First Republic
Private Wealth Management

2022 YEAR AHEAD: A NEW WAVE

KEY TAKEAWAYS

Economy

The global economic outlook continues to stabilize and improve, and while the threat from COVID variants remains ever-present, we now have a broad range of vaccines in our arsenal. Assuming the vaccines and antiviral drugs can keep the new strain at bay, global growth should remain solidly above trend in 2022. While growth in developed economies is likely to slow in 2022, it is unlikely to decline and return to trend until 2023. In the U.S., further fiscal stimulus and infrastructure spending should continue to work its way through the economy supporting growth.

Policy

Both monetary and fiscal policy are unlikely to curb U.S. aggregate demand by very much this year. The Federal Reserve (Fed) will expedite the tapering of asset purchases in 2022 and previously announced a wave of rate hikes with at least three rate hikes in 2022 and at least another three in 2023. The most recent Fed minutes indicate a Fed that is becoming more concerned about the level of inflation but believes the economic outlook is much stronger with a tighter labor market.

Financial Markets

Global monetary policy will be less accommodative throughout 2022. We expect inflation in the U.S., and to a slightly lesser degree globally, to follow a "two steps up, one step down" path of higher highs and higher lows. We expect government bonds and rates to remain low in 2022 as several structural forces (e.g., globalization and baby boomers retiring) that have held rates low start to show signs of fatigue. Despite the gradual rate creep higher, the investing environment still favors equities over bonds as we expect corporate earnings to grow above inflation albeit at a slower rate than we've seen in 2021.

Investment Opportunities

As we begin 2022, the opportunity set for investing is going to be more nuanced. As earnings growth continues to be positive, broad market averages have built in much of the good news, and we see investors' positioning becoming more targeted by sector, style and market cap (to a name a few) within equities. Several disruptive forces and structural trends are likely to emerge — such as the gamification for learning, which has gained greater momentum as learning is increasingly done in a remote environment.

SELECT 2022 FORECASTS

Forecast	
3.7%–4.3%	U.S. Real GDP (annual YoY%)
2.0%–2.5%	10-year U.S. Treasury note yield
0.5%–1.0%	Federal funds rate
2.7%–3.3%	Core PCE
$230	S&P 500 EPS
$4,900	S&P 500 target

Source: First Republic Investment Management Research

GDP = Gross domestic product.
EPS = Earnings per share.

Forecasts and targets are based on certain assumptions and on our current views of market and economic conditions, which are subject to change.

MACROECONOMIC OUTLOOK: U.S.

In 2022, we expect the U.S. economy to continue to heal as COVID vaccines are more readily available and the country continues to reopen. We expect to see slower but still healthy consumer outlays and a spending mix rotation toward services. Higher inflation will remain a headwind but easing supply constraints should support growth. While the Fed will expedite the tapering of asset purchases and likely begin raising rates potentially as early as March, recent Fed minutes indicated that the economic outlook is much stronger with higher inflation and a tighter labor market.

While our base case for 2022 calls for continued growth as the economy continues to heal, we believe the ride in 2022 is going to be a bumpier one. The omicron variant has proved highly contagious and has weighed on sentiment as more workers are forced to stay home. And while we are better equipped to treat the virus, there will continue to be new variants, and this combined with relaxing restrictions then reimposing them will remain disruptive to the economy. As winter sets in across most of the country, so does the probability of an increase in cases. Finally, if omicron becomes the dominant virus strain, causes a greater number of hospitalizations or deaths, and reduces vaccine efficacy, then our downside COVID scenario would become a more plausible worst outcome. The good news is that for now symptoms from omicron are mild and vaccines appear to offer some degree of protection.

The economic landscape will continue to evolve in 2022. We expect consumer spending to show resilience; however, we believe that demand for goods will moderate and service spending will increase as consumers and businesses become more habituated to dealing with COVID. While certain portions of the service sector have partially rebounded (e.g., restaurants), spending on other service sectors (such as movie theaters, amusement parks and concerts) are still down considerably to pre-pandemic levels. Furthermore, U.S. households have accumulated excess savings worth around $2.5T since the onset of the crisis. Some of this money will be spent over the course of 2022, further supporting consumer spending and overall economic growth.

We believe business investment is likely to rebound in 2022 as companies look to increase capacity, rebuild inventories and automate more production in the face of growing labor shortages. After moving sideways for years, core capital goods orders have broken out to the upside. Surveys of capex intentions have improved sharply. The residential investment front should also remain strong in our view. Homeowner vacancy rates are near record lows, as are new and existing home inventories.

The labor market continues to show resilience as well as strong wage growth. While the December jobs report was disappointing, the overall trend is positive. The December jobs report also showed rising participation, which should help increase the labor supply and provide a release to counter strong wage growth. The report also shows strong gains in household employment that easily outpaced a muted 168,000 rise in the labor force, pushing the unemployment rate under 4%.

