

2022 Market Outlook –What should investors be thinking about?

Jack Janasiewicz, Lead Portfolio Strategist, Natixis Investment Managers, Solutions

Introduction

With global equity markets on track to post a 20% return in the year of “Peak Everything”, many market participants are predictably ratcheting back their return expectations for the year ahead. That’s right, it’s “Cautiously Optimistic” season and strategists up and down the street are rolling out their typical 5-7% return forecasts – the average return that everyone always expects yet never seems to arrive year after year. You won’t hear those sentiments around here. **To be sure, 2022 looks to be full of uncertainty and shifts as the global economy continues to normalize from the initial COVID shock nearly 2 years ago, but growth is set to remain robust** and will likely keep powering markets up that ever-growing Wall of Worry.

Global Growth

Let’s start with the growth backdrop. The defining characteristic of the recovery has been a persistent underappreciation of economic and earnings growth. Quarter after quarter some of the largest and most heavily followed companies have shattered expectations while economic growth surprised to the upside. Even as investors braced for a disappointing 3Q21 earnings season name after name cited managing **rising cost pressures and supply chain disruptions that were more than offset by robust top line growth. Not the dreaded margin compression investors broadly feared.** And with those strong earnings came strong guidance and a growing sense of peak supply chain disruptions. Expect more of the same in the year ahead as investors underestimate the operating leverage gains achieved through the pandemic through cost management and optimization.

We have stressed throughout 2021 that growth was unlikely to rapidly revert to precrisis trend levels. Supply chain bottlenecks and labor supply shortages have all but assured that the growth peak in 2021 was lower than what we otherwise may have enjoyed, but that growth was likely pushed into 2022. Trading a lower peak for a wider plateau of elevated growth. And lost within the raging inflation debate is the fact **that robust demand is bleeding into price gains, muddying the picture of true economic growth.** While we would all prefer modest inflation and higher real growth, **the nominal growth picture remains robust with consensus estimates of 7% nominal GDP growth likely still too low.** While a continued normalization of consumption patterns from goods back towards services should help shift the composition of nominal growth away from inflation and back towards real growth, corporates book revenues in nominal terms, and well above trend growth, regardless of the composition, will continue to support the corporate earnings engine.

Consumer Spending

While many investors continue to fear the fiscal cliff, the effects of the fiscal impulse will continue to be felt in 2022 as the growth engine shifts from the public sector to private sector. **Consumer balance sheets have never been stronger with over \$2.7T in excess savings built up through the crisis and plenty of room to re-lever.** Corporates are equally flush with cash and looking for ways to deploy that capital as companies signal intentions to increase capital expenditures with many already doing just that. In both instances much of that cash either makes its way to the bottom line through spending or into multiple expansion as savings and corporate buybacks. A win-win for equity markets. Much

maligned supply chain disruptions have continued to weigh on inventory levels which will need to be rebuilt, providing a further tailwind to growth. **And a robust housing market that is likely to remain strong into 2022 supported by the millennial demographic bulge will serve as yet another upside catalyst for growth.** Putting these forces together, it's not hard to envision another year of strong economic growth supporting further earnings growth and multiple expansion. After all, while we constantly hear that valuations are extended, equities look cheap amidst that backdrop, particularly when compared to fixed income valuations and deeply negative real rates.

So how does one position for this backdrop in 2022? Much the same as is currently appropriate: overweight equities, favoring US over international, and barbell between tech and cyclical sectors. After what felt like an endless consolidation through much of 2021, small caps should likely benefit from a year-end rally into early 2022, though any allocation there should likely be viewed as a short-term rental. **Tech will continue to be supported by a healthy consumer while cyclical components, such as semiconductors, stand to benefit from the emerging capex cycle.** The broader cyclical complex, including industrials, materials, financials, and energy stand to continue posting upside surprises as nominal growth delivers upside beats as well.

Dollar and EM

King Dollar looks set to remain stubbornly strong as well as strong US growth supports a bid for US assets, limiting the attractiveness of international developed and emerging markets, despite what is quickly becoming a consensus overweight in 2022. **Continued headwinds from slowing Chinese growth pose clear risks to EM equities as well as European growth through the critical export channel for trade reliant European economies.** Oil prices that are likely to remain supported into 2022 pose another medium-term threat to demand recovery in Europe. That said, 2022 may indeed be a year of two halves, with US leadership giving way to an international catch-up trade on the back of a true resynchronization of global growth in the second half of the year. What has thus far been a fragmented and rolling recovery from the pandemic should synchronize as vaccination programs continue to push back the pandemic and global economies adapt to a coexistence strategy. That resynchronization and acceleration of global growth is the key to unlocking a weaker dollar and ushering in outperformance from international developed and EM equities.

While there's no shortage of topics to worry about in 2022, from inflation and policy tightening to new variants and stretched valuations, the catalysts to scale the Wall of Worry continue to build. With policy and financial conditions set to remain accommodative while the private sector drives robust growth delivering earnings upside and valuation support **it's not hard to see another year of double-digit equity market gains ahead that broadens as the year progresses.** Not your typical 5-7% year after all.

