# Downshifting: Growth to Slow yet Remain Positive in 2022

"***Life doesn't get easier or more forgiving, we get stronger and more resilient."***
— Steve Maraboli, Life, the Truth and Being Free

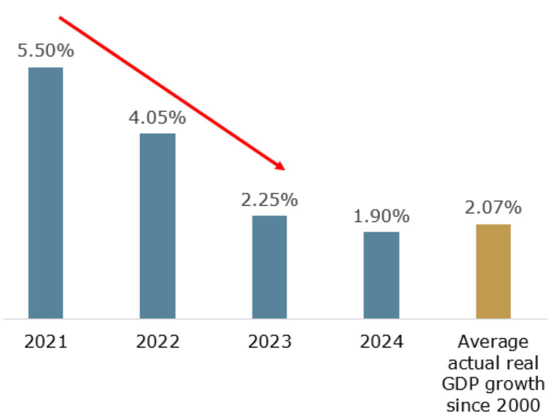
As we embark on a new year, many of us may be more than a little ready to forget the one that just passed. After all, 2021 brought surges in Covid-19 cases fueled by new variants, supply-chain disruptions that exacerbated inflation and other challenges. Even still, the global economy proved remarkably resilient:

- After contracting in 2020, both the U.S. and global economies grew by some 6%, as did the U.S. economy. For the U.S., that represents a multi-decade high.
- Generous fiscal and monetary stimulus put more money into consumers' pockets, driving U.S. personal savings rates to new highs early in the year. Strong gains in equity prices and home values pushed household net worth well above pre-pandemic levels.
- By December, the U.S. unemployment rate dipped to 3.9%, just marginally above its pre-pandemic low. In a further sign of labor-market tightness, by the second half of the year, there were more job openings than people looking for work.
- S&P 500 net profit margins hit new highs and improved in every sector.

Where do we go from here? After the torrid post-pandemic growth of 2021, the year ahead is likely to be characterized by downshifting: a little less economic gas, a little more (monetary and fiscal) brakes, and more headwinds for stock and bond returns.

**The U.S. economy heads into 2022 with slowing momentum and we expect to see slower, yet still-positive growth this year. Notably, despite this downshifting, growth is expected to remain above longer-term averages.**

**Expected Real GDP Growth**




**Source: U.S. Bureau of Economic Analysis, St. Louis Federal Reserve**

Note: this chart shows expected real GDP growth and is for illustrative purposes only. Forward looking estimates may not come to pass. Past performance is no guarantee of future results.

The bond market is also sending signals consistent with slower, yet still-positive growth ahead. One reliable indicator the bond market can provide is the difference between yield on the 10-year Treasury bond and the 2-year Treasury bond. The higher the 10-year yield relative to the 2-year, the stronger the implied growth. That measure peaked in March 2021 and has compressed since, implying a slowdown in economic activity.

The monthly ISM Manufacturing Purchasing Managers Index, which consistently predicts growth across the U.S. economy, is another indicator pointing to a deceleration. It has retreated from its post-Covid peak (in March 2021) but remained firmly in expansion territory as of December.

## What are the factors putting a little more brakes on growth?

**Inflation, tighter monetary policy and the pandemic are lingering risks, although inflation should begin to ease relatively soon and there remains a tremendous amount of liquidity in the system.**

The Federal Reserve and other central banks have begun dialing back stimulus to fight inflation. In fact, the Fed decided late last year to scale back its bond-buying program more quickly than it initially planned, putting it in a position to begin raising rates later this year. Any such pivot in monetary policy raises the risk that the central bank is acting too late, too soon and/or too aggressively. (See my Markets in Minute blog on quantitative easing and tapering for a closer look under the monetary-policy hood.)

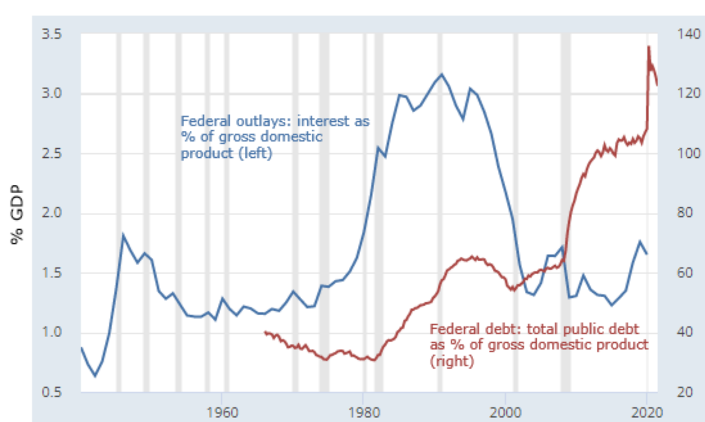
Not surprisingly, inflation is affecting how consumers feel about the economy. It has contributed to a sharp decline in some recent polls of U.S. consumer confidence. Interestingly, consumers' discontent over rising prices has yet to dampen their appetite for big-ticket items. Consumers also appear to have spent merrily over the holidays. Mastercard reports that holiday retail sales rose 8.5% in 2021, one of the biggest gains in years.

