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2022 Outlook

Executive Summary:

2021 was a strong year for stock markets, with US large cap stocks, once again leading the charge. 2022 will bring a path back to normalcy from the economic conditions of the pandemic. Inflation will start to subside in a meaningful way by the later part of the year and the economy will slow down quite a bit in the early part of 2022, earlier than most forecast. And those slowing economic conditions will foster increased competition in the economy. Many investors believe higher interest rates from Fed tightening will be the trigger for poor stock market returns. Modestly higher interest rates will be a headwind but increasingly competitive conditions for earnings growth is the biggest risk to the stock market in 2022. Despite difficult conditions for broad indices to post yet another year of strong returns, there are plenty of stocks, both domestically and abroad, that are reasonably priced and have a good chance of providing good returns in the years ahead.

As the 2021 year has now come to a close, the same trend we have seen over the past decade has continued. US large cap stocks dramatically outperformed international and US small cap stocks. The S&P 500 finished up over 28% vs. under 12% for EAFE stocks and -2.5% for EM stocks.¹ Small cap stocks started 2021 with a bang, soaring in the first couple months but have struggled since then, leading to a just under 15% return.

To assess if 2022 will bring more of the same, strong US large cap returns above all else, one needs to look at both economic growth and earnings growth. While they will generally move together, divergence can occur.

2022 should bring back some normalcy to the US economy, although the early part of the year is going to be disrupted by omicron. While omicron will add more misery to this long and devastating pandemic, initial signs are it will be fast moving and by springtime or even earlier, a path to normalcy should emerge, not just in one's personal behavior and spending patterns but in global and domestic supply chain issues.

2022 will also be the 1st year of the pandemic that has not involved massive stimulus directed at consumers. The word massive is appropriate here because most indications are there will be modest new stimulus for lower-income consumers.

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While delayed, it is still more likely than not, many parts of the Build Back Better Act, including the expanded child tax credit, will pass Congress in early 2022.

Consumers are in pretty good shape, having built up a solid base of savings over the past couple years that has the potential to lead to above trend growth in 2022, if savings support healthy spending. That is the consensus but there are some caveats to consider. Consumers are much more likely to spend money coming from increased wages than money coming from savings. And for the past 7 of 8 months, wage growth has been less than inflation. This is a big obstacle to spending outpacing inflation. That needs to reverse or it is unlikely we will see robust spending in 2022. There are plenty of signs we are at the outset of consumers balking at higher prices and consumers will retrench from 2021 spending patterns. This potential trend bears watching.

For spending to outpace inflation, inflation needs to start subsiding. Supply and demand shocks are both responsible for inflation in 2021. On the demand front, durable goods and housing demand were propelled to a new higher level by the pandemic. Strong durable goods demand, while having subsided recently is still around 20% higher than pre-pandemic. Meanwhile, much of that supply comes from overseas and Covid outbreaks along with shipping challenges have created supply shortages. Housing demand has moved to a higher level than pre-pandemic, as lifestyle changes have occurred. Housing starts are quite a bit higher than pre-pandemic and the housing construction supply chain has not been able to adjust to that level of demand just yet. While increased housing prices are not directly reflected in inflation figures, they slowly are over time by pulling up factors such as owner's equivalent rent.

Durable goods and housing are two areas where demand led to increased prices. In other areas, the story is all about supply. Semiconductor chips have had a big impact on auto production, leading to several months of sales below a 13 million annual rate in the US, recessionary levels. Of course, with so few cars available for purchase, prices have soared and pulled up the used car market as well. New car prices in the most recent CPI report were up over 11% YOY and used car prices were up 31%.² Food prices are up over 6% YOY and that is a big move for food. Demand for food has not shot up to a new higher level, this is about supply shocks in input prices, packaging and transportation. Energy commodity prices are up significantly YOY and from 2019, while global demand for crude oil is still a couple million barrels below pre-pandemic levels, so that clearly indicates a supply shock.

While demand vs. supply should set prices in an economy, inflation has become such a buzzword in the US that there are now psychological factors in play. As the year has played out, companies have known consumers have the wherewithal, at

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least for a while to accept higher prices, and have used the inflation narrative to raise prices even in areas that don't necessarily have a big supply demand imbalance. Small business intentions to raise prices have shot up. Businesses suspect they have a good shot at pushing through price increases without much push back at the moment. Also, many businesses are fearful they may get hit with another round of price increases from suppliers and are preemptively raising to avoid a margin squeeze. Supply demand imbalances eventually correct but psychological inflation can be a trickier dynamic that allows inflation to persist a little longer than it ultimately would.

Supply is going to gradually improve in the early part of 2022, though omicron could slow down that trend. Consumers are going to modestly retrench from accepting higher prices in the early part of next year and there is going to be a demand slowdown. A lot of the excess savings will not be spent. Early retirees need those savings to live on for presumably a long-period of time. Housing prices and auto prices are up quite a bit and younger consumers need to have more money saved for an eventual house or car purchase. The pandemic has made many believe that a higher cushion of savings is more appropriate.

