2022 Market Outlook

This outlook will focus on the **market's** prospects for 2022. I will provide a 2022 outlook for the **economy** in January.

Every year at this time I peruse many economic and market forecasts. This year I have studied forecasts from Merrill Lynch, UCLA, Goldman Sachs, Fortune, Sun Trust, Barron's, WSJ, Invesco, University of California Riverside, Charles Schwab. I look for trends that most agree on, and ideas that are not mainstream. I study these forecasts so you don't have to, (I do enjoy studying these forecasts). My Outlooks are a consolidation of these forecasts.

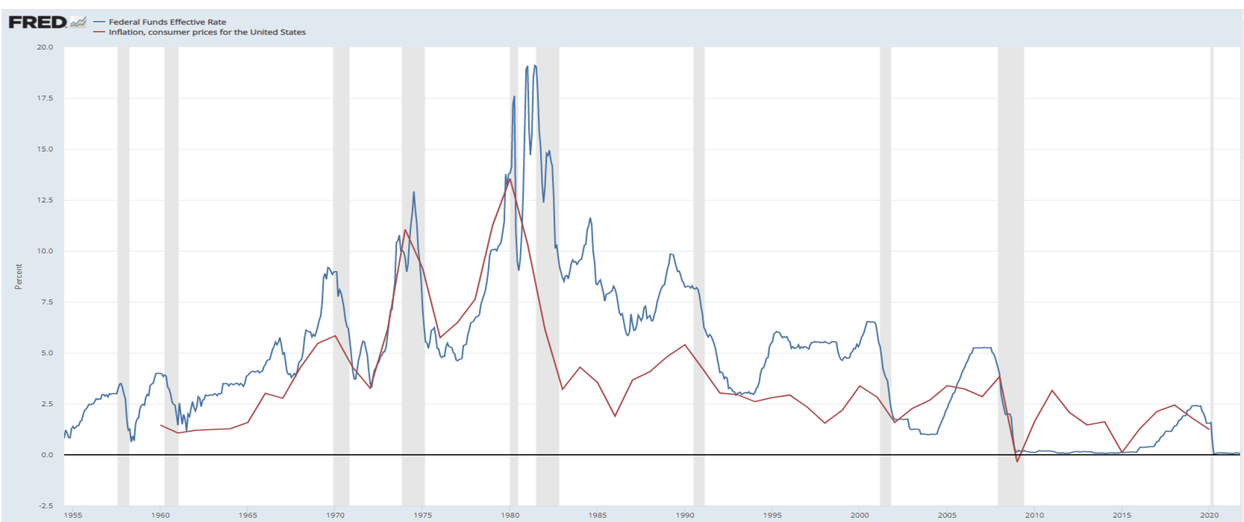
Over the last three years, the markets' returns have been above average. Some of the performance was due to growth; some was due to multiple expansion (investors were willing to pay more for stocks and growth). Most analysts see returns going back to normal levels (see valuation section below).

Most analysts see the momentum in the economy continues, and the markets should reflect the continued expansion of the economy.

Bullish Case

- Covid is the key to the global economy, inflation, and the markets. Even though covid can continue to mutate, most experts believe, for the U.S., the worst is behind us. We still need to keep a sharp eye on covid trends and any new mutations.

- We are in the early stages of this cycle and economic recovery. Below is a chart that shows how our economy essentially works.



Source: Federal Reserve Economic Data

Let's review this chart:

The red trend line is inflation. The blue trend line is the Federal Funds rate. The Fed has two mandates: 1. Maintain price stability 2. Create conditions for full employment.

Notice when inflation rises, the Fed moves rates higher. The Fed raises rates to slow the economy and inflationary pressures. Inflation destroys the standard of living of consumers.

Normally, when the Fed raises rates, the cycle's economic sins (usually bad lending practices) are revealed, and we go into recession (the shaded grey areas)

