

# Global Perspectives Market Outlook 2022

## As the economy booms, inflation rings loud

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### Executive Summary

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- Economic boom continues but the cat is out of the bag, and its name is Inflation
- The fundamentals of corporate earnings, manufacturing and the game-changing consumer are nothing short of explosive on rising GDP and falling unemployment
- The U.S. Federal Reserve must gradually rein in inflation with three rate increases starting in March or risk a much more draconian response later
- We recommend a balanced global portfolio of stocks and bonds in 2022

### Setting the stage for the year ahead

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Markets have been unrelenting and explosive, driven by an equally impressive economic boom stoked by massive, simply massive monetary and fiscal stimulus from around the world. It took all year but finally the words “transitory inflation” were dropped from the U.S. Federal Reserve’s lexicon as it was based on the false assumption that the Fed would not let things get out of control – well “fool me once...”.

Fortunately, the Fed did finally act – well, kind of – with the commencement of tapering in December. While this might carry the connotation of *subtracting* monetary stimulus, i.e. to stop spending and repay debt, this couldn’t be further from the truth. Tapering means the Fed will still be spending – a.k.a., adding to its \$9 trillion balance sheet – through March 2022, albeit at a gradually reducing rate. Thus, the Federal Reserve is still very, very accommodative.

Under such monetary policy conditions and still-high fiscal spending, I anticipate inflation to sport a 7%-handle through the first few months of 2022 and corporate income taxes to rise. Meanwhile, geopolitical risks are also likely to escalate, led by the dynamic duo of Russia and China. What could possibly go wrong?

The Federal Reserve – as both solution and problem – is walking a tight rope, and it is very important for it not to waiver. Markets are expecting a steady Fed hand and the Fed must deliver on tapering and rate increases, or the consequences could be devastating. This may seem counterintuitive, that the market would want a “tightening” posture from the Fed. The reason is the fear of inflation, not in goods but in the market, which is creating identifiable imbalances, raising risks of a far more severe correction if not reined in. Therefore the primary variable for my forecast is based on a strong, unwavering Fed that gradually reins in inflation.

## Equity Markets 2021 Review

### Equity markets had a stellar year in 2021, especially in the U.S.:

- Global REITs were the number-one asset class in 2021 with a 32.4% return
- The S&P 500® reached 70 closing highs on its way to a 28.7% annual return. Its smaller brethren were close behind, as the S&P 400 MidCap's gained 24.8% and the S&P 600 SmallCap's returned 26.82%, both for the year
- International performance was mixed; the MSCI EAFE index was up 11%, but the MSCI Emerging Markets index logged a -2.2% performance, with large losses in the China component, which accounts for almost a third of the benchmark's weight
- All S&P 500 sectors posted gains in 2021, led by Energy – up 55% after its 34% loss in 2020 – followed by Real Estate, Financials and Technology, all up 46%, 35%, and 34%, respectively
- Fixed Income was led by High Yield bonds' 5.3% gain, while Global Bonds were the worst, producing a -4.7% return. The surprise comeback was long U.S. Treasuries, which nonetheless logged a -4.4% return for the year despite a strong showing in December
- The Dow Jones Commodity Index (DJCI) surged 30.8%, and the S&P GSCI rose 40.35%, led by GSCI Energy's 60.7% gain, and despite a surprising loss by GSCI Precious Metals of -5.1%
- The S&P 500/CBOE Volatility index – or the VIX® – ended the year at 17.7% or -24.3% for the year, which is indicative of a positive market and risk-on sentiment

## Forecast 2022

The forecast for 2022 is as straightforward as what we refer to as the “A-B-C’s” of the markets: We have used the “10 Fundamentals” before, but now for simplicity’s sake, we use the first 10 letters of the alphabet, A – J:

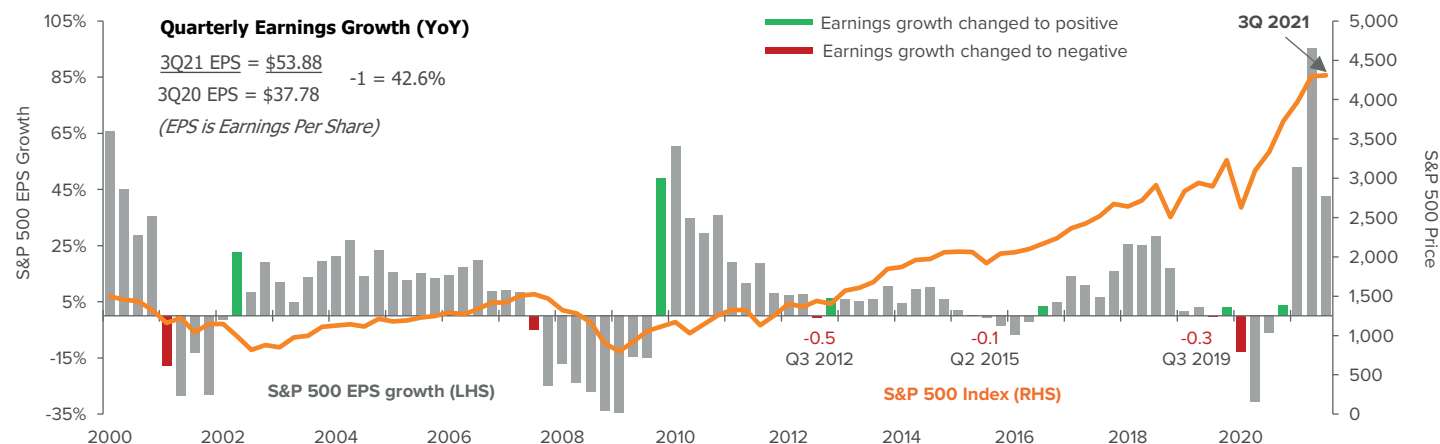
Figure 1. Global Perspectives 2022 forecast

Market Fundamentals	2022 Forecast
S&P500 Index Level	\$5,250
S&P500 EPS	\$250
EPS Growth	21.5%
Crude Oil (WTI)	\$90 bbl
Gold	\$1,700 /oz-t
10 Year UST Yield	2.0%
Trade Weighted \$ (DXY)	97
Bitcoin (CME) continuous	\$25,000
US GDP Growth	4.6%
US Unemployment	3.2%
Inflation	4.0%

## A – Advancing Earnings

The S&P 500's corporate earnings for last year, 2021, is \$205.75 per share, which is 47.2% higher than 2020's \$139.72 per share. This extraordinary earnings growth is due to the rebound along with stronger than expected demand and pricing power. As we forecasted correctly last year, “This snap back is likely to be epic...”. Our forecast for the S&P 500's 2022 earnings is \$250, or an earnings growth of 21.5%. Our bullish forecast for the index includes a 2022 price of \$5250 and a P/E multiple of 21. Yes, that is even with three potential rate increases, which would still be extraordinarily accommodative.

Figure 2. Fundamentals drive markets with an explosive Q3 EPS growth



Source: Refinitiv – Thomson Reuters and FactSet, Voya Investment Management. Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. The S&P 500 index is a gauge of the U.S. stock market that includes 500 leading companies in major industries of the U.S. economy. **Past performance is no guarantee of future results. Indices are unmanaged and not available for direct investment.** Please review important disclosures in the back of this book.

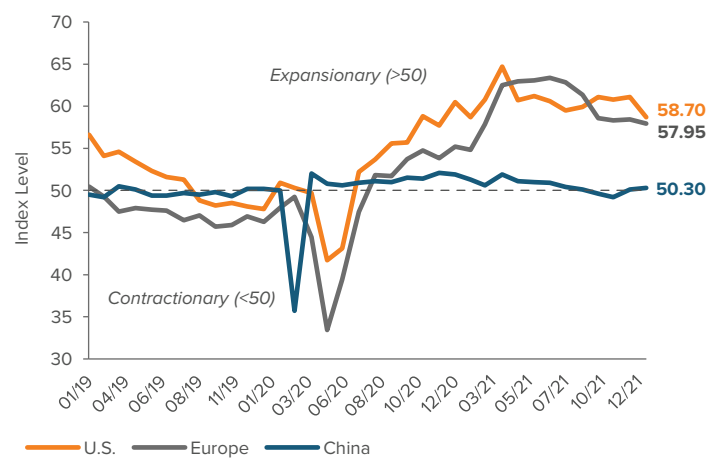
## B – Broadening Manufacturing

The equipment sector of the U.S. economy is booming, with capital goods shipments and orders excluding aircraft reaching all-time highs. We are also seeing a sharp rebound in the mining sector, with the global demand for natural gas increasing at high prices relative to the U.S. price. In November, ISM Manufacturing rose to 61.1, not far below the 37-year high of 64.7 achieved in March of 2021. Not only does the November reading mark the 18th consecutive month in expansion territory, the index has had a 60-handle in eight of the last 10 months on strong demand and inventories that are low and in need of replenishing.

