Peapack Private
Wealth Management

The Weekly
Economic & Market Recap

Peapack Private Wealth Management

SPECIAL EDITION: EXPECTATIONS FOR 2022

 January 7, 2022

| 1/7/2022 | | Wk | Wk | | YTD | 12 Mos |
|---|---|---|---|---|---|---|
| | | Net | % | Div | % | % |
| **STOCKS** | Close | Change | Change | Yield | Change | Change |
| DJIA | 36,231.66 | -106.64 | -0.29 | 1.74 | -0.29 | 16.72 |
| S&P 500 | 4,677.03 | -89.15 | -1.87 | 1.30 | -1.87 | 22.96 |
| NASDAQ | 14,935.90 | -709.07 | -4.53 | 0.65 | -4.53 | 14.30 |
| S&P MidCap 400 | 2,793.14 | -48.86 | -1.72 | 1.39 | -1.72 | 15.37 |

| **TREASURIES** | Yield | **FOREX** | Price | Wk %Change |
|---|---|---|---|---|
| 2-Year | 0.86 | Euro/Dollar | 1.13 | -0.21 |
| 5-Year | 1.50 | Dollar/Yen | 115.63 | 0.41 |
| 10-Year | 1.76 | GBP/Dollar | 1.36 | 0.21 |
| 30-Year | 2.12 | Dollar/Cad | 1.27 | 0.33 |

Source: Bloomberg/FactSet

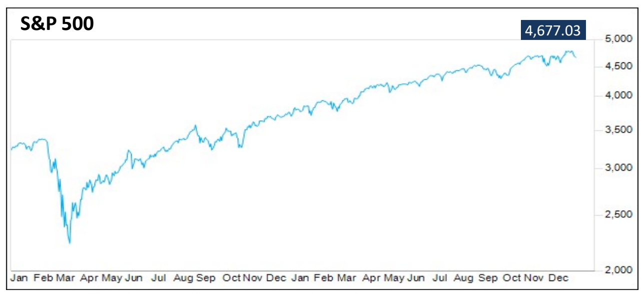
**Equities**

The equity market had another excellent year in 2021. It was the third consecutive year of double-digit gains for most major indexes. Over the last three years, the S&P 500 produced a 100.37% cumulative return for investors. The market's strength was surprising to many after the powerful post-bear market rally in 2020. The equity market was driven by a robust economic restart that lifted the domestic economy almost entirely back to its long-term potential growth trend. The strong economic recovery fueled earnings growth of nearly 45% last year, measured by the S&P 500. Estimated revenue growth of 12.2% was an essential factor lifting earnings as consumption spending recovered, but margins were the real earnings catalyst. Corporate margins are estimated to finish 2021 at roughly 13.5%, well up from 10.5% in 2020 and even better than the pre-pandemic 11.6% level in 2019. Analysts routinely underestimated corporate margins through each of the first three quarters of last year. Corporate earnings consistently provided upside surprises that underpinned raising index price levels. Equity investors were treated to 70 new closing highs for the S&P 500 in 2021 with little volatility. Last year's largest market drawdown was only 5% versus the ten-year average drawdown of 11.5%. It was the second-lowest annual drawdown in the previous 25 years.

The investment environment remains, on balance, favorable for equities. The domestic economy has good momentum heading into 2022. After an exceptionally strong first half of 2021 with the economy growing at a quarter-over-quarter seasonally adjusted annual rate of 6.5%, the third quarter dipped to 2.3%. Still, the fourth quarter should reaccelerate to a rate greater than 5.0%. With a solid fourth quarter, the economy will fully recover back to its long-term trend growth. Overall, strong consumer balance sheets and tight labor markets should continue to drive consumer spending as there seems to be plenty of pent-up demand yet to be satisfied. Additionally, due to the manufacturing and distribution disruptions last year, inventories across the economy need to be rebuilt. The economy will likely run above its long-term potential growth rate in 2022, which should provide solid earnings support but will cause some persistence to above-average core inflation. Consensus expectations for earnings growth are approximately 10%, which seems reasonable if inflationary pressures do not significantly erode margins.

The forward price-to-earnings multiple on the S&P 500 is currently 21.7 times compared to the twenty-five-year average of 16.8, which suggests roughly 1.3 standard deviations overvaluation in equities from a historical context. The justification for the market's valuation is negative real interest rates and chronically low interest rates globally. Stocks appear historically inexpensive on metrics such as the earnings yield of the S&P 500 compared to medium-grade corporate bond yields However, we do not expect further multiple expansion. In fact, with inflationary indicators running uncomfortably above the Federal Reserve's long-term average target and the Fed in the process of removing its extraordinary accommodation, we would anticipate some modest multiple contraction in the future. Therefore, a reasonable expectation would be for large-cap domestic returns to be modestly less than earnings growth and the long-term average return of the asset class.

