December 31, 2021

2022 – THE YEAR AHEAD

The year just ending witnessed the continuation of the economic recovery from the pandemic-induced recession. Massive fiscal and monetary stimulus boosted demand, and U.S. economic growth continued at an above-trend pace. However, the ability to supply this demand was impaired by issues ranging from shipping and other transportation challenges to finding enough workers to staff businesses. As a result, the current rate of inflation has surged to levels not seen since 1982. Meanwhile, new, more contagious, variants of the COVID-19 virus appeared, first delta and most recently omicron, which have called into question just how fast the world can move past the current pandemic.

Supported by strong economic growth and the huge amount of money in the financial system, the U.S. stock market surged to new all-time highs. Bond market interest rates moved up gradually from nearly rock-bottom levels, although they remain extremely low relative to history and to the current rate of inflation.

Will inflation settle down or will it be the new economic problem? Will the Federal Reserve need to respond, potentially shortening this economic cycle? Will new variants slow economic re-opening? In *2022 – THE YEAR AHEAD* we look at these issues and their potential impact on the highly valued investment markets, and conclude that further gains may be a bit more challenging to achieve than in the past couple of years.

The Economy

Although economic growth slowed a bit in the third quarter of this year, likely due to concerns about the more contagious delta variant, it has picked up steam lately and is strong going into year-end. Full-year real Gross Domestic Product (GDP) growth will likely be at least 5%. Consumer spending has been the strongest sector, supported by the benefits of government stimulus payments and the wealth effect of appreciating assets. Investment spending, after pulling back in the first half of the year, has rebounded sharply in the second half. Government outlays have not grown as much as in 2020, and imports have rebounded much faster than exports, exerting some negative effect on GDP. Federal Reserve monetary policy continued to be very stimulative throughout the year.

In 2022, we expect that real GDP will continue to grow above long-term trends as fiscal and monetary stimulus continues to boost consumer demand, although at a less rapid pace than in 2021. Spending on goods has grown the fastest, while services spending began to pick up as the population became largely vaccinated, although the new COVID-19 variants have lately led to more caution around travel and social activities. We expect services spending to grow somewhat faster as re-opening (gradually) progresses. Meanwhile, higher inflation may begin to suppress some goods spending, particularly on large-ticket items. Housing and automobiles, in particular, were subject to astounding price increases exacerbated by shortages of supply. So, consumer spending overall, while still growing, may grow at a slower pace than it did in the past year.

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Business spending will likely be the strongest sector of the economy next year as companies have largely regained the financial flexibility that they might have lost during the recession and have higher cash flows to finance spending. Low interest rates have enabled corporate borrowing to finance projects, and the recently passed infrastructure bill will help as well. Wage expenses will increase, however, taking a larger share of business expenditures than in the past economic cycle, as workers have been slow to come back to work in many industries. In response, investment in automation and capital equipment will likely grow to offset the tightness in the labor market. In addition, the pandemic exposed the lack of redundancy in supply chains worldwide. More spending is likely to occur in order to bring more production closer to home, as well as to ease the bottlenecks that already exist, and to build inventories as a cushion.

Outside of the infrastructure package, the federal government is not currently providing any further stimulus. The additional, bigger, spending bill has had difficulty getting to the stage where it can be passed, so it is unclear what economic impacts that might have. Meanwhile, the likelihood of widespread tax increases has diminished, although there still could be at least a small reversal of the cuts passed in 2017. The upshot is that government spending is not likely to add much to GDP when compared to the past two years.

International trade is likely to see U.S. exports and imports in better balance for the first time in three years as U.S. manufacturing continues to ramp up and more fully meets domestic consumer demand. Also, many trade tariffs implemented in the previous Presidential administration have been maintained by the current one, most notably those placed on China, which is an increasing economic and military threat to the Western world.

