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Capital Markets Outlook
1Q 2022

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Summary

Outlook

- Global growth will likely continue to be robust to start 2022 but may fade as tighter fiscal and monetary policies take hold later in the year.
- COVID-19 will continue to have a large impact on prices. Supply chain constraints and domestic labor availability will keep prices elevated. Above trend inflation will probably continue before decreasing in the second half of 2022.
- Yields are expected to gradually move higher but will still remain low by historical measures.
- There is no playbook for the restart of economic activity after a virus-induced recession. While we expect solid equity returns, market volatility may increase as the dynamics of economic growth, inflation, and policy decisions change.

Risks

- Tighter monetary is expected but could shock markets more than expected if the Fed's becomes more hawkish.
- Another COVID-19 variant could delay economic growth. The nature of a virus having such a large impact on the economy increases the range of possible outcomes.

Fourth Quarter Review

The markets in 2021 were defined by the strength of economic reopening and earnings growth vs. concerns about inflation and the Fed's reaction to the changing environment. Of course, these dynamics were in addition to the uncertainty caused by COVID-19 variants. Returns for the year were generally strong, though the fourth quarter was dominated by US large cap stocks.

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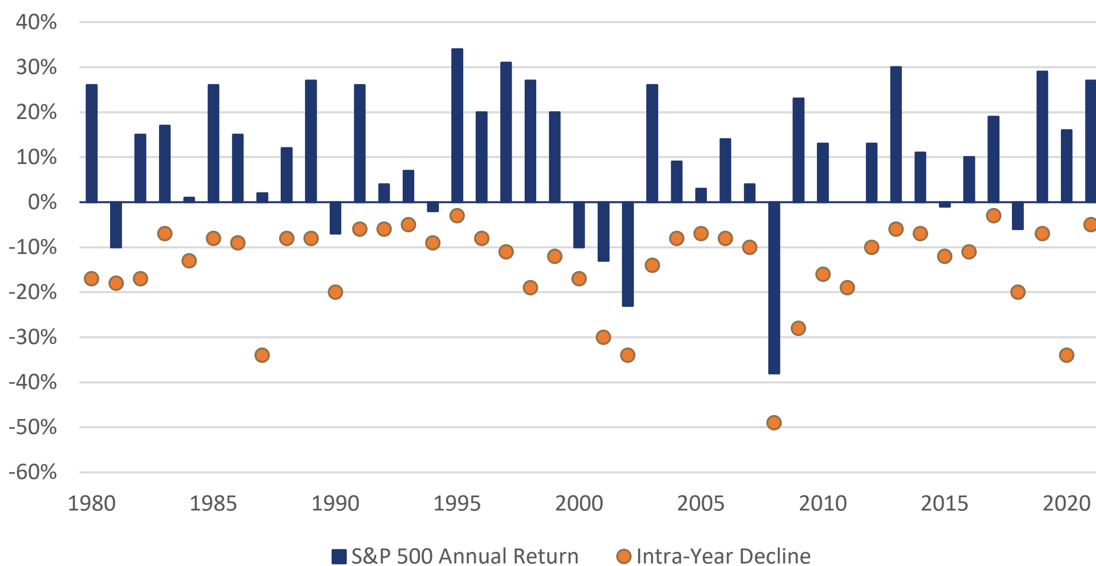
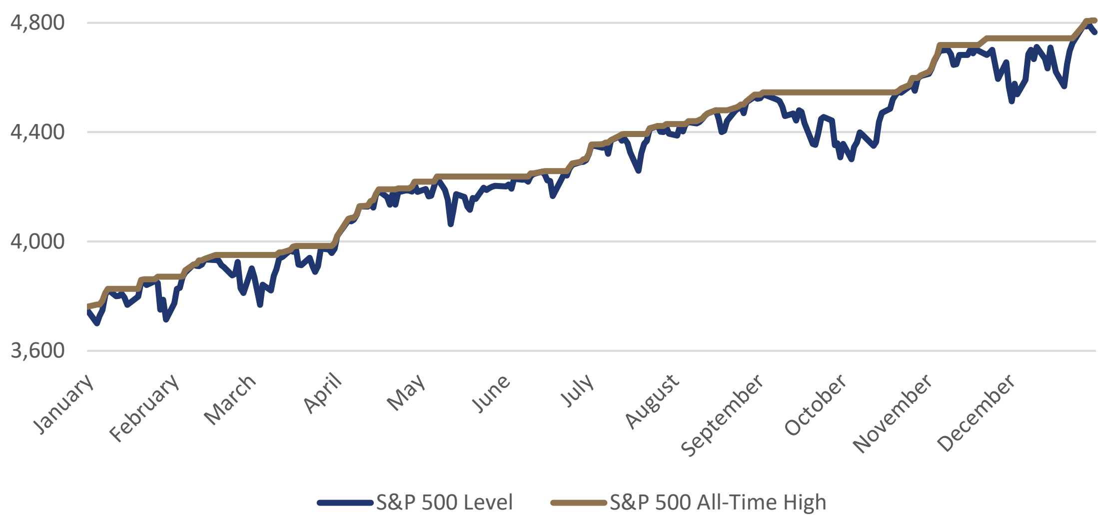
Asset Class	4Q 2021	2021
US Large Cap	9.8%	28.7%
US Small Cap	0.4%	14.8%
International	2.5%	8.3%
US Bonds	-0.3%	-1.5%
US High Yield	0.7%	5.28%