The critical variable in assessing the fundamental risk for equity market returns in 2022 is the market's multiple. If the economy is too strong and inflation remains stubbornly high, it will force the Fed to be more aggressive than the market expects, and interest rates will push higher. Higher rates will cause the market multiple to come down more precipitously, leading to even more muted returns for equity investors. We expect certain areas of the equity universe to outperform others. The risk to growth stocks is more pronounced than economically sensitive value stocks due to higher valuations and the potential for rising interest rates. It is easy to envision a relative rotation into other areas of the market away from growth names trading at elevated multiples. The S&P 500 is more concentrated than at any other time. History has shown that significant valuation divergences and the general tendency to revert to the mean will cause the previously mentioned rotation at some point.




**Economy**

The U.S. economy continued its comeback in 2021 from the massive downturn experienced from the coronavirus pandemic. The domestic economy exhibited strong growth in the first half of the year as a result of the vaccine rollout, receding Covid cases, business reopening, and government stimulus. In Q1 and Q2, real GDP grew 6.3% and 6.7%, respectively, on a quarter-over-quarter seasonally adjusted annual rate. The second half of the year saw a slowdown due to workforce shortages and supply chain bottlenecks; however, the expected real GDP growth of 5.6% year-over-year in 2021 is robust. These elevated growth rates showcase the resiliency of the U.S. economy, but they are not likely to be sustained at these levels. By comparison, we expect 2022 GDP growth of roughly 4.0%, and the rate of growth should decelerate throughout the year as we see the effects of unprecedented fiscal and monetary support wane. Although decelerating, the U.S economy will continue to experience above long-term potential GDP growth in 2022 due to strong consumer spending resulting from healthy consumer balance sheets and pent-up-demand.

The labor market is generally moving in the right direction as total nonfarm payrolls have made a remarkable recovery since the trough in April 2020; however, they still remain 3.6 million shy of pre-pandemic levels. Furthermore, the unemployment rate now stands at 3.9%, a new low for the pandemic era. Although there has been a strong recovery in the number of employed, the labor force participation rate has been moving sideways since August 2020. One of the main reasons is because workers are hesitant to reenter the workforce due to the virus. We expect this to continue in the near term, given the recent surge in new virus cases. Still, the participation rate should improve as business capital spending strengthens and job creation broadens out.

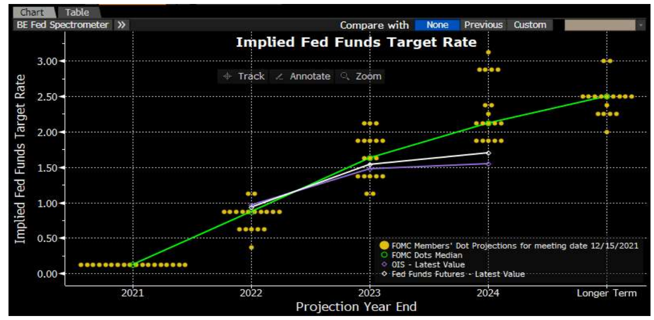
Perhaps the most widely covered economic development this year was inflation. Driven by high demand and tight supply, prices for goods rose rapidly, and core PCE quickly surpassed the Fed's long-term target of 2%. The Consumer Price Index (CPI) is now expected to be up 4.6% on a quarter-over-quarter seasonally adjusted annual rate in 2021. We believe the economy is currently experiencing peak inflation and expect CPI to return to more normal levels over the next year. This slowdown in inflation will be aided by supply-side relief as freight shipping costs come down and factory production improves. Furthermore, the restocking of inventories should ease current supply-demand imbalances.

| COMING UP NEXT WEEK | | Consensus | Prior |
|---|---|---|---|
| 1/12 CPI ex-Food & Energy SA M/M | (Dec) | 0.50% | 0.50% |
| 1/12 CPI SA M/M | (Dec) | 0.65% | 0.80% |
| 1/13 PPI ex-Food & Energy SA M/M | (Dec) | 0.50% | 0.70% |
| 1/13 PPI SA M/M | (Dec) | 0.40% | 0.80% |
| 1/14 Retail Sales ex-Auto SA M/M | (Dec) | 0.30% | 0.30% |
| 1/14 Retail Sales SA M/M | (Dec) | 0.30% | 0.30% |
| 1/14 Capacity Utilization NSA | (Dec) | 77.2% | 76.8% |
| 1/14 Industrial Production SA M/M | (Dec) | 0.50% | 0.50% |
| 1/14 Michigan Sentiment NSA (Preliminary) | (Jan) | 70.6 | 70.6 |

