



The Year Ahead: 2022 Outlook

Q1 2022 Market Update

“You can’t connect the dots looking forward; you can only connect them looking backwards.” Steve Jobs

2022 is the year of the Tiger according to Chinese astrology. The Tiger is a symbol of strength, exorcising evils and braveness. After the past two years, exorcising evils seems like a fitting theme for 2022. As we limp into the final days of 2021, it has been filled with a Ying-and-Yang dichotomy of good and bad making it a taxing year for many. Markets were strong, stumbled in Q4 and face daunting hurdles next year. COVID became less of a threat with vaccinations yet keeps coming back like some pesky underdog that doesn’t know it has been beaten yet; the next variant might have

to be named Rudy since it refuses to quit! We face uncertain times with rising inflation and cost pressures starting to be a major concern for the United States. In the midst of all this bad news, markets were positive on the year, companies grew their earnings, and our economy grew rapidly. The bulk of the returns came earlier in the year before hitting a roadblock in the last few weeks. The Fed looms large over how the year finishes up; however, markets seem determined to rally regardless of any negative news.

As of close on 12/15/2021:

Index	Ending Value 12/15/21	YTD % Price Change
Dow Jones	35,927.43	17.39%
S&P 500	4,709.85	25.39%
NASDAQ	15,565.58	20.77%
Russell 1000 Value	1,621.734	20.16%
Russell 2000 Small Caps	2,195.209	11.16%
WTI (Crude Oil)	\$71.15	40.06%
Avg. US Gasoline Price (AAA)	\$3.316	47.11%
GDP	4.9%	4.9% YoY Increase
Inflation (CPI)	6.8%	6.8% 12-month increase
US 10 Yr Treasury Bond Yield	1.47%	+0.565bps from 0.905%

2022 S&P 500 year-end targets forecasts are all over the map; the most bullish (Credit Suisse, followed closely by Goldman) see it at 5,200, while Morgan Stanley, the most bearish, sees a loss on the year and the Index closing at 4,400. That is an almost 18% difference between the highest street estimate and the lowest, showing that next year may set up to be one of the most volatile and unpredictable we have seen in decades.

G Squared is moderately bullish on 2022, with the expectations that the 1st half is stronger than the 2nd but feel we may see 6-8% return on the S&P 500 (including dividends). This return expectation

is closer to the long-term historical average, but well below the 10%+ it has been generating over the last decade. We see a year-end target of 4,950, and EPS of \$210 on the S&P 500 given those expectations. This is slightly above the street average of 4,843. We feel inflation will moderate and economic growth will be robust in Q1 & Q2 before diminishing in second half of the year. Moderate growth, moderate return expectations. We anticipate at least 3 rate hikes from the Fed in 2022 with the Fed funds rate reaching upper bound of 1.00% by the end of next year. Currently the rate is in the 0-0.25% range, which continues to be historically low.

Firm	S&P 500 Target for 2022
Credit Suisse	5,200
Goldman Sachs	5,100
JPMorgan	5,050
RBC	5,050
Deutsche Bank	5,000
Citigroup	4,900
Barclays	4,800
BofA	4,600
Morgan Stanley	4,400

<https://www.marketwatch.com/story/proceed-with-caution-heres-what-wall-street-analysts-see-for-the-u-s-stock-market-in-2022-11638986154>

Inflation, Fed policy, and virus trajectory are the 3 main risks we see to our outlook.

Inflation

The root causes of inflation are debatable, but we feel the bulk of inflation was brought on by excess monetary supply compounded by supply chains breaking that caused shortages and delays. Consumer behavior pre-pandemic was well known, tracked, and calculated by sophisticated algorithms that allowed for companies to operate with less inventory on hand and higher margins.

