2022 Outlook: No time to hunker down

EXECUTIVE SUMMARY

- After a spectacular U.S. economic recovery in 2021, we expect economic growth to begin to normalize but remain above trend in 2022. We forecast real GDP to rise 3.9% in 2022, underpinned by healthy household and corporate balance sheets, rising capital expenditures and increasing employment and incomes.
- Inflation—and how quickly the U.S. Federal Reserve finishes tapering and initiates a rate-hike cycle—should dominate on the macro front, with occasional hiccups on pandemic flare-ups and potential geopolitical disruptions (Russia-Ukraine, China-Taiwan, midterm elections). Our forecasts for 2022 core CPI and core PCE are 3.9% and 3.4%, respectively.

With equity indexes hitting all-time highs, bond valuations extremely rich and the best of the global recovery from the Covid recession in the rearview mirror, investors may wonder if it's time to hunker down. Not yet, say Federated Hermes investment leaders. There's still opportunity in a global economy that continues to grow above trend.

The macro environment continues to favor risk and Federated Hermes enters the new year overweight equities, underweight fixed income and overweight cash in its moderate growth portfolio models.

To be sure, 2022 is almost certain to be volatile amid all the uncertainty, i.e., How fast will the Fed tighten? How long will decades-high inflation linger? Will the Covid pandemic end?

This argues for a diversified investment approach capable of adapting to, and potentially benefitting from, changing circumstances.

Will this rate-hike cycle be different?

GDP and S&P 500 Index historical performance in the first year of a Fed rate-hike cycle

Rate cycle begins	Rate change in first year (%)	First-year GDP growth (%)	First-year S&P performance (%)
Jun-99	+1.25	5.20	10.48
Jun-04	+1.75	3.60	8.24
Dec-15	+0.25	2.00	8.06

Negative rates typically drive investors to riskier segments of the market

Rate cycle begins	Year-over-year growth in household wealth ($T) as of first rate hike	Real fed funds rate (%) as of first rate hike
Jun-99	3.24	3.52
Jun-04	6.15	-1.00
Dec-15	2.27	-1.04
2Q22E	21.02[1]	-4.60[1]

Past performance is no guarantee of future results. For Illustrative purposes only.

1 Year-over-year dollar increase in net worth of households as of 6/30/21 and real federal funds (fed funds) rate as of 11/30/21, the most recent data available. Median year-over-year increase in net worth of households from 12/31/95 to 6/30/21: $3.76 trillion.

Data as of 12/28/21 unless otherwise noted. Sources: Federal Reserve, S&P, Bloomberg and Federated Hermes analysis.

Net worth of households retrieved from FRED. Increases in net worth of households are as of 6/1/99, 6/1/04 and 12/1/15, respectively. The real fed funds rate is the effective rate minus 12-month core inflation according to the Core Price Index for Personal Consumption Expenditures (PCE). S&P performance in the first year following a rate hike period is calculated from the first day of the month when the Federal Reserve raised the fed funds target rate. Performance periods are as follows: 6/1/99 to 5/31/00, 6/1/04 to 5/31/05 and 12/1/15 to 11/30/16, respectively. GDP growth in the first year is year-over-year growth ending 6/30/00, 6/30/05 and 12/31/16, respectively.

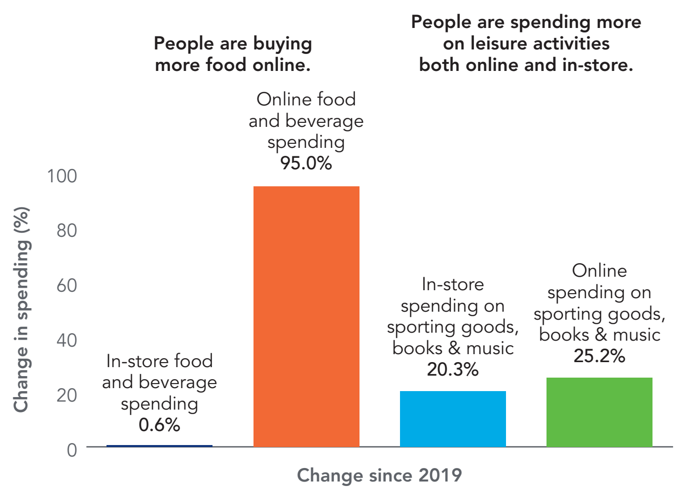
Based on our forecast, the macro environment should support a forward price-to-earnings ratio (P/E) of around 21 times earnings, an increase in S&P 500 Index earnings to $230 from 2021's estimated $210, supporting a 5,300 year-end target. The pace of Fed tightening is a wild card, but generally, GDP growth and stocks tend to hold up in the first year of a Fed rate cycle, particularly when real rates remain deeply negative and households have financial firepower at their disposal.