After a 10% fourth quarter, US stocks saw a third consecutive year of strong gains. Perhaps the most surprising part of 2021 was the lack of volatility. The average drawdown in a calendar year for the S&P 500 is 14%. However, the largest drawdown of 2021 was only 5%.

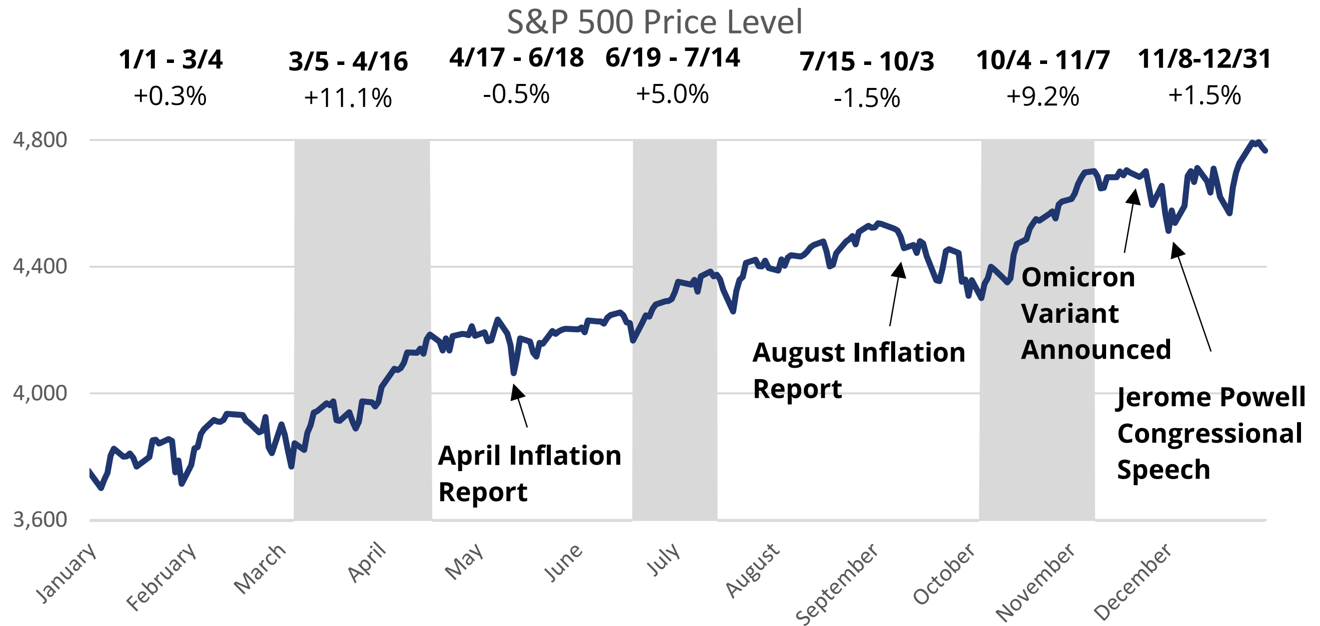


Further highlighting the persistent returns of the S&P 500 – in 2021 there were 75 new all-time highs, a number in market history that is only eclipsed by the mid-1990s.