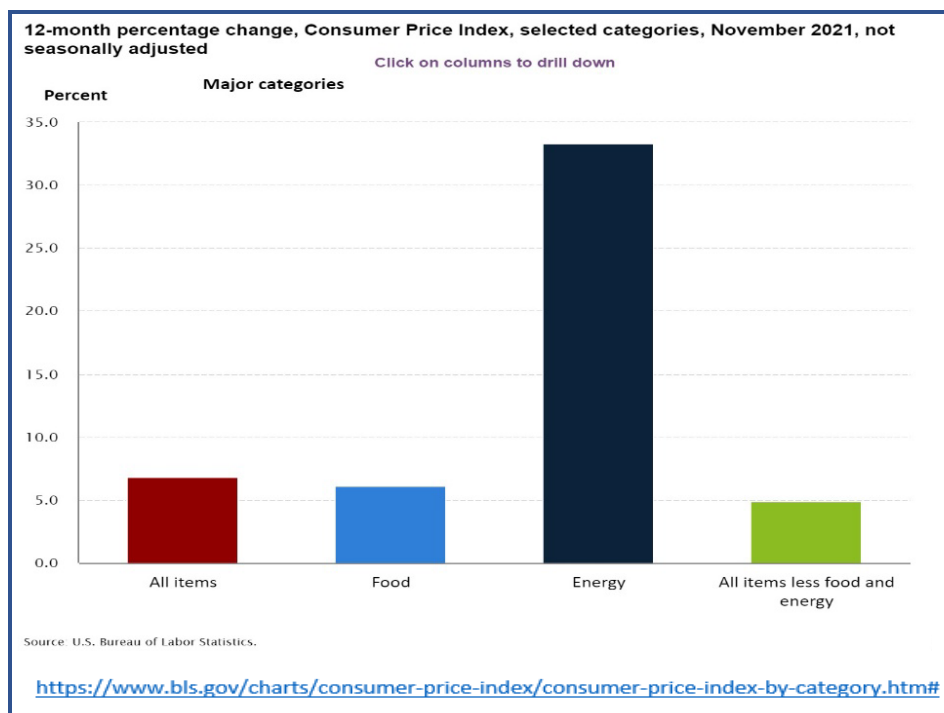
Just In Time Inventory (JIT) management was seen as cutting edge and was popular with retail and manufacturing as it reduced capital required to run the business. JIT turned into a quagmire when consumers radically changed behavior causing runs on products that manufacturing was not prepared for as well as a disastrous domino effect on supply chains. It became difficult to adjust in

an outsourced and meticulously balanced system. Chip shortages brought on electronics shortages which compounded manufacturing shortages from cars to refrigerators. At the same time, you had delays in the supply chain, you saw increased monetary supply pushing more cash into the system bumping up demand. When you already have supply issues, unanticipated demand increases made the system crack.

Some of these supply chain issues are being worked through more successful than others. Backlogs are getting better and consumer behavior is returning to normal. The system normalizing should help alleviate some of the inflationary pressures. The top 5 main categories as of December for 12-month inflationary increases are: Energy commodities (+49.5%), Used Cars and Trucks (+11.2%), Energy Services (+11.2%), New Vehicles (+9.8%) and Tobacco and Smoking Products (+8.5%). Some of the subsectors with the highest rates of growth are: Gasoline +50%, Natural Gas +28%, Beef +24%, Bacon +20%, and Vehicle Rentals +39%. Energy, vehicles, and food are all pain points for most consumers as its difficult to avoid the rising costs.

Many of these areas are directly correlated to supply chain and pandemic issues. Oil & gas

drilling shrank to 171 active rigs when oil prices went negative, down from 675 pre-pandemic, and beef and meat availability & prices struggled with processing plant shutdowns. When these industries come to a halt, it became difficult to bring production back quickly, especially in the current era of labor shortages. Used cars are also one of the areas of highest inflationary growth, which is a great example of this issue. During the pandemic, many rental car agencies sold fleets as it was too expensive to keep inventory during lockdowns which made their product momentarily obsolete. When the world reopened, and reopened rapidly in the USA, you saw increased demand for cars both from individual consumers with better balance sheets and cash on hand, as well as rental car agencies buying back fleets of new and used cars to meet the exploding domestic travel demand. At the same time as this surge in demand, new car production was slowing as multiple car manufacturers dealt with chip shortages. This led to an increase in prices for used cars due to the market imbalance and high demand. As the chip shortage eases, manufacturing ramps up, supply increases and prices come down. Many of these pressures and inflationary issues should see relief in 2022.