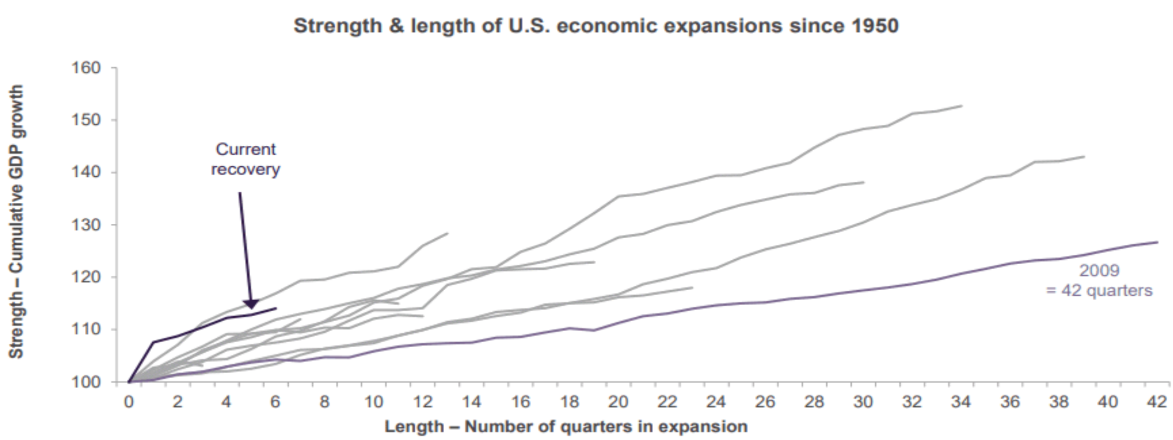
Notice that the first part of the chart (1955 to 1984): 1. Rates were rising 2. We had more recessions. In the second part of the chart, (1985 to 2020): 1. Rates were falling 2. We had fewer recessions. The Fed has gotten better at controlling inflation and the economy. We had a brief recession in 2020.

We started a new economic cycle after last year's recession. If we look at the second half of the chart, economic cycles have lasted about ten years.

- This economic cycle has had a strong start thanks to all covid financial support, aid, stimulus provided by the Fed and lawmakers:

Current U.S. economic recovery is among the strongest in the past 70 years and near-term recession risk remains low

The current recovery is into its sixth quarter and is tracking as one of the strongest recoveries in 70 years. The average expansion since 1950 has lasted 22 quarters, though the 2009 to 2019 expansion endured for 42 quarters.



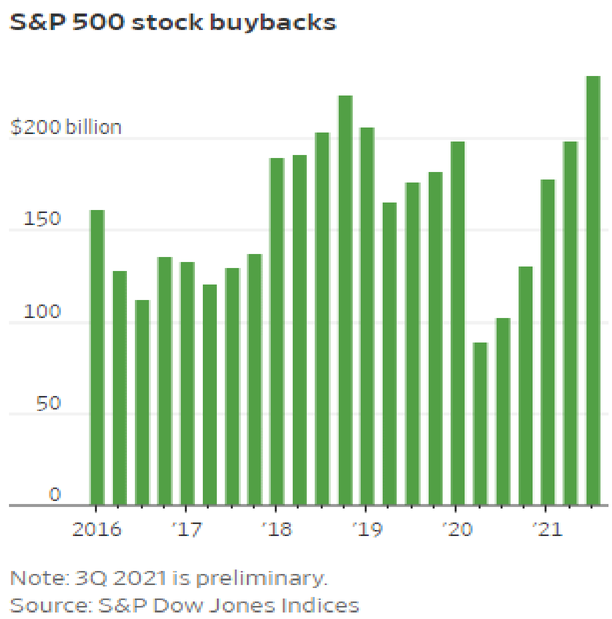
Data Source: Truist IAG, Haver, Bureau of Economic Analysis. Actual data through 3Q2021 with Truist IAG forecast for 4Q2021.
Past performance does not guarantee future results.

Even though economic expansions have been longer since the mid-1980s, market cycles are usually shorter. We have gone into bear markets (the end of a market cycle) without a recession a few times in market history. When this happens (bear market with no recession), the market recovers pretty quickly.

- Earnings are expected to grow 6% to 10% in 2022

- There are trillions of dollars in money market funds and the global financial system that could be potential fuel for the markets.

- Dividend increases and stock buybacks could help increase stock prices in 2022. Buybacks were strong in 2021:



- Consumer spending has been strong

- Financial Advisors and 401k investors are big buyers of index funds and rarely sell, helping the markets be less volatile than past cycles