While we remain optimistic for the economy in 2022, longer-term the outlook becomes a bit cloudier. After our expectation for a rebound in activity in 2022, economic growth will likely cool as the fiscal stimulus fades. The risk of a policy misstep increases as we enter 2022 and beyond, and all eyes are on how the Fed reacts to higher inflation. We view rising inflation as the greatest risk in 2022 as strong demand and tight supply will continue to put pressure on prices and wages in the near to medium term.

MACROECONOMIC OUTLOOK: INTERNATIONAL

International growth will likely remain weaker than in the United States for 2022 as many regions suffer from a spike in COVID cases. Importantly, we expect China's stop-start approach to dealing with COVID to deliver weaker than expected economic growth out of China. The distribution of growth outside the U.S. will remain uneven as even some of the more developed countries with plentiful access to vaccines continue to struggle to bring COVID under control. International developed countries should be able to eke out above-trend growth in 2022 as fiscal and monetary policies remain accommodative across the Eurozone and Japan. Emerging markets growth is likely to be weak as the Chinese growth engine is suffering from several structural problems, most notably weakness in its property market.

The outlook for Europe in 2022 is constructive as the combination of increased energy supplies, easing supply chain bottlenecks and (hopefully) some relief on the pandemic front should all pave the way for better-than-expected growth across the Eurozone in 2022. Euro-area fiscal policy should also remain supportive as infrastructure spending is set to increase and the Next Generation EU fund package works its way through the economy. Though the European Central Bank (ECB) will end its pandemic bond buying program in March 2022, they are expected to increase its Asset Purchase Program to keep monetary policy accommodative, and the ECB is unlikely to raise rates until 2023.

The outlook for Japan is more neutral — while Japan will benefit from a short-term stimulus boost, it is still reeling from a major COVID outbreak this summer. Following the most recent general election, Prime Minister Kishida's government announced a stimulus package worth 5.6% of GDP. The package was aimed at boosting cash payments to households and small businesses, and encouraging domestic travel and consumption in 2022. Manufacturing and capital expenditures in Japan continue to lag, with motor vehicle shipments down significantly. The Bank of Japan (BoJ) is likely to remain on hold this year and leave policy rates unchanged.

In our view, the outlook for emerging markets (EM) remains unfavorable in 2022, particularly for China. The Chinese economy is currently under stress from the property market. Housing prices are falling, the number of new projects starting construction has been declining since April, and a number of large developers have been unable to service their debts. Elsewhere in EM the struggle to bring COVID under control remains a real threat to economic activity. Some EM suffer from marginal access to the COVID vaccine, while others have access to vaccines but the efficacy of these vaccines is less than optimal.

POLICY OUTLOOK

In 2022, the Fed is expected to take concrete steps toward policy normalization: The Fed will expedite tapering of asset purchases, as well as a wave of rate hikes. The FOMC December minutes and recent press conferences in January 2022 showed a Fed that was much more hawkish, indicating they are worried about inflation and will take action to bring inflation under control. We would anticipate at least seven to eight rate hikes through the end of 2023 to address the rise in inflation. U.S. fiscal policy will also get tighter in 2022, but not by a lot. In November 2021, President Biden signed a $1.2 trillion infrastructure bill into law, containing $550 billion in new spending that will help GDP growth for the next several years. However, barring a severe outbreak in a new variant or another major global negative event, there is limited appetite for additional fiscal stimulus beyond what was passed in 2021.

U.S.-Chinese relations continue to falter as there hasn't been much communication between the administrations until recently. In mid-November, a call between U.S. President Biden and Chinese President Jinping reopened the communication channels amid rising tension in the South China Sea but fell short of any true agreement going forward. In late 2021, Treasury Secretary Janet Yellen hinted that the U.S. may trim tariffs on Chinese goods. If the U.S. follows through with this policy action, it would be positive for both Chinese manufacturers and U.S. consumers.

There is a crowded agenda of legislative items that have the potential to impact the fiscal picture in 2022, the biggest of which is the Build Back Better (BBB) bill. Recent momentum to pass the BBB bill continues to stall, and the viability of the bill passing remains in question. There remains a number of outstanding provisions that need to be resolved before the bill is likely to pass (size of the house package, corporate minimum tax, drug pricing, etc.). In our view, it is unlikely that BBB would meaningfully add to current inflationary pressures. Unlike the $5.5T in COVID relief packages passed over the past 24 months, most of BBB's outlays would be spread across 10 years and would be offset by tax increases and spending cuts.

FINANCIAL MARKETS OUTLOOK

A rise in rates will create challenges for equity investors, yet we believe 2022 will remain a favorable environment for equities, given support by corporate earnings growth, even as valuations appear elevated by some metrics. Other relative measures of valuation, such as the equity risk premium (equity yield minus the yield on the risk-free bond), continue to favor stocks over bonds. Even as we expect monetary policy to tighten, market fundamentals should provide strong support. In our view, the next leg for equity returns is likely to be positive but lower than levels experienced over the past few years and volatility will be higher as rates rise.

