Special Year-End Comment

A Look Back, A Look Ahead

December 22, 2021

What else can we say about 2021 that we haven't said for every one of the past 51 weeks since the year began? While we won't be entirely sorry to see this year pass into the history books – a year that began with a riot in the nation's capital and then ended with a new, fighting-fit variant of the irritatingly persistent coronavirus – there were things to celebrate along the way. The vaccines, for starters – proof positive that we as a community actually can solve daunting problems when we put our minds to it. With vaccines, boosters and other drugs for fighting Covid we can at least look ahead in the coming months to this pandemic transforming into something more like an endemic seasonal malady, annoying but more or less manageable.

Economically, too, we have fared better than we might have. Yes, we are seeing the highest inflation in a generation and we have all gotten tired of saying "supply chain disruption" twenty times a day while we grumble about new appliances that won't arrive for another six months. But after the dramatic disruptions of 2020 and even with the curve balls we keep getting thrown from the virus, the economy has managed to stay on reasonably firm footing as we head into the new year.

With that said, here are some of the things we're thinking about as we look ahead – a preview, if you like, of the core themes we will be exploring in the annual market outlook which you will be getting from us later in January. Needless to say, we reserve the right to change our thinking between now and then as new information comes to light.

Inflation, Yes. 1970s-style Inflation, No.

Perhaps the problem with the way the Fed characterized inflation as "transitory" for so many months this year is that the word can have different meanings depending on your frame of reference. Unfortunately for their own credibility, the way Jay Powell and his colleagues used the word more often than not gave the impression that "transitory" meant "gone in the blink of an eye" or at least by the time fall 2021 rolled around. By the time last week's FOMC meeting happened, the Fed finally had to admit that inflation wasn't going to magically disappear by the end of the year, and that this would likely accelerate the calendar for raising interest rates.

But "transitory" takes on a different meaning entirely if our frame of reference is the last period of high US inflation. That period lasted from the late 1960s to the early 1980s, and ensured that the decade sandwiched in between those two – the 1970s – would forever be remembered as the decade of stagnant growth and high prices – stagflation, in a word. Inflation in the 1970s was chronic for a combination of deliberate policy choices (e.g. government spending in the late 1960s, decoupling the US dollar from gold in 1971, wage-price-indexation), external events (e.g. the Vietnam War, OPEC) and ultimately behavioral expectations (households and businesses making spending, investment and hiring decisions based on the assumption of future prices being ever higher).

Compared to the experience of the long 1970s, the inflation we are seeing today really is likely to be transitory. Higher prices today are a direct result of several things all happening at the same time, all related to the pandemic. Demand from consumers started to rise as the economy reopened after the 2020 lockdowns, with added spending firepower provided by the succession of relief and stimulus payments from the government. Meanwhile on the supply side, companies with intricate supply chains spread all around the world had trouble ramping back up after last year's total shutdown. Inventories of crude oil, natural gas and other energy and industrial commodities were at record low levels.

More demand was already chasing lower supply when the delta variant surfaced this past summer. Once again consumer preferences shifted away from in-person services and back towards physical goods – which put additional pressure on the supply chains for those goods. It was this final twist that really caught the Fed by surprise and forced it to revise its assumptions about inflation, especially when the delta variant was upended by omicron, an even more transmissible strain, in late November.

Of course there is always the possibility that new developments next year will prolong these problems and eventually lead to more structural, more intractable inflationary expectations. But as we see it today, the pressure is likely to abate gradually over the first six months of next year, with demand slowing, commodity prices stabilizing or falling, and supply chain shortages replenishing themselves. We could be wrong – we were wrong in the middle of this year (before delta) when we thought inflation would be calming down by the fall. But we do not see a high-probability case for a 1970s-type economic cycle.

The Fed's Policy Dilemma

Let's say we're right about inflation, and that we start to see evidence of consumer prices coming down from mid-single digit increases by, say, July or August. What does the Fed do then about interest rates? A number of economists today are citing "Fed policy error" as their top concern for 2022. The most likely policy error would be misreading the economic growth climate: assuming that low unemployment with inflation still above two percent means getting on with the business of rate hikes, only to find that demand is falling faster than the headline numbers might be showing. In this scenario rising interest rates could effectively choke off growth and bring on conditions that could lead to a recession.

While we agree that there is always the potential for the Fed to miscalculate its policy decisions, we do not see the above scenario as highly likely. First of all, the central bank has not actually committed to anything as far as rate policy goes for 2022. The assumption that the Fed will raise rates three times next year comes entirely from the so-called Summary Economic Projections the bank released after last week's FOMC meeting. Three rate hikes next year is just the median "dot plot" of all the members' assumptions based on conditions today. If conditions are different, as surely they will be in the months ahead, those assumptions will change. Nothing is set in stone.

