INVESTMENT MANAGEMENT

BOK FINANCIAL

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ECONOMIC & MARKET OUTLOOK

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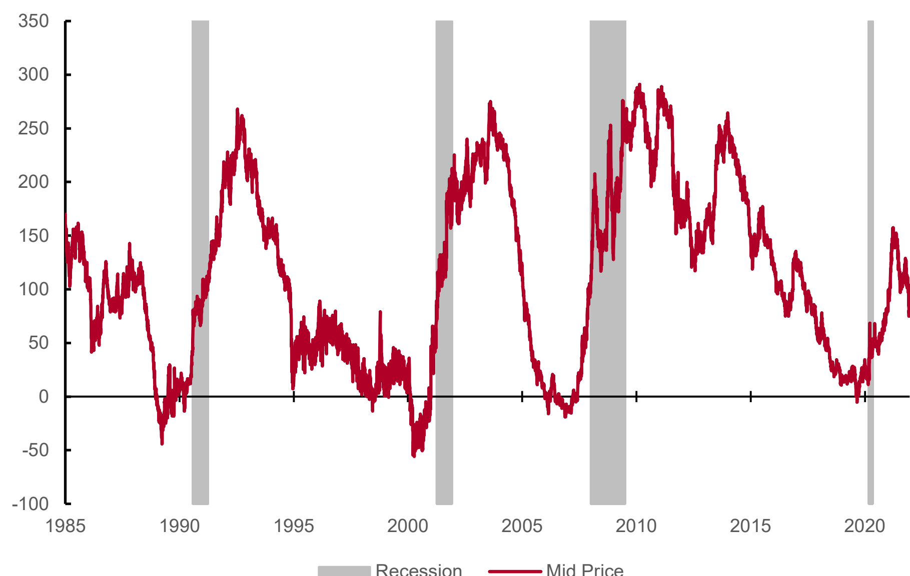
Gauging the Investment Markets: .22 Caliber Style

After popping the cork on another bang-up year in the financial markets, it's time to assess the investment hunting grounds for 2022 and perform a portfolio safety check. As a primer to a good approach for assessing the markets, investors can begin with an understanding of where the herd is headed given consensus outlooks for economic growth and monetary policy. The 10-bagger investment return trophies are typically camouflaged between the worn paths of the herd's economic outlook versus the more probable and surprise market scenarios. The markets are currently huddled around the Federal Reserve's guidance of 4% GDP growth and a target Fed Funds rate of 1% by the end of 2022. In my opinion, economic growth is more likely to be 3% at best during the first half of this year, and two of the interest rate hikes already priced into the front end of the bond market will prove to be blanks.

Why do we think growth predictions will fall short, taking out two interest rate hikes along the way?

For one, the smoke-filled air from COVID has yet to clear. The case count explosion from the Omicron variant will muzzle economic growth, much like previous variants. With continued increased vaccinations in the U.S. and many developed countries, we are all in much better position to protect ourselves against the virus as well as treat the sickness with new antivirals. However, the current vaccination weapons haven't been the ideal armored protection we had all hoped for as breakthrough infections trigger periodic pauses in economic activity. COVID is still with us, and will remain the biggest risk to economic growth in the new year. The virus continues to mutate and the Omicron variant will likely not be the last one.



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Key Points

- Ever-evolving COVID variants including Delta and Omicron continue to cause reopening uncertainty and unevenness across countries and regions.
- With a strong job market and high asset prices, the U.S. consumer remains in a position to drive above-trend economic growth.
- Supply and demand shocks are causing inflation to remain both elevated and concerning. The tension between inflation and monetary policy is likely the greatest source of financial uncertainty in 2022.
- As inflation expectations rise, markets are pricing in up to three rate hikes in 2022. Our view is the Fed moves more slowly so as to avoid choking a nascent economic expansion. Inflation fears fade as the year progresses.
- Equity markets, though historically expensive, are attractively priced relative to other financial assets and still offer upside, though returns may be more muted.

Q4 Results	
S&P 500	11.0%
Russell 2000	2.1%
Barclays Aggregate Bond	0.0%
MSCI EAFE	2.7%
MSCI Emerging Markets	-1.3%

Second, even before the Fed decided to slow the pace of monthly bond purchases and signaled three rate hikes in 2022 followed by five more in 2023 and 2024, the tail end of the bond market had been on point in sniffing out a significant slowdown in economic growth and inflation this year. Setting aside the clear downward trend in yields on the long end of the bond market for the last 30 years, we have continued to see yields fall relentlessly in the past quarter in the face of very high economic growth and inflation data. Investors flinch every time they see the near record low negative real yields offered in the bond market after considering the current high inflation rates. While front-end yields have been ratcheting higher, rates on the more inflation sensitive long end of the yield curve have been falling. The bond market is telling us that GDP growth and inflation are likely to slow down. The flattening of the U.S. Treasury curve between the two-year and 10-year alongside a terminal funds rate that caps out near 1.75% should be viewed as a warning shot over the Fed's bow as to the market's expectations for how fast and how high the funds target can go.

What else should investors consider?

Looking at fundamentals to track future economic growth trends, two additional factors stand out from the tree line. One, we have passed peak fiscal policy support which over the previous two years accounted for more than 10% of overall GDP and trillions of dollars in higher levels of public debt. The one-time pandemic stimulus package that included sending trillions of dollars to consumers was a major reason we even grew above our long-term 2% GDP growth trend. Two, the vaccine-driven reopening last year was a proverbial shot in the arm for the economy, and likely won't be repeated. For 2022, it appears President Biden's $2 trillion Build Back Better program was more like a BB-gun compared to previous COVID policies that didn't make it off the rack. With President Biden's BBB misfire, fiscal policy likely will be a neutral for growth this year, albeit a positive for earnings expectations without higher corporate tax rates.

What do we see through our sights for 2022?

To be sure, the U.S. consumer is in good financial shape overall and, coupled with a very strong labor market, should drive U.S. economic growth above the long-term 2% trend. In 2022, 2.5% to 3.0% U.S. economic growth would be positive for risk assets. Without another round of COVID stimulus checks, the lower income segments of the population are largely out of extra financial ammo to increase spending above personal income growth. With excess savings already drawn down, reduced demand from the lower income segments should help alleviate the upward inflation trajectory on durable goods. Remaining dry powder in the form of excess savings resides primarily with the wealthy income segments of the country. With record high net worth levels and reasonable consumer debt levels relative to income, the high-end U.S. consumer has a lot of extra firepower to increase spending on services, which will in turn drive growth.

Look for positive but subdued returns in the equity and bond markets

We are likely to see a brief beta rally early in the year as the most punished stocks rebound from the November and December sell-offs. Then the stock market is likely to be led by the higher profitability and balance sheet quality names as the economy slows and the markets debate the magnitude of Fed rate hikes, which appear to me to be part of a coordinated decoy to mitigate inflation.

Cheers to another good year in the markets!

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Disclosures

Chart data source: Bloomberg

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