Another big story is the GDP Services rebound, which surged by an annualized rate of 9% in the third quarter of 2021 over end-of-prior-year fourth quarter 2020. Services has lagged the CAPEX Equipment spending and capital goods rebound but is quickly making up for lost ground. Also, the ISM Non-Manufacturing (NMI) Services Index soared to 69.1, a new record high in November. The ISM-NMI is remarkably elevated despite supply chain disruptions, alongside a steady climb in factory sentiment. The Services rebound is a gamechanger, as they account for two-thirds of Personal Consumption expenditures and are a key driver to our 2022 forecast for GDP growth of 4.6%.

Figure 3. Blockbuster manufacturing in the U.S. and Europe

### Global Manufacturing PMIs



Source: Institute of Supply Management, FactSet. The Purchasing Managers' Index (PMI) is an indicator of economic activity in the manufacturing sector. Measures above 50 indicate economic expansion, measures below 50 indicate economic contraction. PMI's as of 12/31/21.

## C – Consumer

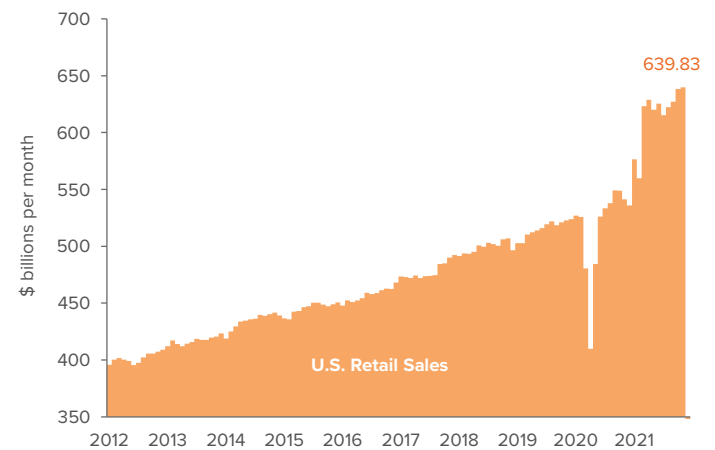
The consumer is “The Gamechanger” and continues to deliver the *goods and services*. Yes, pun intended since GDP's personal consumption is made up of goods and services, but there is far more. For example:

- The consumer is 68.5% of U.S. GDP, or \$15.9 trillion of the overall \$23.2 trillion economy

- U.S. wealth hit an all-time high of \$145 trillion in 2021
- Retail sales for November 2021 hit a record high of \$639.8 billion, or nearly \$100 billion more per month than pre-pandemic November 2019, which was \$546.5 billion
- Jobs are plentiful, as the unemployment rate is expected to drop to 3.2% from the 4.2% at year-end
- Housing is going gangbusters as prices gain 19.1% year-over-year on the latest Case-Shiller report
- Housing starts in November rose 11.8% to a 1.68 million clip versus a 15-year high of 1.72 million in March, leaving an 8.3% year-over-year gain

A consumer backdrop of this magnitude is a counterbalance to almost any risk... except for “closing the economy”.

Figure 4. Consumer as a gamechanger



Source: FactSet. U.S. retail sales as of 11/30/21.

## D – Diversification

For decades to come, 2020 will be the *raison d'être* for diversification. The epic moment was during the first quarter bear market when the S&P 500 plummeted 19.6%, while the super-safe U.S. 20-Year Treasury bond skyrocketed 21.5%, or a staggering 41.1% return differential in one quarter! That was what we usually think of when talking about risk control – protect the downside. Behavioral Finance even has a name for it – Prospect Theory – and it makes crystal clear that clients hate losses twice as much as they like gains. That is why having a plan for bear markets is so important.

