WATERFRONT
ASSET MANAGEMENT

2022 Outlook

Executive Summary:

Good morning and Happy New Year!

I am always a little nervous about writing annual outlooks. After all, the future is unknown and unknowable. As a result, this exercise opens the author up to ridicule and derision for either being hopelessly optimistic or unnecessarily worried. However, it is a helpful exercise to articulate your view and support it with as much objective data as possible in order to focus attention on the variables that seem determinative. So, with an appropriate blend of temerity and confidence, here is my outlook for the new year.

US GDP growth of 3.5 - 4.0%

S&P 500 EPS growth of 8 - 10%

S&P 500 Index return of ~7%

U.S. 10yr yield on 12/31/2022: 2.5%

In my view, the economic expansion that began as the world recovered from the pandemic appears durable. The health of the U.S. consumer is an important building block of that positive outlook. Employment statistics point to an improving jobs market with ongoing evidence of rising wages. Strong consumer balance sheets and elevated savings rates are also encouraging. Monetary stimulus is fading as the Fed tapers its asset purchases but is still supportive for risk assets over the near term. I do expect the Fed to begin the process of normalizing interest rates during the first half of 2022 but the first rate hikes, while often associated with short-term volatility, are unlikely to cause a recession. It's the last rate hike that hurts; not the first! Fiscal stimulus is somewhat of an unknown given the political environment, but fiscal stimulus works with a lag, such that the U.S. economy will continue to benefit from the stimulus put in place over the last three years. As a result, a strong consumer; still accommodative monetary policy; tailwinds from fiscal policy put in place over the last several years all lead me to expect economic growth to continue, albeit at a slower pace than 2021. I expect S&P 500 EPS growth to approximate 9% in 2022. And finally, I expect the S&P 500 to post a more pedestrian return that approximates 7% which implies a modest amount of multiple compression.

While always a risk to make a prediction, I take some solace in the history of equity market returns. As most people in our industry know, the domestic equity market has average ~10.7% annualized returns over the last 100yrs and ~9.4% over the last 25yrs. As a result, it would be fair to suggest my forecasted return of 7% is far from heroic. I would simply say history suggests my return forecast is probable.

I also find confidence in the history of corporate earnings growth. Through thick and thin, U.S. corporations have averaged double-digit annual earnings growth over the last 20yrs. While I think companies will struggle to hit that bogey after a phenomenal performance in 2021, a supportive global economic backdrop and pent-up demand will push them close to that hurdle in my view. I believe an inventory restock cycle is likely to be a tailwind. In addition, I expect a proliferation of an emerging trend of companies choosing to prioritize local production as opposed to the multi-decade trend of globalization. These tailwinds are powerful!

However, there are meaningful headwinds to earnings growth. Inflation in a broad range of inputs is likely to pressure gross margins. Wage inflation is a growing headwind to operating margins for all companies. And finally, taxes are likely to rise in the years ahead though the timing is uncertain. A noteworthy partial offset to these headwinds is a healthy domestic consumer and continuing low interest rates which are conducive for corporations to pass along those costs in the form of higher prices. Even so, these headwinds are real…I simply believe they will be overwhelmed by the positives.

A brief comment on the pandemic is necessary. I find great hope in the historical pattern of pandemics which is instructive in my view. Epidemiologists have chronicled over decades the tendency of viruses to mutate into more benign variants over time. The science behind this is intuitive: the most lethal variants kill their hosts and thus limit their ability to spread. As time progresses, the variants that persist are less lethal but more transmissible. We can attest to the fact that this pattern has continued with COVID-19. While the pandemic is first and foremost a terrible human tragedy and every life lost to this scourge is a cause for mourning; we can have confidence that science would support a hopeful view that the worst is behind us. I doubt Omicron will be the last variant, but I believe that the next variant (and each successive one after it), will be less fatal and have less of an economic impact as a result. As has been the case for the last year, risk assets should be purchased when they decline due to fears over a new variant.

So given that rosy outlook, what are the risks? Before getting to those, I want to address a few common concerns I have heard over the last several months: risk asset valuations and the Fed. I don't see the level of pervasive excesses in risk asset valuations that typically precede a recession. While there are clearly pockets of excess, I don't see valuations as so excessive that they can independently create a correction. I also don't believe the Federal Reserve is concerned enough with inflation to purposefully slow the economy quickly by raising interest rates at a pace in excess of ~25bps per quarter. There are real risks to the outlook as always; I just don't see those risks as the most likely.

I think the greatest risk in 2022 are exogenous factors outside of the economy. Most notably, I would highlight the global geopolitical environment. In particular, two events seem uncomfortably probable: a Russian annexation of Ukraine and a Chinese invasion of Taiwan. While both would be disruptive, Taiwan has become a key U.S. ally and a global supplier of semiconductors. Chinese ownership of TSMC Semiconductor would be particularly worrisome to U.S. national and corporate interests. A strong global alliance is needed to convince the respective countries to curb their nationalistic aspirations.

Secondly, I'm concerned that inflation could prove more difficult to contain than recent history. Given the 'compare', inflation is very likely to decelerate in the second half of 2022. However, I worry that the ingredients for a re-acceleration in inflation late in 2022 are appearing. I am particularly focused on wage and rent inflation which tend to be 'sticky' or difficult to slow.

A final, and less impactful concern I have is the impact on personal income tax payments resulting from the change to monthly 'pre-payments' of the child tax credit. While helpful for consumers over the last several quarters, the impact will be a smaller tax refund (and potentially even a tax liability) when returns are filed. I'm not sure consumers are broadly aware of and prepared for the impact of this change in tax policy.

Despite these risks and concerns, the positives exceed the negatives in my view. I have a positive outlook for economic expansion and earnings growth. While the pace of each will slow from a remarkable 2021, I expect the economic expansion and market advance to continue.

To close, I want to point you back to our 'true north'. While we continue to monitor macroeconomic forces and trends, we maintain an emphasis on finding high quality, growing companies whose securities are trading at a reasonable valuation with visible catalysts to drive relative outperformance over the next twelve months. This approach has served investors well over time and our confidence in it has not waned.

Matt Hekman
Portfolio Manager