Q1 2022 Outlook, January 5, 2022
Traub Capital Management

Another Year Coming Up

Well, we are starting a new year with people wondering what to expect.

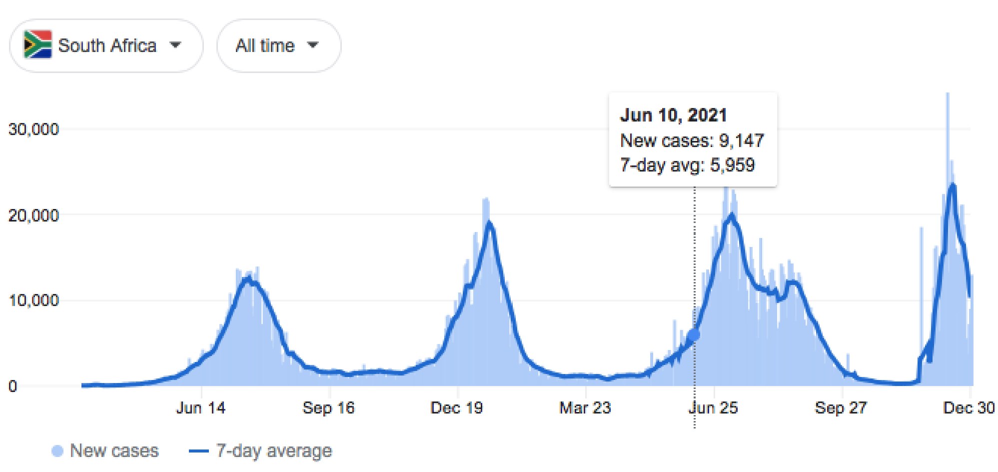
If you are one of the those wondering, here is a spoiler: the market returns in 2022 are not going to be as good as they were in 2021. The details follow below, but let's first look at 2021 to get our foundation. For bonds, our forecast last year was for consistently higher interest rates across the board, but with no enormous jumps. We thought rates would be a bit higher than they actually turned out, but the difference was not material.

The opening value of the S&P 500 was 3,756. Our equity forecast here a year ago included the observation that the consensus forecast of other forecasters was for the year to close with the S&P 500 at a value of 4,102. By contrast, here is a quotation from our outlook from January 2021: "Our take is that the year-end value for the S&P will be higher than the consensus and that a value of 4,200 is not unrealistic." Even though we were substantially below the actual year-end closing value of 4,766, we do take some solace in being closer than most other forecasts that were made at the beginning of the year. Our record of being closer to actual than the consensus goes back each of the last few years. With that background, let's look at where we are now and where the markets are likely to go.

Coronavirus

The Coronavirus seems to be confounding <u>all</u> of "the experts" most of whom are professional epidemiologists with specialties in and entire careers spent in the realm of Public Health. Even just a few months ago, the world's vaccination program was going along well and the overall numbers of cases were down dramatically as were the number of reported virus mutations.

The Omicron mutation, as are virtually all of the reported coronavirus mutations, is a result of random chance. The chance could have gone the other way, but it didn't. So, the world is suffering through another major increase in infection rates. All accounts of the severity of the virus point to it being much more contagious than the Delta mutation, but considerably less lethal than either the original strain or the Delta strain. The Omicron mutation was first discovered in South Africa. Here is a chart of their daily cases:



The spike that begins in late November 2020 is the Omicron spike. Our Omicron spike in the US started a month behind. The telling sign is the very sharp increase in the infection rate in South Africa followed by a very sharp decline. Experts in this country are projecting a similar picture here, with a peak in late January or early February. These projections are widely known, and Wall Street seems to be taking the whole Omicron mutation in stride as if there is no surprise or uncertainty here.

Corporate earnings remain strong and it looks like investors are looking beyond the recent spike to what would appear to be a decline in the virus pandemic. Even though the Coronavirus continues to take a devastating toll on thousands of people's personal lives, the markets are looking at other variables - generally those that affect those earnings. So, let's look at these below.

Economic Outlook

The US economy rebounded sharply from the pandemic lows. By the second quarter of 2021, the domestic GDP had already matched the high point reached in the fourth quarter of 2019. That overall performance continues to build steam. Calendar year 2021 real GDP finished up 1.8% from 2019 and up 5.8% from 2020. Growth should add another 4.5% for 2022 over 2021 and yet another 3.3% for 2023 over 2022.

