2022: A year of shifting gears

Tylar Lunke: Hello, and welcome to a discussion focused on the Global Insight 2022 Outlook from RBC Wealth Management. We're recording this on Thursday, January 13, 2022. My name is Tylar Lunke, and I lead the Managed Portfolio Strategies team, and I'm joined today by Janet Engels, head of the Portfolio Advisory Group, and Kelly Bogdanova, co-chair of RBC's Global Portfolio Advisory Committee. Thank you all for joining us today and for your trust in RBC. Our goal over the next 20 minutes or so is to provide additional perspective on the 2022 Outlook, including our views on the market, highlights on a few trending topics, and we'll close with our thoughts on current thinking for portfolio positioning. So with the setup complete, Janet, right over to you to get us going. The 2022 Outlook report does cover a wide range of topics, but let's get right to our high-level outlook, or simply the question: What's the big picture?

Janet Engels: Well, happy New Year Tylar, and thank you all for joining us. Well, we expect 2022 to be another year of above-trend economic growth, moderate earnings growth, and positive but more modest returns for equities with some increased bouts of volatility. We remain modestly overweight equities in our asset allocations for the year ahead. We're calling it a year of shifting gears as growth slows a bit and as central banks around the world begin the next tightening cycle.

Tylar Lunke: So you mentioned above-trend economic growth. Let's go there right now and talk about our view on the economy, and as part of that, maybe some thoughts on those contributing factors in your eyes. So Janet, what's our view there?

Janet Engels: Sure. How do we get to above-trend growth for the U.S. economy for yet another year? I put it this way. While we think we're past, or we know we're past, the peak in terms of growth, growth should still stay well above trend, and there are a number of very powerful tailwinds behind the U.S. economy and to support that economic growth. So here's a few of them. First of all, credit conditions remain very easy, and certainly that supports businesses. Really, we often focus on the consumer, which is a driving force behind growth in the United States. We are a consumption-driven economy, so when we think about the consumer, we continue to point to that excessive amounts or excess savings that exist for consumers today, over $2.3 trillion, nearly 10% of U.S. GDP. In addition to that, consumer balance sheets overall are quite healthy, and there continues to be strong growth within household net worth.

Think of the value of one's home, think of the value of one's investment account, and they have increased dramatically. But if we look at the business side as well, there's a number of things going on. Business spending we believe should continue. Inventories are simply too low. Inventories have been low. They need to be rebuilt. Stocks of goods on hand are unusually depressed, and we are beginning to see companies increase inventory levels, and quite frankly, rethink that just-in-time inventory model that worked before the pandemic, but isn't working so well right now. When I think about capital spending on the business side as well, capital spending is surging, with more to come, in our view. CapEx by businesses in the third quarter was up by almost 9% on a year-over-year basis in the United States. That's a driver of quite vigorous growth, and supported by low interest rates, strong corporate profits, as well as the need for more capacity and a more resilient supply chain.

When we listen to companies right now on the business side, quarterly management commentary by many companies reveal the capital spending intentions for the coming year are unusually strong. So I guess in summary, Tylar, we think there are a number of factors that will support a year of good economic growth above trend, not as great as 2021, but still quite solid.

Tylar Lunke: So one of the things you talked about in that review of the economy is businesses, and kind of the next topic up here, and one we can't avoid these days, is COVID and Omicron and other variants. And so maybe just some perspective on how COVID and potentially future variants impact the economy and business for the rest of the year, as you see it.

Janet Engels: Yeah. I think what will happen, just like Omicron, just like we had with Delta, there can be some temporary disruptions to economic activity. So if you think about that path forward for 2022, don't expect it to be a straight line of growth. We can have some temporary disruptions. We're seeing that right now. We can also see continued disruptions within the supply chain that can certainly lead into inflationary concerns, but we think that they will be temporary. We've moved through them before. These variants may still come about. Again, just some disruption in economic activity from time to time.

Tylar Lunke: So you mentioned the supply chain there and the impact on inflation. Why don't we go there? Certainly a key factor in the economy, and people are talking about it all over the place. You can't ignore the headlines that we see on inflation. But in your view, kind of, maybe how did we get here on inflation? And where does inflation go here in 2022?

Janet Engels: It is probably the hottest topic that we hear and get questions from clients on, and let me give you our view. We do believe that inflationary forces will moderate later in 2022 and into 2023, but they may stay a little higher than people or investors are expecting at this point. But let's think about how we got here in terms of higher levels of inflation, really the restart of the economy, surging demand on the part of consumers. And at the same time, manufacturing, shipping, labor shortages were not able to keep up with that demand, so we went into a period of significant supply chain disruptions. We know that we have had labor force disruptions. Shipping costs and other costs have escalated, so those all come together to bring us to multi-decade highs with inflationary prices.

