Outlook for 2022: Economic Growth Expected to Moderate This Year

2022 May be a Year of Slower Growth, Lower Inflation, Less Stimulus and Lower Stock Market Returns

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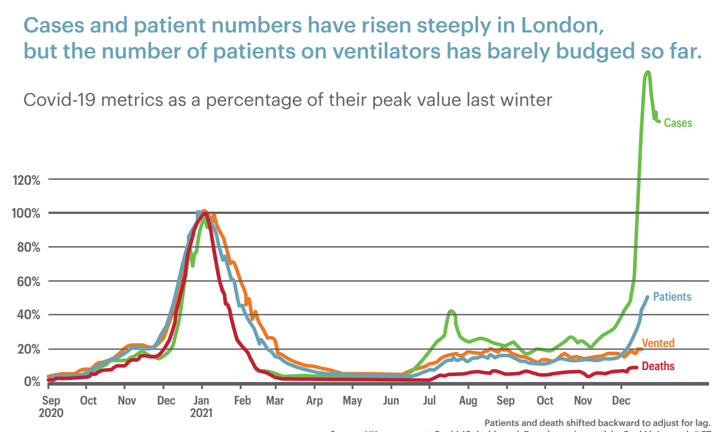
LAST YEAR, many looked forward to a return to some semblance of normalcy after more than a year of challenging modifications in their daily lives due to the pandemic. Unfortunately, just when it seemed like that was about to happen, a new variant of the virus surfaced and the world was again faced with rising case counts and business disruptions. The possibility of partial economic lockdowns was being revisited as many flights were cancelled, restaurant closures were common again, and the progress made repairing supply chains slowed.

Despite almost 50 percent of the world's population being fully vaccinated, the daily number of new COVID cases is now higher than at any other time during the pandemic. However, while the new COVID variant, Omicron, appears to be spread more easily, the symptoms appear to be much less severe, so it remains to be seen how much of an impact it will have on economic growth. Thankfully in most places hospitalizations and deaths have not surged along with the case counts. Most of the vaccinated, and many of the unvaccinated, are having only mild symptoms. Further, the FDA has approved a pill developed by Pfizer called Paxlovid that reduces the risk of hospitalization and loss of life if taken once symptoms begin. As a result, there have been only a few areas where lockdowns or travel restrictions have been reimposed.



Despite the good news on vaccinations and the development of new drugs, the Omicron variant and

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potentially new variants are likely to continue to be somewhat of a drag on growth as people take a more cautious approach to their lives. Eventually, the world's leaders will need to come to the realization that the previously stated goal of "zero COVID" is unlikely to happen, but economic activity can continue with modifications made to daily life. The recovery in business activity can continue but will likely be at a slower pace than last year. As a result, economic growth, inflation, and stock market valuations all may have peaked, and 2022 may be defined by a return to a more normal level of growth.

THE ECONOMY

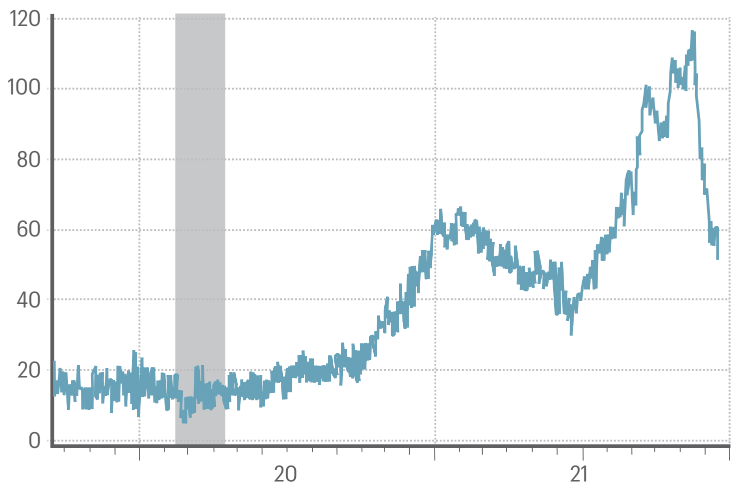
After a soft third quarter, economic growth strengthened in the fourth quarter last year as retail sales, airline passenger, and hotel occupancy rates were all strong. The recovery is expected to continue in 2022, and the passage of President Biden's stimulus bill in some form will further boost economic activity. Still, the economy is likely to grow at a slower pace than last year because we are still dealing with numerous issues left over from the pandemic-induced shutdown of business activity.

Supply chains remain strained, although recent data suggest the bottlenecks are easing. Delivery delays are getting shorter in most countries, which is helping factory output to expand. In the United States, according to the Institute of Supply Management, there are "some indications of slight labor and supplier delivery improvement." Port backlogs have dropped precipitously. While this improvement is a welcome sign, the continuing spread of the Omicron variant has the potential to undo the progress.

Supply chain bottlenecks are also contributing to inflationary pressures. Higher input costs, as well as higher wages, will be a drag on the profit growth of many companies. By the end of this year the inflationary pressures should ease as the supply constraints ease, but also because economic growth will be slowing.

