2022 Outlook: Hot, Crowded, and Flat

By George Mateyo, Chief Investment Officer, and the KeyBank Investment Center team

Hot inflation and crowded markets could spell flat returns for 2022, but those who remain hopeful will be rewarded for their optimism.

Thirteen months ago, after my immediate family and I finished Thanksgiving dinner (no extended family in 2020), we reflected on the moment, expressed sentiments of gratitude for our health, and wondered how the following year's holiday would differ. Several hours later, after enjoying several rounds of Scrabble, agreeing to suspend a game of Monopoly, and then kissing my wife goodnight, I returned to my "home office" in our spare bedroom to write what I thought might unfold over the ensuing year.

In looking back, it turns out that we had a pretty good sense of how the economic narrative would unfold. However, admittedly, we underestimated the magnitude and the vigor of the recovery.

Worth noting, we don't intentionally "keep score" when making predictions. Nor do we publish point-specific forecasts. Instead, we focus on a range of outcomes that could ensue and contemplate larger forces that may influence the capital markets and investment portfolios. Nevertheless, seeing several of our views come to fruition for the benefit of our clients is satisfying.

Our first issue was COVID-19. By late 2020, vaccines had shown significant (95%) efficacy in combatting the virus. This was an enormously positive development, which turned out to be the game-changer we had hoped it would. Roughly 5.5 million Americans had received at least one dose by the end of 2020. By December 31, 2021, nearly 245 million Americans had received at least one dose, and more than 200 million were considered fully vaccinated. An additional 70 million have been given a booster.

Cautiously noting that vaccine durability, the emergence of other strands of the virus, and non-trivial logistical challenges were all potential obstacles, we still believed that economic restrictions imposed at the beginning of COVID-19 would not be broadly reinstated. Thus, we expressed a bullish view on the economy and recommended modestly overweighting risk assets such as stocks versus bonds relative to one's strategic asset allocation targets, which proved rewarding.

We also advocated slight tilts toward high-quality cyclical companies. Further, we felt that international markets could close the gap on their U.S. counterparts as they had greater potential to catch up in addition to sporting less demanding valuations. In hindsight, the first part of our thesis was correct (cyclical stocks outperformed defensive ones), but we were wrong in thinking that international markets would keep up with domestic shares as U.S. markets meaningfully outperformed once again in 2021.

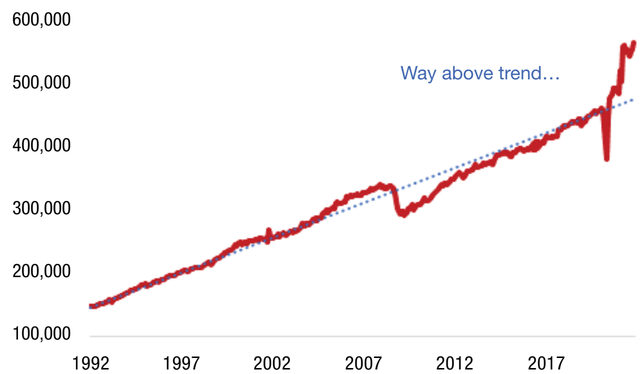
More broadly, we correctly foreshadowed the reemergence of inflation, a word we mentioned more than 20 times in last year's Outlook. Citing an environment characterized by too much money chasing too few goods and too much demand with too little labor supply to meet that demand, we felt inflation would be a force that policymakers and investors would have to contend with for the first time in a long while.

This dynamic can be highlighted by charts 1 and 2 at right — one highlighting record retail sales (i.e., demand) and the other illustrating the U.S. labor market (i.e., supply) or total U.S. payrolls. As noted, the labor market has experienced a remarkable recovery following an epically deep but thankfully brief collapse in early 2020. Yet the jobs market in the aggregate is still smaller than it was pre-pandemic. Demand, meanwhile, is far, far above its long-term trend.

Not only is demand exceeding supply, but a record number of workers are also voluntarily quitting their jobs, a phenomenon that has been labeled The Great Resignation. Many people are quitting their jobs believing their prospects are brighter elsewhere. Others are leaving the workforce altogether due to retirements, childcare obligations, healthcare reasons, or other motivations. Regardless of the reasons, millions of Americans willingly leaving the labor market strains supply even further. In response, companies are lifting wages to entice workers back, and, as a result, overall levels of inflation are also increasing, as seen in charts 3 and 4 at bottom.