But what about upside risk? Diversification stands out by expanding the opportunity set. In the fourth quarter of 2021 the “Santa Clause” rally was in full swing, bringing the S&P 500 to an approximately 29% return for the year. But maybe a bigger story was that “left-for-dead” Global REITs were the number one performing asset class with an astounding return of 32.4% for the year, rocketing in December by nearly 600 bps.

**Figure 5. Most equity markets continued their multi-year bull run, despite the Q1, 2020 bear market**

	Q4 2021	2021	3 years	5 years
<b>Equity</b>				
S&P 500	11.0	28.7	14.2	15.2
S&P Midcap	8.0	24.8	8.4	12.3
S&P Smallcap	5.6	26.8	7.7	12.4
Global REITs	10.4	32.4	2.5	4.7
EAFE	2.7	11.8	4.8	8.0
Emerging Mkts	-1.2	-2.2	6.6	13.2
Average	6.1	19.5	7.4	11.0
<b>Fixed Income</b>				
Corporate	0.2	-1.0	7.1	6.7
U.S. Treasury 20+	3.5	-4.4	10.0	8.0
Global Aggregate	-0.7	-4.7	4.8	4.8
High Yield	0.7	5.3	6.2	8.6
Average	0.9	-1.2	7.0	7.0
<b>Overall Average</b>	<b>4.0</b>	<b>11.2</b>	<b>7.2</b>	<b>9.4</b>

Source: FactSet, FTSE NAREIT, Voya Investment Management. The Overall Average model allocation includes 10 asset classes, equally weighted: S&P 500, S&P 400 Midcap, S&P 600 Smallcap, MSCI U.S. REIT Index/FTSE EPRA REIT Index, MSCI EAFE Index, MSCI BRIC Index, Bloomberg Barclays U.S. Corporate Bonds, Bloomberg Barclays U.S. Treasury Bonds, Bloomberg Barclays Global Aggregate Bonds, Bloomberg Barclays U.S. High Yield Bonds. Returns are annualized for periods longer than one year. **Past performance is no guarantee of future results. An investment cannot be made in an index.**

## E – Emerging Markets

In 2018, MSCI decided to dramatically increase the MSCI Emerging Markets Index's exposure weighting to China. With the latest breakdown at nearly one-third, China has a very heavy impact on that index's returns. I have received many questions about China, and whether the U.S. may play second fiddle at some point soon. My assessment is that China is the Japan of the 1980s. In the 1980s Japan looked ready to unseat the U.S. at some point, not in small part due to its auto manufacturing success. What happened, of course, is that Japan reached the pinnacle of its success about a decade later and has since spent the last thirty years in decline. I believe China today may have reached its pinnacle, too, due to the demise of its natural resources and is not as self-sustaining as the U.S. Here's why:

- China is the world's largest importer of agriculture goods, as required to meet the needs of its population
- China buys three quarters of its oil abroad and Europe imports 60% of its energy, while the U.S. is a net energy exporter
- China's factories – a.k.a. the “supply-chain for the world” – in 2021 were told to cut back to preserve power, and intentional blackouts were initiated across the country
- China's water crisis is especially dire, and water is a “tectonic shift” that warrants close watching:
  - I. China has 20% of the world's population, but only 7% of its fresh water\*

\* “China Is Running Out of Water and That's Scary for Asia”, Bloomberg, December 29, 2021.

- II. Thousands of China's rivers have disappeared in the drought-stricken nation
- III. By some estimates, 80% to 90% of China's groundwater and half its river water cannot be made potable; half of its groundwater and a quarter of its river water cannot be used for industrial farming\*
- IV. China is planning to dam key waters in the Himalayas before they reach India