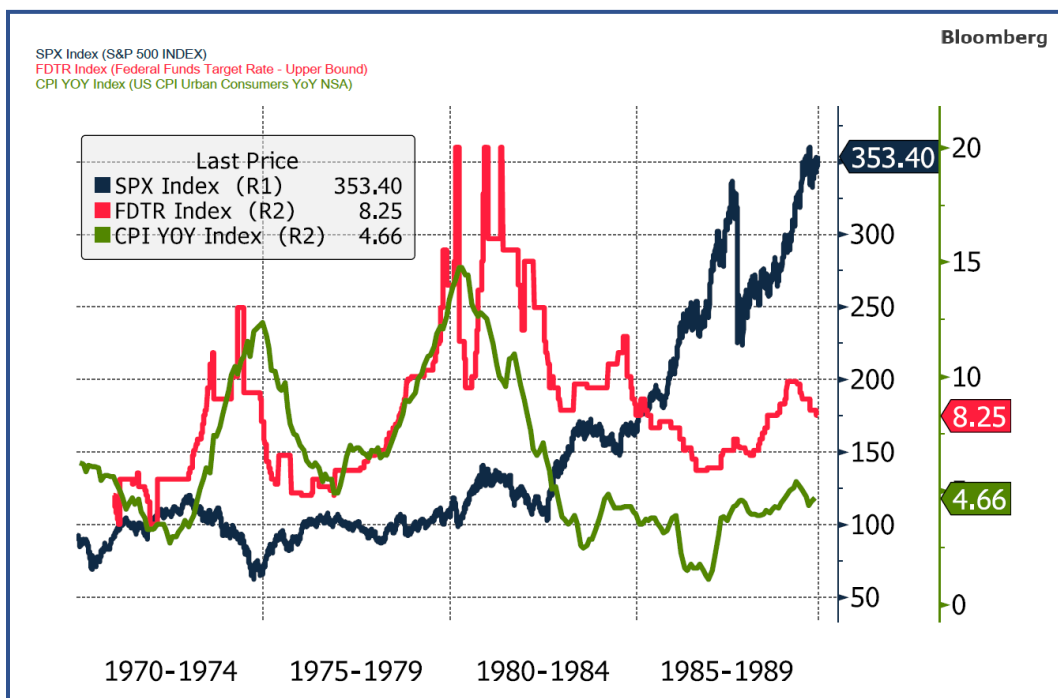


Fed Policy & Rates

Rate hikes are not an automatic death blow to stocks; in fact, an economic environment where the Fed is raising rates typically corresponds to economic growth and has been positive for equities. The same cannot be said for bonds. The bond market will be volatile and an area that may generate negative returns in 2022 depending on where you are on the maturity, duration, and credit spectrum. Interest Rates coming up are good for short term or laddered investors who can constantly reinvest as the market offers them new bonds with higher interest rates. It is interesting to note that convexity and the shape of the yield curve may drive what sections of the bond market struggles and which will generate positive returns. Convexity is the measure of the curvature, or the degree of the curve, in the relationship between bond prices and bond yields. Typically bond yields are not a straight line and the shape of the yield curve can change dramatically as Fed policy evolves. This video shows a time lapse since 1965 of the treasury yield curve changing shape over time

