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2022 Outlook – Equities (Joe Williams)
12/15/21

Chris:

Welcome to Conversations with Commerce Trust Company. This is where our investment team covers some added insights from our annual Outlook. Today, we have Joe Williams, our chief investment strategist. Joe, looking at the outlook for 2022, you remain quite optimistic on equity performance, even following gains of over 31% in 2019, over 18% in 2020, and 25% so far in 2021. Isn't it time for a correction?

Joe:

Chris, we are still optimistic for stock prices as we enter 2022. Some of the reasons are the economy remains quite strong. We're slowing somewhat in 2022, but we still expect gross domestic product that's economic growth to be at 4%, versus 5.5% last year. But 4% is still very high on a historical basis. Earnings in 2021 are expected to grow at 65 to 70%, granted from very depressed earnings 2020, but twice as fast as originally expected at the beginning of 2021.

Companies have navigated well through COVID, variant restrictions, major supply chain disruptions, and labor shortages. But we believe earnings can gain another 10 to 15% in 2022, which is a very nice backdrop for stronger stock prices. Another positive we see is the amount of liquidity that's been supplied by the government and the Federal Reserve, and where that liquidity is going to end up. This liquidity surge in the U.S. is also evident worldwide.

In many ways, options for investors to invest this money remain the same as a year ago. Money market funds currently yield zero, at least for now. Total bond returns were negative in 2021, around minus 1.5%, and they looked like they could be negative again in 2022. We have a 10-year treasury yielding 1.5% with inflation at 6.8%, giving an investor a negative 5.3% rate of return, which doesn't sound great. But on stocks, on the other hand, we have a 1.3% dividend yield that's increasing, earnings that are increasing. And we think that they are the most compelling option investors have to beat inflation this year.

Chris:

Joe, I think you said the magic word there. Inflation. You have to say that inflation is aggressively turned up. I think that's fair. Inflation is nearing 7%. Won't this have a negative impact on earnings and valuations?

Joe:

Well, yes. High persistent inflation is a problem eventually for stock prices. But in the early phases of inflation, it can be a tailwind for earnings growth. The key is whether companies can pass through cost increases to their customers, or do they absorb those cost increases through lower profit margins? So far as inflation has crept up, companies have been able to pass those cost increases through, and it's been driving profit margins actually higher.

This will eventually change. But at the current time, it's a real positive earnings growth in 2022. Now, over a longer period, inflation does cause price earnings ratio...that's how we measure the valuation of the market, to decline. And this could be a possible headwind as we approach mid-year. Every 1% increase in the long-term expectation for inflation potentially could reduce the price earnings level by 5 to 10%. So if earnings now are at 20 times earnings, and inflation longer term expectations increase 1%, we could see earnings drop to 19 or 18 (times), which could reduce your stock returns next year.

Chris:

Joe, we said in our outlook that a rising interest rate scenario does not necessarily mean the end of the equity bull market. I've always heard when the federal reserve starts to increase interest rates that economic recoveries lose steam. Could that be the case in 2022?

Joe:

Well, economic recoveries don't... out on their own, but recoveries turn into recession following numerous federal reserve interest rate hikes. Now, this is true. Interest rates hikes have a long lead time before the economy is affected. Currently, investors believe we could see the first rate hike in the spring, and that will spell trouble for stock prices. In fact, historically, stocks increase into the first rate hike. Stock prices are a bit more mixed after that first rate increase, but generally higher for another one to two years as rates continue to increase.

Chris:

Well, I would say even though the sharp rebound has slowed a little bit, the domestic markets seem to be the place to be. Are they going to outperform international markets?

Joe:

We do believe international market will continue to underperform the U.S. market again this year. Probably not the underperformance that we saw in 2021. The reason for the underperformance, again, centers around the mismatch and weighting of technology stocks in the S&P 500s, and the EAFE Index. And that's Europe, Australia, and far east, which is a large cap international index. In the S&P 500, technology represents 29% of the index versus 10% for international index. If we throw in Alphabet, the old Google, Meta Platform, the old Facebook, and Amazon, we're up to about 35% of the S&P 500.

Technology continues to outperform the heavily weighted financial and industrial sectors in the EAFE Index. Our long-term target that we use in the trust department is 30% of the portfolio weight in international securities. Last year, we recommended a 20% weight. And as we entered 2022, we have reduced that farther to 15%. Also on emerging markets, which is included in our international weightings, they look inexpensive. And again, emerging markets would be mainly China, Russia, India, Brazil. But until we see a clearer outlook of what the Chinese government does with regulation of private companies, we expect emerging markets, which incurred a negative return in 2021, to continue to underperform as we go through 2022.

Chris:

Joe, thank you very much for the analysis. This was Conversations with the Commerce Trust Company with Joe Williams.

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