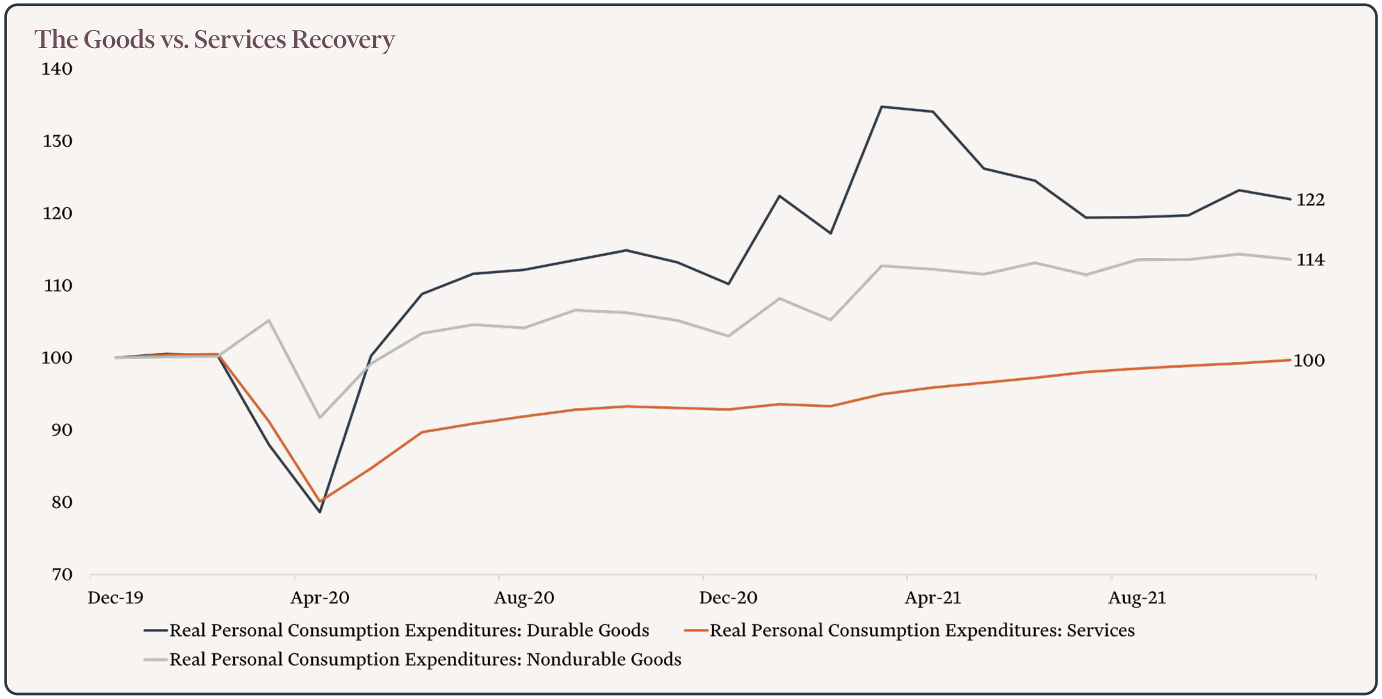
MOVING INTO 2022



With the virulence of Covid apparently subsiding even as transmission accelerates, we concentrate our investing efforts on the largest opportunities given the reshuffling of risks. The economic recovery sectors of the market, particularly those in the services sectors, stand to benefit from what will be a resumption of consumers spending less on goods and more on services and experiences. Goods production should accelerate in reaction to both higher prices and the loosening of supply chain disruptions as workers return to factories and ships are more quickly unloaded at the ports.

This should benefit the more cyclical sectors of the economy, and perhaps allow the closure of the performance gap between the growth and value sectors of the equity market. It can also lead to some performance catch up in international equities whose markets tend to be more heavily weighted to the cyclical sectors.