Source: YCharts

The movement of the S&P followed a distinct pattern. Strong upward price movements around earnings season were interrupted by news of inflation and COVID-19. When the Federal Reserve unveiled plans to accelerate monetary policy tightening in 2022, large cap stocks continued to climb.

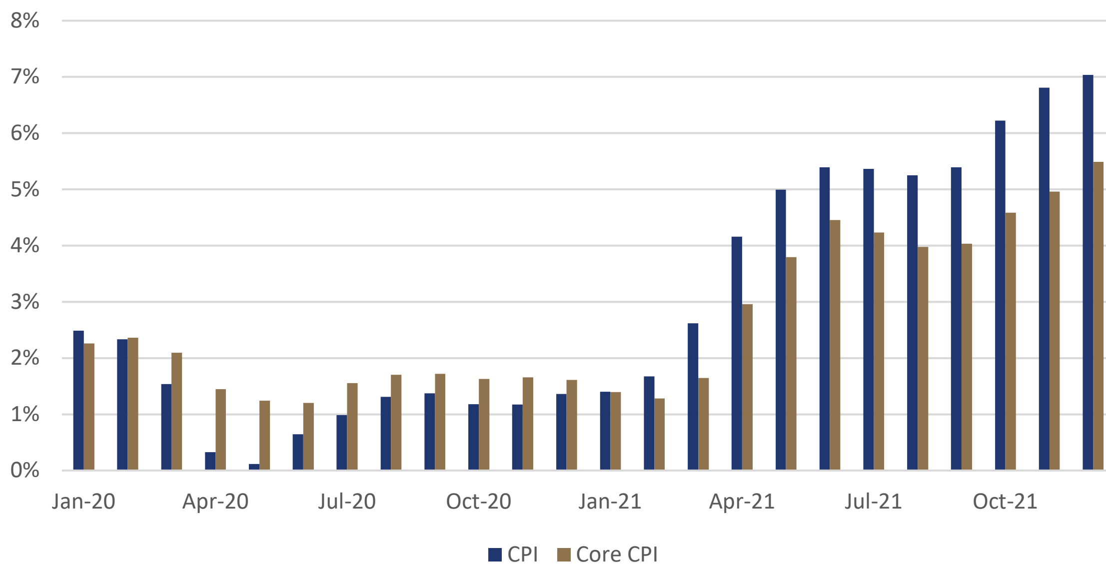


Source: YCharts

Economic Update

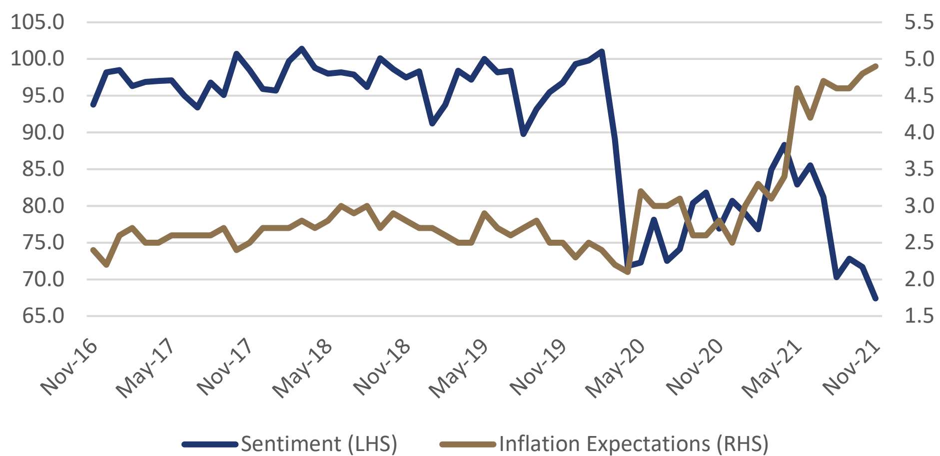
The COVID-19 pandemic was the dominant driver of the global economy the past two years and it looks set to continue the trend at the start of 2022. While it is not new for the pandemic to dominate the near-term outlook, the way it is likely to impact the global economy has changed over time. In its initial stages, COVID-19 was a demand shock. Economic activity halted as people were forced to stay home. Subsequently, the combination of fiscal and monetary responses provided support for household incomes and allowed the economy to reopen and increase demand.

