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MARKET SIGHT*LINES*

Second Half 2022 and Beyond:
Part 2: Reasons for a Positive Outlook

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In last week's Second Half 2022 and Beyond: Part 1: How Did We Get Here? we reviewed some of 2022's Balancing Acts, highlighting imbalances like supply constraints from the pandemic and war in Ukraine, excess demand from policy support, and heightened inflation. We reviewed the shift in Federal Reserve (Fed) policy as it tries to find its balance and the resulting market declines that followed. Now it is time to look forward.

In this week's Sight|Lines, we share our views on the slowing economy, recession, earnings, and the reasons to have a positive outlook going forward.

SLOWING ECONOMY

At the beginning of the year, the Fed and market consensus forecasted robust GDP growth in the U.S. Last December, the Fed forecasted this 2022 GDP growth to be 4.0%, while the consensus forecast around that time was 3.9%. In June, the Fed's forecast fell to 3.3%, and the most recent consensus is 2.1%. So, most are expecting lower but positive economic growth this year.

RECESSION?

Many are talking about the potential for a recession, and almost everyone agrees that the chances of a recession have increased. But in our view, we see the most likely outcome being that a recession will not happen for at least 12-18 months or later. If we are wrong, we don't expect a deep or a long recession. There continues to be positive forces at work as the economy continues to heal from the damage done by the pandemic and related shutdowns.

REASONS FOR A POSITIVE ECONOMIC OUTLOOK

There are several reasons for a still-positive economic outlook. There is an excess demand for labor, with many industries hiring back more workers than were lost during the pandemic. The consumer continues to spend, with retail sales still well above longer-term trends. Most purchasing managers' index measures, like those from ISM and S&P Global (formerly Markit), remain above 50, signaling expansion. Businesses continue to rebuild inventories, and the housing market remains strong. But inflation remains elevated.

We expect inflation to cool for three reasons. First, certain key drivers of higher prices, especially oil, have declined from recent peaks. Brent crude is trading at $106, off 17% from its $128 high in March. Second, there are signs that supply chain pressures are easing. The New York Fed's Global Supply Chain Pressure Index peaked at 4.35 in

December but has fallen to 2.41, driven by meaningfully improved delivery times from China. This index is still elevated but improving. Then third, market participants expect inflation to fall. The breakeven inflation rate, a reflection of market views, is expected to be about 3.8% over the next year, around 2.4%-2.6% for the next two years after that, and 2.2% four years from now.

The Fed expects inflation to cool and has forecasted levels of 2.7% in 2023 and 2.3% in 2024. It expects to ease monetary policy or lower its benchmark fed funds rate in 2023. Market forecasts signal this ease sooner. If inflation cools more quickly than the Fed or market participants expect, the Fed may have room to be less aggressive in this tightening cycle, a positive for the economy and markets.

EARNINGS

Despite concerns about higher inflation and a slowing economy, companies continue to produce and grow earnings. The consensus for S&P 500 earnings growth is 10.0% in 2022, 8.8% in 2023, and 8.4% in 2024. Profit margins are an important input to earnings. And the estimated second-quarter net profit margin for the S&P 500 is 12.4%, which is above the five-year average of 11.2% and the previous quarter's net profit margin of 12.3%. Such a result would be the fourth-highest net profit margin reported since 2008.

REASONS FOR A POSITIVE INVESTMENT OUTLOOK

Our discussion over these last two weeks builds the case for a positive investment outlook. As interest rates have risen, yields, a known measure of the potential return for a fixed income investment, have risen. So, bonds are more attractive looking forward.

Our positive outlook for stocks is based on three observations. First, with a bear market, valuations are more attractive, especially for active managers able to find good companies whose stocks have been beaten down in this environment. Second, is the positive earnings growth we've discussed. Earnings growth may slow some, compared to consensus, but we believe earnings will grow at least in the neighborhood of our 6% long-term assumptions. And third, given the prospect of cooling inflation, any shift by the Fed away from its extremely hawkish policy sentiment will likely be met with relief for investors, a strong positive for stocks.

While we expect market volatility to continue, we are positive on bonds and stocks looking forward.

CONCLUSION

Last week, in Second Half 2022 and Beyond: Part 1: How Did We Get Here?, we reviewed imbalances that have fueled higher inflation and a dramatic shift in Fed policy. This week we've looked ahead, and we see reasons for hope. We expect slowing but positive economic growth, a very good chance the Fed can manage a softish landing and avoid a recession, the prospect of the Fed even being able to pause rate hikes sooner, and a foundation for growing earnings and positive market returns looking forward.

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