Recall that in 2018 the Fed was intent on continuing to raise interest rates but blinked when the stock market plunged towards the end of the year. It seems hard to believe that attitudes have changed much since then; if there is even just a little bit of evidence to argue against raising rates from the standpoint of declining growth, this Fed would be very unlikely to plow ahead with rate hikes. We do see the Fed as a potential source of risk to the market, but not because of a policy error in raising rates too quickly. That risk will come whenever the Fed's arsenal of unconventional monetary policy measures is simply unable to contain a financial panic the way the bank so convincingly did in March 2020.

Will Corporate Earnings Live Up to Expectations?

The third strand of our core themes for 2022 as they now stand is the outlook for corporate earnings. In 2021 earnings had a relatively easy time in putting down double digit growth numbers based on year-on-year comparisons with the lockdown conditions of 2020. In turn, the fast pace of earnings growth kept valuations in check. The S&P 500 stock index is currently up around 24 percent for the year, while S&P

500 earnings are on target to grow by 45 percent. The P/E ratio for the index is currently around 21 on a forward-looking basis and 24 on a last twelve months calculation. Both valuation metrics are down from their highs earlier this year (of around 24 and 30 for NTM and LTM respectively) but still well above their 20-year averages of 15.8 (NTM) and 17.8 (LTM).

Currently, the outlook for S&P 500 earnings growth in 2022 is around nine percent. That may be optimistic, and it will be interesting to see whether the analysts who cover these companies revert to their old ways of ratcheting down their expectations as the dates for quarterly earnings reports approach. Companies will have plenty of variables to deal with. For those who derive substantial revenues from foreign markets there will the impact of continued lockdowns and other Covid-related restrictions in many major economies. China, which still tries to maintain a zero tolerance policy for Covid cases, may present a particular problem depending on how it handles the omicron outbreak.

There also remain questions about how well companies will be able to handle the inflationary environment. Even with the higher input prices most have had to face so far, including commodity, transportation and labor costs, corporate profit margins remain close to historic highs. That may change as the demand environment shifts from the manic post-lockdown, stimulus-fueled spending frenzy that carried over into 2021 to a more subdued climate for consumer outlays. We expect to see that nine percent growth estimate come down closer to mid-single digits as the year moves on.

Valuations didn't matter much this year. Many of the best-performing stocks throughout the year owed more to viral chatter on social media outlets than to anything particularly strong about their own fundamentals. But the popularity of these so-called "meme" stocks and other more speculative corners of the market has waned recently. We think this trend is likely to continue. For 2022 we expect that valuation will matter more, and that will work to the benefit of higher-quality companies and to the detriment of whatever the flavor of the week happens to be in Reddit chat rooms.

Putting It All Together

The highly speculative nature of many risk asset markets in 2021 has drawn comparisons with the frenzied conditions in 1999 and early 2000, as the mania for Internet stocks peaked and then went into a sharp, prolonged reverse. The probability of such a major reversal is never zero – there is always a scenario one can construct to model a repeat of something like the tech crash of 2000. But there are many more scenarios that show other, less dramatic outcomes. We do not see a high probability for a deep crunch; nor, on the other hand, do we think the speculative flows are likely to produce another torrent of animal spirits pushing all things good, bad or otherwise into the stratosphere.

We do believe conditions remain in place to support a generally positive environment for equities, particularly (as we noted above) higher quality companies with solid debt-to-capital ratios and healthy cash flow generation. In terms of the broader economy we do not see much evidence at all for a recession – and on this point we should note that virtually all prolonged bear markets in the past have coincided at least in part with recessions. That being said, we do expect growth will slow, and the Fed will have to be careful about how it manages a slowing growth trend (particularly if inflation does persist more than we currently think it will).

These are just the things we know enough about to comment on today. There are many more things about which we know nothing today that will probably be figuring into the mix for next year – the "unknown unknowns" in the memorable phrasing of the late Donald Rumsfeld. And then there are also the "known unknowns" – things we can identify but cannot predict if, when and how they will manifest as clear and present risks. The "Four Cs" – contagion, climate, cyber and China – are the biggest of the "known unknowns" in our thinking, and we will be talking about these in further detail in our annual outlook next month.

Until then, we hope you will have the chance to take some time away from the daily news feeds and financial prognostications, and spend that time instead with those nearest and dearest to you. We wish each and every one of you the happiest of holidays, with a safe, healthy and fulfilling year ahead.

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