Entering 2022, the pandemic has become a supply shock. Global supply chains have proven more fragile than expected and business have struggled to source raw materials and other important inputs. Inflation has increased to levels well above the original consensus estimates and has also been more persistent than predicted.



Source: YCharts

As inflation pressures got more intense the more persistent nature of price increases eventually had an impact on consumer expectations.



Source: Federal Reserve Economic Data (FRED)

The composition of price increases leads us to believe that inflation will moderate in the second half of 2022. The US economy is typically dominated by services but goods inflation has been the main catalyst to increasing prices. During the height of the pandemic, services became more difficult to consume – people could not go get a haircut or fly on a plane. It was much easier to stay at home and make purchases online. As the economy continues to reopen and demand shifts back to services, supply chains should be able to recover and allow prices to moderate.

CPI Category	Category Weight	November 2021 YoY CPI	Pre-Pandemic YoY CPI Avg.
Services	58%	+3.4%	+2.8%
Goods	21%	+9.4%	+0.01%
Food	14%	+6.1%	+2.3%
Energy	7%	+33.3%	+4.3%

Source: BLS

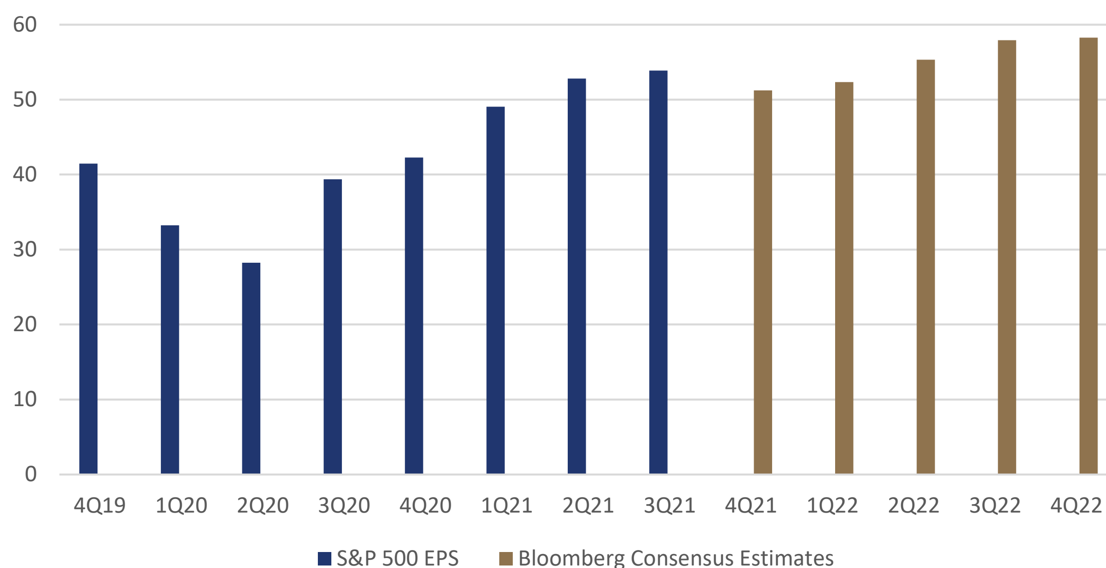
The Fed has responded by moving up plans for balance sheet tapering and rate increases. At the start of 2020, the base case was the Fed would not begin tapering. Since then, the Fed has moved up the tapering timeline, accelerated the pace of tapering, then further increased the pace in addition to projecting a rate hike in March this year.

Asset Class Update

Equities

A recovering supply chain could benefit equities but also have a moderating effect on upside potential. Last quarter, we discussed the record number of positive earnings surprises being a boost to stock prices. Earnings surprises, whether positive or negative, are more likely when uncertainty is high. If inflation moderates and COVID-19 cases decline, there will be less uncertainty in the market which could limit returns relative to 2021.