Source: FRED

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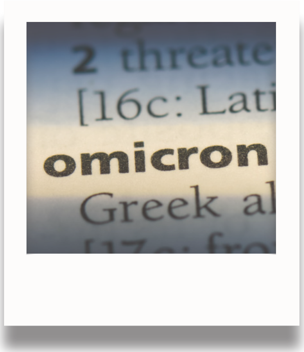
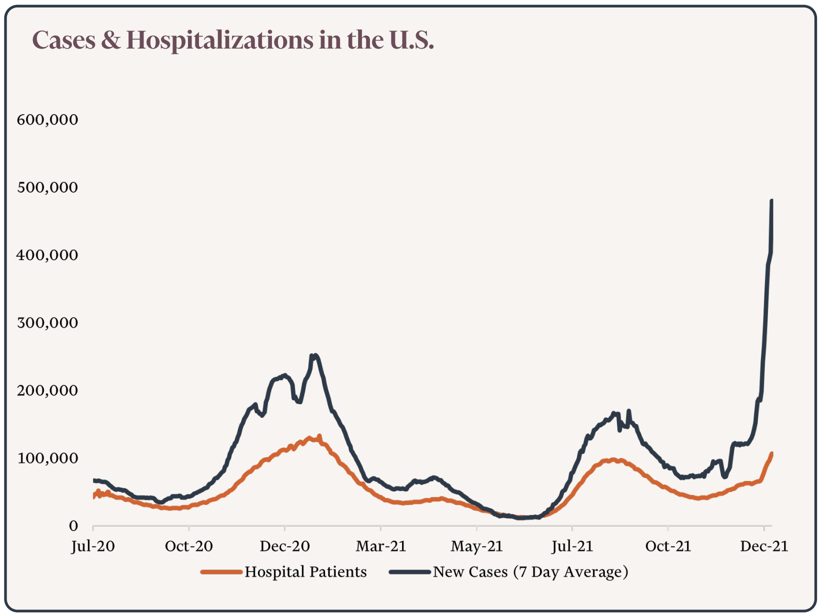
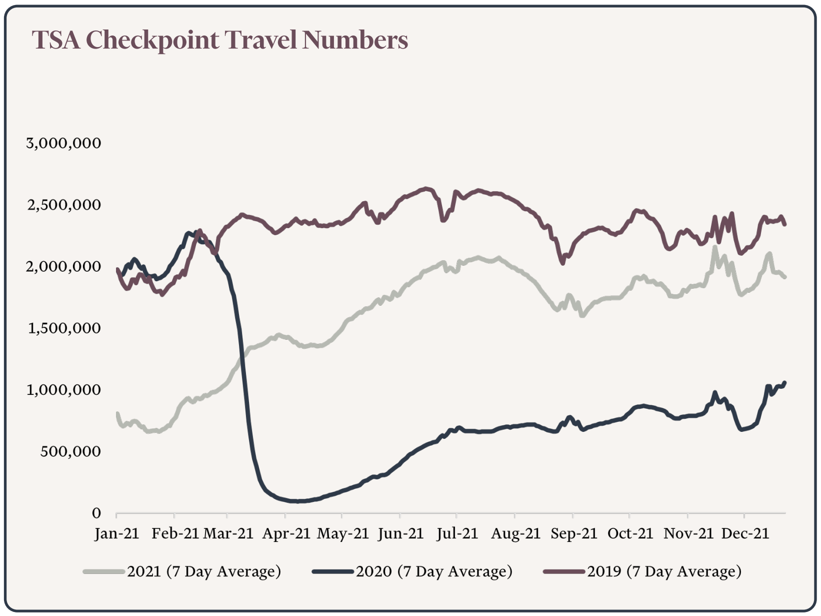
CONSUMPTION IN A PANDEMIC



The Omicron variant of Covid-19 caused some disruption to the year-end holiday season with the cancellation of many flights, cruises, shows, and sporting events. With case counts climbing rapidly at the beginning of 2022, it is best to analyze hospitalization rates to better predict the government and consumer response around the reimposition of restrictions and the hesitancy to buy certain services.

As a percentage of cases, hospitalizations at year-end dropped to their lowest level since the onset of the pandemic. There has been a slight downtick in TSA checkpoint numbers at the airports and Open Table reservations at the restaurants, but consumers appear to be trying to resume a level of normalcy in their purchases of services.





