Comerica Wealth Management

MARKET OUTLOOK 2022

December 2021

- Policy
- Economy
- Fixed Income
- Equities
- Global
- Currencies and Commodities

John Lynch
Chief Investment Officer
Comerica Wealth Management

EXECUTIVE SUMMARY

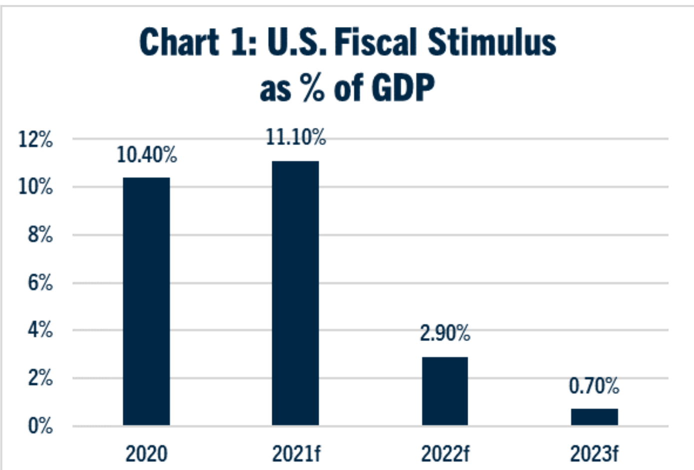
This past year was characterized by policy support, global recovery despite Delta+, and better-than-expected growth in GDP and corporate profits. While the discovery of the Omicron variant has injected new uncertainty into the possibilities for 2022, we will focus on the "known fundamentals" supporting slower, but steady growth in GDP and profits in the coming year.

- **Policy** – Fiscal legislation remains challenged, and the positives of infrastructure may be limited by the complexities associated with debt ceiling debates and Build Back Better negotiations. We suspect the impact of "fiscal drag" is underappreciated by investors. Monetary policymakers must contend with concerns over inflation and the pandemic while tapering asset purchases. We do not believe the Fed will raise rates to the degree consensus currently projects.
- **Economy** –A disappointing third quarter GDP report was quickly followed by a surge in activity during October and November. The push-pull of holiday sales and new virus cases will help determine the platform on which we build for 2022. We look for U.S. Real GDP growth of 4.9% next year with CPI moderating from peak levels and the unemployment rate falling to the 4.0% range.
- **Fixed Income** –The bond market has been pricing in the effects of inflation and prospects for less accommodation from the Federal Reserve. Though Omicron has caused market interest rates to pivot recently from that stance, we suspect the trends for growth in the economy and pricing will see the yield for the benchmark 10-year Treasury note to nudge higher toward 2.0% next year. The gradual steepening of the yield curve and a lack of stress in corporate credit spreads support our preference for securities with below benchmark interest rate sensitivity (duration) and higher credit quality.
- **Equities** –The equity markets have performed well in 2021, boosted by the combination of favorable policy tailwinds, low interest rates, economic reopening, and stronger than expected corporate profits. In the coming year, we look for profit growth to moderate while margins and valuations largely hold steady. Until clarity emerges on the new variant, trends favoring growth and the "stay-at-home trade" may prevail near term. Our base case, though, remains the "recovery trade," with preferences for value, small caps, and cyclical sectors. We project S&P 500® EPS growth in the range of 9.0% to 10.0% next year, believing the S&P would be fairly valued in the 5000 range by yearend.
- **Global**–We look for global GDP growth of 5.9% next year, with Advanced Economies experiencing slight moderation in GDP and inflation. Central banks in Europe and Japan will likely remain on the sidelines as inflation moderates from peak readings. Emerging Economies are also poised to experience a decline in output growth. Elevated inflation has already led many Emerging Market central banks to increase interest rates. While global valuation metrics are more attractive than in the U.S., we maintain benchmark weightings in this space.
- **Currencies and Commodities**–The U.S. dollar has enjoyed surprising strength in 2021, despite deficits in budget and trade. We look for technical and fundamental trends to limit dollar gains next year, supporting commodity prices while favoring industrial metals over precious metals.

POLICY

Over the course of the past year, investors were largely assured of U.S. policy support, whether in the form of record levels of government spending or favorable trends in monetary policy. Yet, the combination of politics and inflation have pressured fiscal legislators and central bankers, leading to what we expect to be a more challenging policy environment in the coming year.

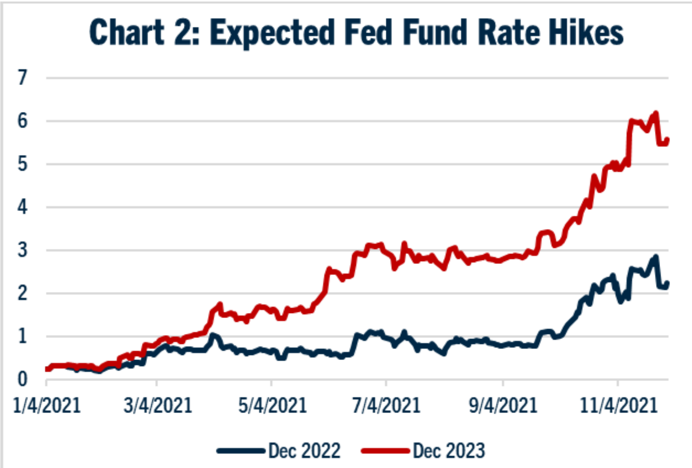
To be sure, the sausage-making of fiscal spending has been painful to observe for voters and investors. The Biden Administration's original $3.5 trillion plan for social spending, climate and education has been narrowed down to less than $2 trillion, with plenty of debate surrounding the longer-term costs of the new Build Back Better proposal. This will likely extend negotiations in the Senate, though the bill recently passed in the House of Representatives. While the $1 trillion infrastructure plan has already been signed into law, investors must prepare for the impact of "fiscal drag" next year. Even if the Senate approves BBB in its current form, fiscal policy stimulus as a percentage of GDP is poised to fall markedly in 2022. **See Chart 1.**