Going forward, earnings expectations are expected to level off after a rapid recovery from the pandemic lows last year.



Source: Bloomberg

What remains to be seen is how much investors will be willing to pay for those earnings. Valuations remain elevated though they have already come down from recent highs due to strong earnings growth. If earnings growth does moderate it could lead to slower equity returns. However, the growth outlook is still strong and continued low interest rates are supportive of equity returns.

Valuation Measure	**Trailing P/E**
12/31/21	25
Average Last 5 Years	23
Pre-Pandemic (2/21/20)	21
Pre-Pandemic 5 Year Average	20
Average Last 10 Years	20

Source: AllianceBernstein

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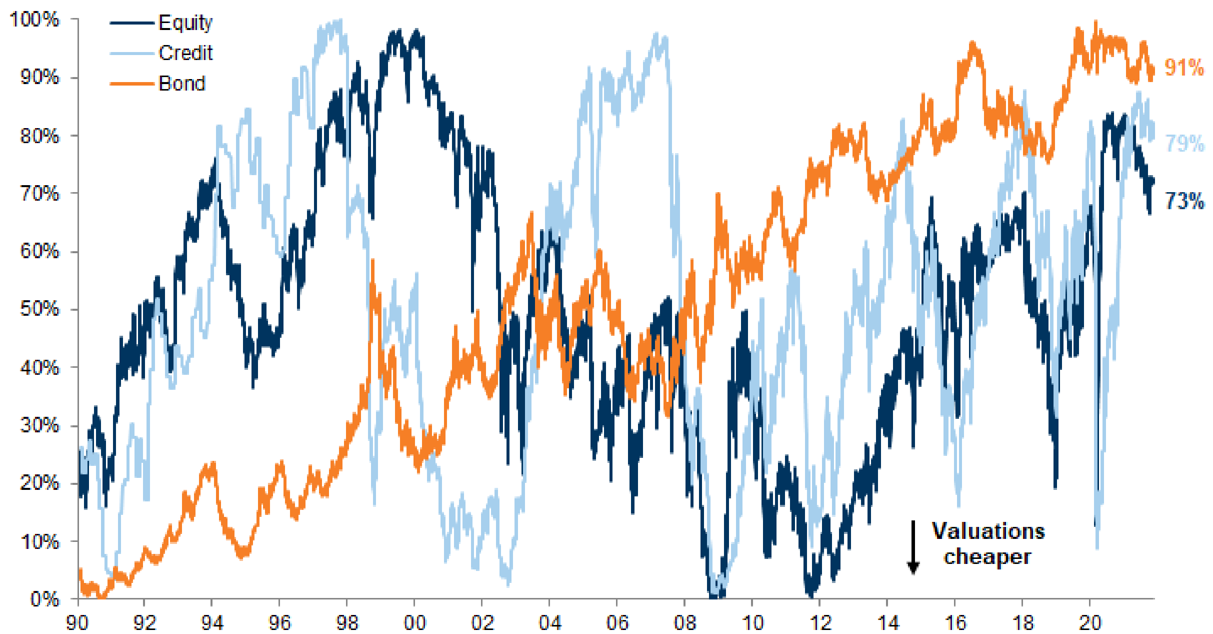
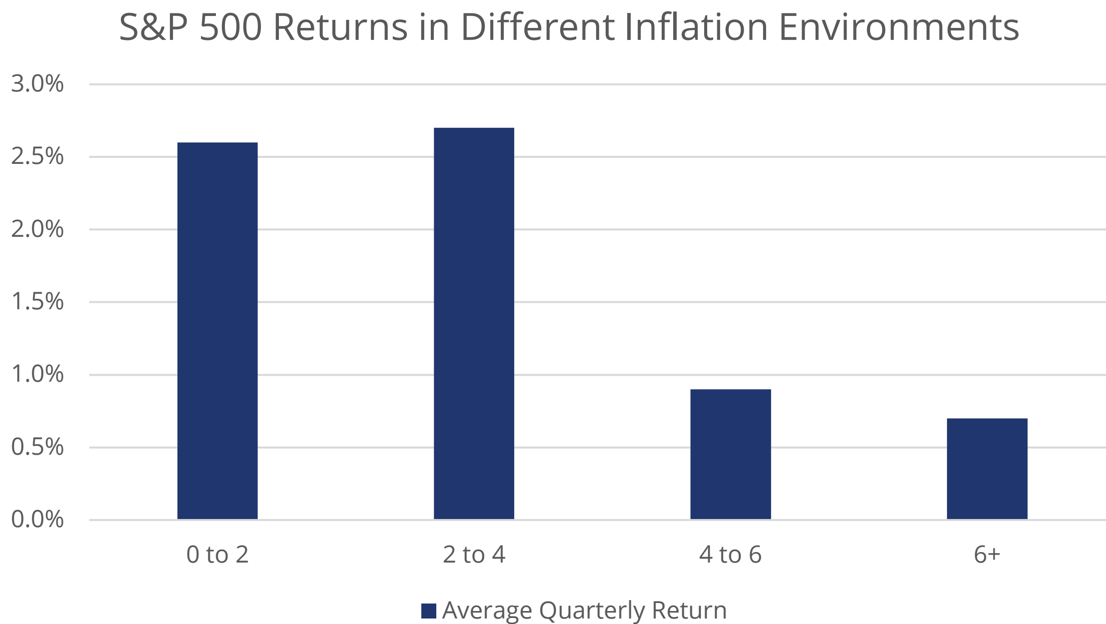
Although stock market valuation is higher than long-term averages, relative to other asset classes it is more favorable. Asset prices recovered extremely quickly from the COVID-19 crisis compared to other bear markets such as the Tech Bubble and the Great Financial Crisis. This recovery has led to high valuations across asset classes, but equities stand out as the best value.

