Strengthening Our Clients' Financial Lives

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FROM THE DESK OF BOB CENTRELLA, CFA **January 10, 2022**

2022 OUTLOOK LETTER

Happy New Year and wishing you all a healthy, prosperous, and blessed 2022! Last year our motto was "Let's get it done in 21". This year I'm going for "Get Rid of the Flu in 22!" Humorist writer Dave Barry noted that the one positive we can say about 2021 was that it was marginally better than 2020. He then says "Another improvement was that most stores got rid of those one-way anti-covid arrows on the floor. Remember those, from 2020? You'd be halfway down a supermarket aisle, and you'd realize that you'd gone past the Cheez-Its but you couldn't turn around and go back because you'd be going AGAINST THE ARROWS, which meant YOU WOULD GET COVID." Not to make light of last year as there was much hardship to endure and like every year it had many lows but there were highs too.

One high for 2021 was the stock market. The economic recovery that began after the hard lockdowns of early 2020 ended, continued in 2021. The unprecedented fiscal and monetary support that was rapidly applied early in the pandemic was further aided by December 2020's $900 billion and March 2021's $1.9 trillion fiscal packages. This, coupled with the vaccine rollout, helped surging economic activity produce better-than-expected profit growth throughout 2021. This led the S&P 500 stock index to 70 record highs in 2021 and a total return for the year of 28.7%, the 7th highest in the last 50 years. That follows 18.4% in 2020 and 31.5% in 2019. Stocks have doubled in 3 years! On the flip side, the healthy economic readings also led to underperformance from high-quality bonds with the Barclays Bond Aggregate Index losing 1.5% for the year. Can this performance overall be repeated in 2022? Read on for our take.

Below is a table with 22 asset class price returns for 2021.

ASSET CLASS	RETURN %	ASSET CLASS	RETURN %
Ethereum	452.5%	Euro Stoxx	20.4
Coffee	76.3	Dow Jones Ind Avg	18.7
Bitcoin	59.8	German DAX	15.8
Nymex crude	55.01	Russell 2000	13.7
Nat Gas	46.9	Nikkei 225	4.9
DJ REIT	41.6	iShares Muni Bond	-.78
France CAC	28.9	Comex Gold	-3.5
S&P 500 (total rtn)	28.7	Vang Total Bond	-3.9
Nasdaq 100	26.6	US 7-10 Treas Bd	-4.1
S&P Small Cap 600	25.27	Euro	-6.9
S&P Midcap 400	23.21	Turkish Lira	-44.2

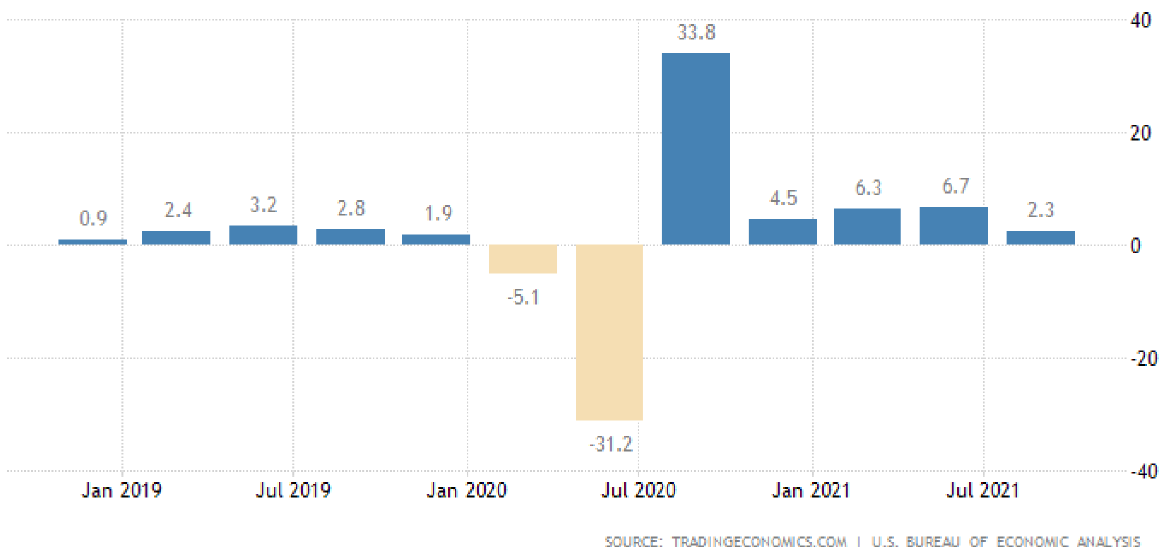
Capitalization and Style Benchmarks: The Russell 1000 Growth (31.2%) outperformed the Russell 1000 Value (23.5%) for the fifth consecutive year, and for the 11th time in the last 15 years. Midcap Value (28.3%) outperformed Growth (12.7%). In the small cap arena, the Russell 2000 Value (28.3%) beat the Russell 2000 Growth (2.8%) by 25.4%, the second-biggest spread on record.

