Market analysis

January 24, 2022

At a glance
Markets have been shaken by soft economic data in the wake of the recent Omicron infection surge and uncertainty regarding the path of the Federal Reserve in 2022. The slowdown in infections and resolution of recent supply constraints could be constructive.

-11.5%
Performance of the Russell 2000 Index, a measure of small-company stocks, so far in 2022.

TERM OF THE WEEK
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Valuation – The analytical process of determining the current (or projected) worth of an asset or a company. There are many techniques used for doing a valuation. An analyst placing a value on a company looks at the business’s management, the composition of its capital structure, the prospect of future earnings and the market value of its assets, among other metrics.

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— Terry Sandven, Portfolio Manager, Chief Equity Strategist, U.S. Bank
Global economy

Quick take: The jobs market and regional Federal Reserve (Fed) surveys reflect the impacts on economic activity from the recent surge in coronavirus infections and hospitalizations. The recent moderation in case growth could alleviate some strain in coming months. Outside the U.S., China’s fourth quarter growth slowed further but offers some hope for a 2022 rebound.

Our view: Our proprietary economic Health Check points to still strong growth in the U.S. and developed foreign markets, though we are likely moving past peak acceleration. Our score for emerging market economies is below long-term median levels, but economic growth is still positive. The global coronavirus pandemic remains the key risk to the global expansion.

- Initial jobless claims increased by roughly 50,000 to 286,000, the highest number of Americans filing initial unemployment claims since October 2021. The increase comes on the heels of the Omicron variant’s spread intensifying in early January, prompting a surge in school closures, which further complicates the labor market recovery. The recent decline in Omicron case growth from mid-January’s high could alleviate some of these added labor market strains.

- Regional Fed surveys present a mixed assessment of manufacturing activity. The New York Federal Reserve’s Empire State Manufacturing Index fell sharply as new orders declined, while the Philadelphia region’s survey reflected improved industrial activity. Both indexes show continued supply chain pressures.

- China’s fourth quarter gross domestic product (GDP) slowed compared to the third quarter on a year-over-year basis but exceeded economists’ estimates. Industrial output improved in December, reflecting strong global goods demand, while retail sales slowed in the face of increased lockdowns surrounding COVID-19 outbreaks. China’s zero-tolerance COVID-19 policy — fighting outbreaks with severe activity restrictions — remains a material drag on consumer mobility and spending activity. The success of China’s coronavirus policy during the Olympics and the Lunar New Year holiday may set the tone for the rest of 2022.

Equity markets

Quick take: Stocks remain under pressure in the new year reflecting angst as the Fed prepares to raise interest rates to help temper inflation. Rising interest rates are compressing valuation and increasing price volatility. For investors with longer-term time horizons, bargains are more plentiful.

Our view: We maintain our “glass half-full” orientation for U.S. equities, aided primarily by continued sales and profit growth, moderate inflation and relatively low interest rates. We expect elevated volatility as inflation, implications of Fed policy changes, supply chain pressures, labor shortages and uncertainties around the economic recovery persist. We expect favorable returns in 2022, albeit subdued from robust 2020 and 2021 levels.

- Lackluster equity performance is broad-based. The popular broad-based indices are down year-to-date between 5.7% and 12% as of Friday’s close. The technology-oriented NASDAQ Composite (-12%) and small-cap Russell 2000 (-11.5%) are well into correction mode, implying widespread weakness, but also improving risk/reward metrics following the pullback.

- Fourth quarter corporate reports are trending in line with expectations. Approximately 13% of S&P 500 companies have reported fourth quarter results as of Friday’s close. According to Bloomberg, sales are up 13.5% over year-ago levels, modestly above expectations heading into the quarter for sales growth of roughly 12.5%. Earnings are up 21.3%, in line with expectations.

- Estimated valuations remain within a “zone of okay.” The consensus S&P 500 earnings projection for 2022 is approximately $222 per share, nearly 10% over last year’s levels. The S&P 500 closed Friday trading at 20 times the current 2022 estimate, well below the 2019 pre-pandemic and dot-com era multiples of roughly 28 and 30 times, respectively.