Even with evaporating stimulus, the consumer remains in a good place, flush with savings and job and income growth. Nominal GDP growth, which drives corporate earnings, should remain elevated even as real growth subsidies. We expect inflation as measured by core CPI to moderate to 3.9% from 5.5% in 2021.

This downshift should come as supply chain issues ease, consumption shifts toward less costly services such as entertainment and travel from big-ticket consumer goods such as appliances and furniture, and Fed tightening begins to take root.

As the sugar high from unprecedented fiscal stimulus fades and monetary policy moves closer toward normalization, Federated Hermes expects annualized real GDP growth in the U.S. to slow but remain above trend at 3.9%.

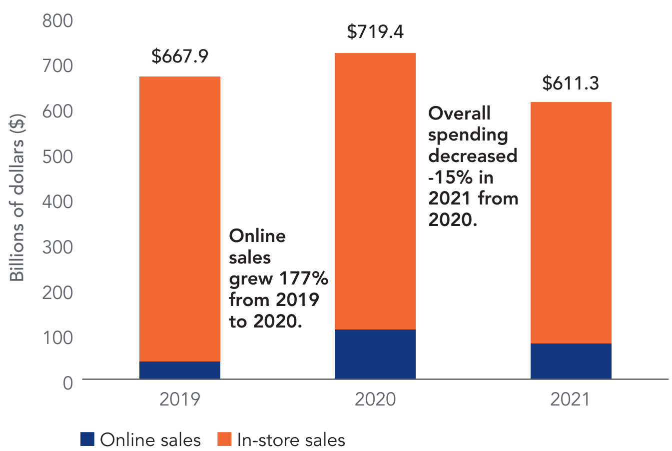
The consumer is back, but more online than ever



As of 11/30/21. Sources: U.S. Census Bureau, Bloomberg and Federated Hermes analysis.

Less spending on big ticket items could help ease inflation

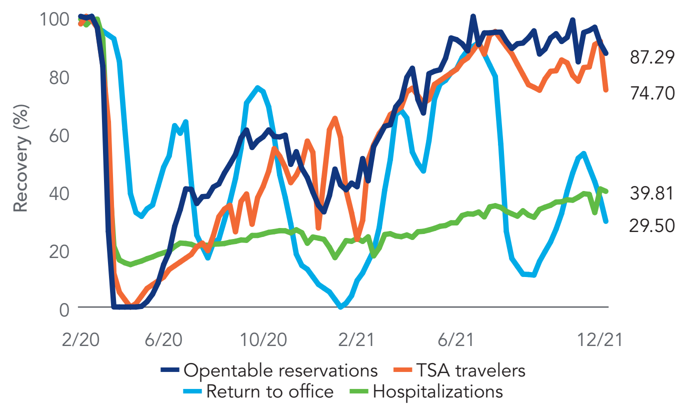
Furniture, building materials and electronics spending



As of 11/30/21. Sources: U.S. Census Bureau, Bloomberg and Federated Hermes analysis.

An uneven return to normalcy

Percent recovery in restaurant reservations, travel and return to work since pre-pandemic



As of 12/13/21. Sources: Bloomberg, Federated Hermes analysis.

Domestic equities

In domestic equities, we are tilted toward cyclical value stocks on relative valuations, growth expectations and an upward bias in rates. We estimate S&P 500 Index earnings-per-share for 2022 at $230 and set a year-end target of 5,300 for the index.

Value has tailwinds, but security selection is important

Stephen Auth, Federated Hermes chief investment officer for equities, suggests leaning into the more cyclical and inflation-hedged sectors of the market in the year ahead, including financials, energy and materials. These are areas that have relatively modest valuations and tend to do well when the economy is expanding, and hold up well when inflation is elevated (within reason) and rates are rising.