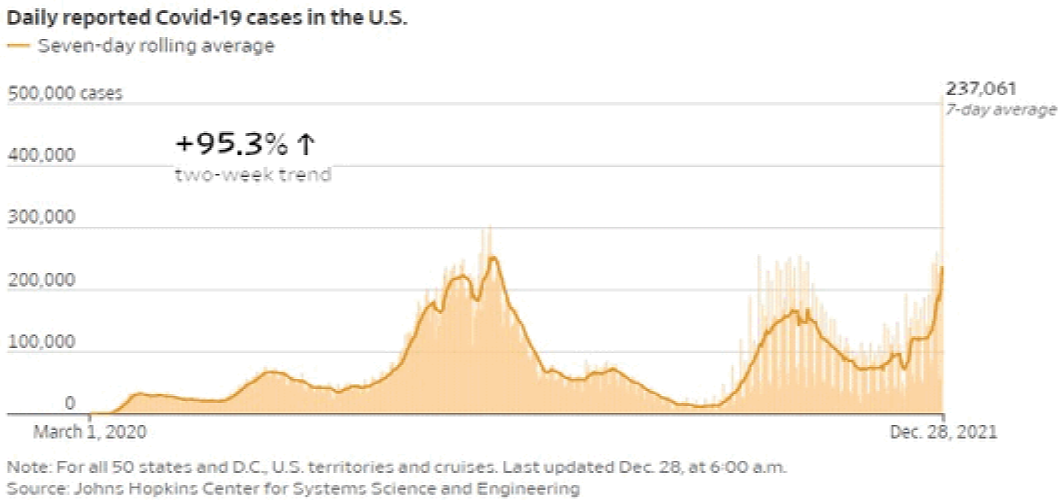
- There is short-term money (hedge funds, algorithm traders, trend followers, and momentum traders) who buy and sell short-term. These short-terms buyers and sellers make the markets volatile in the short run.

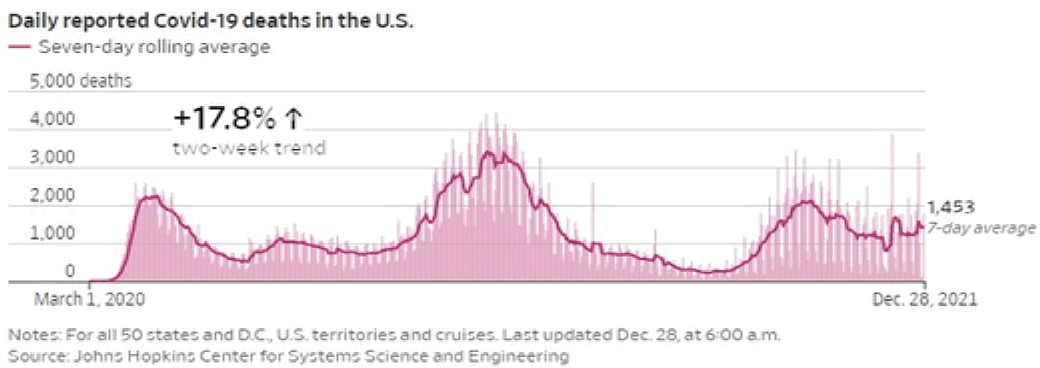
- Mergers and acquisitions hit historic records in 2021. Strong M & A activity will probably continue in 2021.

Financial Advisors, 401k investors, value/fundamental investors, and other long-term investors tend not to sell, and some of these participants buy on dips keeping declines shortlived and losses moderate.

Bearish Case

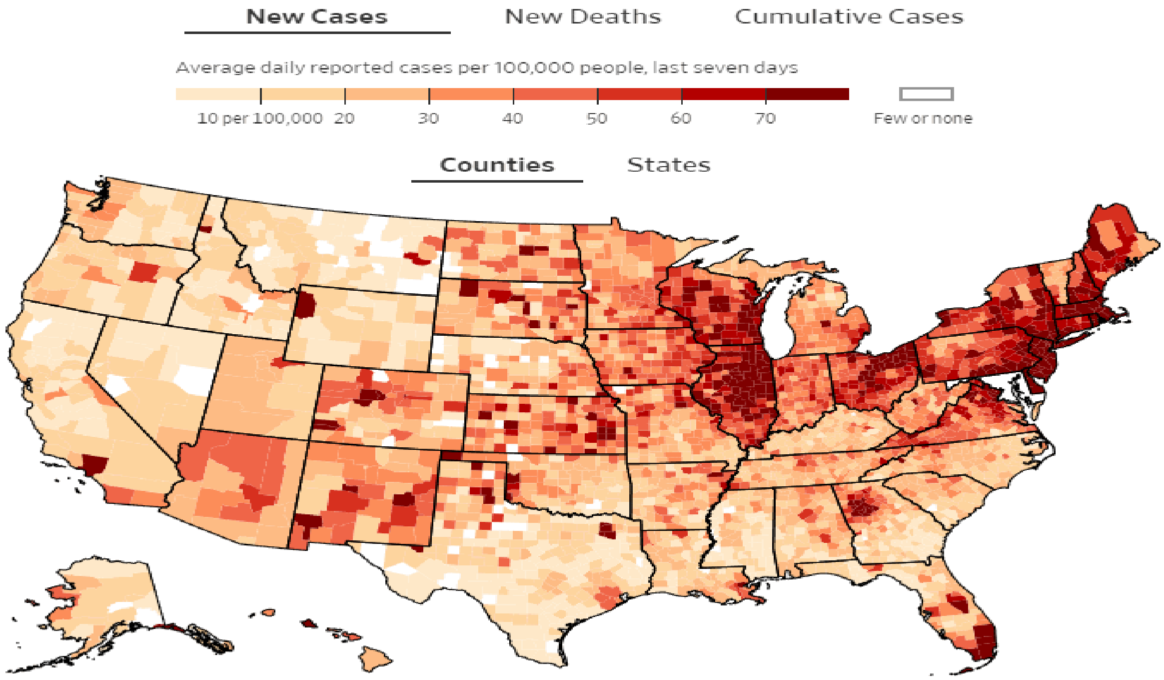
- Most of us thought that covid would be behind us by now. Below is a chart that shows how many waves of covid we've gone through:





We have had at least five different waves of infections in the U.S. Last year's wave toward the end of last year was the worst. Currently, infections are rising and are beating last year’s infections, but fortunately, deaths in this wave are about half. Some experts say it’s normal for viruses to mutate and be more contagious but less dangerous.

The current covid variant, Omicron, is spreading very fast:



Note: Last updated on Dec. 27, at 5:00 p.m. Some states may not report county-level cases or deaths data. Any negative values are due to revised figures.
Sources: Johns Hopkins University (cases); Census Bureau (population)

Covid can continue to be with us due to: poor countries that have low vaccination rates are where covid could mutate; because the world is mobile, covid can spread widely and quickly; people are getting covid fatigue and are wearing face makes and socially distancing less.

The markets have been wrong about covid as they believed covid would have ended by now. Because the markets have not taken covid seriously, it makes the market volatile when we have these waves. We can expect covid to be with us, and this can make the markets volatile. I will keep a sharp eye on covid and report any significant developments, good or bad.

- Inflation is a major concern among consumers, investors, economists, businesses, and the Fed. I wrote a Special Report on inflation where I analyzed the causes, and their roots are in covid.

Here is the conclusion from the report:

"Most economists believe that supply chain issues should improve by the middle of next year. They also see inflation falling below 3% starting next year. These forecasts will change. If the forecasts have significant adjustments, I will include the forecasts in future Updates. The low inflation of about 2% that we have had for the last dozen years will probably end and may be closer to 3%, the historical inflation average.

Covid continues to cloud the economic and market outlook. Inflation is now another concern. Interest rates will have to rise to slow inflationary pressures.

With higher interest rates and a cloudy investment outlook, investors will have to bring down their expectations for next year. Also, stock picking with a focus on valuations and catalysts for upside momentum will be essential. Indexes could struggle because of their high valuations and the real possibility that we will see higher interest rates.

Covid could worsen, and the Fed could make mistakes (raising interest rates to slow or fast, tapering too fast or slow) in taming inflation. There is a small probability of having a double-dip recession, similar to the early 1980s. I doubt prices would fall back to last year's prices, so we will sit tight if this happens."

As the first chart on the first page shows, the Fed raises rates when inflation rises, and we usually go into recession. One of the few times this did not happen was when the Fed raised rates from late 2015 to 2019 and, we did not go into recession (see Technical, Price Analysis section below.) We did go into recession in 2020 caused by covid and the shutdown of the global economy.

The big question is- can the Fed raise rates and reduce their bond-buying (tapering) to slow inflation without causing a recession. This is one of the biggest risks for the economy and markets. Again, if the pandemic improves, so can inflation and the global economy.

If you would like a copy of my Special Report-Inflation, email me.

- The markets are overvalued. See valuation section.

- China is the second-largest economy in the world and is essential to the global economy for growth, capital, and cheap goods. Most economists see slower growth for China.

  Real estate is important to their economy. One of their largest real estate developers with $300 billion in debt has defaulted on some of their debts. The Chinese real estate industry is in a slump. The Chinese will not be able to depend on real estate for growth and jobs as they have in the past.

  China is strict when it comes to covid. When they discover an infected person, they will shut down the community so the virus can't spread. This is causing their economy to slow and is also causing global supply chain disruptions.

  China is facing energy shortages, and it's disrupting the economy.

  They are also changing their focus on five major industries and distributing wealth in China more fairly. Before, their focus was on manufacturing, exports, major capital expenditures for infrastructure.