We do expect that inflation will ebb or cool down in the second half of 2022 and recede further in 2023 under the influence of, quite frankly, the resolution of some of the factors that brought us here. So as we continue to reopen the economy, as we continue to see labor force starting to come back to normalize, we should start to see some easing in those supply chains. That's simply going to take time, but we should see that easing taking place in 2022, probably the latter half, and into 2023.

Tylar Lunke: So inflation cools down in the back half of the year, potentially. And directly connected to that, at least in the headlines, would be the Fed and their response and what we've seen over the last couple of years as we've worked through COVID here. But as we consider the Fed, Fed policy, and the impact on rates, and maybe the same question as we had with inflation. Where are we today, and what do we expect to see the rest of the year?

Janet Engels: Well, we are entering the first rate hike cycle that we've had in some time. We do expect the Fed to do a number of different things, and other central banks, quite frankly, around the world. So for the Federal Reserve, we do expect them to finish the tapering that they've discussed, and that should probably take place in the March timeframe. That will set the stage for a turn in the cycle, which means they will begin to raise interest rates. They will hike interest rates in 2022. We are right now anticipating three rate hikes on the part of the Federal Reserve this year. Now, a couple things to keep in mind. Simply changing or hiking interest rates does not mean that we are in a tight monetary policy condition. I think the important thing to keep in mind is: Why is the Fed beginning to increase interest rates? And there are two main factors here.

The first factor is the strength of the U.S. economy. We have regained all the lost momentum in the U.S. economy since those short recession lows back in 2020. So that would be number one: The economy is in good stead. The other is that inflation is running hotter than was originally expected, and if the Fed begins to raise interest rates, that should help to dampen some of those inflationary pressures in the U.S. economy. Again, the point I want to make once again is just because they begin to move rates or withdraw accommodation does not mean we have tight policy, probably far from that in 2022. The Fed's intention when they go into a new of rate cycle is not to put the U.S. economy into recession, and that's an important thing to keep in mind. But we are... This is another shift in gears as the economy is slowing down a bit. Central banks around the world are shifting into a new gear, and that is increasing rates, and that with that will come some increases in the 10-year Treasury rate as well.

Tylar Lunke: So they're looking to, or will be, increasing rates. But one last topic for you, and this moves into a view of stocks. And some people might think it's a bit counterintuitive with raising rates and where our position might be, but we are positive. We're constructive. You mentioned the overweight at the outset of your comments. So how would you summarize our view of equities from here?

Janet Engels: Yeah, we remain constructive on equities. We are looking for modest returns, positive returns in 2022, and a bit more volatility than we experienced in 2021. Really, the setup for positive returns for equities goes something like this: Above-average economic growth and moderate earnings growth will help to drive stock prices higher. In years of above-average economic growth, that has tended to be positive or constructive backdrop for equities overall. And if we think about what is on everyone's mind, not just inflation, but the Fed and increasing interest rates, would be very important to note that as we look back on the last 17 Fed cycles, tightening cycles, and we looked at those in 15 of the 17, share prices moved higher into the first rate hike with a median return of 17%.

And the year after the first Fed hike, 13 of those 17 years, share prices moved higher with a median return, which was a bit less of 9%. Now, admittedly, Tylar, we are within a year of that first Fed rate hike, probably three months away at this point. But again, we still believe that the trajectory for share prices can move higher in 2022. We are modestly overweight stocks.

Tylar Lunke: Thank you, Janet, and thanks for the perspective as always. Now, we're going to bring Kelly into the conversation. And Kelly, let's shift and begin talking a bit about how we're going to incorporate our views into portfolio decisions. We'll do this within the conversation, breaking apart into a couple pieces here. First will be how we're starting the year out, and then kind of later on into 2022. And so as we step into the new year, Kelly, what are you thinking about when it comes to portfolio allocations?

Kelly Bogdanova: Really, one of the main things I'm thinking about right now is: How are portfolios positioned with U.S. equity exposure versus international? And the reason this stands out right now is because we just had such a fantastic year last year for U.S. stocks. The S&P 500 surged 27%. But if you look at international developed markets, that performance was much less robust, about 10%. And it's not just last year, but the S&P 500 has been on a fantastic winning streak for many years. It's outperformed international since 2011. It's risen by double digits in 10 of the last 13 years. That's a spectacular run. So the question that comes in my head, and what we're thinking about as we manage portfolios, is: How long is this likely to persist? And what is this doing to portfolios? It's great if you've been invested in U.S. stocks, and our clients have been, of course, but what it naturally does, it boosts the allocation to U.S. equities at the expense of international. And that can lead to a U.S. bias or a home bias in portfolios.