We do not, however, believe that the growth will be smooth. What we are seeing is different than a smooth growth pattern. Rather, the economy will follow a pattern of successive overshoots and undershoots as corporations adjust to the severe economic shock of the economic reopening in the summer of 2020.

At the reopening, businesses discovered they did not have enough inventory. Shortages of raw materials resulted in large increases in commodity prices. As demand continued to exceed supply, we then started to experience shortages in shipping and delivery resources as well as shortages of intermediate parts like computer chips.

Suppliers of raw materials, shipping resources and intermediate parts responded and the supply constraints in these items are now easing. The number of containers handled through the Port of Los Angeles declined in November by 11% compared to October and more than 20% since reaching its high last May. Commodity prices across the board are retreating from their highs. Stories of queues for unloading container ships have subsided. The Post Office, UPS and FedEx all were able to handle the shipping volumes for this past holiday period without major issues.

For most of 2022, we expect to see businesses realize they have enough of the things they need and scale back a bit. The scale back will ripple through the economy until very late in 2022 when businesses discover they have scaled back too much, and their inventories are down and need to be rebuilt. Eventually this cycle of oversupply, undersupply will dampen out, but it will take well into 2023 for that to be the case.

Meanwhile, through at least the first nine months of 2022, we will see modest economic growth and newspaper stories will abound with doom and gloom extrapolations as various parts of the economy experience overshoot and undershoot. The continued oscillation will mask the positive underlying trend that will not start to become clear until late in the year and the main economic increases for 2022 will likely be in the later part of the year.

The overall economy, however, is not the only thing that impacts the stock market. Variables such as corporate earnings, interest rates, inflation and uncertainty are a few of the other variables that will weigh in. Let us look at these in turn.

Inflation

As we have said in these Outlooks many times, the inflation we have seen in 2021 is not "transitory." Once all the data is in, we expect inflation for the full year 2021 to hit 4% for a year-to-year comparison. We expect the quarterly inflation rate to hit over 6% when the price increases seen in the fourth quarter are annualized.

Inflation is not coming back to levels under 2% anytime in the forecast horizon. However, it will be back to 4% by the end of 2022 and show further modest declines in 2023. We expect it will level out at a bit over 3%. This is a long way from actual deflation seen for one quarter in mid-2020. However, the "steady-state" value of 3.1% is a long way from the average inflation of 1.8% in 2019 and 1.2% overall seen in 2020.

The Federal Reserve was willing to tolerate inflation in 2021 at a rate over 2% because that offset the more modest rates in 2019 and 2020. However a steady-state value of a bit over 3% is a long way from the goal of the Federal Reserve, which is 2%.

Interest Rates

The Fed has finally opened its eyes here and is beginning to react. We believe that the Fed will make the first substantive increase in the Federal Funds rate in March. This increase will bring the Federal Funds rate from well under 0.1% up to 0.3%. Successive increases throughout 2022 will bring the rate to just about 1% by year-end and on its way to 2% by the end of 2023.

Other longer-term rates will show increases as well, keeping the yield curve positively sloped. We believe the 10-year rate will increase from its present rate of 1.5% to about 2.4% by the end of 2022 and on its way to over 3% by the end of 2023.

Interest rates, and the 10-year interest rate in particular, are inversely related to the stock market's overall Price to Earnings (P/E) ratio. With the 10-year interest rate below 1.5%, a P/E ratio over 21 times was justified. With the increase in the 10-year rate, that P/E ratio will come down and it will come down in 2022.

Uncertainty

The fluctuating economic cycle through the first nine months of 2022 will keep uncertainty higher than usual. Higher uncertainty results in lower stock prices. Adding to the uncertainty will be the run up to the mid-term Congressional elections. During that run-up, the fate of Biden's "Build Back Better" will be decided and there will be a lot of noise about Roe v. Wade and the Supreme Court.

Nobody knows what parts, if any, of the "Build Back Better" plan may actually get implemented into law and Roe v. Wade is very emotional on all sides. These issues will add to the overall battles with China, with the Coronavirus, with the environment, etc. and will serve to keep uncertainty elevated.

We expect that as we near the Congressional Elections that uncertainty will subside. We take no side in the red – blue debates, but we do believe that there is a very good chance that come November, that there will be a change in either or both of the President's very slim margin in the House and even slimmer margin in the Senate. Once a political divide is established at the Federal level, it will be clear that nothing of substance will be accomplished on Capitol Hill and uncertainty will be reduced. At the same time, the path to higher interest rates will be established, reducing uncertainty on that variable as well.

