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Q1 2022 Outlook

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Economy: Expect continued real GDP growth slightly ahead of long-term trends, but less than what was experienced in 2021.

- Our outlook calls for US GDP growth in a range of 3.5%-4%.
- Recession risk is low, in our estimation, for the foreseeable future. Numerous forecasters and prognosticators have begun calling for an economic pullback around the end of 2022 or beginning of 2023, but we do not yet see the trigger that would cause this reversal in growth. At Hollencrest, we view recessions as part of a financial cycle, generally triggered by credit conditions deteriorating. A build up of excesses leads to a sudden change in conditions that restricts the ability to borrow, causing defaults and an inability to borrow for investment and growth. Some point to Fed and fiscal stimulus as the inflator of a bubble, but in reality we have seen nothing but improvement in private sector credit metrics and solvency since the actions taken in March 2020 – instead, credit conditions point to continued growth and stability in 2022. We do view the economic cycle as being in an advanced stage since the current cycle began in 2009, with the 2020 recession being man-made and not driven by traditional cyclical causes. This leaves us vulnerable to recession, but it is impossible to time a reversal in trend by simply making the statement that "it is time" or that we are "overdue." Instead, Hollencrest sticks with the trend while monitoring macro and market data for signals that the trend is indeed changing.
- We expect the inflation rate to continue to run well above the Fed's targets early in 2022, but we do expect it to abate closer to 3%-3.5% by the end of the year. As most of our investors know, we believe long-term deflationary forces will prevail and that shorter-term market inefficiencies causing the current spike in inflation will resolve themselves as the world adjusts to the new COVID economy norms. Despite our long-term view on this topic, inflation will continue to be a widely discussed topic and is something that must be monitored closely. Both deflation and rapid inflation are powerful forces that can have dramatic psychological and behavioral effects on individuals and markets when they begin to "spiral." When individuals and businesses shift to fear-based decision making there can be severe economic consequences. We must also monitor the ability of businesses to pass on price increases to customers. When cost increases begin to cause profit deterioration, it is a signal that inflation has likely become a problem, but to date corporate profits have remained strong. The 10-year US Treasury bond's inability to rise above a ~1.5% yield may have many reasons, but it surely signals that there is little concern in the bond market that inflation will run out of control for an extended period.
- COVID, its Omicron variant, and possible future variants remain as economic risks. With shutdowns, travel restrictions and forced changes in consumption, growth could be impacted meaningfully. More importantly, we acknowledge that not all countries and markets have dealt with the virus the same, and as we are necessarily participants in a global economy, different outcomes and decisions made abroad may continue to impact our supply chain.

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Stocks: Our S&P target for the end of 2022 is 5,200, representing 9% growth from the 2021 closing level of 4,766.

- The major indices closed the year at what most consider overvalued levels after 100%+ price advances off March 2020 lows. However, earnings-based valuation metrics remained remarkably steady for much of 2022 despite the continued rise in prices, with the S&P closing out 2021 at about a 23x multiple of forward earnings. The steady growth of corporate profits has validated the uptrend in the market, and we expect this to continue.
- Viewed in the light of risk-free rates and returns on other asset classes being historically low, the market's valuation could be seen as very reasonable, and there may actually be room for slight multiple expansion if rates were to stay where they are at. Combine this with our expectation for continued economic growth, and gains in 2022 seem probable.
- We do expect increased volatility as some of the tailwinds that have masked bad news over the past 21 months fade. Some of the headlines that caused volatility in 2021 did not result in declines as large as what we would have expected, and this will likely change in 2022. The Fed's withdrawal of liquidity and generally more hawkish stance will provide a test for asset prices that have risen strongly since their accommodation was introduced. The market's perception that the Fed has overshot or made a misstep in policy could cause a market revolt that jeopardizes our price target. The misstep may have already occurred in waiting too long to tighten policy, as we believe the economy could have withstood asset purchase tapering earlier in 2021.

Bonds and Rates: Rates should trend upward across the curve in 2022.

- As expected, the Fed began to taper its asset purchases in Q4, and in fact had to accelerate the taper as it became clearer liquidity injections were less necessary. The Fed should be done providing stimulative liquidity by Q2 2022, removing demand for bonds across the curve and eliminating one of the pressures keeping rates low.
- By Q2 2022, the conversation will have fully shifted to when the Fed will begin to raise short-term rates, and more importantly how quickly those rates are raised. There should be room for a handful of rate increases before economic activity is impacted. We expect the Fed will have raised short-term rates between 50-75 bps by the end of 2022.
- The 10-year Treasury closed out the year at a yield at 1.51%, a yield far below what one should expect given the inflation data seen in 2021 and what most are projecting for 2022. The Fed's exit from this market should allow the yield to rise. Global interest rates are also likely a drag on this rate as a 1.51% yield on the US bond is attractive relative to negative rates in other markets for acquirors of low-risk assets. Nonetheless, the bond market would price this yield higher if it didn't see moderate inflation with modest economic growth over the intermediate term as the market would not accept meaningfully negative real returns for a prolonged period. We expect the yield to get to 2% in 2022.

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