Overall, we are looking for GDP to grow at around a 4.0% annual pace for the full year 2022, a bit of a slowdown from 2021 but still above longer-term averages. Both consumer and business spending should grow at above-average rates. Employment will likely continue to grow gradually as the lack of new government support packages and higher wages in many sectors draw more people back into the workforce. The unusual effects of the pandemic on the seasonal adjustments that government economists make have likely understated the amount of job growth since the last economic trough. A major unknown remains the extent to which some workers have permanently left the workforce, particularly older workers who might have been approaching retirement age in any event.

One wild card in any economic forecast is the effect of the latest COVID-19 variants. The delta variant caused some slowdown in economic recovery, but the peak of that surge appears to have passed. More uncertain is the effect of the omicron variant, as it is still too new to fully know its implications. However, initial indications are that, while it is by far the most contagious variant to date and the most resistant to current vaccines, it so far appears to be the least deadly. If so, this variant could move the world more to an equilibrium phase where continually evolving vaccines and new antiviral treatments would render the virus endemic rather than pandemic, and it becomes something like influenza. In such an environment, U.S. and world economies would stay open and some type of new "normal" would be achieved.

Inflation, Interest Rates, and the Bond Market

A resurgence of inflation was one of the major economic stories of 2021. First to be seen were the year-over-year comparisons with weak inflation numbers during the depths of the pandemic. These were followed by a recovery in prices of many goods and services as the economy re-opened and consumer demand soared. At the same time, the ability to supply this increased demand was limited by greater-than-expected supply-chain issues worldwide along with a shortage of workers in many industries. The Consumer Price Index looks to have risen by around 5% this year, and we expect elevated inflation in 2022, although less than 2021's rate. Some supply-chain pressures will be worked out and workers will gradually continue to re-enter the workforce, as the growth of consumer demand slows to a more normal rate.

Extremely stimulative monetary policy, in concert with similarly stimulative government fiscal policy, has enabled the surge in demand that has helped to create higher near-term inflation. Until late this year, the Federal Reserve had indicated that it felt no need to rein in monetary policy, including the unprecedented $120-billion-per-month quantitative easing. Its primary metrics of unemployment (the rate remained elevated) and inflation (the high numbers were viewed as "transitory") did not yet compel it make a policy change. However, the Fed has recently pivoted to a viewpoint that inflation may be more of a threat than it previously thought. It has begun reducing its quantitative easing by $30 billion each month, a rate which could fully end this program in the first quarter of next year. Further, the members of the Fed indicated that they expected the Federal Funds rate to be raised from its current near-zero level by as much as 0.75% during 2022, along with 1.0% in 2023 and possibly yet another 0.5% in 2024.

In an environment of continued economic growth and renewed inflation, interest rates in the bond market moved up a little this past year, although less than we would have expected given the rise in inflation. The yield on the benchmark ten-year U.S. Treasury note rose from 0.9% at the end of 2020 to a current yield of around 1.5%, with a brief trip up to 1.7% before the delta variant surged through the economy. Bond market participants appear to be giving the Fed the benefit of the doubt that it will be effective enough in fighting inflation that interest rates do not need to rise dramatically. For now, we think at least some gradual continued increase in bond rates is likely over the course of 2022, and the yield on the ten-year Treasury could exceed 2.0% at some point during the year. Yields on short and intermediate bonds may rise somewhat more than those on longer bonds, as they are more sensitive to changes in the Fed Funds rate.

Thus, the coming year will likely reward a continued defensive position in bond portfolios, at least until yields have risen to the higher level we expect later in the year. BTR therefore maintains fairly short average maturities in the bond portion of accounts, and an underweighting in bonds relative to target allocations.

Within bond portfolios, we continue to emphasize corporate bonds and own almost no Treasury securities. There is still enough extra yield on corporates—particularly at the lower end of the investment grade spectrum—to make these a better risk/reward tradeoff. At a later point in the economic cycle, we would want to reverse this relative exposure but, as long as the economy continues to grow, corporate bonds will continue to offer better relative value. One area of Treasury bonds that has performed better has been Treasury Inflation Protected Securities (TIPS), as the inflation component of their coupons has risen this year. However, a rising rate environment will blunt this advantage somewhat as rising rates have a negative impact on all bond prices. Further, much of the higher inflation expectations already appear to be priced in, as TIPS sell at a premium price to regular Treasuries.