<https://www.youtube.com/watch?v=SdAuHSKtpmk>

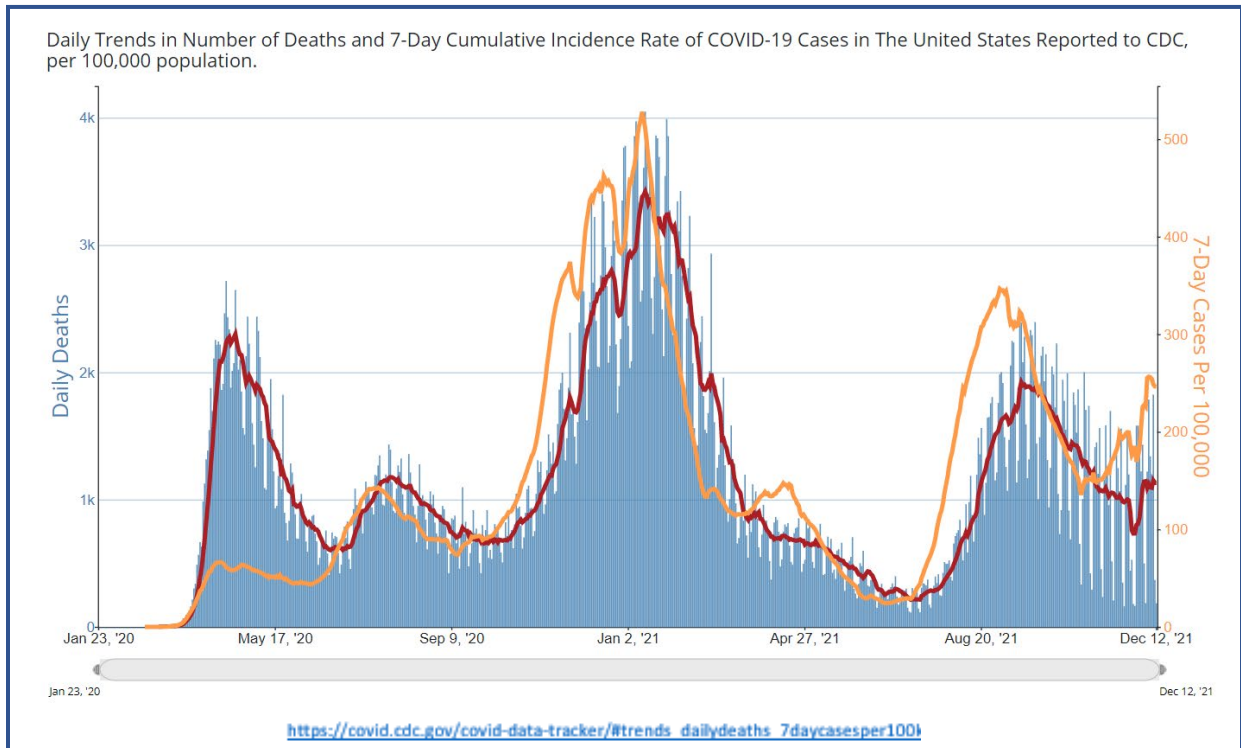
Fed policy is anticipated to be Hawkish starting in December of 2021 and throughout 2022. The Fed is desperately attempting to rein in inflation while also continuing to stimulate employment. Its almost a conflicting mandate as on one hand, they are striving for full employment and need the economy to continue to grow and be strong, while on the other, they are fighting very high, very fast inflation that threatens to derail economic growth. As we covered, we feel inflation has mostly been brought on by supply constraints and supply chain issues and should moderate in 2022 as the world normalizes. You have seen some encouraging signs even while the headline numbers have been abysmal. The recent CPI 12-month increase of 6.8%, this is the highest year-over-year figure since 1982. Let's take a look at what markets did back in the 80's. For the decade from 1972 (when the first inflation/hikes started) to 1982 when rates started coming down, the S&P 500 was actually up 37.76%. We also feel that the 1971 full exit from the gold standard causing a severe drop in the US Dollar, and the 1973-1974 oil embargo had outsized effect on that inflationary period. Those 2 events are highly unlikely to occur again during 2022.



Virus Trajectory

This is the wild card, and one I am well aware that we are all tired of talking about. Our base case assumption is that vaccination levels increase Worldwide, continued improvements in treatments further limit severe cases, and hospital stays and that the World reopens in 2022. It may not happen instantaneously in Q1 of 2022, however we feel the return to normalcy will occur next year. There will be more variants and I do not think continued recovery will happen in a straight line (see current ongoing Omicron issues). We may end up having to reuse the Greek Alphabet or switch over to new naming nomenclature for ongoing variants as I feel they will remain prevalent. However, the world will continue to diagnose, treat, and prevent the virus with more skill as we have learned tremendous amounts about its pathology and structure. There will be risks of shutdowns, restrictions, and continued disruptions especially in Q1 coming off the holidays as well as over the summer as we have seen a pattern emerge of when the virus surges.