- Consumer Discretionary and Information Technology are the two worst-performing sectors year-to-date, down 12.2% and 11.4% respectively, but they are favorably positioned to benefit from longer-term secular trends. E-commerce is the new normal, driven by product availability, convenience and flexibility. Data capture, storage, analytics, software, computing and mobility are bolstering digitalization and the attraction toward Information Technology companies. Near-term, however, concerns over valuation and looming monetary policy change are overshadowing these longer-term growth trends.

Bond markets

Quick take: Fears of aggressive rate hikes from the Fed in the coming months drove a flight to safety; investors favored long-term Treasuries. Riskier bond prices fell, but modestly so compared to equities. Issuers’ strong credit fundamentals likely insulated riskier bonds from souring investor sentiment.

Our view: We expect low yields and tighter Fed policy to remain a headwind for bond returns as interest rate hikes push up Treasury yields. While faltering investor optimism introduces heightened volatility potential, the extra income on lower-quality bonds can aid in their outperformance over time. This week, we anticipate the Fed will foreshadow policy actions in March, including the end of its bond purchase program and an interest rate hike.

- We do not anticipate the Fed will change monetary policy at its meeting this week, but the market is already priced for rapid interest rate hikes and Fed bond portfolio reductions. We think it is unlikely the Fed ends its asset purchasing program early, preferring to make gradual policy decisions that are telegraphed well in advance. Instead, the Fed will likely lean on forward guidance to prepare investors for a 0.25% interest rate increase in March followed by more hikes and reductions in its bond holdings later this year. The market expects four hikes this year with a chance of a fifth. It’s unlikely the Fed commits to a specific timetable, preferring to remain flexible in response to changing economic conditions. Inflation remains the primary catalyst for more urgent Fed policy changes, thus Employment Cost Index and personal consumption expenditures data will be in focus this week. Wage gains are considered a sign of more persistent inflation and an improving labor market that justifies tighter monetary policy.

- Riskier high yield bonds and bank loans underperformed high-quality bonds but held up well relative to equities. High cash balances and the low cost of servicing debt are expected to continue limiting defaults. Beyond corporate and municipal debt, we also find mortgages not backed by the government attractive because of high consumer savings, a strong housing market and compelling yield.

Real assets

Quick take: The defensive market environment was a benefit to real assets last week. Most real asset sectors were lower but outperformed the broader market. Investors appear to be pricing in risks of slower economic growth this year.

Our view: Defensive positions in real assets appear to be beneficiaries of a potential growth slowdown accompanied by tighter monetary policy. We believe investments with stable cash flows have a home in portfolios but acknowledge real assets will usually lag assets with better growth opportunities when economic growth is accelerating.

- Real Estate outperformed the S&P 500 by 2% last week as interest rates fell. The secular growth companies, such as cell tower and data center operators, were the best performers. Defensive assets with stable cash flows will be in demand if economic growth concerns persist. Additionally, lower interest rates would be a tailwind to real estate, but high prices relative to cash flow and earnings metrics are a headwind.

- Crude oil prices rose 1.5% last week, despite growing inventories. We see the crude market as undersupplied, which should be supportive for prices, but caution that fear of a growth slowdown could affect prices in the near term.
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**Past performance is no guarantee of future results.** All performance data, while obtained from sources deemed to be reliable, are not guaranteed for accuracy. Indexes shown are unmanaged and are not available for direct investment. The **S&P 500 Index** consists of 500 widely traded stocks that are considered to represent the performance of the U.S. stock market in general. The **Russell 2000 Index** measures the performance of the 2,000 smallest companies in the Russell 3000 Index and is representative of the U.S. small capitalization securities market. The **NASDAQ Composite Index** is a market-capitalization weighted average of roughly 5,000 stocks that are electronically traded in the NASDAQ market. The **Employment Cost Index** is a quarterly economic series published by the Bureau of Labor Statistics that details the growth of total employee compensation. The index is prepared and published by the Bureau of Labor Statistics, a unit of the United States Department of Labor. The **Empire State Index** reports on the monthly survey of manufacturers in New York state conducted by the Federal Reserve Bank of New York. It summarizes general business conditions in New York state; survey participants are asked to rate the change for 11 indicators and for “general business conditions.”

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