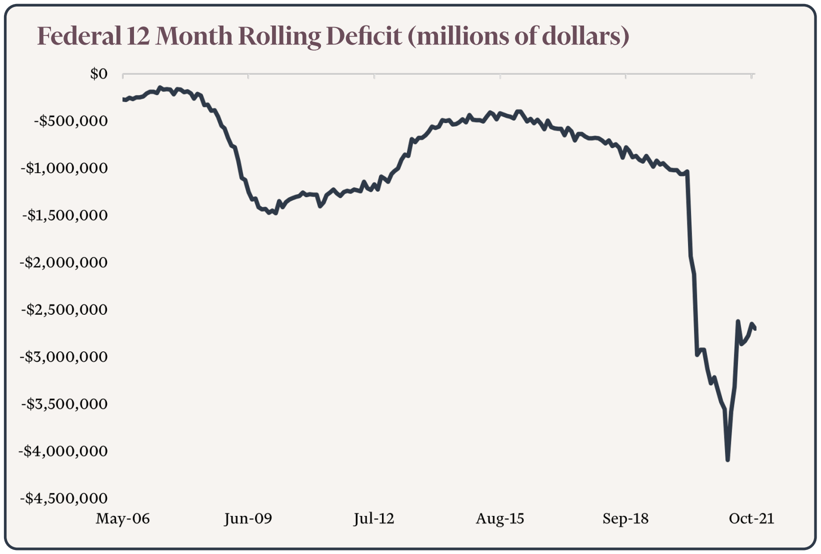
Source: Our World in Data, TSA

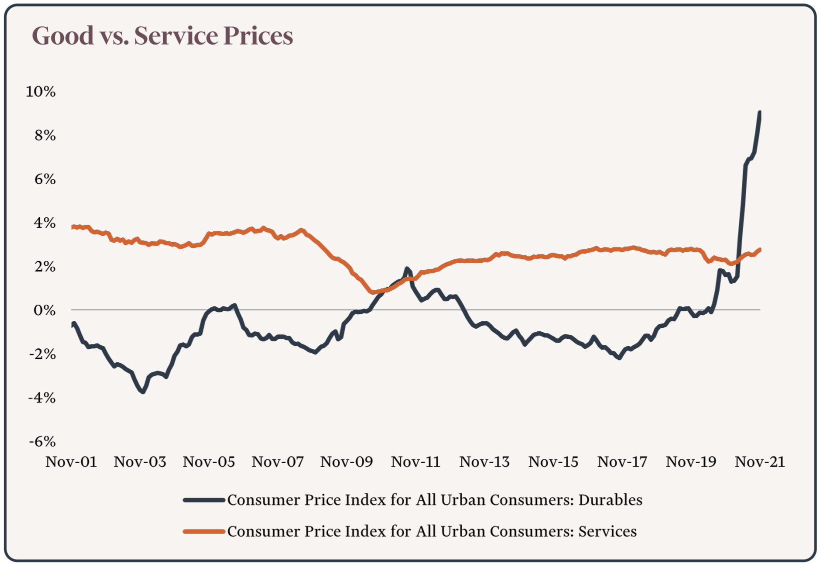
Despite the severity of the pandemic, U.S. consumer spending was supported by several government fiscal relief programs that replaced lost incomes and led to an explosion in the savings rate as consumers were unable to spend on certain services and items that were in short supply. With fiscal policy waning as a support, and savings rates back near the longer-term average, wage and salary income will take the baton from government relief programs driving healthy consumer spending in 2022.

The clogging of supply chains was arguably the biggest contributor to global inflation in 2021 as manufacturers were not able to sufficiently meet consumer demand. There are signs at the beginning of the new year that some of the supply chain issues are improving. However, expect the supply of both goods and services to continue to be sporadic in the early part of 2022. Material shortages tend to rectify themselves with price being the primary driver of incremental supply. Labor supply, on the other hand, may have been more permanently affected by an acceleration of retirements and a more permanent withdrawal from the labor force by members of the working age population.

Along with the apparent peak in supply chain disruption, inflation rates are likely in the process of peaking heading into the year. Inflation should remain high in the first few months of the year, but then decline towards 3% by year-end as the supply of goods catches up to more muted demand. The reason is that consumer purchases will likely skew more towards services and experiences in the travel/leisure space.