Sector Analysis: All sectors finished the year with double-digit gains for the first time since 1995. Sector leadership leaned cyclical with Energy (+47.7%), Real Estate (+42.5%), and Technology (+33.4%) and Financials (32.6%) the top four performing sectors in 2021. Meanwhile, two defensive sectors were major laggards with Utilities (+14%) and Consumer Staples (+15.6%) the worst, while cyclical Industrials (+19.4) also underperformed on the year.

As we head into 2022, let's look at some key issues one by one and analyze potential outcomes.

1. Covid is likely here to stay but should hopefully have less influence on our lives after the Omicron wave. However, as I said last year, Covid still remains the biggest risk to the economy and financial markets. There are still too many unknowns with changing rules and wasteful mandates, but expectations are that covid spikes in coming weeks.

2. Looking at the big picture, US GDP was strong overall. GDP growth for the 4th quarter is expected to rise 5.2% which would bring full year GDP to about 5% as well. This was much better than expected in 2021 compared to a 3.7% forecast by most economists at the beginning of the year. The chart below shows GDP from 2019 thru Q3-21.



Looking into 2022, the Omicron variant or any other emergence of Covid remains a wildcard but the first two quarters are forecasted to rise 4.5% and 3.4% with a full year estimate of between 3.8% to 4.2% based on economists. This will be driven by a strong capex cycle, increased inventory building as the supply chain issues start to get better thereby reducing the demand imbalance.

3. Corporate profit growth had a record year in 2021 and should finish with a gain of 45% or more. As a result, even though S&P 500 stocks rose about 27%, the market has gotten slightly cheaper with a forward PE ratio of 21x compared to 22.8x at the start of the year. This is still ahead of the 5-yr average of 18.5x and the 10-year of 16.6x. For 2022, earnings are currently expected to grow around 9-10% which is a huge deceleration but still potentially in double digits. Revenue growth for 2021 may finish at 15.8% which would be the highest rate since this was tracked starting in 2008. The 5-yr and 10-yr average rates are 6.5% and 3.5%. Revenue growth in 2022 is estimated at around 7.5%. Q4 earnings season starts this week and we will get initial corporate outlooks.

4. The Federal Reserve has indicated that at least three rate hikes are expected in 2022 as it battles inflation. Whether it does more or less is debatable. The initial move in markets as a result has been a rise on bond yields as the 10-yr UST yield has moved to around 1.77% from 1.515% at year-end. Still, this looks mild in the face of inflation of 6%+. Real rates are still significantly negative. Investors seem to be recalling that in 2018 when the Fed embarked on a rate hike campaign the market corrected almost 20%. Below is a chart of the Fed Funds Rate the last 25 years.

Fed Funds Rate in % the last 25 Years

5. The rise in rates has caused selling and a vicious rotation out of high growth tech and into value cyclical and financial stocks as the year starts. I believe this move to value could broaden the market breadth and be a positive for stocks. Performance last year was very concentrated although many sectors did well. **For the S&P, of the 27% gain, 12% of that was due to 6 stocks** (Apple, Microsoft, Google, Tesla, Nvidia and Facebook). For 2022, broader participation would be a positive and allow for less reliance on the "big boys". Apple briefly became a $3 trillion company, Microsoft is at $2.5 trillion, Google and Amazon near $2 Trillion and Facebook (Meta) near $1 Trillion. Those 5 companies are larger than many countries GDP (and dominate our social loves).

6. Equally important, Federal Reserve money stimulus is going to be subsiding as the Fed tapers its bond purchases removing trillions of stimuli from the economy. It may also begin to reduce its $9 Trillion balance sheet which would drain liquidity and tighten financial conditions. Easy money has certainly been good for stocks.

7. Further government fiscal stimulus is also unlikely as BBBB (Biden's Build Back Better) plan to increase entitlements and taxes is (hopefully) stuck in limbo. It's still possible that a scaled back version can get passed but it would be surprising if Democrats would vote for tax hikes in an election year. Although, if they feel that they are going to get clobbered in the mid-term elections, then what do they have to lose anyway? Stay tuned. Regardless, this reduced stimulus could help lower inflation but also be a headwind for the economy.