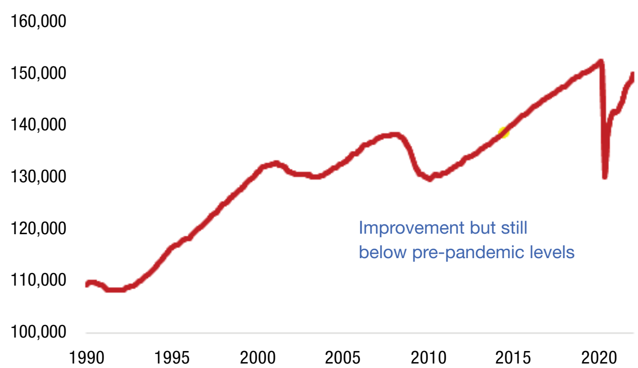
However, inflation can be a double-edged sword: Some view it positively as higher wages can spur future consumer spending. But this can be illusory, for the prices of consumer goods may also be rising. Also, higher wages can be a headwind for corporate profit margins. Some companies can offset higher wages with higher prices on the goods and services they provide, but others cannot.

Chart 1 — U.S. Retail Sales ($ in millions)



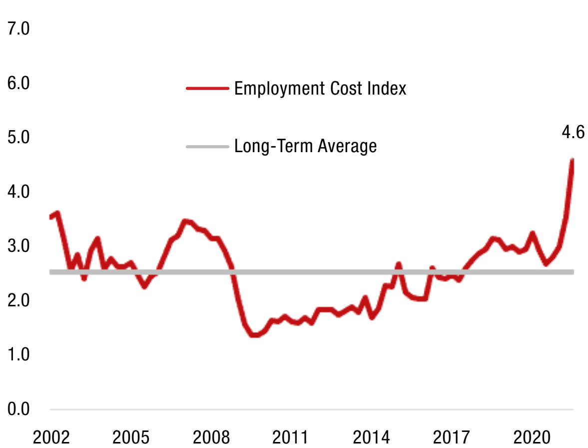
Source: Federal Reserve Bank of St.Louis (https://fred.stlouisfed.org/)

Chart 2 — U.S. Nonfarm Payrolls (in thousands)



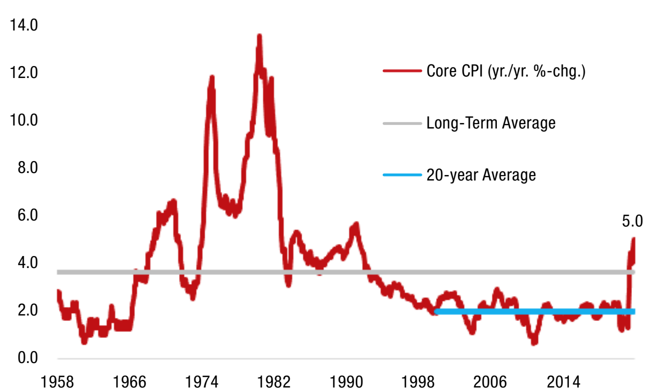
Source: Federal Reserve Bank of St.Louis (https://fred.stlouisfed.org/)

Chart 3 — Employment Cost Index (yr./yr. %-chg.)



Source: Federal Reserve Bank of St.Louis (https://fred.stlouisfed.org/)

Chart 4— Core Consumer Price Index (yr./yr. %-chg.)



Source: Federal Reserve Bank of St.Louis (https://fred.stlouisfed.org/)

Inflation can also cause policymakers to act by raising interest rates in an attempt to cool demand, which, in turn, can cause the economy to slow and corporate profits to moderate even further. With massive government-related debt outstanding, higher borrowing costs can cause significant stress on government budgets. Higher debt burdens then ensue, crowding out spending for other, more productive purposes.

For much of 2021, the Federal Reserve repeatedly reiterated that inflationary pressures were transitory or fleeting. They argued that supply chain issues, additional costs associated with COVID-19, and base effects (comparing 2021 activity relative to the depressed activity of 2020) were temporarily distorting the inflation picture.