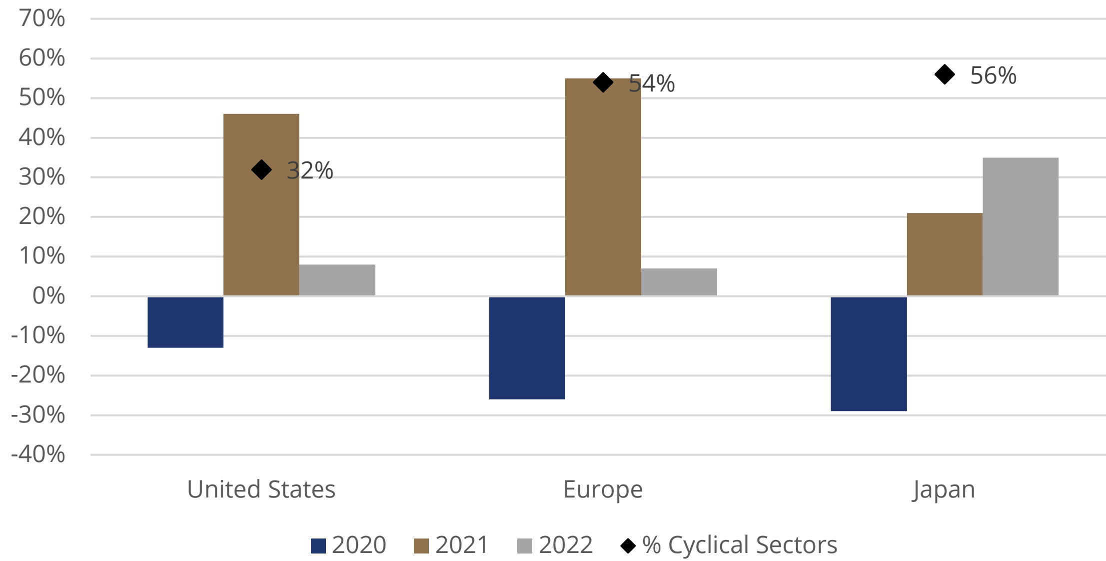


Source: Datastream, I/B/E/S, Goldman Sachs Global Investment Research

Another positive for equities is that they tend to do well when inflation rises. If price increases do moderate and come down below 4%, that has historically been an attractive environment.