  - Geopolitical risks – There have been tensions between the U.S. and Iran, North Korea, and Russia for decades. Unfortunately, our relationship with these countries has not improved.

    Some are concerned that war can start with Russia because of Russian troops at Ukraine's border.

    Iran increased its efforts to build nuclear weapons after the global Joint Comprehensive Plan of Action (participants of the agreement are China, France, Russia, United Kingdom, U.S.) agreement was broken in 2018. Participants of the deal are trying to revise talks and develop another agreement that could slow, derail Iran's nuclear ambitions.

We can now add China to the list of geopolitical risks. There are concerns that China may take over Hong Kong and Taiwan with force. Will the U.S. and its allies intervene, raising the probability of a military conflict with China.

- The U.S. government has too much debt. I will go into the potential risks to the economy in my economic outlook that will be out next month

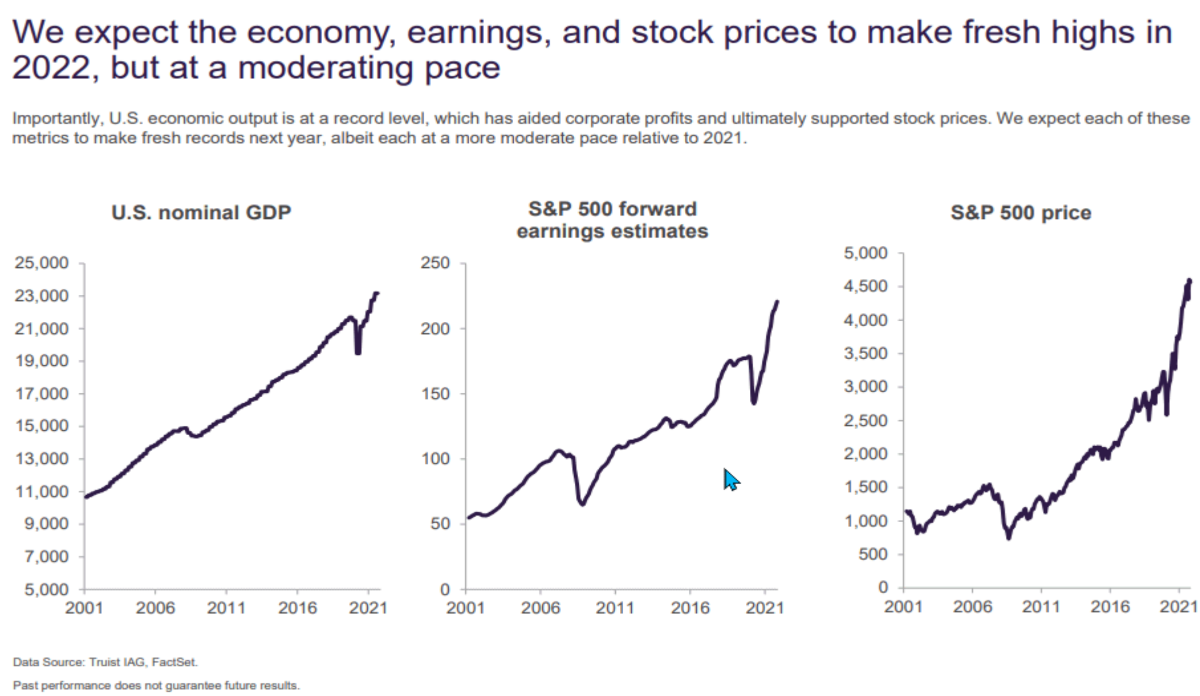
- Cyberattacks on our financial system, energy infrastructure, businesses, schools, hospitals, cities… will probably continue. So far, the damage from these cyberattacks is limited, but collectively they are a problem for our economy and markets.

- Black (low probability high impact events) and gray swans (climate change-related weather events like floods, droughts, wildfires)

- There is still a probability that taxes can go up for the very rich and for corporations. The tax on corporations could lower earnings.

Valuations

The chart below shows the correlation between GDP growth, earnings, and stock prices. The charts also show how the markets have gotten ahead of themselves.



Let's review the charts:

- The chart shows how GDP doubled in 20 years, and during this period, the economy went into recession in 2009 and 2020.

- Earnings rebounded strongly after the recession. Earnings increased about 350%. There were a few hiccups during the recessions and when the Fed started raising rates toward the end of 2015. See Technical, Price Analysis in the next section.