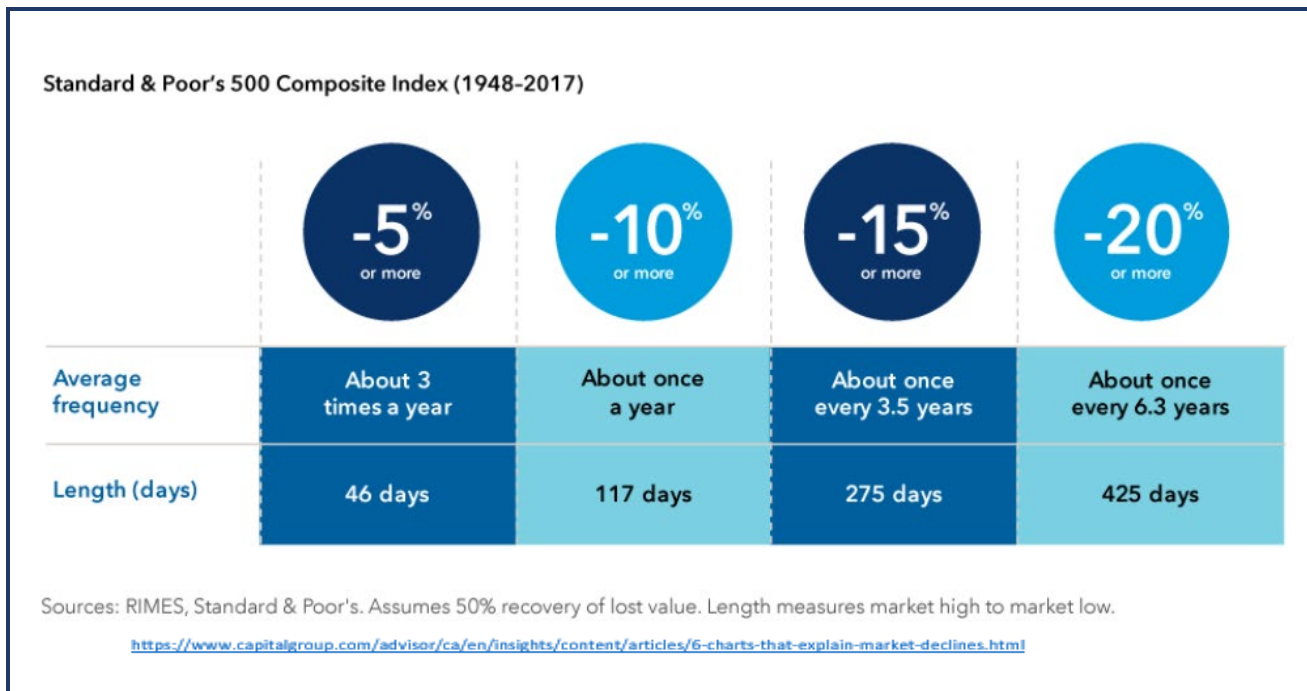
I am optimistic that we will be able to continue to improve our remedies and prevent deaths with new drug treatments, better knowledge, and faster awareness in the population regarding the virus. This is the hardest trajectory to attempt to predict for 2022: How prevalent will the virus be and can we finally get it under control globally? Our economies are so interconnected (supply chains!) that if Europe starts lockdowns its not just a blow to airlines and tourism, but it hurts our economy too as we depend on many foreign countries for critical parts and supplies to continue to generate our economic growth. In the 20 months since COVID emerged as a threat, some companies and countries have handled it better than others. I do think we could continue to see “winners” and “losers” in the COVID battle, as those that adapt and move quickly on new information may fare much better than those who rely on outdated methods. Flexibility may be the prevailing theme in 2022.



Markets in 2022

The future is always unknown to us. Black Swan events can occur that we didn't see coming, or we may see unexpected growth and above average returns like we did in 2020-2021. The feeling that markets are overvalued, and doom and gloom of the world is hard to shake, however we believe in our base case assumption for continued recover, steady EPS growth and inflation moderating in 2022.

There is always going to be a reason to not invest. Markets are too high and overvalued, or the world is too scary, or your political party isn't in power so obviously it's going to be an Economic disaster. There are many possible events that could derail our economic expansion and market rally. However, with inflation creeping up you need to stay invested and keep an equity position to protect the real value of



There will be bumps along the way; similar to how Dante had his 9 circles of Hell in *Inferno*, we have 3 levels of potential market pain that may occur in 2022. A Pullback (5-10% loss), Correction (10-20% loss) and Bear Market/Crash (>20% loss) are normal market events over a full market cycle. So, what to expect? 2021 saw some minor drops but no corrections, so we do warn we may see a correction next year at some point, either due to Fed Policy error, Virus trajectory or some unknown event that occurs.

your assets. Always invest, as boring as it may be, to what is the most probable and likely outcome, not what is possible. There are millions of possible outcomes that may occur over the next 365 days. But WILL they happen? And even if they do, will the markets react the way you think they will? Charles Dickens puts it well, "I know enough of the world now to have almost lost the capacity of being much surprised by anything."¹

¹Dickens, Charles, David Copperfield, Bradbury & Evans. May, 1849



1470 Copperfield Parkway
College Station, Texas 77845

(979)314-4830
GSquaredPrivateWealth.com



Victoria Greene CFA®, CRPC®
Chief Investment Officer