Although supply will start to improve in early 2022, that progress will likely be slowed down by omicron. In addition, psychological factors leading to inflation will not subside just yet. Because of expectations for sticky high prices in early 2022 combined with lower consumer spending than most forecast, real consumer spending growth will come in weaker than forecast in early 2022 but will stabilize at a healthy level in the later part of 2022 when price growth subsides.

However, real growth is going to be challenged for many years to come. Labor force participation should pick up and certain portions of the Build Back Better plan can help with participation, but the early retirees are likely done working and are planning to live off savings with more modest lifestyles. The US has no meaningful immigration and demographics are not favorable to increasing the labor force. As a side note, economists who claim a lower labor force is inflationary use convoluted logic that does not hold water over any longer period of time.

Any growth baton needs to be handed off to productivity from labor. Growth from productivity will take place but will not surge. Our current political system with constant major deficits will end up not allowing as much productivity as could have otherwise been possible.

US economic growth has not been particularly strong over the past decade, weaker than many international markets, and yet the stock market has continued to perform much better. Part of that is due to strong earnings growth but part of that is due less risk-adverse investors in the US willing to bid stocks up to very questionable levels.

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Investors often point out that the high valuation of the US stock market is due to very low US interest rates. While that has some merit, investors in Europe and Japan, have even lower interest rates but lower market valuations. A rebuttal to that point many investors fond of the US markets will point out is that US earnings growth is superior to international markets. Over the past decade, the earnings growth of the S&P 500 has approached 8% annually while earnings growth in Europe is closer to half of the US.³ Still, Japanese companies have grown earnings at a superior clip to US companies, yet still trade at a meaningful discount.

A move higher in interest rates may cause modest selling pressure for the S&P 500 but to have more than a modest correction, earnings growth needs to stall. Can 2022 be a year when earnings growth isn't able to meet lofty expectations? That is what it the most likely outcome at this point. Competition, not interest rates, is going to be the primary culprit for stalling returns of stocks.

The ability of companies to drive earnings growth above economic growth comes down to a few items. Can revenues grow faster than the economy and then can there be operating leverage on those growing revenues to create even stronger earnings growth? Finally, share repurchases are another important means to drive earnings per share growth. The pandemic was a benefit to many of the companies that make up the S&P 500. It pulled forward some spending on secular technology trends giving a revenue boost (Information Technology is close to 29% of the S&P 500 and that does not include companies like Alphabet Inc., Meta Platforms Inc. (formerly Facebook) and Amazon.com Inc.) at the same time many companies were diligently managing costs. Meanwhile, the service sector that is a huge part of our economy but not represented very well in the S&P 500 suffered. Additionally, larger publicly traded companies with more robust digital platforms were able to handle disruption better than private peers and take share. And perhaps the biggest benefit of the pandemic was the enormous amount of money the government gave to households. That created robust economic growth conditions.

The concern is that these things like stimulus and hurried digital spending have led to a distorted sense of what growth can be once the economy settles down to a post-pandemic level. And once the economy does settle down, there is a lot more competition on the horizon than has previously existed. The threat of competition hurting margins is not given enough respect by investors. To really assess earnings growth, one needs to get granular and understand both pandemic pull-forward earnings growth and post-pandemic competition. Since the largest companies make up a very significant percentage of the overall S&P 500, one needs to assess conditions for those companies.

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Apple caught lightning in a bottle during the pandemic. It had a major new product release in the iPhone 12 during a time when durable goods demand was soaring and to boot, a fiercely competitive Huawei was severely handicapped by the US government allowing Apple to take more share. But it is more likely than not, Apple's earnings plateau at a new higher level instead of continuing the excellent growth trajectory. And at 30x earnings investors are expecting strong continued growth.

Microsoft will continue to have a long runway of growth from cloud computing transitions. However, PC demand is likely to plateau and settle back into low single digit growth after the pandemic surge. Office software is not deemed necessary by younger generations and the 365 transition looks to be the last hurrah there as pricing power will stall. Even within the cloud, Google and now Oracle are going to be fiercely competitive and the public cloud market is going from a 2 horse to 4 horse race. Besides, as workloads move to the edge, there are even more than those 4 that can compete.

While Alphabet and Meta Platforms have some impressive technology, their revenues are still dominated by advertising spend. Advertising spend surged back as advertisers saw consumers with both the wherewithal and the desire to spend some money in 2021. Still, advertising spend tends to track GDP growth which is a lot slower than the revenue growth these two have experienced. That is because they have been able to take share but the days of share take for them are coming to a close. Competition for internet ad dollars is going to heat up and the pool of legacy ad dollars to take share from has dwindled.