- Stock prices should reflect the growth in earnings, as they do. But, 2,000 points of the gain were made in 2020 and 2021. It took more than 15 years for prices to make the same move in 2001. The chart shows a parabolic move, and this type of momentum is difficult to maintain, especially with the conditions the markets face in 2022. Rising rates and Fed tapering normally make the market volatile. See chart in the next section, Technical, Price Analysis

Currently, the 2022 S & P consensus earnings forecast is about 223. Briefly, in a perfect world with no inflation and few external risks (wars, weather/climate change risk, disruptions to energy supplies…), the P/E could be 20. Investors do not want to pay for growth due to inflation, rising prices, so the P/E should be adjusted to inflation. If inflation falls back to the average inflation rate, about 3%, then the P/E should be about 17. Let's calculate the potential price target:

S & P price target is about 3,791 = 17 times consensus 2022 S & P earnings forecasts of 223. This is about 26% lower than the current price of the S & P. There is a history of P/Es contracting when there is inflation and when the Fed is raising rates. Or, rather than the P/E contracting, prices can go sideways until valuations catch up with prices. Prices went sideways when the Fed started raising rates in late 2015. See Technical, Price Analysis section below, second chart.

The market is overvalued as the P/E is about 22. If the P/E can remain elevated at 22, then the price target for the market would be about 4,906 (22 P/E times 223 earnings estimate.)

Currently, the market is around 4,800. If the P/E contracts, then the market is overvalued. If the earnings are met and the P/E stays elevated, then the market has about 2.2% upside. There are better individual stocks that have better risk/reward prospects.

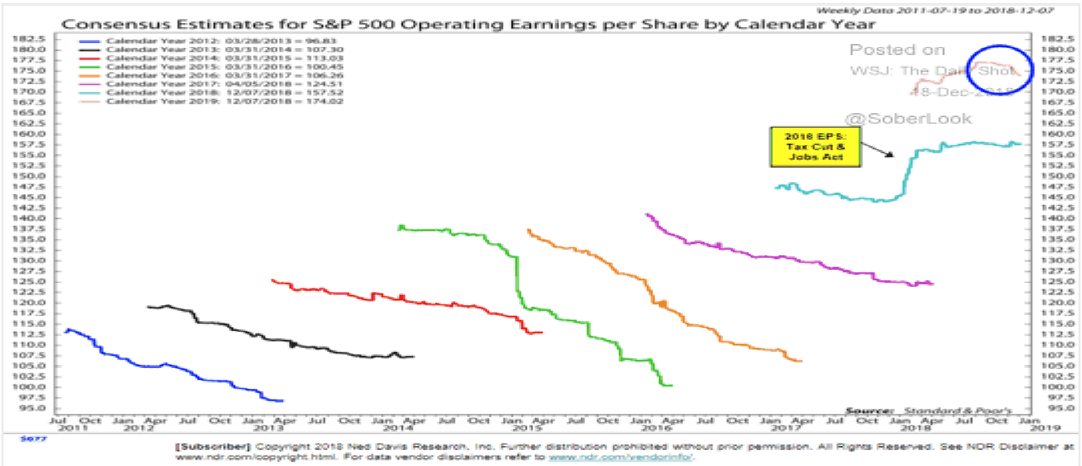
Below are the earnings forecasts for the S & P and its sectors:

EXHIBIT 8C. S&P 500: CY 2022 EARNINGS GROWTH

Sector	Today	1 Oct	1 Jul	1 Apr
Consumer Discretionary	28.6%	28.8%	31.7%	37.4%
Consumer Staples	7.2%	7.9%	8.0%	8.8%
Energy	28.1%	25.9%	27.8%	36.1%
Financials	-9.3%	-6.9%	-1.0%	10.7%
Health Care	4.1%	4.7%	6.1%	6.5%
Industrials	38.0%	37.3%	36.9%	35.9%
Materials	0.9%	0.1%	1.6%	10.0%
Real Estate	6.8%	6.5%	6.0%	9.6%
Information Technology	9.2%	9.7%	11.4%	12.9%
Communication Services	10.2%	10.2%	13.2%	17.6%
Utilities	6.9%	6.8%	7.8%	6.5%
S&P 500	*8.6%*	*9.2%*	*11.6%*	*15.3%*

Source: I/B/E/S data from Refinitiv

I highlighted the S & P growth estimates. Notice how the growth has declined from around 15% to 8%. Consensus earnings forecasts do change. It's essential to update the target prices as the earnings forecasts are updated. Below is a chart of earnings' forecasts and how they change:

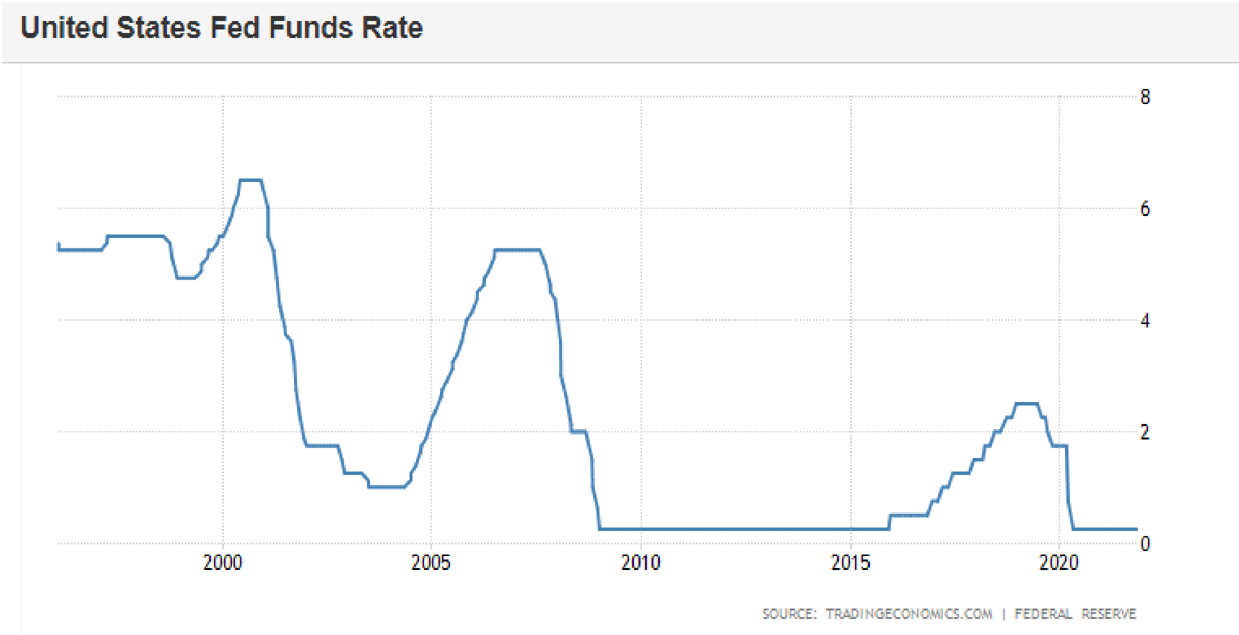


As the chart shows, earnings forecasts start as optimistic and have to be adjusted downward as a year progresses. There are rare exceptions, like 2018, when earnings had to be adjusted upward because of President Trump's tax cuts, a windfall for corporations, investors.

Technical, Price Analysis

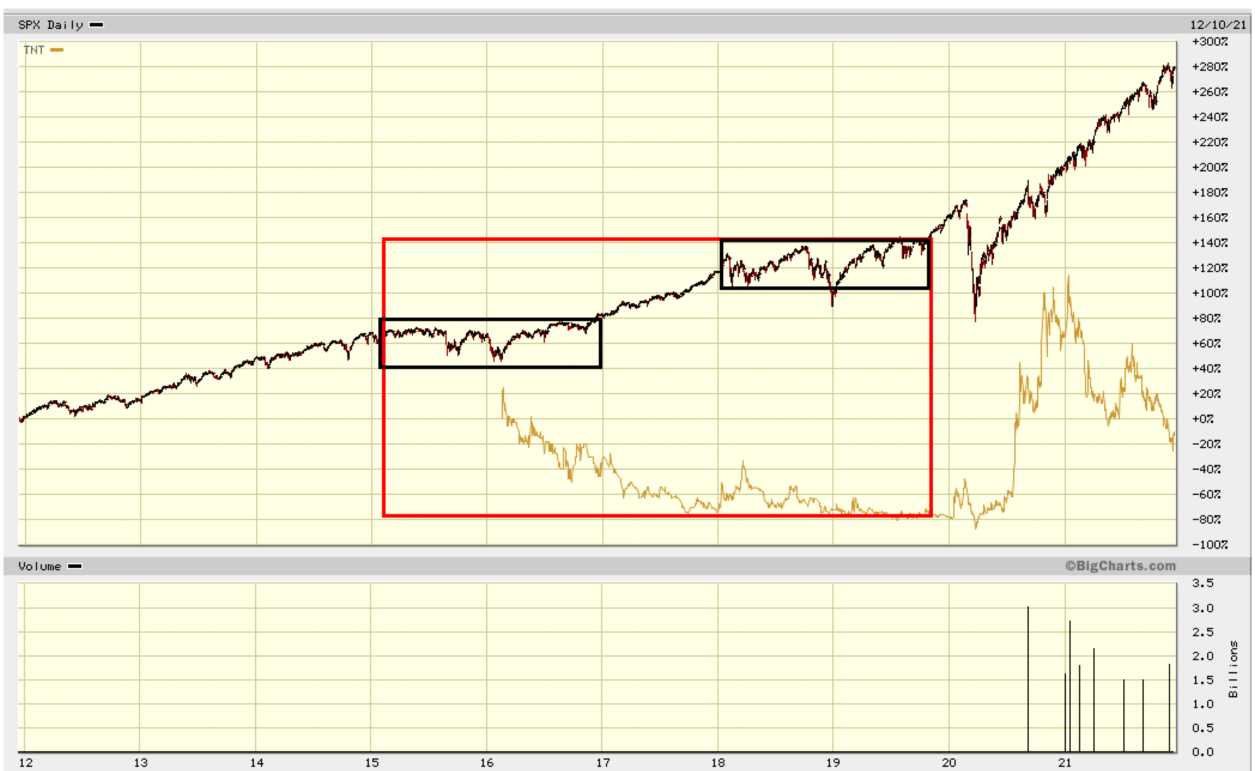
I use technical, price analysis to identify trends (trajectories up or down, or stocks that are stuck in trading ranges). More importantly, I use technical analysis to identify entry and exit points once I've made a buy or sell decision using fundamentals, valuations.