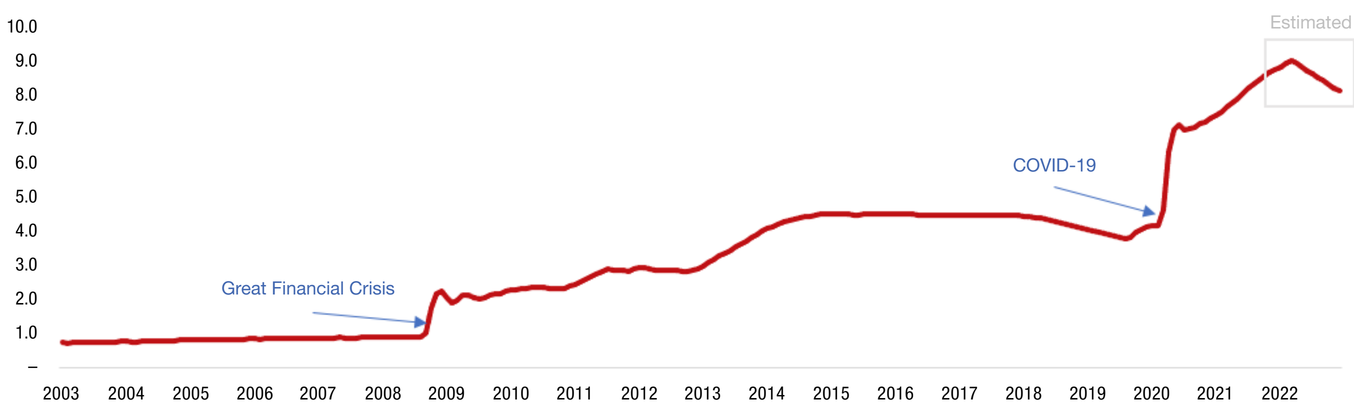
As 2021 progressed, however, inflation proved more tenacious and more widespread than initially anticipated. As a result, in December, Jay Powell, chair of the Federal Reserve, announced that his view and the Fed's policy had changed. More specifically, the Fed would soon stop providing liquidity to the economy by discontinuing the expansion of its balance sheet — a balance sheet that doubled from $1 trillion to $2 trillion during the financial crisis in 2008-09, then doubled again to $4 trillion in late 2019 and then doubled yet again to over $8 trillion post-COVID-19. This has been a massive amount of firepower to support the economy, and later this year, it would diminish. The Fed also signaled that it would raise interest rates as many as three times in 2022 after previously indicating that interest rates would not change for an extended period.

This signal represented a significant course change. What made this policy shift even more remarkable was that it came days after the omicron variant had been detected. Omicron has since proven to be substantially more transmissible than other strands of the coronavirus. In other words, the Fed views inflation as a more significant economic threat than COVID-19, and it is acting accordingly.

Peering ahead, we acknowledge that some of the forces that previously kept inflation in check, such as globalization, innovation, and demographics remain in place, although perhaps some of their influence may have peaked (a longer topic we may explore later this year). We also believe some of the inflationary pressures sparked by COVID-19 will moderate.

But other factors, including strong demand for housing, higher energy prices, and rising labor/wages, may likely be more persistent. And while we don't think the inflationary environment that defined the early/mid-1970s will repeat (e.g., multiple years of double-digit inflation), neither do we believe the disinflationary period that defined the 2010s will be repeated. Moreover, nearly all Fed policymakers, corporate finance managers, and investors in their respective seats today have never experienced persistent inflation. Thus, it may be difficult to contain and prove problematic if inflation becomes self-reinforcing.

Chart 5 — Federal Reserve Balance Sheet ($ in trillions)



Source: Federal Reserve Bank of St.Louis (https://fred.stlouisfed.org/)

One other worry: The Fed and the economy are ostensibly operating at different speeds. The Fed deserves to be commended for responding forcefully and swiftly once COVID-19 was first identified, but it seems to have been slow to adjust its policy once the economy recovered. As a result, the odds of a policy error have increased and could materialize if the economy — and inflation — begin to cool in the second half of 2022 at the same time that the Fed is raising interest rates.