Tax-exempt municipal bonds have also become more richly priced relative to Treasuries as they held up relatively better during the year, due at least in part to concerns of possible tax increases for high-income individuals. One must go out longer than five years in maturity to receive more tax-equivalent yield from such a bond than a Treasury bond of equal maturity, and out nearly ten years to receive an expected return of even one percent. One continuing opportunity, when we can find it, lies in callable tax-exempt, high-coupon bonds. The high coupon makes it likely that they will be called at the first opportunity, lowering the maturity risk.

Bonds continue to provide diversification to stock market volatility, so even an underweighted position will help preserve capital in uncertain times. If Treasury rates move above 2.0% in 2022, that would also provide an opportunity to increase bond weightings a bit and lock in higher yields.

The Stock Market

The U.S. stock market has had an even bigger year than we would have expected. Earnings growth was greater than forecast as companies were able to take advantage of stronger demand in a growing economy. Surprisingly, price-to-earnings ratios (P/Es) expanded even further, in spite of the increase in bond market interest rates which would normally compress P/Es. Investor enthusiasm increased amid a lack of promising alternatives to invest some of the massive amounts of money floating around in the financial system. Many cyclical sectors of the market, such as energy and financial stocks, recovered sharply, but some of the previous pandemic beneficiaries also got a second wind in the second half of the year as the delta variant surged.

In contrast to 2021, we expect stock market gains to be more muted in 2022, with increased volatility along the way. Earnings growth, while still positive, will slow to a more normal pace, and valuations of earnings, having risen to levels last seen in the runup to the stock market bubble of the late 1990s, may contract somewhat. Earnings per share for the S&P 500 index as a market proxy are estimated to grow by about 10% next year, as revenue growth slows from its pace early in the pandemic recovery due to demand growth slowing. Profit margins are also likely to have peaked, as input costs continue to increase, including both materials and wages.

Even as interest rates gradually increased in 2021, the price-to-earnings ratio of the S&P 500 rose to the point that it is now about 23 times estimated earnings for 2021; we had thought that it would contract to something more like 20. Although still-low interest rates can support above-average P/Es, we would expect finally to see some P/E contraction in the coming year as interest rates continue to rise gradually. A P/E declining to 21 or 22 would be consistent with such an interest rate raise. Combining this contraction with a 10% earnings increase would produce a price increase of 0-5%. The dividend yield on the S&P 500 is currently only 1.4%. Adding the expected price increase over the year with the dividend yield would equal a low- to mid-single digit total return.

Along with a lower expected return than in recent years, the stock market could be subject to greater volatility than we saw this past year (which was unusually low). On the one hand, uncertainties around the COVID-19 virus could lead to bouts of concern about how fast the economy can grow, and changing Federal Reserve policy will be an increasing focus. On the other hand, continued demand for stocks in the absence of compelling alternatives could take valuations even higher, at least temporarily. So, investors should buckle their figurative seat belts. We would note that, as long as monetary policy has not reached truly restrictive levels, the economy can continue to grow, so we are not yet looking for the next cyclical bear market for stocks. We will be focused on changes to the Fed's course over the coming year.

While many cyclical stocks have recovered nicely from pandemic lows, we think there is still room for continued positive performance from these sectors. Financial stocks should benefit from a rising interest rate environment, and economic growth will support loan growth. Industrial companies should profit from the continued need to spend on capital goods, and the recently passed infrastructure bill may help some as well. Energy stocks, the strongest sector of the market this past year, may have seen their biggest gains, but continued economic growth will mean continued growth in energy demand. Both traditional and alternative energy stocks should benefit.

In contrast, the large technology and internet stocks will probably be helped relatively less by a further recovery in the economy. While many will still post good earnings growth, there will be some headwind from the ongoing reopening of the economy and a movement of demand from pandemic-driven products and services to those more in demand in an economic recovery. Further, the late-year resurgence in the price of some of these stocks has put valuations back on the high side, and any decrease in the extremely positive sentiment toward these groups could cause a compression in those valuations, as would increasing interest rates. Thus, we remain underweighted in these areas. However, the market-dominating presences of these companies should allow them to continue to prosper (although increased regulatory scrutiny bears watching), and at more appropriate valuations we might consider raising our exposure.