Port Backlogs Lowest Since June

United States: *Los Angeles/Long Beach Harbor container vessels in port*
(number)



Shading indicates recession

Source: Haver Analytics, Rosenberg Research

A big part of the acceleration in growth since the start of the pandemic has been the flood of stimulus coming from the U.S. Federal Reserve and other Central Banks around the world. The Federal Reserve is expected to taper its bond purchases at a faster pace than previously anticipated and will likely raise rates two or three times in 2022, so that stimulus will begin to dissipate as the year progresses. Monetary conditions will be tightening throughout the year, further restricting economic growth, but remain somewhat loose relative to historical standards.

Rising interest rates will be another headwind for economic growth this year. Interest rates are likely to initially move higher as the Federal Reserve begins to raise rates this year but will probably not rise substantially over the longer term. Economic growth and inflation have already peaked so the anticipation of slower economic growth in 2023 and beyond will likely keep a lid on the rise in interest rates. A Bloomberg survey of economists forecasts 5.5 percent GDP growth in 2021, then down to 3.9 percent growth in 2022, and then only 2.5 percent in 2023.

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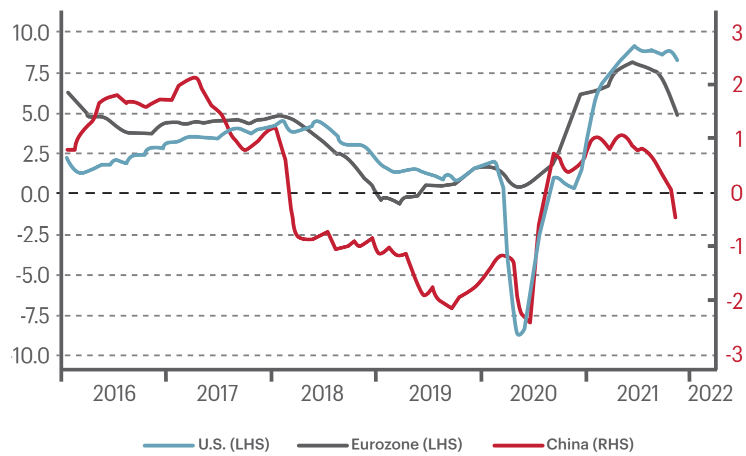
The Leading Economic Indicators in the U.S., China, and the Eurozone have already peaked and are rolling over, although the drop off has been more severe outside the U.S.. The United States appears poised to lead the world in growth again in 2022 thanks to a somewhat better success rate in vaccinating its population and avoiding business lockdowns in the face of the Omicron emergence. It remains to be seen if this relative advantage over the rest of the world continues the rest of the year.

A wild card that could derail the recovery is China's ability to contain its real estate crisis. Can the authorities there let the air out of the property bubble without causing a financial crisis? So far it looks promising, but it is difficult for those outside the country to know exactly what is happening. In any case, it is a situation that cannot be ignored.

VP Country LEIs



THE STOCK MARKET

Another year of solid yet slowing economic growth should be enough to support further gains in stocks. However, there are plenty of reasons to worry about the potential for a correction in prices.

There are many ways to gauge if stocks are expensive. After a 12-year period of rising stock prices that was only briefly interrupted in the initial stages of the global pandemic, almost every measure indicates that stock market valuations are high relative to historical averages. One of the most widely cited measures is the Shiller PE Ratio, which calculates a price-to-earnings ratio based on average inflation-adjusted earnings from the previous 10 years. The Shiller PE Ratio is nearing an all-time high, which was reached in 1999.

By itself, a rich valuation does not mean stock prices will fall. It does mean, however, that the risk of a stock market correction is high if other conditions are met. Some of

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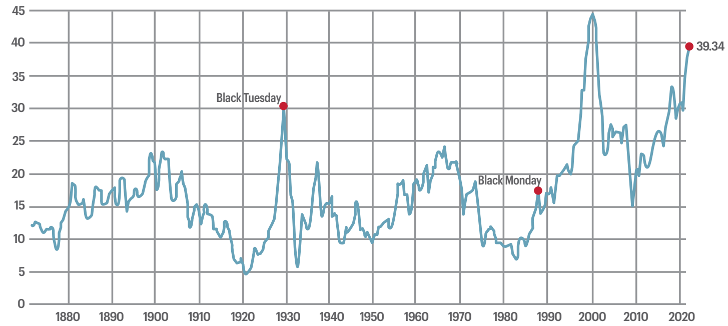
those conditions would be if interest rates rise, corporate profits fall, and if the performance of a handful of stocks is disguising weakness in the rest of the stock market.