Corporate Earnings

Corporate earnings will be good, but the growth in those earnings will slow. The S&P 500 operating earnings totaled $164.73 in 2018, 166.32 in 2019 and declined to $144.51 in 2020. In 2021, those earnings should recover to $210 and increase further to $235 in 2022. Our forecast of earnings in 2022 is a bit above the consensus as noted below. However, that forecast of notably higher earnings is already built into today's stock market prices.

For 2023, we forecast earnings of $256. This is an increase of 9% over our forecast of corporate earnings for 2022. Whether you believe our forecast or the consensus forecast noted below, it is clear that the overall earnings gains are slowing. With slower overall growth, it will be possible to overload that gain to later in the year, which is what we expect. Corporate earnings will be modest in the first three quarters of 2022 and most of their overall gain will be delayed until the final quarter.

Consensus Forecast

In looking at a forecast of the stock market, it is illuminating to look at the consensus of forecasters. It is rare that the stock market does what "everyone" thinks it will do, since it will have already reacted to "what everyone thinks" and the value today reflects what everyone thinks is going to happen tomorrow (the next 6-12 months).

The most recent issue of FactSet's Earnings Insights has the consensus expectation of all professional analysts. That publication shows the consensus earnings for 2022 to be $223 (our forecast is $235). The consensus P/E ratio based on those earnings is 21.4x (4766/223). Our P/E ratio is 4766/235 or 20.3.

Compared to the consensus, we think the earnings forecast is too low, but the valuation is too high. The analyst's consensus is for an increase on the S&P 500 of 12.8% over today's level or 5,376. We believe this estimate is too high. We believe that during the first nine months of 2022, we will see a basically flat valuation with variations up and down depending on the headline of the month – be it bullish or bearish and we will see both kinds. In the fourth quarter, earnings will improve, uncertainty will come down and the uncertainty in interest rates will subside. These factors will allow the market to move higher. However, the gain will be considerably less than we saw in 2021 or 2020, or in 2019 for that matter.

Conclusion

We believe that a year-end value for the S&P 500 will be 5,120 or a gain of about 7%. That forecast is based on an earnings forecast of $256 (for 2023) and a decline in the market P/E ratio to 20x. (256 x 20= 5,120).

Most every analyst expects the market gain to be above 8% but less than 15%. The market, however, rarely does what most people are expecting. People are not expecting lower than 8% nor higher than 15%. We believe a gain exceeding 15% is unlikely given the high returns in the past three years and the decline in overall fundamentals. On, the other hand, we are comfortable with a forecast that is below the consensus.

Forecast aside, what does that mean for portfolio holdings? The answer is no substantial change. We love seeing double-digit gains, but earning an overall 7% gain on equity is just fine. The important thing is to avoid a big loss. We just do not see any big loss on the horizon with the economy continuing to improve and uncertainty declining.

For bonds, the forecasting game is a bit easier, but the results are not as encouraging. With interest rates going up across the board, the overall return on bonds will likely be negative. A negative bond return projection does beg the question whether we should reduce our bond allocations while increasing portfolio weightings to equities. However, we don't think that is the right decision for now.

First, we have more confidence in our long-term investment plans, allocations, and forecasts. Over the long-run, stocks will outperform bonds but with more risk. Therefore, we think it's appropriate to have bond exposure to provide stability in returns for clients and that is appreciated during large declines in the stock market. For some clients who are more conservative and/or can't stomach large fluctuations in their portfolio we may have the majority of their portfolio in bonds. But even for less conservative clients, bonds provide a kind of insurance portfolio, so you have something in your portfolio that doesn't go down in a stock market meltdown.

Second, the forecast for bonds is based on the Bloomberg Barclays US Aggregate Bond Index ("the Agg"). This is an index of traditional investment-grade bonds that trade in the US. We believe we can provide a bond portfolio that will not have a negative return in 2022, as was the case in 2021. In 2021, "the Agg" had a negative 1% return, but our bond portfolios were positive for the year. We did this by investing substantially in other areas of the bond market given our concern that bond yields would rise in 2021. We incorporated things like convertible bonds, floating-rate bonds, emerging market bonds, closed-end bond funds, and importantly last year, TIPS, whose maturity values increase with inflation rates.

Assuming we can provide positive bond returns this year as in 2021, the return gap between overall stocks and our bond portfolios will be fairly modest.

As always, we appreciate the continuing confidence you have shown in Traub Capital and look forward to continuing to work with you in the coming years.