U.S. earnings revision ratios continue to reaccelerate, and we expect earnings to grow albeit at a slower rate than 2021. Above-trend growth and consumer price inflation point to revenue growth in the high single-digits. Profit margins have been expanding since 2009, are now at all-time highs, and are high enough in our view to stand up to the combination of accelerating wage inflation along with rising input prices that has led to fears of margin contraction in the year ahead. However, our base case remains that strong revenue growth in 2022 will overshadow a pause in profit margins and equity multiple compression, allowing U.S. equities to produce modest returns.

Our fixed income outlook remains relatively unfavorable as rates continue to hover at low levels and are poised to slowly drift higher through 2023. The Fed accelerated reducing accommodation to markets by severely shortening their timeline to end asset purchases (Quantitative Easing (QE)) and are now expected to raise policy rates at least three times in 2022, followed by at least another three times in 2023. Expectations from only about six months ago were for the Fed to slowly terminate QE by year-end 2022 with rates on hold until at least 2023. With the Fed in full motion, we expect rates across the curve to move higher, led by shorter maturities, thereby flattening the yield curve. We also expect the ECB and BOJ to avoid any rate increases until at least mid-2023, well after the Fed has begun to tighten.

Credit market fundamentals remain strong as we begin 2022 and, along the same lines as equities, will continue to remain strong throughout 2022. However, it's likely the high-yield sectors will come under some pressure (i.e., wider credit spreads, increased delinquencies and defaults) with higher borrowing rates against a pending wall of maturities. For the municipal market in 2022, we expect credit conditions to remain favorable for most issuers with low delinquencies and defaults. Municipals' state and local tax revenues remain strong and are additionally supported by ongoing fiscal stimulus. Lastly, volatility in fixed income markets is elevated and will likely remain elevated with this backdrop. We continue to recommend a shorter duration stance relative to benchmarks within U.S. fixed income portfolios.

INVESTMENT OPPORTUNITIES AND PORTFOLIO POSITIONING

In 2022, we believe that the global economy continues to heal and reopen as additional COVID treatment options become more available. We do view 2022 as a transition year and portfolio positioning needs to be more nuanced. Investors should look to rebalance portfolios that are in line with their risk tolerance as we expect higher volatility throughout the first half of 2022. As markets become more and more interconnected, diversification becomes even more important — not just diversification in the traditional stock/bond sense, but also diversification within asset classes.

As rates remain historically low and corporate earnings continue to surprise to the upside, we continue to favor equities over fixed income and cash. We would still favor an allocation to bonds as a ballast, as we expect greater market volatility in 2022 than we saw in 2021. Recently we've seen higher volatility in the fixed income markets, and higher fixed income volatility historically transfers into equity market volatility. Despite 2022 being a midterm election cycle, we expect elevated political uncertainty as we go into the fourth quarter. If Republicans secure a midterm win, markets might applaud that action as it would likely freeze fiscal policy until 2025. Given the wide range of outcomes, we would not recommend any changes to our positioning solely based on the political outlook.

We continue to remain selective within equities, with a bias toward segments exposed to cyclical profit sources, and secular growers with earnings growth, pricing power and operating leverage. We also have a bias toward quality over highly leveraged companies, as higher interest rates could enhance the debt burden and limit liquidity. From a regional equity perspective, we favor U.S. and Europe. Our U.S. equity view is based on above-trend growth in 2022 with revenues and earnings continuing to power ahead. In Europe, we find support from incredibly supportive monetary and fiscal policy, more reasonable valuations and cyclical tailwinds to segments including Financials. We continue to see a wave of thematic opportunities that focus on trends — such as gamification of learning, and as remote learning becomes a more integral part of society, we see companies focused on this trend as well positioned.

For fixed income portfolios, duration management will remain paramount in 2022. The combination of above-trend economic growth and strong demand for corporate credit will provide support for the corporate market in 2022. Credit fundamentals remain strong; however, lower quality credits will likely come under pressure with credit spreads widening. With higher than anticipated revenue coupled with strong fiscal support, the municipal market is poised to remain very strong from a credit perspective. Lastly, in our view, the technical environment (i.e., supply-demand dynamics, yield ratios vs. other fixed income sectors) for municipals will remain favorable and municipals should remain in good shape.

Finally, we believe investors should also consider a greater allocation across alternative investments that go beyond broad asset classes and can provide an additional layer of diversification. Some of these nontraditional investments, including private credit and venture capital, have the potential to generate value while helping investors reduce volatility. Acceleration of tech adoption across products/services has fueled the venture market sector. As a result, we expect tech unicorns to emerge across innovative industries, including learning gamification, fintech, health technologies and green technologies. We also believe that some of the hardest-impacted areas of the economy will offer private equity firms dislocation opportunities, such as secondary investments, distressed debt and special situations. Lastly, we also see opportunities in real estate, particularly in select suburban housing (multifamily, single-family residential and manufactured housing) and industrial real estate.