One of the most significant risks for the markets is the high probability that the Fed will raise interest rates. Below is a chart that shows the last time the Fed raised interest rates.



The Fed started raising rates in late 2015 for several reasons: 1. the Fed wanted to normalize rates by reflecting inflation 2. We were very late in the economic cycle, and the Fed needed interest rates to be higher in case there was a recession and needed to lower rates. 3. The Trump tax cuts caused the economy to accelerate, and they were concerned about inflationary pressure.

Below is a chart showing the impact of rising rates on the equity and debt markets during this period:



Let's review the chart:

- The red triangle shows the period when rates rose and the impact on the debt and equity markets

- The gold trend line is the 20-year Treasury ETF. Bond prices collapsed in the ETF. When the Fed lowered rates again, bonds had a strong rally.

- When the Fed started raising rates in late 2015, the market did have a sell-off. Also, prices went sideways from about two years. President Trump's election caused the bulls to come out and were encouraged by a businessman who would cut taxes and regulations.

- The market really took off when the Fed and lawmakers created trillions of dollars in aid, support, stimulus to help the economy and especially workers get to the other side of the pandemic.
- We can expect similar performance from the bond and stock markets when, not if, rates start rising.

A lot has been written and talked about how FANG (Facebook, Apple, Netflix, and Google) have led the markets and how expensive they are with high P/Es and market capitalizations. I wrote an article about these stocks – *Beware of Fang* and how these are lousy business propositions. It would take decades to break even when looking at free cash flows and market capitalizations.

Not all stocks are overvalued. There are plenty of fair to undervalued stocks, pay an above-average dividend and have catalysts for the upside. Remember, we are probably in the early stages of this economic and market cycle.

Summary and Conclusion

- The economy has enough momentum to grow in 2022. The start of this economic cycle has been strong thanks to plenty of aid, support, and stimulus from the Fed and lawmakers.

- The covid pandemic has killed over 5 million people (probably higher as poor countries don't have the infrastructure to keep track of the sick and dying), causing a global recession, supply chain disruptions, and global inflation. Even though the U.S. is probably past the worst, the rest of the world is not out of the woods. Covid will probably be with us in 2022, and investors need to watch covid trends.

- The economy, especially markets, faces several headwinds (and when doesn't it): covid, inflation, supply chain disruptions, Fed tapering, rising rates, geopolitical risks, climate change events.

- The economy typically goes into recession when the Fed raises rates. The 2015 time frame is an exception. At the very least, inflation, rising rates, and Fed tapering will probably cause volatile markets. See the Techncial, Price Analysis section, chart on the previous page.

- The markets have had above-average returns for the past few years despite a pandemic, a global and U.S. recession. The markets are now overvalued, but many stocks are not. Investors will need to bring down their expectations regarding returns and focus on fairly and undervalued stocks to reduce downside risk.

- We are in the early stages of this economic and market cycle, so there is room for the economy to expand, and the current bull market can continue. The last three economic cycles lasted about ten years.

I will provide my 2022 economic outlook next month.