So if you step back and look at what your intention is with allocations, U.S. exposure may actually be a lot higher than you might think, and that can throw allocations out of whack. And the reason this is an issue is because markets tend to move in streaks. So the fact that we've had a long run in U.S. stocks isn't so rare. It's happened before. When we go back to 1975, for example, and you look at international performance versus U.S. performance, you see they tend to jockey back and forth. So you have multi-year winning streaks for U.S., and then it flips back to international, and then it flips back to U.S., and so forth. And it's fruitless to try to attempt to precisely time when performance is going to shift back to international, but if we look at history, realistically it will at some point. There's no bell that's going to ring, though.

But for diversification purposes, we think that now is a good time just to at least check portfolios to make sure that you've got the mix of U.S. versus international stocks that you want, that you don't have too much of a U.S. bias. We're positive on U.S. equities for this year, for sure. We would slightly overweight them in portfolios, but we don't want to be extremely overweight, because at some point, that performance is likely to shift back to international.

Tylar Lunke: So at the very least, a reminder to review target allocations, and keeping some of those stats in mind. So the next thing, Kelly, would be we just talked about U.S. versus international. That's one decision that's available. Another would be, within equity portfolios, considering the style and sector allocation. So maybe talk a little bit about our current thinking when it comes to style and sector.

Kelly Bogdanova: And here, let's just focus on the U.S. when we think about this. So for a number of months, we've been recommending overweight exposure to economically-sensitive stocks, those are also called cyclicals, and also to growth stocks. We thought that those would be beneficiaries coming out of much of the COVID headwinds, and so that's where our overweight has been focused. And specifically in terms of sectors, we've been oriented toward energy and tech. That's how we're starting the year in terms of positioning. But in 2022, we think investors need to be flexible, and that's because the economy is shifting. It's shifting from being white hot to a more normal growth phase. And because of that, we've got lingering uncertainties, Janet mentioned them, about COVID, about inflation, about Fed policy. Things are changing. So these factors could prompt us to shift our style and sector recommendations in the coming months. And when I think about 2022, to me, one of the keys to the year is for investors to be nimble.

Tylar Lunke: So remaining flexible, certainly a key behavior for investors to remember. And so as I mentioned, that leads us to talking a little bit further out, down the road in the year. So maybe next question, Kelly, would be: What are you thinking about as we look at maybe the back half of 2022?

Kelly Bogdanova: The back half of 2022 will likely be influenced by inflation trends, by uncertainty about what the Fed is going to do. And within that, we could potentially have some volatility. 2021 was really unusual. We had very little volatility, and the biggest correction was a 5% decline in the S&P 500. And that's not even a correction, that's just a dip in the market. Usually, corrections of 10% or more happen. Even in good years, it's not uncommon. So if you go back since 2000, the S&P 500 pull back 10% or more at some point during the year in more than half of the years. So that's what we should expect. If it happens this year, and we think it could, a pullback of even 5 or 10% though might actually feel like a big pullback in the market, and that's because we haven't had that kind of decline in a long time. So when you go through a streak of not having much volatility, and all of a sudden you're hit with a 5% pullback, or even a 10% pullback, it tends to feel exacerbated.

But I think just in our minds as investors, we should prepare for more volatility, remember that it's totally normal, it happens in most years, and really stay focused on the leading economic indicators. So as we have uncertainty about the Fed, as we have uncertainty about inflation, check back on the leading economic indicators, because they really tend to give us a good roadmap as to where the economy's headed, and that helps tell us where the stock market's headed. And as long as those leading economic indicators aren't signaling that recession risks are rising... And they're nowhere close to that right now. There's no recession risk out there, according to our indicators. As long as that's the case, we think that the market can push through any correction periods, and that the bull market will persist. So that's what we're going to have our eyes on in the second half of the year and as the year progresses. It's those leading economic indicators. And prepare for some volatility.

Tylar Lunke: That is a good reminder, for sure, that if we see more volatility, it would be normal. So with that, we're going to wrap up our conversation with those thoughts on portfolio positioning. So thank you to Kelly, and thank you to Janet as well for your thoughts today. We want all of you to know the 2022 Outlook content is available in the email you receive. There's some focus articles as well, so feel free to check those out. Or you can head over to rbcwealthmanagement.com and then click on the insights tab at the top to browse through the various articles. Also, want you to keep an eye out in the coming weeks, as there'll be additional articles published and available for you to browse as well, right there in that same location. If you have any questions about the Outlook or your investments in general, we would encourage you to stay in touch with your RBC financial advisor. Thank you all again for the time today. Take care, and we hope you have a great 2022.

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