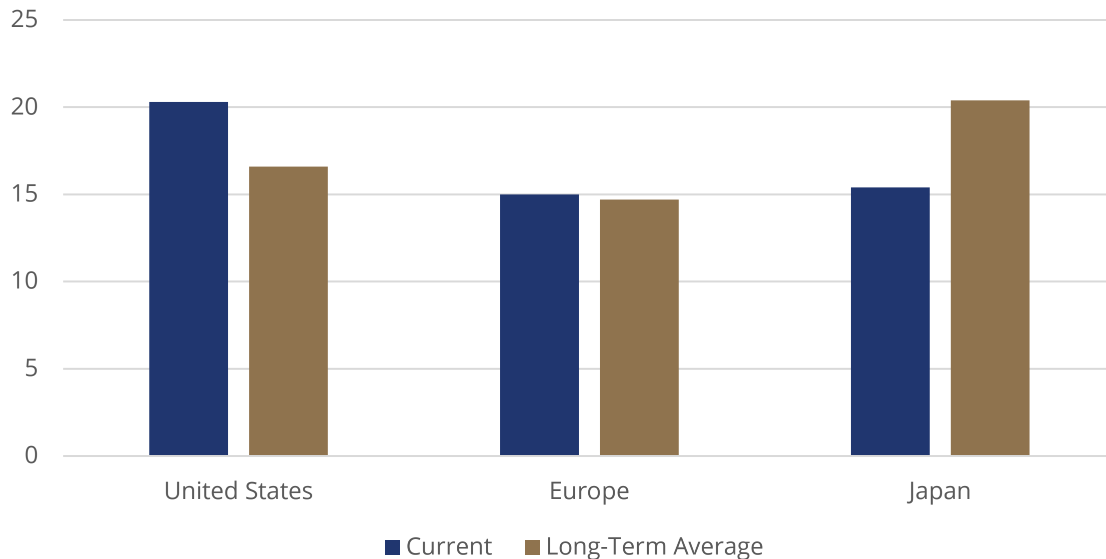


Much like in the United States, a broader recovery from the pandemic has allowed economies and corporate profits to resume growth. Stocks in Europe and Japan have had strong rebounds in earnings. Additionally, international equities have a larger percentage of cyclical sector companies, which have been more sensitive to the economic rebound from the pandemic.



Source: JPMorgan Asset Management

Valuations in international equities are also more attractive compared to the United States.



Source: JPMorgan Asset Management

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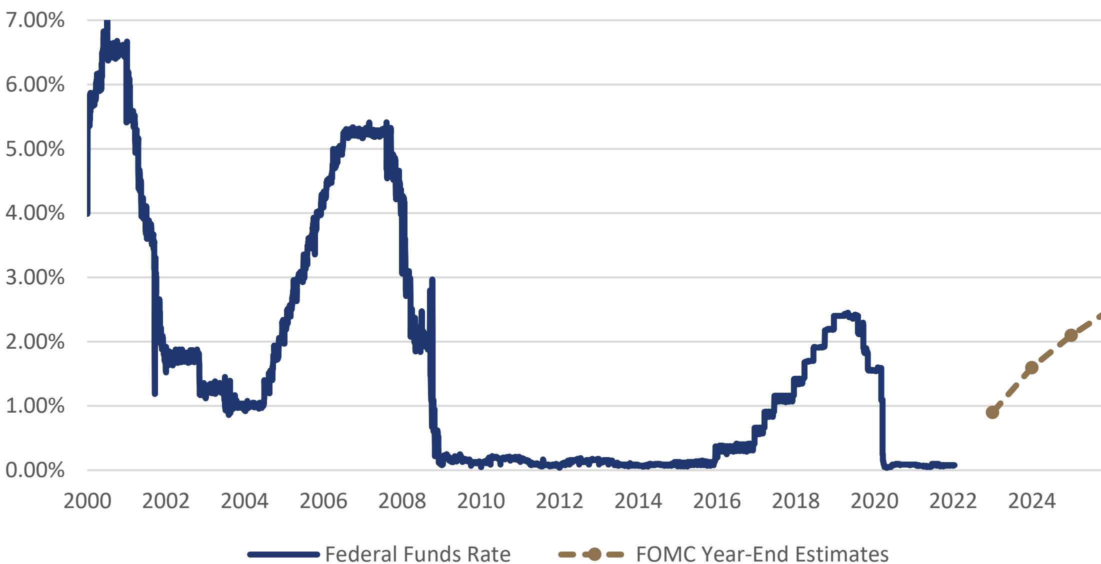
Fixed Income