Shiller PE Ratio 2021



Source: www.multpl.com

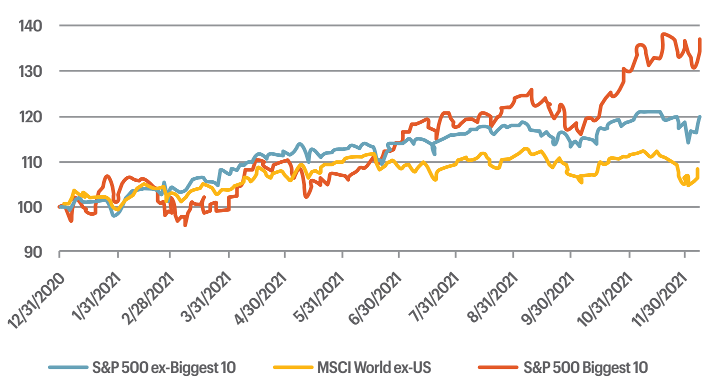
Interest Rates: One reason given for the above average valuation level of stocks is that interest rates remain low by historical standards. However, if interest rates rise substantially, the value of the future cash flows in equities are worth less today. So, the high valuation stocks would likely fall substantially and take the market down with them.

A Recession: More often than not, the end of a bull market is caused by an economic recession, which is characterized by falling corporate earnings. Corporate earnings drive stock prices, so a drop in corporate earnings usually leads to a drop in stock prices. Today, corporate earnings are still strong and consumer demand is rebounding.

Neither a recession nor a substantial rise in interest rates is likely to occur in 2022. Still, there is the risk that the U.S. Federal Reserve could hike rates too many times in 2022 which could slow growth and bring about a recession. There is an adage that bull markets don't die of natural causes, they are murdered by the Fed. This is unlikely to happen in 2022, but the possibility could cause uncertainty and volatility in the markets throughout the year

Stock Market is very thin: A few stocks have accounted for an unusually large amount of the returns in the stock market. The top ten stocks in the S&P 500 Index have been surging in price and driving the index higher.

A Perfect Ten

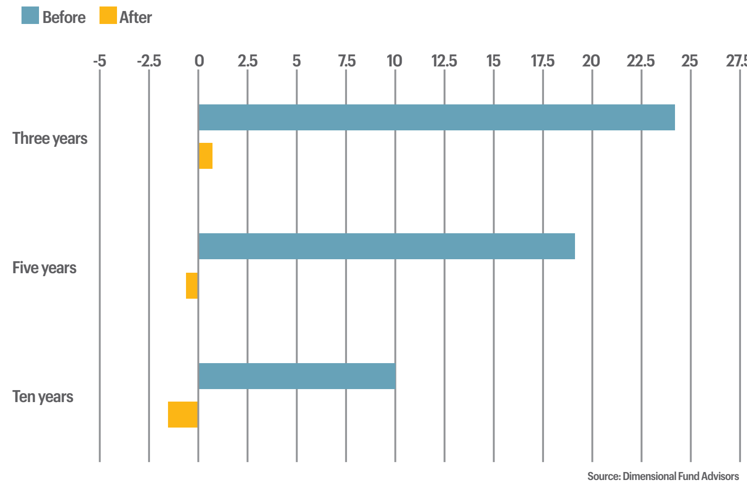


Source: The Financial Times

A stock market that is being driven by such a small handful of stocks is considered to be an unhealthy sign. Historically, when the stock market is driven by such few stocks it is near the end of an upward cycle. One of the reasons for this is that as the companies get larger it becomes much harder to continue growing earnings at an elevated rate. That is why after a stock performs well enough to reach the top ten in the index it typically only manages minimal gains in the years that follow.

The stock market is likely to continuing moving higher but at a more moderate pace and with more volatility.

Annualized relative performance of 10 largest U.S. stocks relative to market before and after reaching that level



Another sign of an unhealthy market is when stock prices rise much faster than corporate profits. Historically, during a bull market, about 70 percent of the rise in stock prices is attributable to increases in corporate profits and about 30 percent is attributable to an expansion of its valuation (the level of the price-to-earnings ratio increases). However, in the last three years this has been reversed, with only about 30 percent of the rise in stock prices attributable to increases in corporate profits and 70 percent attributable to expanding price-to-earnings levels. This has been even more pronounced in the largest t10 stocks in the index, where about 10 percent of the rise in stock prices is attributable to increases in corporate profits and 90 percent is attributable to expanding P/E levels.

While a correction in stock prices is not inevitable, the risk in owning stocks is rising, and the uneasiness around these concerns will likely drive an increase in volatility in 2022. However, investors still have the mindset that "There Is No Alternative" to stocks (TINA). Investors have been unwilling to move a significant amount into bonds because the earnings yield on stocks is still higher than fixed income yields. The earnings yield is the 12-month earnings of the stock market divided by the price. If investors can yield more in the stock market than in the fixed income market, they are more apt to invest in stocks. As a result, the stock market is likely to continuing moving higher but at a more moderate pace and with more volatility. Only a recession or substantially higher interest rates would jar investors out of this mindset, and neither seems likely in 2022.

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HBKS® principal and chief investment officer, Brian Sommers, oversees the firm's investment management processes for HBKS® investment advisory representatives. He chairs the firm's investment policy committee and is instrumental in the identification, evaluation and recommendation of the investments that make up the firm's client portfolios. He brings HBKS® clients the expertise of more than 20 years managing a wide range of portfolios for both high-net-worth individuals and institutional clients.