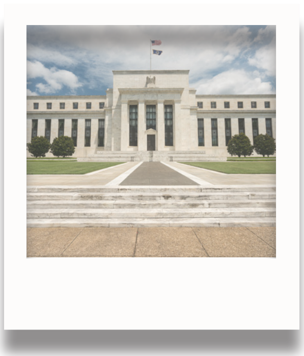
The outlook for energy prices, the most important commodity to both producers and consumers, is more of a wild card as supply continues to be artificially constrained by the OPEC+Russia cartel. Energy inflation is particularly acute in Europe as Russia has been holding back supply for largely geopolitical purposes. The potential for U.S. shale production to ramp up to take advantage of higher prices should limit any sharp upward spike in prices.





Source: FRED

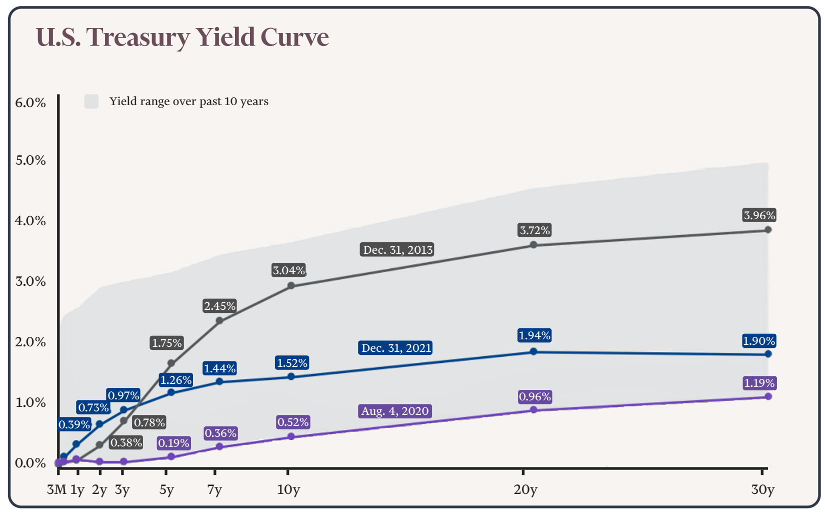
FED MAKES US A LITTLE LESS SMART



The Federal Reserve is beginning the process of incrementally tightening monetary policy and, to have more flexibility to increase rates should current inflation rates persist, was forced by the higher-than-expected inflation numbers to accelerate the end of the asset purchase program. The Fed and other developed market central banks understand their limited tools in addressing supply induced inflation. However, markets currently expect the Fed to begin increasing the benchmark fed funds rate in the summer which will lead to two to three 25 basis point rate hikes in 2022 with another two to three in 2023. A more "normalized" fed funds rate of 2.0%-2.50% would be achieved in 2024 which would effectively close the extremely negative real fed funds rate assuming inflation normalizes towards 2%-2.5% as well.

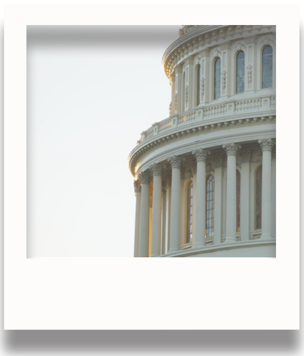
With the Fed apparently "behind the curve" in fighting incipient inflation, there is growing risk of a monetary policy error by tightening too quickly into an already subsiding inflation environment. A distinct flattening of the treasury yield curve over the last few months of 2021 reflects this risk although, in a sign of a still healthy economy, the yield curve is still comfortably positive going into the year.

Another potential tool the Fed could use between tapering asset purchases and outright rate increases would be to let the engorged portfolio of treasury notes run off the balance sheet which would buy more time to allow inflation to naturally decline as supply issues abate.