> The bottom line is that inflation continues to be the most significant macro risk to the economy, and with it comes new complexities and new policy uncertainty. Investors, therefore, should be prepared for more volatility in the year ahead.

Volatility may also arise from capital markets becoming, in our word, "crowded." Equity markets (namely U.S. large cap equity indexes) are dominated by a small handful of mega-sized companies. The five largest companies within the S&P 500 Index presently make up one-quarter of the entire index as measured by their market capitalization. Similarly, most of today's investment-grade bond market now consists of BBB-rated securities, the lowest quality rating for investment-grade securities. At the same time, the bond market has become more sensitive to interest rate fluctuations, too.

By themselves, these statements are not a cause for concern as they are unlikely to be a direct source of market instability. They are merely observations. But they could exacerbate volatility if the underlying macroeconomic and broader market conditions abruptly change and thus deserve mention.

Therefore, our base case for 2022 is as follows:
In the first half of the year, we see inflation remaining elevated before losing some momentum in the second half but staying above the Fed's inflation target of 2%. Accordingly, interest rates will rise, and other forms of monetary support will be withdrawn. The odds of additional fiscal stimulus such as President Joe Biden's Build Back Better proposal have decreased considerably in the past few months. Some type of legislation should not be ruled out, but certainly not as expansive as the Green New Deal plan first proposed in 2019 with a price tag of upwards of $6 trillion. The House passed a far less ambitious bill of $1-2 trillion, but passage in the Senate still seems tenuous due to the trajectory of inflation.

In this environment, following a year when many fixed-income investments generated negative returns, bonds may again post lackluster returns in 2022. We believe that bonds can act as an effective hedge against deflation. Still, if inflation persists and the Fed is compelled to act more aggressively, given their already low yields, bonds may no longer be seen as providing risk-free returns and instead be viewed as assets that offer "return-free risk."

On the other hand, equities had a banner year in 2021, led by U.S. large-cap stocks, which soared nearly 30%, far more than we and most market observers predicted. Stocks have been buoyed by exploding corporate profits, improving corporate productivity, stock buybacks, and inflows from investors who, like us, concluded that the outlook for stocks was more compelling than bonds.

Let's put some numbers behind this: Over the past 35 years, in a given year, on average, the S&P 500 Index registered an intra-year decline of 14%, yet it still has finished higher 75% of the time for the full year. In 2021, the largest intra-year decline was a relatively mild 5%, which came in late November amid omicron-related fears. In 2022, we think that stocks can continue to outpace bonds, but returns likely will be bumpier than in 2021. In other words, it would not be uncommon to experience more volatility in the year ahead.

A reemergence of equity market volatility may be sparked by the aforementioned shift in the Fed's policy, ongoing supply chain challenges, ripples from China's ongoing real estate deleveraging, or an exogenous shock such as a geopolitical event. Overall, though, we expect stocks to post modest gains in 2022, and our bias toward high-quality cyclical stocks remains. But we also think that investors may need to employ a degree of nimbleness and transition from quality cyclical bias to a quality growth bias if inflation moves faster than we anticipate, the Fed raises interest rates aggressively, and economic activity falters.

A bigger concern for equity investors would be a Fed-induced policy error sparking a recession outside of expected volatility. At present, the U.S. economy is displaying considerable momentum. Furthermore, consumers, corporations, and financial institutions, as a whole, remain in sound financial shape rendering the odds of a recession in 2022 as low. But as noted above, the economy and the Fed are operating at different speeds, and thus a policy error cannot be ruled out. To monitor this, investors can examine the difference between long-term and short-term rates (also known as the slope of the yield curve), which historically has been a good predictor of recessions, as the shaded areas highlight in chart 6 at bottom.

In short, with volatility likely to return in 2022, equity investors should remain disciplined, flexible, and place a premium on selectivity.