If the US e-commerce market gets as competitive as it is becoming in China, it won't bode well for Amazon. Amazon still has incredible brand power in the US and its platform is strong but Walmart, Target, among others are not folding. They are competing very well and expectations are even smaller companies are going to be able to compete as well. The notion that Amazon is going to put everyone out of business is just not nearly as prevalent as was before. Obviously, Amazon benefitted in a big way from the pandemic. 2022 will be a very interesting year to see where revenue growth goes for Amazon. The cloud business, similar to Microsoft should continue to be strong, but will face more competition ahead.

Nvidia will finally have some competition from Intel and AMD in 2022. Intel is planning to enter the GPU market with very aggressive pricing and now finally has a coherent plan for Artificial Intelligence vs years of bad management. AMD will finally have something to offer in the AI as well.

Tesla will face a wave of competition starting the later part of 2022 and beyond. Right now, there is not enough competitor supply to impact demand. Even with a margin advantage, there is nothing at this point to suggest Tesla can put others out

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of business. And that is what will be necessary to really capture meaningful share. It won't happen. The ease with which EV companies can raise capital now is actually planting the seeds of very competitive auto markets from 2023 onwards.

JP Morgan Chase trades well over 2x tangible book value, and now has to face a flat yield curve and slowing capital market business. The pandemic stimulus and Fed buying, combined with a speculative market, have been goldilocks conditions for capital market businesses that won't last.

United Healthcare is trading at 26x earnings and it is a health insurance business, a good one at that but still the business itself is not very high quality and something that has idiosyncratic risk. Insurance companies trading above 20x earnings is a rarity and up near 26x is extreme. They don't often trade that high because competition can easily erode pricing power.

Berkshire Hathaway is an expensive stock at the moment. Visa and MasterCard trade well above 30x earnings even after selloffs. Technological developments are going to lead to the payment space being much more competitive in the US, like it is internationally, and that is slowly being factored in. Amazon's warning to Visa is just an early sign of things to come.

Home Depot trades at 25x earnings and clearly benefitted from the pandemic so future growth is going to be challenged. Procter and Gamble trades above 25x earnings with slow growth.

The list goes on and on with the top S&P 500 companies and the story is the same. High earnings multiples and underappreciated competitive factors. That competition is really going to show up when economic growth slows down like it will in 2022. Consumers will be more discerning with their money and businesses will still spend money on capex, it will just settle down into a rate that fosters competition. Competition is the number one obstacle to earnings growth.

Some investors ponder whether labor costs will have a meaningful impact on profit margins as many data points show labor is regaining bargaining power. Labor is expected to be a modest headwind to profit margins but not a major headwind. The labor market has a little more slack than is currently believed. Participation will pick up a little bit in 2022. In addition, businesses continue to improve the efficiency of current labor. Besides, perks like hybrid work schedules for office workers are a nice bargaining chip that employers have to tame strong labor input pressure. A more competitive environment is viewed as a bigger risk to profit margins than labor costs.

International stock markets are more attractive than the US stock market. The EAFE countries can grow just as fast as the US in upcoming years. There is still some delayed stimulus working its way through EAFE countries and labor force

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participation is now on par or better than the US for many countries. The drop in the US labor force is unique to the US and not something that most other developed nations have experienced. There is nothing that convincingly suggests productivity in the US has a better forward looking outlook than in other developed nations. While US stock markets have more talented companies, those talented companies are heading into more competition and so the large premium investors pay for US stocks vs. international ones is not justified.

As it relates to emerging markets, China's stock market is a good example of what can happen when competition heats up. Not all of the negative 21% return in the MSCI China Index can be attributed to China government scrutiny, companies are fiercely competitive in China, and that competition tends to really start showing up when economic growth slows.⁴ What happens with the Chinese property market absolutely bears watching because anything more than a modest fallout there will spread to other sectors. In China, almost all of an individual's wealth is locked up in the home. There isn't much diversification between securities and housing. If consumers lose confidence in the value of home prices, it will impact broader spending. And commodity demand that is used in construction will take a hit if weakness persists.

China makes up a little over 30% of most EM indices. Its stocks have gotten hit so much this year that valuations are intriguing. Having 30% exposure to China in an EM allocation that itself probably would only be 10 to 15% of a portfolio is not a large risk. Investors should not avoid an allocation to EM stocks. Even with a crushing experience for China stocks this year, EM indices are only down a little over 2%. Actually, small cap EM stocks were up almost 19% this year.⁵

While most of the above outlook is gloomy, there are plenty of stocks that are priced in a manner that can allow for returns that are close to double digits over the next decade in a slow growth environment. Investors just need to stay diversified and buy good companies that have enough earnings power to pay a solid dividend or buy back large chunks of stock if broader market weakness sets in. The stocks that are priced for exceptional growth are the ones that can really lead to painful losses if that growth does not pan out. But that is not the entire market. Investors should not buy stocks based on past performance. That is a risky move that has no fundamental backing.

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⁴ Bloomberg

⁵ Bloomberg