Outlook for February 2022

Key Market Drivers

- The Omicron variant of Covid-19, which slowed economic growth at the end of fourth quarter 2021, continues to impact the economy at the beginning of 2022 by provoking employee absenteeism, prolonging labor shortages, and restraining consumer demand for services, particularly within the travel and leisure/hospitality sectors. This comes at a time when goods demand is declining due to sharply higher prices of certain items and generally satisfied demand.
- With Omicron cases in the U.S. beginning to sharply recede following the patterns seen in South Africa and the UK, the transition of consumer spending from goods to services should resume by the end of the first quarter. Any lost output from delayed demand should be recovered in the second quarter allowing the economy to grow at roughly 4% for the entire year.
- As logistical constraints loosen with key ports unloading goods at a higher rate, and participants reentering the labor force to enhance production, inventories should be sufficiently rebuilt over the coming months. Some sectors the economy may see an element of overstocking which should lead to a notable decline in goods inflation as we approach the summer months. Higher services inflation will produce a somewhat offsetting effect. However, the relative lack of government fiscal stimulus payments should temper demand enough to allow the overall inflation rate to decline from current peak levels.
- More aggressive mobility restrictions in many overseas economies are likely to cause larger economic slowdowns in Europe and Japan. But we will not see a recession as these economies will benefit from the resumed economic reopening and higher U.S. demand for services, particularly global travel.
- The aspirational zero Covid approach adopted by the Chinese authorities is adding further pressure to an economy suffering from poor demographics, a trade war with the U.S., and regulatory policies which is meaningfully impacting the growth of some of their industry champions. Watch for the government to attempt to implement some expansionary policy initiatives to offset these effects.

Our Perspective

Equity Markets

- After a prolonged period of low volatility driven by extraordinary monetary ease implemented at the outset of the Covid-19 pandemic, equity market volatility has increased as the Fed begins to remove excessive stimulus and the emergency government transfer payments come to an end. The positive outlook for GDP and earnings per share growth should allow U.S. equities to produce returns commensurate with the 8% earnings growth expectations, unless interest rates spike higher which will negatively impact valuation multiples.
- Developed international equities should see slower earnings growth than their U.S. counterparts. But they will benefit from still easy monetary policy regimes which may allow multiples to expand and perhaps even lower some of the performance gap with U.S. equities that has developed over the past decade.

Outlook for February 2022

Our Perspective

Equity Markets *(continued)*

- After a very disappointing 2021 performance, emerging market equities have so far bucked the correction trend seen in many developed markets. They are flat through January. Higher commodity prices and Chinese policy ease are the likely drivers of this strong relative performance although geopolitical issues with Russia/Ukraine, China/Taiwan, the Iran nuclear deal, and North Korea missile development would take a heavier toll on these markets should any of these issues develop into a larger crisis.

Bond Markets

- Early this year, government bond yields rose notably across most maturities due to heightened expectations the Fed would have to accelerate the end of bond purchases and increase the Fed funds rate as inflation has been higher and more persistent than originally forecast. Given our strong economic outlook and incrementally fewer central bank purchases, we expect bond yields to continue their rise. However, a receding inflation rate and less treasury issuance should prevent a sharp spike higher. Our year-end forecast for the 10-year treasury remains at 2.0%.
- The yield curve, particularly the closely followed spread between the two- and ten-year treasury rate, has flattened a bit but remains comfortably positive. Any further flattening and move towards inversion would be a potential sign of a monetary policy error where the Fed is tightening too aggressively with an increased risk of recession. However, this is not reflected by widening credit spreads in neither the investment grade nor lower quality corporate bond markets. This gives us further confidence that the risk of recession is currently very low.
- Emerging markets debt is also impacted by higher inflation and rising rates. China's credit struggles have provided an additional element of risk that may be offsetting the favorable impact of rising commodity prices in other areas of this market.

Monetary Policies & Currencies

- The U.S. Federal Reserve has given clear signals that they will end emergency bond buying by March and that same month will begin increasing the Fed funds rate in 25 basis point increments. More uncertain is the frequency of rate increases this year and the approach to letting its bloated balance sheet run off through maturities and principal repayments on their mortgage-backed securities.
- With inflation set to naturally recede over the coming months, the Fed will try not to tighten too aggressively into an already slowing economy. Look for two to three additional 25 bps rate increases after the March meeting and a clear announcement around the process to be implemented regarding the balance sheet.
- Through rate increases and less bond buying, the Bank of England will also begin to implement a measure of monetary tightening. However, continued economic pressures from the sloppy exit from the European Union should temper the relative magnitude of these tightening moves. A much slower economic recovery in continental Europe and Japan will keep both the European Central Bank and Bank of Japan on hold at current policy rates for the rest of the year unless inflation moves even higher and proves surprisingly stubborn.

Outlook for February 2022

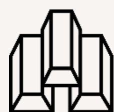
Our Perspective

Monetary Policies & Currencies *(continued)*

» The Peoples Bank of China (PBOC) has more rate flexibility than the developed market central banks as they are comfortably higher than the zero bound. Going slightly against the grain of most central banks around the world, the PBOC implemented small rate decreases and targeted lending facilities to partially offset the effect of recent regulatory and mobility constraints. They are likely to continue to implement these tools if economic growth falls short of their goals.

» Relative economic growth rates, a higher absolute level of interest rates, and an incrementally tighter monetary policy continue to favor the dollar against most other currencies despite the current inflationary environment in the U.S. One exception is the Chinese renminbi which benefits from higher rates and greater government control. Expect the dollar to be flat at current levels over the coming months as the Fed ultimately tightens less than current expectations.

Commodities



» Continued surprising capital discipline, whether self-imposed or dictated by the markets, has prevented U.S. shale producers from reasserting their role as energy swing producers taking advantage of the spike higher seen in global energy prices. This reticence may embolden the OPEC+Russia cartel to maintain its own production discipline, although near $90 WTI crude should begin to precipitate enhanced U.S. shale drilling activity.

» Gold prices have fallen into a narrow trading range as the Fed will be raising short-term interest rates multiple times this year. The eventual "normalization" of inflation and interest rates will make a non-interest-bearing asset like gold relatively less attractive.

What This Means for Investors

» Supply chain bottlenecks and inflation are likely in the process of peaking. Their improvements will only be gradual throughout this year. The Fed will have to react to current inflationary pressures, but it will also continue to manage its message to prevent making a policy error by tightening too aggressively into an already slowing economy. Consumers and businesses have strong balance sheets and should drive above trend economic growth which should lead to reasonable returns in the equity markets this year given the recent pullback to more attractive levels.

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