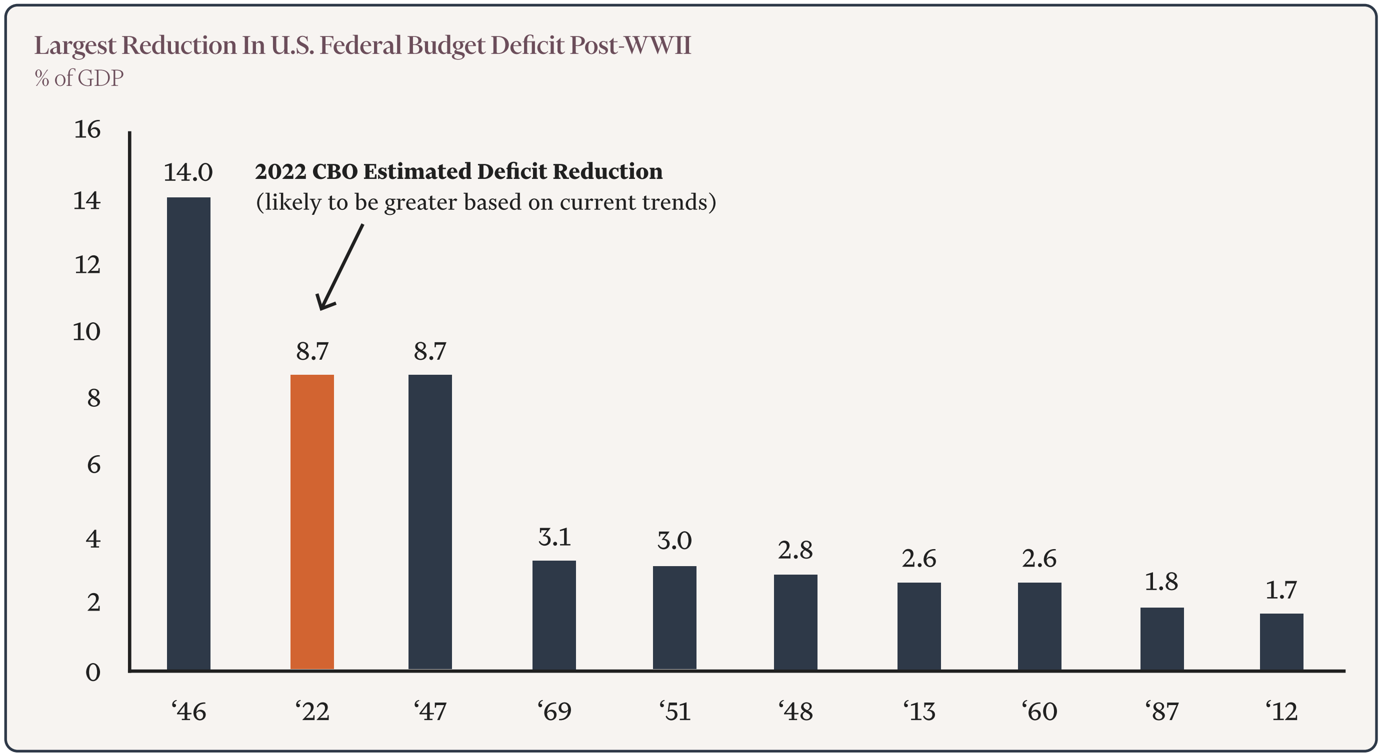


Source: JPM Guide to the Markets

FISCAL POLICY NOT A HEADWIND AS FEARED



Emergency fiscal relief spending should no longer be necessary to support consumer spending with the loss of that stimulus offset by increased jobs and wage growth. The fear that fiscal policy would turn notably contractionary is reduced by the intraparty dissonance exposed in the failure of Congress to pass the Build Back Better Act. While a scaled-back version of the package may be signed into law in 2022, it will no longer have the dangerous teeth of large corporate tax increases which would have called into question equity valuations and current corporate bond spreads.



Source: Strategas

BOND MARKETS

Central banks around the world will begin relaxing some of the extraordinary monetary ease, particularly the various longer maturity bond buying programs. But the era of financial repression which dominated most of this century, is likely to continue with benchmark rates remaining near zero in developed market economies for at least the next few years.

In the U.S., rates across the yield curve should rise given the strong economic growth forecasts and the incremental decrease in bond purchases by the Fed. Waning inflation rates and somewhat less bond issuance by the Treasury should limit the increase and prevent a spike higher in yields. Expect the 10-year treasury to be trading around 2.0% by year end 2022, a level that will entail some principal deterioration and another year of near zero returns in the investment grade bond markets.

Moving down the credit quality spectrum will enhance the yield earned on fixed income securities. Default rates should remain low in an economic expansion environment. However, this is fully reflected by the current record low interest rate spread on high yield bonds leaving little room for further spread compression to offset the expected rate increases. Better opportunities for yield enhancement exist in the illiquid private debt markets.