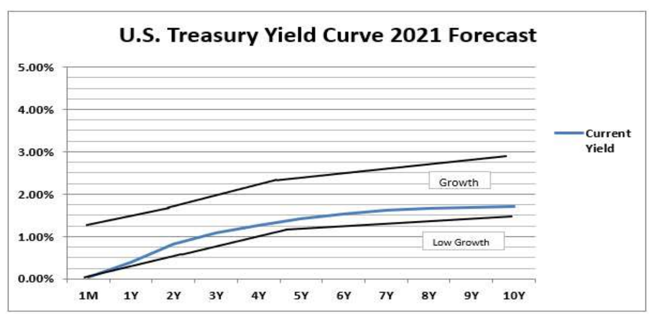
**Fixed Income**

With inflation running at the highest level in nearly four decades, thanks to extraordinarily accommodative monetary and fiscal policy, supply chain dislocations, pandemic impacts and the partial economic reopening, the Fed finally capitulated and admitted that the current elevated level of inflation was no longer transitory. In November, the Fed announced that it would taper its enormous asset purchase program and only a little over a month later, it accelerated the pace of the asset purchase taper to give it more flexibility to adjust the Fed funds rate if need be. The Fed's balance sheet has grown to more than $8 trillion in size and is now expected to peak in March of 2022 according to the latest communication. Thanks to the fact that the Fed now has a flexible average inflation target of 2.0% it can be reactive as opposed to proactive when it comes to inflation. Moreover, the Fed has clearly hit its inflation objective and feels confident that the labor market has improved substantially. The pivot from monetary policy accommodation to tightening is expected to begin in 2022, and the Fed must balance a fine line between attempting to pull back inflation while keeping the economic expansion intact.

If the U.S. economy progresses according to the FOMC's most recent projections, the Fed funds rate should end 2022 at 0.875%, which implies three 25 basis point (bp) rate hikes over the course of the year. The Fed funds futures market is in close agreement and projects the fed funds rate to end the year at approximately 0.9%. If the labor market continues to heal, we expect the first 25 bp rate hike to arrive in the first half this year. The FOMC forecasts their preferred inflation metric (core PCE) to decline 140 bps over the course of 2022 to 2.3% as the reduction in monetary and fiscal policy accommodation coupled with the restoration of supply chains helps in combating the current elevated level of inflation. However, a tightening labor market and elevated housing prices may cause inflation to stick around longer than the FOMC had originally expected. In fact, the FOMC does not expect inflation to drop below 2% before 2024. Containing elevated inflation will be an arduous task in the year ahead, but with an expanded tool set, the FOMC has confidence that it will be able to meet this daunting task.




Like 2021, U.S. Treasury (UST) yields have surged during the first week of trading in 2022, albeit, for very different reasons. The initial back up in yields towards the end of 2021 was caused by the combination of the Fed's tapering of asset purchases, the increase in the pace of tapering one month later, removal of "transitory" inflation from the Fed statement, and a change in the dot plot. But the biggest catalyst so far in 2022 has been the market's ability to shrug off any potential disruptions to elevated inflation and the labor market caused by the omicron variant. While 1% on the 10-year Treasury was a psychological level at the beginning of 2021, we can now say the same thing about 2% in early 2022. Currently, the 10-year yield is at 1.76%, up 25.2 basis points (bps) so far this year and just 1 bp shy of 2021's intraday high of approx.-imately 1.77%. However, while rates might be on the rise, we are very unlikely to see a parallel shift across the yield curve. In prior Fed tightening cycles the yield curve has flattened. Over the last three months we have seen a similar trend emerging. For context, the 2-year and 10-year spread (2/10 spread) has averaged 99.5 bps since early October and is trading at just 90.0 bps presently. The 2/10 spread peaked at 129.4 bps on October 8th. Bloomberg's forward curve matrix is forecasting a 2/10 spread of just 45 bps one-year from now.




U.S. Investment grade (IG) and high yield (HY) corporate bonds turned in a mixed performance in 2021. IG bonds provided investors with a total return of -1.04%, substantially below 2020's total return of 9.89%. HY on the other hand provided investors with a positive total return of 5.28%, underperforming 2020's 7.11% total return. The dichotomy of the return profiles can be partially explained by the changed in credit spreads for the respective sectors during 2021. In the investment grade sector, the 5-year AA and A – rated composites dropped 3.3 bps and 1.5 bps, respectively. Meanwhile the 5-year BBB – rated composite spread incre-ased 5.1 bps. The change in HY credit spreads were more pronounced with the sector seeing 5-year BB and B – rated composites narrow 52.5 bps and 54 bps, respectively. With a Fed liftoff looming, higher interest rates could pressure corporate balance sheets in 2022; however, Fed balance sheet normalization will pose a bigger threat in the near-term given that reduction of the SOMA (System Open Market Account) portfolio remains an uncertainty. A combination of rate hikes and Fed balance sheet run off could cause too much tightening too quickly potentially straining financial conditions for corporate borrowers.