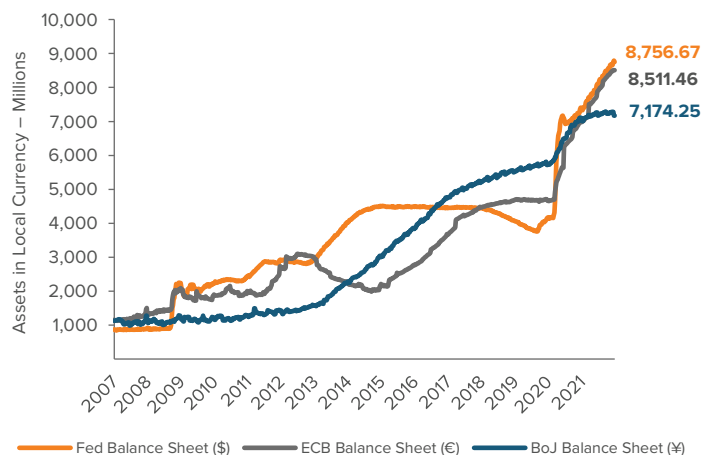
China, while important to the world, is not competitive in the long term with the U.S. with its vast natural resources and natural ports; “China is the Japan of the 1980's”. A review of Global Perspectives “Tectonic Shifts” are based on Energy, Technology, Global Trade, Frontier Markets and Water. In the future we will categorize these under Environmental, Social, Governance (ESG).

## F – Federal Reserve

### Central Banks

As we noted above, the Fed is walking a tight rope and must be very careful in the coming months. But the Fed is not alone. In the interest of not overly rehashing what we've already said, Matt Toms, the CIO of Voya Fixed Income summed it up nicely with, “Given their historical failure to meet inflation targets, developed market central banks will be slow to remove accommodation.”

**Figure 6. The Fed and other central banks continue to expand their balance sheets.**



Source: FactSet, Voya Investment Management, as of 12/31/21. ECB = European Central Bank; BoJ = Bank of Japan.

## G – Global Growth

“The combination of pent-up demand for services, spending of excess savings and inventory restocking will support growth in the near term. The durability of global growth will benefit from multiple drivers including a more balanced Chinese economy and enhanced U.S. and European investment.” – Voya Investment Management's Matt Toms “Seven Themes to Monitor in the First Half of 2022”.

## H – Housing

Soaring prices are providing a lift for starts and permits, alongside the ongoing migration to the suburbs. This is good for homeowners, but bad for renters and younger buyers trying to buy their first house. In fact, in a December 2021 article, “Affordability Falls to Its Lowest Level Since 2008, According to First American Real House Price Index,” First American Financial Corp. said that as nominal prices of houses have increased by around 20% in 2021, wages have increased a meager 4%. A big mismatch indeed.

Other insights into the housing market are as follows: There is a historic shortage of existing homes for sale and soaring prices; the months’ supply of existing homes posted a five-month string of new all-time lows through January of 2021, and was a still-lean 2.1 months’ supply by November 2021.

Furthermore, the median sales price for existing homes was pegged at \$351,900 in December 2021, slightly below the all-time high of \$362,800 in June of that year. For new homes, the median sales price rose to a new all-time high of \$416,900 in November 2021 from the prior all-time high only a month earlier in October of \$408,700.

Housing is an important multiplier to GDP growth and a significant benefit to consumer wealth, despite hurting younger households that are seeking to own but are renting instead. This is not 2008 though since strong capital restrictions against leverage were instituted following the Great Recession. There are also supply and labor constraints, which effectively put a “governor” on the speed of building new homes.

## I – Inflation

The massive fiscal and monetary stimulus over the past two years was successful a year ago, but has since metastasized into core issue, as U.S. policy-makers seem to hang on to their fear of disinflation as inflation rages. The Fed finally took action via the commencement of tapering and is expected to begin raising rates in March 2022. This is better late than never, but is too late to prevent further high inflation. Thus, be on the lookout for impending “shocks” to the middle class as inflation acts like a stealth tax.

To sum up what is happening with inflation: The year-over-year CPI headline metric rose to a 39-year high of 6.8% in November 2021, and the year-over-year core CPI measure rose to a 30-year high of 4.9%, capping the seven largest gains since 1991. However, the December 2021 year-over-year CPI gain is expected to rise to a new 39-year high of 7.0% and will be the largest since a 7.1% rise in June of 1982.