8. Speaking of inflation, we now know it is not transitory as that word was dropped from the Fed's vernacular. Rising prices are everywhere – just go to the store or out to eat. The supply chain issue must be resolved but it's looking more like it won't fully resolve until 2023. Labor shortages due to both Covid and a smaller workforce continue to be a problem. The low unemployment rate of 3.9% is largely due to fewer people in the workforce but who are getting paid more. Payrolls are 3.6 million below where they were in February 2020 pre-covid. Overall, however, the labor market is healing and healthy. We just need more workers! That is the single biggest complaint of most businesses.

BONDS

The Barclays Aggregate Bond index returned -2.2% in 2021 and returns may be negative again in 2022. If the 10-year UST rises to over 2% then we could see some money moving over to bonds. If the Fed does indeed raise rates and the economy still grows above 3%, then it would seem only natural that bond yields finally will move higher. Higher yields equal lower prices. A 75-basis point (.75%) move up in yield on the 10-year will result in a 6.6% loss in price. This could finally be the reset year in bond yields that we've been waiting for. However, it would take sustained rate increases to get the bond yield to 3% where equities would be negatively affected. That could be a 2023 event if the Fed were to continue raising rates. Overall, we see a trading range with the 10-yr yield in a 1.5% to 2.25% range, ending the year at

or above 2%. Covid or a flight to safety geopolitical event remain the usual wildcards. We favor high yield, convertible, floating rate and short-term bonds but otherwise see negative bond returns as rates rise.

EQUITIES

We believe that equity prices will track profit growth this year. Last year, we saw outsized profit growth of 45% compared to an estimated 22% when the year started, ergo, huge stock gains. Still, the market is cheaper than it was 12 months ago even after a 27% gain. With corporate profits currently expected to gain 9-10% in 2022, it is more likely that they will come in above 10% as analysts are more conservative in the beginning of the year. But you also must factor in interest rates as a rise in rates could cause some PE multiple compression. (This is happening right now.) So, our base case and highest probability is that life continues to return to normal, corporate profits rise 10% to 13% and with some multiple compression stocks can return near 10%. Our negative case (and lower probability) is that inflation remains stubborn, the Fed raises rates more aggressively and GDP growth is slower than expected. We still see positive profit growth but more like mid-single digit growth which would be a negative surprise. In this instance stocks could be flat to down. Finally, the most bearish scenario involves Covid and inflation being much worse than expected causing more labor shortages and lockdowns. Initially markets could decline significantly but eventually bounce back as things improved. We assign a low probability to this but it's a possibility.

In terms of styles, we favor a blended portfolio of Value stocks and Growth-at-a-Reasonable-Price (GARP). In a rising rate environment, expensive Growth stocks are seeing PE multiple contraction as a headwind while cheaper stocks paying dividends are more attractive. For sectors we like cyclicals such as Financials and Energy but still think core Technology companies will provide strong profit growth and should be owned. Healthcare and consumer companies can offer some defensive characteristics during volatile trading. Select Industrial and Material companies should round out the diversified portfolio. Small and midcaps may underperform large caps while rates move higher but value shares should prevail here as well.

International stocks may be a mixed bag. On the positive side, the region has more room for catch-up growth than the US. The world economy is expected to grow above 4% in 2022. That's a positive and above the 3.5% average for the last 30 years. If Covid abates, consumption of services and travel should pick up. Major central banks are still expected to be accommodative with another $1 trillion in balance sheet expansion. But it may have to decide what to do about inflation and may also start to consider when to raise rates and lessen stimulus. But right now, this is seen as a 2023 event. Rising US rates are not good for emerging markets. Developed markets in Europe and Japan are likely to do and cope better. China's growth is expected to slow to 5.5% with some downside risk.

FINAL THOUGHTS

As the world moves on from the pandemic, 2022 is likely to be characterized by somewhat slower but still solid economic growth, higher inflation, elevated volatility, and ultimately outperformance of equities over bonds. But in this uncertain environment, proper diversification and active management remain key to improve portfolio performance. We would have cash available for buying opportunities that we may get during volatile periods.

We are entering the January corporate earnings season. I'm anxious to hear how companies did in the 4th quarter and what 2022 Outlooks are to start the new year. Perhaps some buying opportunities will develop. Have a great 2022 and let's talk in the coming month for an update.

Bob