It's also worth noting that inflation isn't monolithic. Over the past year, it has been driven by several factors: higher goods prices, linked to a combination of supply-chain disruptions and increased demand for certain types of goods; wage increases, particularly among workers with lower levels of education and income; and double-digit increases in home prices nationally. We expect supply-chain disruptions to ease in the second half of 2022, helping to balance supply and demand for goods. Housing, which is rate-sensitive, and wages bear watching.

As we know all too well, the pandemic continues to be a major source of uncertainty. Fueled by the highly transmissible Omicron variant, Covid-19 case counts have been skyrocketing, but there are some silver linings in the latest surge: governments have been redoubling their vaccination efforts and making vaccines and booster shots available to larger swaths of their populations. While some reimposed restrictions, there seems to be little appetite for a return to strict lockdowns. Omicron also appears to cause less-severe disease than previous variants.

The U.S. national debt, which has climbed to extreme levels relative to history, has also been a source of consternation. Yet because of today's low rates, interest payments on the debt are at the lowest levels in history, which gives the federal government room to maintain its current debt levels.

**Federal Debt & Interest Payments as a Percentage of GDP**



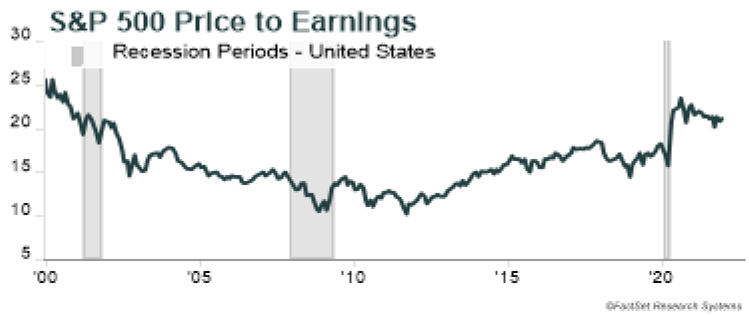

**Source: U.S. Bureau of Economic Analysis & OMB, St. Louis Federal Reserve**

Forward looking estimates may not come to pass. Past performance is no guarantee of future results.

## What does all this mean for the markets?

**High valuations will provide a headwind for equities in 2022, and we expect returns to be more muted.**

Early in the pandemic recovery, U.S. equity valuations largely outpaced earnings growth, which is typical of the early phase of a market recovery, driven by rising confidence plus enormous monetary and fiscal stimulus. As the recovery matures, further growth in stock prices is likely to be driven by earnings growth while valuations compress.




Past performance is not a reliable indicator of current or future results. Forward looking estimates may not come to pass. Indexes are unmanaged and not subject to fees. It is not possible to invest directly in an index. Index proxy: S&P 500 Index.

Outside the U.S., the outlook remains clouded by the dramatic surge in Covid-19 cases, particularly in the U.K and parts of Europe. The pandemic has also exposed considerable challenges in emerging markets, and many of which don't have the level of monetary and fiscal firepower that the developed markets have used to combat the pandemic's economic effects. Of course, all eyes will be on China, which dominates the emerging-markets world. It's by far the largest component of the MSCI Emerging Markets Index, as weighted by country.

**With interest rates still at historic lows, credit spreads tight and the Fed likely to raise rates this year, fixed-income returns will be muted over the next year.**

While bonds are unlikely to deliver the types of returns that previous generations enjoyed, they still play an important role in investors' portfolios, in the form of dependable income and downside protection. Investors should also be mindful of adding too much credit or duration risk to their fixed-income holdings to compensate for the shortfall in yields. (Read my "Markets in Minute" blog on bonds for more on the importance of fixed income.)

## Conclusion

As we reflect on the past year and the road ahead, it can be helpful to think of the economy as a car that's been traveling above the speed limit and now must slow down as the terrain gets a bit rougher. Certainly, we can expect market volatility as we hit bumps in the road. But we continue to favor equities and an allocation to bonds amid the still-favorable economic backdrop.

Our economic and market outlook is based on extensive research and more than a century of collective experience in the investment industry. For a closer look at the research that informs our views, please see the accompanying presentation. We hope you find it useful.

Happy New Year!

Invest well and stay healthy,

**Kara Murphy, CFA**

Chief Investment Officer, Kestra Investment Management

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