Outlook 2022: A Closer Look at the Big Five

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In the world of safaris, "the big five" are highly prized among sightseers and photographers: the lion, leopard, black rhinoceros, elephant, and buffalo. But in investing, the big five could more aptly refer to the connected categories of growth, inflation, interest rates, valuations, and style.

2022 is shaping up to be one of slowing toward more normal, healthy rates of economic growth and inflation, thereby paving the way to a sustainable, multiyear expansion. However, the route to get there, as we have already seen, will likely be marked by periods of high volatility.

This is not unusual in transitions, and the nature of the ongoing pandemic is adding to the volatility of this particular transition. Both the direction and the complexion of the market in 2022 will be determined by the unique nature of this global economic cycle.

Below I discuss our expectations for the categories I mentioned: growth, inflation, and interest rates, as well as valuations (where we expect multiples to contract) and style (where we're seeing the aforementioned factors play out in the relationship between growth and value equities).

Growth

The focus for us in 2022 will be the transition of the economy and corporate profit growth as the economy normalizes to a post-pandemic world, or at the least becomes more comfortable coping in a pandemic.

While we are still in the middle of what we believe to be a long-term economic expansion, corporate profit growth appears to have peaked, and we believe it will likely continue to decline sequentially.

The sharp nature of the initial economic recovery was almost by definition unsustainable, with output growing more than 5.5% in 2021 and corporate profits growing more than 50%. We believe we will experience a healthy profit growth in 2022 .

Inflation

Another unique feature of this recovery has been the surprising rise of inflation. The big question is, “Just how much of a risk does this represent?”

With output still well below trend on both sides of the Atlantic, rising inflation, especially in the United States, is largely a function of persistent and sudden supply disruptions as the pandemic continues to wreak havoc. COVID-19 has exposed the weakness of pairing global supply chains with national responses to medical challenges.

For example, China has pursued a practice of zero-tolerance of infections, while the United States and many other countries have embraced economic activity while attempting to minimize severe illness outcomes.

China’s policy has translated into impossible-to-anticipate, sporadic, and highly disruptive closures of plants and ports. This has had significant impact on supply chains, given that China’s ports now process nearly 50% of global container volumes. The result is goods prices rising at a 12% rate in the United States, which is a sharp and temporary reversal of multidecade price deflation. Fortunately, purchasing patterns suggest that consumers do not expect pricing pressures and scarcity to persist, as there are no signs of hoarding.

We will continue to watch this situation closely, because the persistence of the price inflation has surprised us. But our base case remains that as supply chains normalize, inflation will subside.

Interest Rates

Given these expectations for growth and inflation, we expect the 10-year U.S. Treasury rate to settle into the 2.5% to 3% range we experienced prior to the pandemic.

While relatively low and manageable compared to its historical levels, the market has recently reacted—to both the direction of travel from extremely low 2020 levels and the risk of policy moves that would drive rates even higher due to fears of persistent inflation.

In other words, the markets have had a natural reaction to the normalization of the economy and the potential risks that go with that.

Valuations

This leads to a discussion of equity valuations, and if the general relationship between rates and valuations holds, we would expect multiples to contract as the expansion continues and rates go higher.

In fact, this has already been occurring: All of the market's increase in performance since mid-2020 has been driven by earnings growth, not multiple expansion. Global multiples have quietly contracted during this period.

Given our assumption that rates will revert to pre-pandemic levels, this would imply further contraction, especially in the United States.

Style

This phenomenon has direct implications for the performance of growth equities relative to value equities, which we saw play out in the latter part of 2021 and the first trading sessions of 2022.

Growth equities, on balance, have a larger percentage of their cash flows occur in the outer years than do value stocks, and thus are considered longer duration. Simply put, higher assumed discount rates reduce the present value of those cash flows, disproportionately impacting traditional growth stocks. Valuation as a factor appears to have been the strongest driver of performance recently.

The backdrop for growth outperforming value in the era after the global financial crisis can be characterized by low economic growth and low interest rates, as well as an acknowledgement in the real economy that corporate innovation and business models were changing the economic and competitive landscape in material ways. Thus, companies with perceived sustainable competitive advantages re-rated, as did those with higher rates of expected growth and profits. Additionally, future cash flows were being discounted at relatively low rates. The environment was ripe to reward current and expected future execution.

This was further fueled during the pandemic when the difference between growth "haves" and "have-nots" expanded even further. Some of this was initially a preference for "visible" growth (COVID demand beneficiaries); some could be categorized by increased risk tolerance for future growth driven by abundant liquidity (special purpose acquisition companies, initial public offerings, thematic funds, cryptocurrencies). As expected, both of these categories have already been punished as central banks threaten to take away the punchbowls.

But does this imply, by extension, that traditional growth equities will completely give way to a preference for value stocks? We don't think so. Many of the drivers of growth's outperformance are still in place: positive but low-ish economic growth, low (albeit rising) interest rates, and a competitive landscape that acknowledges the structural advantages of (a) some areas of the economy over others and (b) differentiated, innovative business models.

In other words, we believe the next several years will look more like the years leading up to the pandemic rather than reverting to something different from what we have seen in the recent past.

However, as we said at the outset, this year will be one of transition, and we do expect volatility. So it is likely that expected corporate revenue or profit growth that does not materialize will be punished. Value stocks with near-term visibility may get rewarded more than growth stocks with long-term potential. Valuations may contract more than earnings will grow, and markets may struggle to deliver gains.

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