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GLOBAL INVESTMENTS

10 Predictions for 2022

Tug of war between earnings tailwinds and valuation headwinds

10 PREDICTIONS

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2021 Review

Equities have enjoyed strong gains since the pandemic low of 2020, aided by massive monetary and fiscal stimulus, excess consumer savings, and incredibly negative real policy rates and bond yields. 2021 experienced amazing earnings growth, which powered equities higher offset only slightly by rising inflation and interest rates. In fact, earnings expectations exceeded beginning of the year estimates by a record amount as corporate revenue growth and profit margins exceeded expectations. COVID variants entered the mix at a few points, creating some volatility and style rotation. Although it was a tug of war, growth beat value, large beat small, and the U.S. beat non-U.S. equities. Treasury yields ironically reached their high for the year in March (1.75% for 10-year Treasury) and cyclical stocks beat defensive stocks handily.

Risk taking was heavily incentivized by extreme monetary and fiscal reflation. For example, meme stocks captured headlines several times during the year as short squeezes created significant upside in some stocks with little overall market impact. These types of activities were amplified because consumers enjoyed record (more than $2 trillion) excess savings created by government transfer payments and reduced consumption in some COVID-impacted industries.

During the year, one of the most noteworthy developments was a substantial rise in inflation from the less than 2% annual rate that existed for about a decade to nearly 7%, the highest in about 40 years. Belatedly, the Fed admitted that inflation was not transitory and has accelerated its recently announced tapering program, preparing the way for rate hikes in 2022. Policymakers acted as if the economic cycle was fragile and ready to fall into recession even though the threat of deflation had long since ended.

Given these developments, 2022 will likely be more challenging for investors, as the Fed and other central banks progressively unwind accommodative policy in response to the ongoing economic recovery/expansion and elevated inflation readings. While economic and earnings growth are likely to be good, a “too-high” inflation backdrop and rising real interest rates suggest less favorable and more volatile conditions for investors than have prevailed since the pandemic lows.

With this backdrop I proceed as usual with fear and trepidation (and hopefully some good educated guesses) to unveil my prognostications for 2022 in the form of my 10 Predictions.

10 PREDICTIONS

10 Predictions for 2022

1. U.S. real growth and inflation remain above-trend but decline from 2021 levels.
2. Inflation falls, but core inflation remains stuck at around 3%.
3. For the first time since 1958/1959, 10-year Treasuries provide a second consecutive year of negative returns.
4. Stocks experience their first 10% correction since the pandemic and fail to make the gains widely expected.
5. Cyclical, value, and small stocks outperform defensive, growth, and large stocks.
6. Financials and energy outperform utilities and communication services.
7. International stocks outperform the U.S. for only the second year in the last decade.
8. Values-based investing continues to gain share.
9. After a 60+ year low in 2021, federal interest expense as a percentage of revenue begins a long-term move higher.
10. Republicans gain at least 20-25 House seats and barely win the Senate.

Conclusion

Our view is that the equity market is in a tug of war between a good earnings tailwind and a modest valuation headwind. Despite a positive earnings picture, the overall macro backdrop will become less favorable for the equity market in 2022. The Fed's recent tapering announcement, initiation, and acceleration mark the beginning of a shift towards a less accommodative monetary policy stance along with reduced fiscal stimulus. The combination of elevated market valuations, revenue and earnings growth losing steam, and rising bond yields point to a more challenging year with more frequent pullbacks and higher volatility. Valuation will be of paramount importance in positioning equity portfolios. We believe that it makes sense to lean modestly in favor of cyclicals.

2022 is shaping up to be more challenging ... creating more volatility and ... churning

It will be difficult for companies to sustain their year-end 2021 level of profitability as revenue growth slows in the coming quarters. That said, some of the headwinds to margins from moderating top-line growth could be offset by declining shipping and raw materials input costs, as bottlenecks begin to gradually ease in response to stepped-up efforts by policymakers to resolve logistical logjams. Sectors with relatively higher labor intensity and/or facing heightened competitive pressures will remain at greater risk of margin compression. However, a significant erosion in aggregate net profit margins is unlikely if nominal economic growth remains moderately strong and keeps corporate revenues expanding at a healthy pace.

Sovereign bond yields will likely rise in 2022, triggering losses on government bonds. Decent economic growth should enable credit to outperform government bonds. Interest rate differentials may provide some short-term support for the U.S. dollar, with a shift to foreign currencies as economic and earnings momentum shifts overseas. Geopolitical uncertainties will likely raise their ugly heads amid the absence of leadership in Europe, an increasingly assertive China, and a weakened U.S. administration.

In sum, 2022 is shaping up to be more challenging for investors, as central banks progressively unwind unprecedented monetary accommodation in response to ongoing economic recovery and expansion and elevated inflation pressures. While solid economic and earnings growth will be a tailwind for equities, rising interest rates and stubborn inflation will be headwinds. This is likely to create volatility and, at times, turbulent churning. This is why I propose the theme of "Tug of War Between Earnings Tailwinds and Valuation Headwinds" for 2022.

