WESTEND Advisors

Economic and Market Commentary

Q4 2021

Expansion Ahead

We see continued economic expansion supporting positive equity returns in 2022, particularly for select areas of the market with a mix of cyclical and secular tailwinds.

SUMMARY

- As a whole, 2021 was a strong year for the global economy and equity markets, as we saw the rapid economic recovery off of COVID-19 lows decelerate toward more typical cyclical expansion.
- In 2022, we expect the global economic expansion will continue, with a mix of ongoing consumer strength, business investment, and inventory build driving slower but healthy economic growth.
- In the U.S., we are emphasizing sectors that should benefit from a mix of cyclical and secular earnings growth drivers, and globally, we are emphasizing the U.S. and other developed markets over more economically-sensitive and challenged emerging markets.
- We anticipate rising interest rates will be a headwind for fixed income securities and certain equity sectors, while providing an earnings growth catalyst for other sectors, like Financials.

2021 AND Q4 REVIEW

While successive waves of COVID-19 and various economic and political disruptions presented headwinds in 2021, we saw economies start the transition from rapid recovery to ongoing expansion and equity markets power through near-term risks and volatility. At the start of 2021, we expected economic recovery would drive strong earnings growth which, partly offset by contraction in valuations, would generate high single-digit equity returns for the year. In fact, full-year 2021 EPS for the S&P 500 is now expected to grow over 45% year-over-year, double the consensus estimate at the start of the year according to FactSet, and the S&P 500 returned 28.7% for the year.

As 2021 progressed, the economic backdrop evolved. In the U.S., the level of real GDP surpassed its pre-pandemic peak in Q2, driven by strong consumption supported by above-trend wages and salary gains. Economic growth then began to decelerate in the back half of the year. This deceleration may have partly reflected the impact of successive waves of COVID, but slowing growth is also typical of economic cycles.

In the equity markets, we saw shifts in leadership from some of the most economically-cyclical areas, like the Industrials and Energy sectors in the U.S. and emerging markets abroad, to areas with both cyclical and secular growth drivers, like Information Technology and Consumer Discretionary. Meanwhile, some defensive sectors, like Consumer Staples and Utilities, continued to underperform in 2021.

2022 OUTLOOK

Our overall outlook for the coming year is positive. We believe the U.S. economy will continue its shift into the expansionary mid-phase of the cycle in 2022. Global economic growth is likely to continue decelerating in the near term, in our view, but should remain healthy and above long-term trends. We expect continued economic growth to support positive earnings growth and equity returns, though valuation multiples are likely to continue contracting, particularly given the potential for rising interest rates in the U.S.

With an increasingly mid-cycle economic backdrop, we anticipate sector and regional allocation will remain critically important in 2022. For U.S. sectors, we see material upside to earnings growth for certain sectors amid these shifting economic trends, and while rising interest rates are a headwind for some sectors, they should be an earnings catalyst for others. Globally, we believe healthy but decelerating economic growth will favor developed markets over emerging markets, which tend to outperform when supported by more robust, early-cycle growth.

Market Dispersion: We expect sector and regional performance dispersion will make active allocation crucial in 2022.

U.S. Economy and Markets: While personal consumption and business investment were key drivers of the economic recovery and expansion in 2021, we expect both are likely to slow even as they continue to support growth in 2022. U.S. consumers accumulated over $2.5 trillion in above-trend savings during the pandemic, driven by stimulus payments and reduced spending on recreation and other services. While the savings rate, which spiked to over 33% during the pandemic, has fallen back to single-digit trend levels, we expect accumulated excess savings along with ongoing growth in personal income (already 10% above pre-pandemic levels) will continue to support economic expansion through 2022 and beyond.

We also see under-appreciated potential growth drivers for the U.S. economy in the coming quarters. As consumer and business spending growth slows in 2022, we believe pockets of improvement in other areas of the economy, such as trade, production, travel, and nonresidential construction, could pick up the slack.

We expect economic conditions will have fully shifted to mid-cycle expansion by the second half of 2022. We began positioning portfolios for this deceleration in 2021 by reducing exposure to more cyclical, early-phase sectors like Industrials and Energy, eliminating U.S. small cap exposure, and adding to sectors with a mix of cyclical and secular earnings growth drivers. We are currently emphasizing sectors like Information Technology, which we believe will see less earnings deceleration than other economically-sensitive sectors as growth slows; Health Care, which can benefit from spending on the pandemic as well as a rebound in elective treatments, yet currently trades at an atypical valuation discount; and Financials, which we expect will get a boost to earnings growth from rising interest rates.

There are, of course, ongoing headwinds to growth and risks to our outlook, including uncertainty around the evolution of COVID-19. As we write, the rapid spread of the Omicron variant has pushed new daily cases to record levels in the U.S. and elsewhere. However, while Omicron and other potential new variants can create disruptions, we have seen the U.S. economy gain in resilience and face less economic damage with each successive wave of the pandemic. We believe a mix of improved vaccination rates, evolving treatments and virulence, and better-targeted public and private policy responses should continue to dampen the economic impact of the pandemic.

We also expect interest rates are likely to rise in 2022. In addition to cyclical upward pressure on real interest rates from economic growth, we believe elevated inflation, tied to lingering supply disruptions and wage pressures going forward, is likely to support higher nominal interest rates. The strong rebound in economic activity together with only limited recovery in the labor force participation rate have driven the fastest decline in the unemployment rate on record. The Federal Reserve, despite a willingness to tolerate interest rates above its 2% target, has increasingly signaled that inflation pressures and the tight labor market justify removing monetary accommodation. The Fed is now expected to end bond purchases by March and may hike the Fed Funds rate as many as three times in 2022.

Interest Rate Risk:
Given our outlook for rising interest rates, we are currently emphasizing equities and shorter-duration fixed income.

International: In our view, developed economies are likely to benefit from recovery tailwinds in 2022, even as the global economic cycle continues to mature. Europe and Japan have experienced slower recoveries than the U.S. tied to continued COVID-19 outbreaks and lockdowns. We believe these regions are now poised to rebound materially in 2022, with higher levels of community immunity, fewer pandemic restrictions, and healthy labor markets. Personal consumption growth is a notable area of potential upside for these economies. For example, our work indicates that there is more pent-up savings as a percentage of pre-COVID spending in Japan (approx. 25%) than in the U.S. (approx. 20%), which could provide fuel to Japan's spending upswing. Furthermore, valuations in international developed markets have become increasingly attractive. Japan, in particular, trades at a record-low forward discount to the U.S., even as consensus earnings estimates look conservative to us.

Meanwhile, emerging economies, many of which initially rebounded from pandemic lows faster than developed markets, now face decelerating global growth, which tends to disproportionality impact these more economically-sensitive markets. We believe risks to China, in particular, have become more acute. While China's initial recovery was amplified by above-trend global demand for goods and rebounding manufacturing, its growth is now slowing as export demand peaks, its property sector slows, and the Chinese economy becomes more dependent on household consumption.

Conclusion: Overall, we see a strong likelihood of continued global economic expansion in 2022, even as risks from COVID-19, inflation, and other uncertainties persist. As always, we continue to evaluate the economic and market environments and will adjust portfolios accordingly as our outlook evolves.

WestEnd Advisors Investment Team | January 3, 2022