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The 2022 Earnings Outlook

Since the start of the Coronavirus Pandemic central banks across the globe have been quick to adopt massive stimulus packages in an effort to provide economic support in order to boost the economy. As of the end of 2021 the total net worth of the stimulus pumped into global markets equates to around $32tn. In a research piece published in late December by Bank of America, this is "equivalent to buying $800m of financial assets every hour of the past 20 months".[1]

Closing the Taps on Liquidity

Easily one of the most supportive central banks has been that of the US Federal Reserve, which early on in the pandemic committed to a bond-buying program wherein it purchased $120bn in bonds every month in an effort to pump money into the economy. In a statement made in mid-December, the Federal Reserve announced that the asset purchase will be ended by March of 2022 in order to contain the high levels of inflation currently present in the financial system. Furthermore, the Fed is expected to hike interest rates three times over the next 12 months to combat inflation.

Looking toward the year ahead, and taking the abovementioned factors into consideration, there are several themes which underpin the investment outlook and strategy for portfolios on a 6-12 month time horizon.

The Path of Inflation & Bond Yields

By now the rhetoric of "transitory inflation" has well and truly abated as most market participants and asset managers agree that inflation is unlikely to subside in the short term. What still lacks consensus, however, is the path inflation will take from its current levels. American Investment Bank Morgan Stanley expects inflation to peak in the first half of 2022 but then moderate as supply chain issues ease. BlackRock, currently the largest asset manager in the world, predicts higher inflation "for years to come". In a contrasting view, Columbia Threadneedle, an American Asset Management Firm with over $700bn in assets, expects inflation to fall in 2022 due to significant improvements in the supply chain. This, if realised, would result in the US Fed increasing interest rates at the precise time that inflation begins to fall; an outcome that would be wholly unsupportive to financial markets.

Investors generally agree, however, that expected inflation, if realised, will not be as broad-based as was experienced during 2021. Already we have seen supply-side inflationary pressures begin to ease as the global economy continues to reopen and supply chain bottlenecks start to subside. This will lead to a moderation in price increases related to that of consumer goods. What is expected to continue rising, however, is demand-side pressures which will lead to an increase in service price inflation. Overall, headline inflation is expected to moderate slightly in the year ahead, however core inflation (excluding food and energy components) will remain at elevated levels. This scenario will continue to favour equities over bonds in a global investment portfolio.

The combination of persistent inflation, economic recovery, and the removal of monetary accommodation by the Federal Reserve will cause a meaningful rise in global bond yields (and drop in bond prices) over the coming year. The greatest risk to bonds lies at the long end of the curve (bonds with a time horizon of 10 years and longer) where the divergence between bond yields and the potential GDP growth outlook is largest. These bonds are at the greatest risk of a yield increase in order to better reflect the economic growth outlook in the US. As such, Inflation-linked bonds and Treasury Inflation-Protected Securities (TIPS), both of which increase in value during inflationary periods, will provide a degree of inflation protection in a global fixed income portfolio.

Rising Global Equities

Economic growth is expected to remain strong over the coming year, supported by the continued easing of global Covid restrictions, along with the increased demand for services from cash-heavy investors. Along with rising economic growth investors should expect volatility in the short to medium term due to the combination of solid economic momentum coupled with rising interest rates and elevated inflation. Corporate earnings have continued to steadily rise as firms that have been able to weather the Covid storm return to normal operating activity. As we have often stated in our economic feedbacks, market prices follow the underlying earnings of companies, and not the other way around. As such, rising corporate earnings in 2022 will provide a supportive tailwind to equity prices and their continued positive performance.

As indicated by the above image published in the Financial Times, analyst expectations for US equities are generally positive for the year ahead. The vertical dotted line depicts the value of the S&P 500 index on the 22nd of December 2021 and each corresponding dot reflects the expected value of the index at the end of 2022. [2]

Most large Investment Banks expect a positive year for US equities and predict growth of between 8 and 12 percent. There are those, such as Morgan Stanley and Bank of America, who have more unfavourable expectations for the year ahead, based on the interest rate outlook and anticipation of heightened volatility.

As discussed above, higher interest rates and expected volatility will put a degree of drag on valuations and earnings, however currently the positive investment factors outweigh the negative, and investors should maintain a moderately pro-growth stance in their investment portfolios going into 2022. The Omicron variant, which alarmed the world in late November due its high transmissibility, remains a near-term risk to global financial markets, however the ongoing effects of the mutation are expected to be minor. Local residents would no doubt have breathed a sigh of relief to learn that their holiday plans would not be interrupted by the latest variant as the South African government opted not to impose further lockdowns and restrictions in the face of the Omicron mutation. Globally we are witnessing a similar narrative as most countries have relaxed their travel limitations and have done away with the mandatory isolation period for individuals entering their borders.

Currently the year ahead has the potential to generate positive returns and increased growth for investment portfolios, provided one looks in the right places. While investors should be wary of taking any year-end prediction as an inexorable truth, an upbeat view is underpinned by excess saving and robust labour demand, both of which are backed by strength in US and Euro area consumer spending. As we have seen countless times in the past, the disciplined investor who remains invested in a well-constructed portfolio will be rewarded for their patience.

Sources:
[1]Lex, 23/12/2021, “2022 forecasts: and they all lived happily ever after”, *Financial Times*
[2]Steer G, 19/12/2021, “The Big Market Questions for 2022”, *Financial Times*