The economy is starting to shift from early to mid cycle, providing more runway for economically sensitive, cyclical and small-cap stocks. Moreover, valuation gaps between value and growth stocks, and small caps and large caps, are wide, favoring a reversion-to-mean trade.

That said, we aren't blindly wedded to a singular style or sector, and instead, believe security selection has become even more critical. The past few years—Covid's abrupt arrival and destructiveness, inflation's surprisingly stubborn run-up, supply chain bottlenecks—taught us to expect the unexpected and to be ready to react tactically.

Fixed income

In fixed income, we are underweight Treasuries and believe tight spreads and higher rates make credit more of a coupon trade, with yield curve and duration positioning potentially offering the most alpha. In the liquidity space, Fed hikes—and the run-up to them—should create welcome increases in rates.

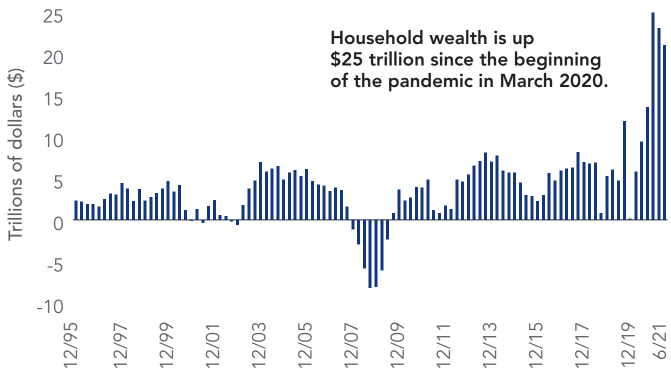
Short duration opportunities have more runway

The backdrop of above-trend inflation and a more hawkish Fed is anything but bullish for government bonds. But Robert Ostrowski, Federated Hermes chief investment officer for the Global Fixed Income Group, continues to see value in shorter-duration credits in high yield as well as lower-rated investment-grade corporate bonds and emerging markets (EM).

Opportunities should also lie in shorter-duration segments of the credit market strongly linked to global economic growth. These would include bank loans and floating-rate securities, trade finance and fixed-income strategies with equity exposure, as well as asset-backed securities (ABS) tied to specific areas of the economy such as consumer credit and autos.

Historically strong consumers present potential investment opportunities in ABS

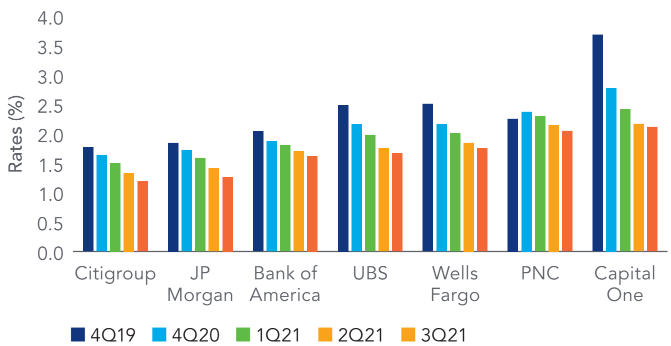
Net worth of households
Dollar change from the previous year



Net worth of households as of 6/30/21.

Sources: Federal Reserve, Federated Hermes analysis.

Credit card delinquency rates are low



30+ day credit card delinquency rates, smoothed on a four-quarter basis, as of 9/30/21.

Sources: Empirical Research Partners, company reports.

On the shortest end of the curve in the liquidity space, Fed liftoff should create some welcome increases in prime and government money market yields, which have been hovering near zero for some time, says Deborah Cunningham, Federated Hermes chief investment officer for Global Liquidity Markets.

Rate positioning may offer the most potential alpha but this is not without its own set of challenges and uncertainties. The yield curve, for example, "bear flattened" toward the end of 2021 but not in a typical way, when short rates rise faster than long rates. Instead, it was more of a twist, as short rates spiked but long rates stayed in a fairly tight range and even drifted down in the year's closing months.

The Fed's tightrope

The new year could see a more traditional flattener but we acknowledge that as the Fed tapers quantitative easing (QE) and initiates a rate-hike cycle, the trajectory of long rates will partly depend on whether inflation starts to moderate.