2022 is likely to be a more challenging year for fixed income compared to equities. Inflation, fiscal and monetary tightening, and rising rates are all significant headwinds for bond returns. Central bankers have determined that the risk of inflation is greater than the risk of economic slowdown and are therefore tightening monetary policy. In the US, the Federal Reserve accelerated its tapering of QE and is now headed toward rate hikes as soon as March. In our view, the increased likelihood of rising rates diminishes the attractiveness of government bonds. They will continue to play a role as a portfolio ballast during market volatility but are unlikely to produce strong returns.



Source: Federal Reserve Bank of St. Louis

Investment grade and high yield corporate bonds have higher income opportunities, though they carry more risk than government bonds. However, the economic recovery has allowed corporate fixed income to remain relatively attractive. Although spreads are tight, fundamentals are very strong. Default rates are low, balance sheet leverage has been improving, and cash positions are increasing. These factors do justify some of the low yields in corporate debt.

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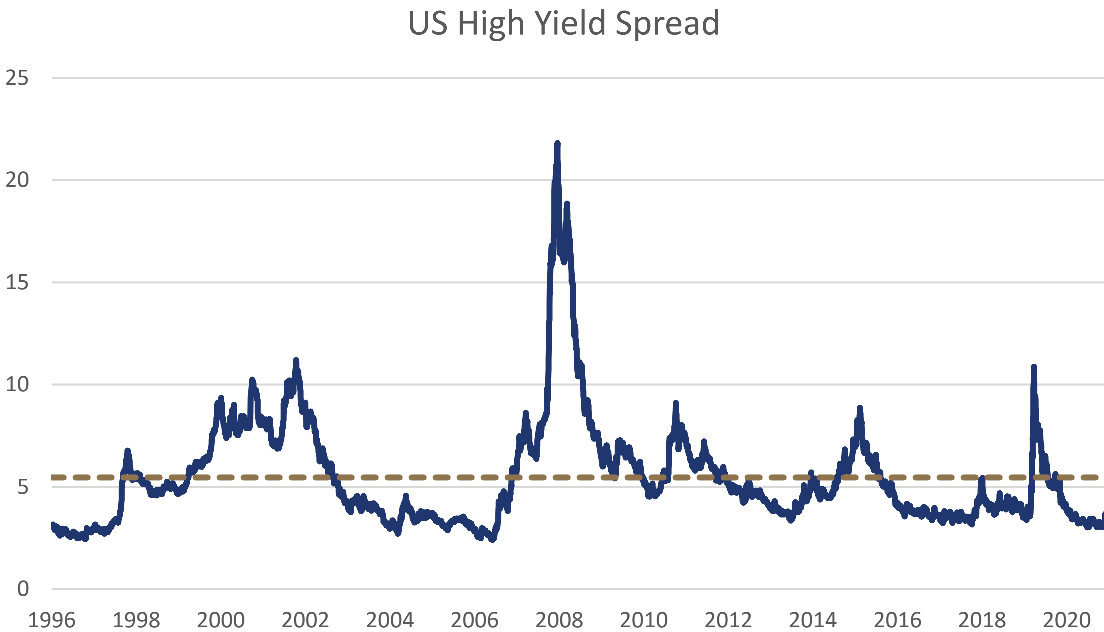

Source: YCharts

Conclusion

The start of 2022 continues to carry the risk and uncertainty of COVID-19. If additional surges do have an impact, economic growth may be delayed but is unlikely to be completely derailed. Monetary and fiscal support will de dialed down, largely because they have helped boost a historically rapid economic and market recovery from recession. We expect growth to remain strong and continue to favor stocks over bonds on a relative basis. We will continue to monitor trends that we believe could impact your portfolios, such as the pace of the recovery, earnings growth, valuation, and inflation. Our goal is always to be efficient and selective in portfolio construction to best position clients for success.

If you have any questions, please don't hesitate to reach out to your Academy Financial advisor.

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