Source: Factset

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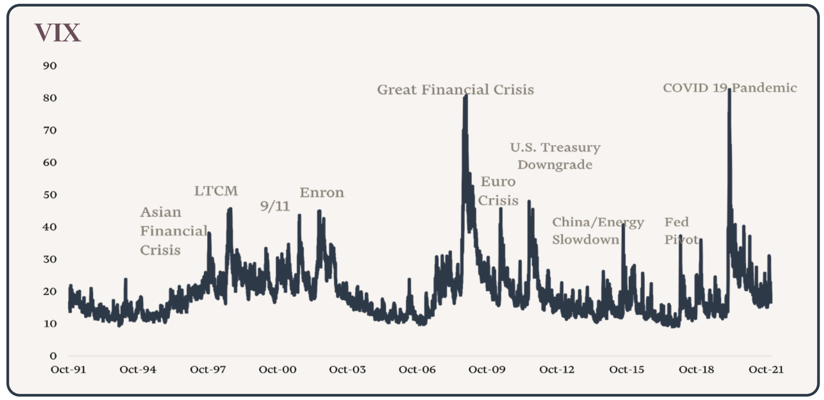
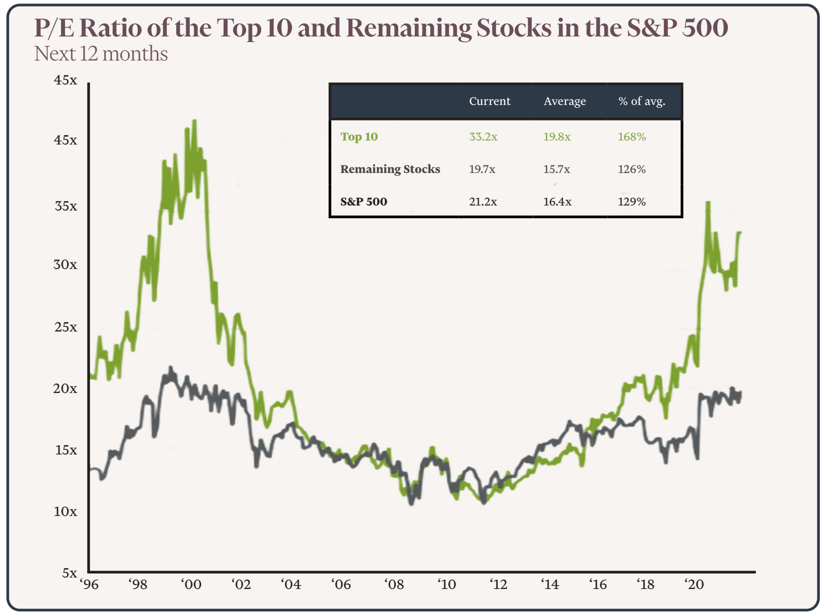
U.S. EQUITY MARKETS
CONTINUE TO EFFECTIVELY CLIMB THE WALL OF WORRY

A natural byproduct of the strong equity advance in 2021 was a notable decline in price volatility as market participants effectively shrugged off news on the Covid variants, global supply chain disruptions, and the resulting inflation while continuing to focus on the benefits of easy monetary and fiscal policies.

Equity markets tend to be more difficult to navigate when monetary policies become incrementally tighter so volatility should increase moving into 2022 with the heightened possibility of 10% price corrections which did not occur last year. Despite the increased risk, the fundamental backdrop of 3-4% GDP growth and roughly 8% earnings growth should be supportive of stock prices unless interest rates spike sharply higher.

Equity valuations are historically high, so it is difficult to forecast much more in the way of valuation multiple expansion. The markets will rely primarily on earnings growth to drive positive returns. Looking further beneath the broader market index levels and excluding the top ten constituents that have generated outsized gains, the average stock trades at more attractive valuations. With the expected transition of consumer spending from goods to services in the U.S. and the global economy finally coming out of the Covid recession, the cyclical sectors of the equity market should show relatively strong performance and help close the large gap that has developed between the growth and value styles of equity investing.