Fixed Income

On the fixed income side, bonds will continue to be challenged throughout 2022 just as they were in 2021. With solid corporate earnings and a continued global economic recovery that will see monetary policy begin the year highly accommodative, it's not hard to see rates drifting higher. Couple this backdrop with low yields and tight spreads in a historical context and it's easy to see why fixed income is set to be uninspiring. To add to the headwinds, **bond market duration continues to extend, offering up even less reward** for each incremental unit of risk one takes to earn extra income. So what do we think for the coming year?

Inflation

Inflation is very much expected to end up at a level higher than pre-COVID levels. But we are at odds with any expectations for a significant increase. Inflation could very well end up as a one-time step up in prices rather than a persistent and steady march higher. **Supply chain and bottlenecks related issues will prove transitory - or not permanent.** Get COVID under control and people will eventually return to the labor markets and pressures will ease. Sure, some of those job losses will be gone forever and some of those workers will not return as they permanently retired. But there is still labor market slack and productivity gains that will limit the wage-price spiral fears that we are hearing about. In addition, consumers are balking at higher prices, not stockpiling because expectations are for those price advances to remain elevated. In this sense, the cure for higher prices is higher prices, providing a self-governing mechanism preventing that wage-price spiral scenario from unfolding. We also caution about reading into the wage gains that we are witnessing. The markets are laser focused on these increases from a *percentage* perspective. But looking at the *absolute dollar gains* – and this matters more because this is the actual dollars in our pocketbooks and wallets that we spend – tells a different story. **The largest percentage gains in wages are accruing to the segment of the market that has the lowest average hourly earnings.** Said otherwise, a 15% increase on someone earnings \$10 an hour is very different in cumulative dollar terms than someone seeing a 15% increase making \$50 an hour. The gains accruing to the lowest average hourly earnings cohort is simply not enough to sustain a demand push higher in prices.

So while wage increases do not appear as the persistent inflationary catalyst, rates will likely drift modestly higher. They will however, end lower than many expect. Why? Demographics and demand. Simply put, the number of economically insensitive buyers in the world are fast outpacing the growth in assets that throw off any positive nominal yield. Adjust this for real yields and that pool becomes even less. Think pension funds and insurance companies. Think of life insurance companies in Japan, Taiwan and Europe where their domestic bond markets simply are too small to absorb the demand while offering very little yield at the same time. These buyers are forced to find liquidity and yield in the US bond market. And this will keep a lid on rates pushing aggressively higher.

And while rates may end up drifting higher, curve flattening is likely to persist. Inflation is expected to remain contained and long-term expectations remain very well anchored...so far. As a result, the long end of the curve should remain fairly well behaved with the front end moving higher in step with Fed hike expectations. We do caution that we think the market may be getting ahead of itself with current expectations for 3 hikes in back half of 2022. This seems a bit aggressive to us and expect to see a modest dovish pivot by markets as they unwind some of this hawkishness.

Credit markets

Shifting to credit, take note of several historical data points. Default cycles tend to turn some 4 to 5 years after the initial Fed hike within a tightening cycle. And defaults accelerate roughly 1 to 2 years after the peak in the Fed Funds rate. That puts the default cycle years away. And recall, equity markets tend to rally into the first few Fed hikes as growth is often increasing – risk on. In addition, default activity usually lags tighter financial conditions. Based on metrics that reflect financial conditions like the Fed's Senior Loan Officer Survey, signs of tightening from commercial banks regarding lending standards is far from raising any red flags. The proverbial Wall of Maturities for credit remains well managed as corporates have continued to extend maturities well into 2025. Within Corporate America, companies

continue to pass along higher costs, and in many cases, the rise of input prices has been slower than the increase in top line revenues. Profit margins have surprised to the upside and above trend growth coupled with modest inflation should prove to be highly supportive for credit fundamentals as revenues expand. Firms have shown the ability thus far to retain pricing power and with many funded via fixed rate debt, the credit backdrop looks well supported for 2022.

Despite this, the headwinds to the fixed income market remain its lack of cushion: little spread compression opportunity that may absorb any move higher in the risk free rate. So where does that leave us? US Treasuries still offer the traditional equity risk offset. However, rising rates could prove to be the catalyst for an equity market shake out at some point in 2022. **Investment Grade will prove even more challenging given that spreads have marginal room to tighten** and will likely widen in a risk off scenario. In addition, yields will likely move in tandem with any Treasury re-pricing. That leaves us with more spread related product: high yield, emerging market debt and loans. Given the economic backdrop we have outlined coupled with the limited prospects for defaults, **we see loans as the more attractive play relative to high yield given the duration component. And emerging markets? We'll see if we get a re-synchronized global growth story in the second half. Should that manifest, emerging market debt could have its time to shine.** But for now, a barbell between Treasuries and Loans may serve a portfolio well.

Regardless, fixed income will once again provide endless headaches for 2022. The generic and uninspiring 2022 outlook also rings loudly: expect spread volatility with the accompanying monetary policy uncertainty along with a modest drift higher in rates. Yawn.