Federal Reserve Chair Jerome Powell specifically mentioned the Employment Cost Index (ECI) - a.k.a. wage inflation - as an important reason for doubling tapering to \$30 billion per month

in December. The ECI skyrocketed to its largest-ever third-quarter gain of 1.3%, beating the prior largest quarterly increase of 1.2% in March of 2003, and logging a 17-year high, year-over-year increase of 3.7%. The Fed’s intention to continue with measured rate increases - or an accommodative stance - may be derailed by the recent stickiness of wage inflation. Our forecast is for 4% inflation by year-end.

## J – Jobs

Payrolls through December 2021 have now reclaimed 83% of the jobs lost in March and April of 2020. Hours-worked have reclaimed a larger 93% of the drop. The GDP rise through Q3 has reclaimed 114% of the pandemic-drop, thanks to a big productivity boost.

In the week ending December 25, 2021 the advance figure for seasonally adjusted initial claims was 198,000, a decrease of 8,000 from the previous week’s revised level. The four-week moving average was 199,250, a decrease of 7,250 from the previous week’s revised average. This is the lowest level for this average since October 25, 1969 when it was 199,250.

Initial Claims are the best predictor of the unemployment rate. Pre-pandemic, on January 30, 2020 the four-week moving average was 210,000, with a coincident unemployment rate of 3.5%. Due to an even lower four-week average, our forecast for unemployment will be even lower this time around.

Our forecast is a 3.2% unemployment rate. This is extraordinarily bullish for the consumer, economic growth, and corporate profits.

## Conclusion

The cat is out of the bag and its name is *Inflation*. Although the Fed talks a big game about tapering our expectation is for still-extraordinary monetary stimulus. This will continue to stoke stocks. There is a chance that the Fed gets more serious and tightens more than our three expected rate increases. Unfortunately, I am joking – there is no chance of this. Thus, equities may continue to be in the sweet spot, but not as sweet as in 2021.

Risks are the unforeseeable, such as a cyber-attack on our electric grid, or worse. I was surprised and anguished that the current U.S. Administration made no mention of this in their infrastructure proposal.

The good news is that we will continue to be in an economic boom in 2022 with record low unemployment, still high GDP, a veritable manufacturing boom, and a relentless consumer.

Welcome to 2022, and remember that “Fundamentals Drive Markets”.

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## Disclosures

General Investment Risks: All investing involves risks of fluctuating prices and the uncertainties of rates of return and yield inherent in investing. All security transactions involve substantial risk of loss. Diversification does not guarantee a profit or ensure against loss. MSCI EAFE Index is a free float-adjusted market capitalization weighted index designed to measure the developed markets' equity performance, excluding the U.S. and Canada, for 21 countries. MSCI Emerging Markets Index is a free float-adjusted market capitalization index that measures emerging market equity performance of 23 countries. MSCI BRIC Equity Index is a market capitalization weighted index of about 320 companies located in Brazil, Russia, India and China. S&P MidCap 400 Index is a benchmark for mid-sized companies, which covers over 7% of the U.S. equity market and reflects the risk and return characteristics of the broad mid-cap universe. S&P SmallCap 600 Index covers approximately 3% of the domestic equities market and is designed to represent a portfolio of small companies that are investable and financially viable. MSCI U.S. REIT Index is a free float-adjusted market capitalization weighted index comprised of equity REITs that generate most of their revenue and income from real estate rental and leasing operations. The CBOE Volatility Index (VIX) is a real-time index that represents expectations for the relative strength of near-term price changes of the S&P 500 index. Bloomberg Barclays U.S. Aggregate Bond Index is composed of U.S. securities in Treasury, Government-Related, Corporate and Securitized sectors that are of investment-grade quality or better, have at least one year to maturity, and have an outstanding par value of at least \$250 million. Bloomberg Barclays U.S. Corporate Bond Index is a component of the Bloomberg Barclays U.S. Aggregate Index. Bloomberg Barclays U.S. Corporate High-Yield Bond Index tracks the performance of non-investment grade U.S. dollar-denominated, fixed rate, taxable corporate bonds including those for which the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below, and excluding Bloomberg Barclays Global Aggregate Bond Index measures a wide spectrum of global government, government-related, agencies, corporate and securitized fixed-income investments, all with maturities greater than one year. The Dow Jones Commodity Index is a broad-market commodity index comprised of liquid commodities from energy, agriculture and livestock, and metals.

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