We have maintained our long-term overweighting in the healthcare sector and continue to think that the trends favoring this group remain in place. The population of our country continues to age—and become wealthier—supporting demand for healthcare products and services. Technological innovation marches on (thank you, COVID vaccines). This area can be defensive in a more volatile market environment due to relatively steady earnings, and valuations, while higher than in some past years, are not too elevated relative to the market.

Other defensive areas have mixed attractiveness at this point. Consumer staples stock are not overly expensive, although pricing power in a higher-cost environment bears watching. Utilities and real estate investment trusts (REITs) have been sought after for their higher-than-bond yields. Now they look stretched from a valuation standpoint, are vulnerable to rising interest rates, and will grow relatively more slowly than other industries in an environment of economic recovery.

We discussed precious metals as a possible option in last year's outlook. They have continued to be weaker than the overall market, as the hedge they offer against inflation, a weaker dollar and geopolitical crises has been unneeded this past year. Going forward, this hedge may become more useful, although it is too early to say if investor interest will again be rekindled. For now, we retain some small exposure, but will re-evaluate this during the year.

We have continued to monitor international investments as a possible diversifier to domestic equities. During this past year, some overseas markets have begun to perform better, although the U.S. market has continued to be the leader, as it has been for the past decade. Of the major international markets, Europe seems to have the most potential to generate returns competitive with those of U.S. stocks. Monetary and fiscal stimulus, while not as great as that in the U.S., has aided economic recovery, and the U.S. dollar's strength may have peaked for the moment. Valuations are meaningfully cheaper (although partly due to less expected long-term growth), and the markets are more weighted toward companies that benefit from cyclical recovery vs. the U.S. market's higher exposure to technology and internet stocks. The recent waves of the virus have caused more temporary shutdowns of economic activity, but manufacturing and exports are having a positive impact. Thus, we think that Europe may have the potential for returns equal to those of the U.S. in the coming year.

Asian markets are another story. Japan's economy continues to be mired in its ongoing problem of aging population and low economic growth, although it too will see some benefit from fiscal and monetary stimulus packages. China has turned away from free market policies and property rights, and become more belligerent politically and militarily. So, we would view any exposure to that country, and emerging Asian markets that trade with China, as speculative.

Conclusion

We are slightly more cautious about economic growth in 2022 compared to the very strong recovery from the pandemic this past year, although we don't think the cycle has fully run its course just yet. Positive effects from past stimulative monetary and fiscal policy will be dwindling, and the Federal Reserve has put the markets on notice that it will likely start raising short-term interest rates. However, there is still capacity for further growth, both from investing in more capital infrastructure and a gradually returning workforce.

Inflation has reared its head and presents a risk to the economic cycle. While we think the headline-grabbing rates of late will diminish somewhat, inflation may remain at a higher level than in the previous cycle. Bond market interest rates are likely to continue to rise gradually in response, although if investors remain confident that the Fed is on the right track with inflation then increases should not be too drastic, at least in the near term. Nevertheless, the risk to rates is to the upside, so we continue to keep average maturities relatively short in bond portfolios and emphasize bonds other than Treasuries.

We expect stock market returns to be more moderate than those of the last couple of years. Slowing earnings growth and high valuations leave less room for upside, particularly in a rising rate environment, and volatility is likely to be higher than this past year. We continue to favor stocks of companies that benefit from the economic cycle, along with our ongoing overweighting in the healthcare sector. We remain underweighted in the expensive technology and internet stocks, while acknowledging their strong fundamental positions, and could increase exposure to them on any significant weakness. Internationally, European stocks could see a relatively good year, but we are not yet ready to make more meaningful investments overseas.

We wish all of our friends and clients peace, joy, health, and prosperity in the New Year, and for many years to come.