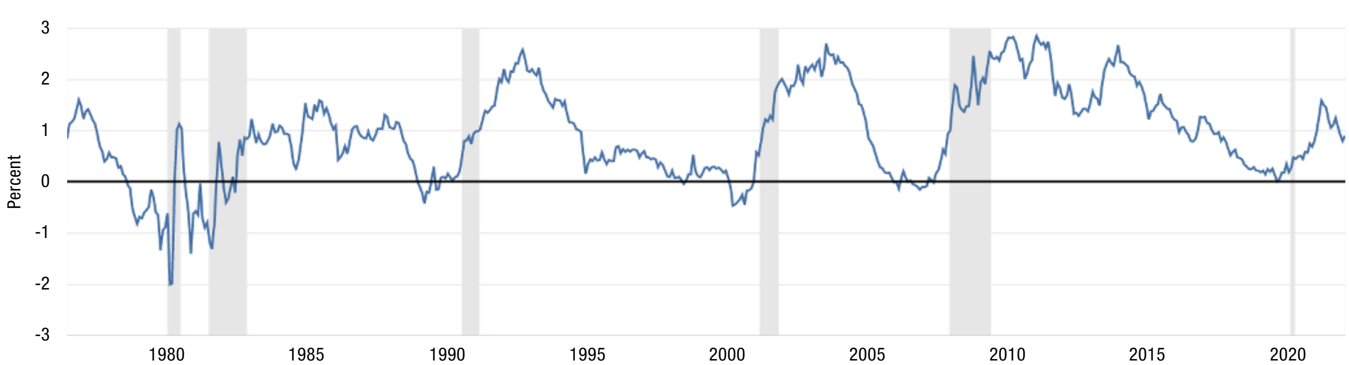
Lastly, as this new year begins, we would be remiss if we failed to recognize that the future path of COVID remains unclear. That said, just as we wrote slightly more than one year ago, there are reasons for optimism: Effective vaccines are widely available in most developed countries to prevent further transmission, and proven treatments now exist for those suffering from the most severe symptoms.

There is also reason to be hopeful with respect to the newest variant, omicron. As we write, omicron appears to be more transmissible than delta, but it also seems much less lethal. If this holds true, omicron could become the dominant variant, displacing others, infecting many but killing fewer. Those unwilling to get vaccinated may eventually acquire immunity by contracting the omicron variant bringing about herd immunity and allowing us to return to **relative normalcy**.

> Under this scenario, COVID-19 would be treated similarly to how we treat other endemic viruses such as the flu. In 2018–2019 (the last full season pre-COVID), 29 million Americans were diagnosed with the flu, 380,000 were hospitalized, and 28,000 Americans were estimated to have died from the flu.[2]

While in no way do we wish to suggest that 20,000 deaths are insignificant, such numbers amount to 1.3% and 0.07%, respectively, of those who are hospitalized and perish from the flu. And because these are relatively manageable or socially acceptable statistics, many of us receive an annual flu shot, and most all of us lead our lives freely — no mask mandates, no social distancing, no travel bans, no quarantines, and no lockdowns.

Chart 6 — 10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity[1]



2022, therefore, may be another year of unease and unevenness. But scientific evidence regarding viral mutations, combined with effective vaccines, better treatments, people's innate resiliency, and kindness, along with human ingenuity, all lead us to conclude that reasons for optimism will be rewarded and will ultimately prevail.

Looking back to the Spanish Flu of 1918, what some refer to as the last global pandemic, upwards of 50 million people died as it spread globally for two brutal years before the virus finally burned itself out. Five years after that, in 1925, in reflecting how far America had come after tolerating so much — both a global pandemic in addition to World War I — then-President Coolidge said the following:[3]

> "… the chief business of the American people is business. They are profoundly concerned with producing, buying, selling, investing, and prospering in the world.
>
> "Of course, the accumulation of wealth cannot be justified as the chief end of existence. But we are compelled to recognize it as a means to every desirable achievement.
>
> "So long as wealth is made the means and not the end, we need not greatly fear it...But it calls for additional effort to avoid even the appearance of the evil of selfishness or undue pessimism."

On behalf of my colleagues, I wish you good health, peace, prosperity, and continued optimism in the year ahead.

For more information about how to adjust your strategy based on this outlook, contact your advisor.

[1] Source: Federal Reserve Bank of St.Louis

[2] Source: Centers for Disease Control and Prevention (CDC): Disease Burden of Flu

[3] Source: ThisDayinQuotes.com: "The business of America is business."

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