In many ways, 2022 comes down to the Fed walking a tightrope as it tries to rein in inflation without undercutting its soft 'third mandate' of lifting society's disadvantaged through a continued expansion. "The question is whether policymakers can find the sweet spot," says R.J. Gallo, senior portfolio manager and head of Federated Hermes Municipal Bond Investment Group and Duration Committee.

The fixed income group expects QE to end in the first quarter of 2022 and rate hikes to commence shortly after, pushing the upper fed funds target range to 1.00% by year-end. The group also expects 10-year Treasury yields to settle in the 2-2.25% range, with the potential to break higher if inflation doesn't moderate by mid to late 2022.

International

Internationally, we like Europe on valuations, especially as an economic recovery there could gather momentum, and we see idiosyncratic opportunities in EM.

While developed markets play catch-up, keep an eye on China

The economic recovery was slower to come across the pond, in part because it was hit harder by the delta wave, and the omicron surge is bringing a new set of restrictions on activity. But this is setting up Europe, and its more cyclically oriented economy and more attractive equity valuations, for a stronger year in 2022.

"From a cyclical perspective, Europe tends to lag developments in the U.S. by about two quarters, and I think this cycle is no exception," says Silvia Dall'Angelo, Federated Hermes senior economist, international business. Her base case for real global GDP growth in 2022 is 4.5%, faster than in the U.S., due to better activity in Europe but also on improvements in EM, including China.

A mixed picture in EM

What happens in China impacts the entire global economy. After regulatory crackdowns on technology giants, mounting property losses on overbuilding, zero-tolerance Covid policies and both fiscal and monetary tightening, the world's second-largest economy appears to be easing off. The People's Bank of China cut bank reserve requirements for a second time late in 2021.

The rest of the EM is somewhat of a mixed picture. On one hand, higher prices for oil, gas, minerals and agricultural commodities have been positive for many resource-rich emerging economies. But the combination of the pandemic, inflation and a stronger dollar has been a drag.

Brazil, for example, is challenged, having raised its policy rates nearly 800 basis points in the past 12 months to stem soaring inflation and currency devaluation. On the flipside, the situation in Brazil has become so bad that a bottoming process may be nearing an end.

Excelsior!

The coming year promises the potential for good, just not great, returns on risk assets and good economic growth. In this environment, hunkering down risks missing opportunities. The wild cards—inflation, the Fed, the virus, midterms—make the case for a balanced, active approach that seeks to diversify potential risks and rewards with the flexibility for tactical moves when opportunities arise.

Past performance is no guarantee of future results.

Views are as of 12/31/21 and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

Growth stocks are typically more volatile than value stocks. Value stocks may lag growth stocks in performance, particularly in late stages of a market advance.

Yield Curve: Graph showing the comparative yields of securities in a particular class according to maturity. Securities on the long end of the yield curve have longer maturities.

The yield spread is the difference between the yield of a security versus the yield of a U.S. Treasury security with a comparable average.

Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

Duration is a measure of a security's price sensitivity to changes in interest rates. Securities with longer durations are more sensitive to changes in interest rates than securities of shorter durations.

Credit ratings of A or better are considered to be high credit quality; credit ratings of BBB are good credit quality, and the lowest category of investment grade. High-yield, lower-rated securities generally entail greater market, credit/default and liquidity risks, and may be more volatile than investment grade securities.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designated to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

International investing involves special risks including currency risk, increased volatility, political risks, and differences in auditing and other financial standards. Prices of emerging markets securities can be significantly more volatile than the prices of securities in developed countries and currency risk and political risks are accentuated in emerging markets.

The value of equity securities will rise and fall. These fluctuations could be a sustained trend or a drastic movement.

Small company stocks may be less liquid and subject to greater price volatility than large capitalization stocks.

Bond prices are sensitive to changes in interest rates and a rise in interest rates can cause a decline in their prices.

Diversification does not assure a profit nor protect against loss.

Consumer Price Index (CPI): A measure of inflation at the retail level.

Personal Consumption Expenditure (PCE) Index: A measure of inflation at the consumer level.

The value of some asset-backed securities may be particularly sensitive to changes in prevailing interest rates.

Alpha measures the excess returns of a portfolio relative to the return of a benchmark index.

In addition to the risks generally associated with debt instruments, such as credit, market, interest rate, liquidity and derivatives risks, bank loans are also subject to the risk that the value of the collateral securing a loan may decline, be insufficient to meet the obligations of the borrower or be difficult to liquidate.

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