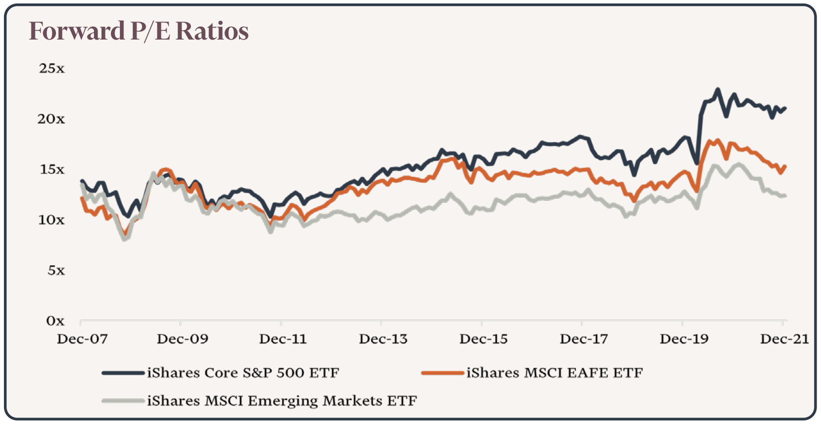




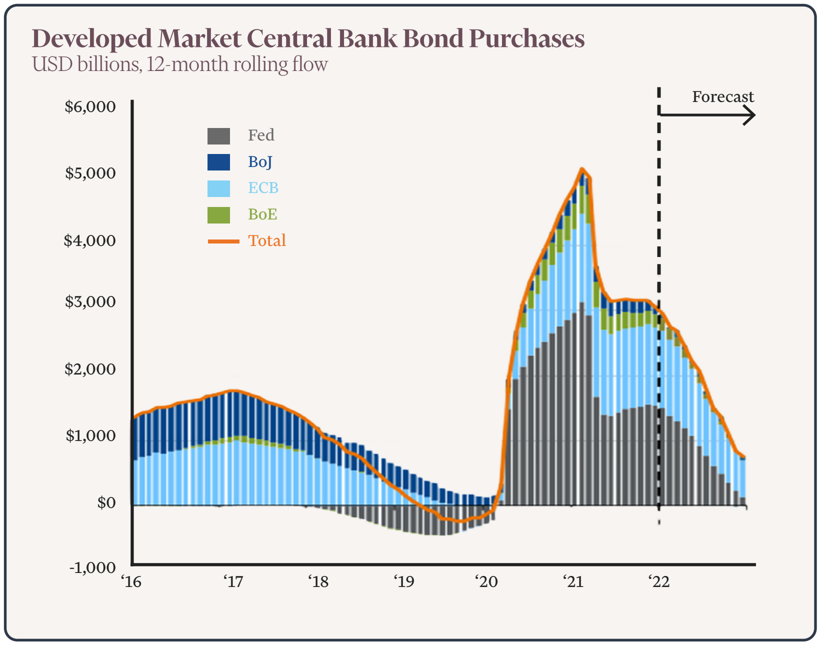
Source: Factset and JPM Guide to the Markets

INTERNATIONAL EQUITIES

Developed and emerging international equities underperformed their U.S. counterparts yet again in 2021 with the performance gap growing ever wider over the last ten years. The rationale for a meaningful valuation differential between the U.S. and most international markets can be explained by distinct differences in market structure.



U.S. equity markets are unique in their outsized weighting to large technology, consumer discretionary, and communications companies who have effectively grown both their markets and their respective shares of those markets. Given the outlook for less severe Covid restrictions and a general relaxation of supply chain bottlenecks, an economic reopening and cyclical rebound theme should help support overseas markets which tend to have a greater percentage of companies in the more cyclical industries. Another important support to international markets could be continued monetary ease at both the European Central Bank and Bank of Japan as inflation rates have not spiked up as high as they have in the US.



After being one of the best performing markets in 2020 as the country emerged early from the first Covid wave, Chinese equities, both on the mainland and in Hong Kong, performed rather miserably in 2021, effectively dragging down the returns of the Emerging Markets equities asset class. In addition to imposing more severe mobility restrictions on their population as subsequent Covid waves spread during the year, Chinese authorities also tightened regulations on some of their highly profitable industries as a key element of the national Common Prosperity program which ostensibly aims to reduce income and wealth inequality.

Source: Factset and JPM

The net result of these government-imposed restrictions was to further slow an economy whose growth had already been slowing prior to the pandemic. Given its sheer size, China will continue to play an important role on the global economic stage. The demographic challenges of slow population growth and the inclination towards strong government involvement in industry are likely to reduce their contribution to world economic growth over the coming years.

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