Source: Strategas Research Partners

Regarding monetary policy, the situation is also suspect due to the combination of rising inflationary pressures, new developments in the pandemic, and changes in the makeup of the Federal Reserve Board. President Biden recently reappointed Fed Chair Jerome Powell to serve another four-year term, while Fed Governor Lael Brainard was appointed Vice Chair. Both positions are subject to Senate confirmation in the weeks/months ahead, yet we expect approval for each. Three other open positions suggest the possibility for a more dovish tilt, where the Fed's employment mandate is prioritized over inflation. Speaking of inflation, the market has already viewed pricing pressures as tenacious, rather than transitory, as the central bank continues to assert.

Consequently, bond investors began pushing up yields on U.S. Treasuries and other market-based indicators, including the prices for Treasury Inflation Protected Securities (TIPS) and breakeven inflation expectations. Yet, the recent discovery of the Omicron variant has quickly scaled back projections in the fed fund futures market. **See Chart 2.**



Source: Bloomberg L.P.

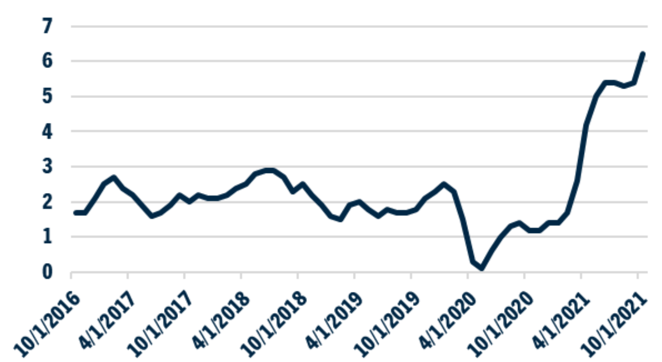
As supply catches up with demand next year, we look for inflation to moderate from elevated readings. The Fed may accelerate the tapering process in early 2022, and we suspect it will begin raising its target for the Federal Funds rate by midyear. We do not look for an aggressive tightening campaign, however, as several other factors may play into the endpoint for rate hikes. These include the global pandemic, wide interest rate spread differentials with other sovereign bonds, servicing costs for U.S. federal debt, and a likely switch to a more dovish composition on the Federal Open Market Committee. As a result, it is conceivable the Fed hikes two to three times over the next 18 months, rather than the five hikes currently projected by the end of 2023.

ECONOMY

Economic activity encountered some swings in 2021 as consumers and businesses adjusted to reopening, spread of the Delta+ variant, and surging inflation. Indeed, the cyclical recovery was in full force during the first half of the year, as real GDP expanded in the 6.0% range. Yet, activity weakened during the third quarter, with GDP declining to a +2.1% rate, as consumers reassessed spending patterns amid rising prices.

Among the curious dynamics of this economic recovery has been the pattern of personal consumption exceeding trend growth for goods yet trailing the trend on services. Job openings exceed the number of unemployed workers by a record amount, and the number of "quits" continues to increase as workers either leave the labor force entirely or have the confidence to secure other, improved situations. Logistics and distribution remain challenged on a global scale, as supply chain disruptions persist. Inflation, as measured by the Consumer Price Index (CPI), rose more than 6.0% on a year-over-year (YOY) basis through October and is now three times greater than the Fed's definition of price stability. See Chart 3.

Chart 3: Consumer Price Index (CPI) YOY % Growth



Source: Bloomberg L.P.

Despite these trends, economic growth is surging thus far in the fourth quarter. Real time data from the Federal Reserve Bank of Atlanta was indicating a fourth quarter GDP pace of +8.0% heading into Thanksgiving weekend, as reported economic data repeatedly exceeded consensus forecasts. Holiday sales enjoyed a strong first weekend, but the fate of December sales likely rests with Omicron. See Chart 4.

Chart 4: Domestic Indicators

	2019a	2020a	2021f	2022f
U.S. Real GDP	2.2	-3.5	5.5	4.9
Consumer Price Index	1.8	1.2	4.6	5.3
Unemployment Rate	3.7	8.1	5.4	4.0
10-Year Treasury Note	2.14	0.89	1.45	1.72

a= actual; f = forecast

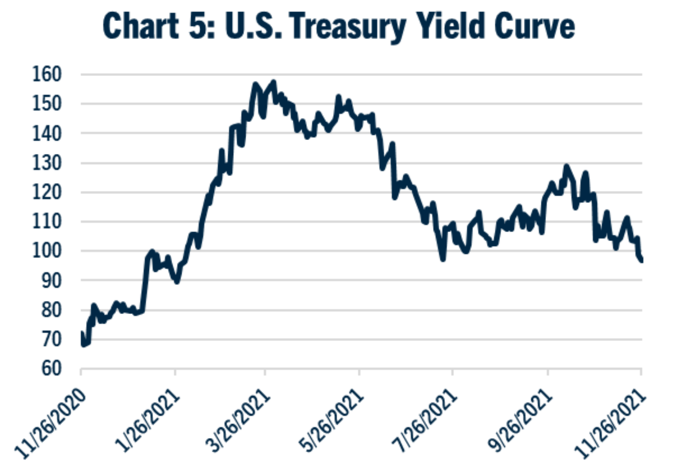
Source: Comerica Bank

In the coming year, we look for economic activity to remain solid by historical standards, yet somewhat weaker relative to the pace of this past year's economic recovery. Comerica Bank Chief Economist Dr. Robert Dye projects U.S. GDP growth of 4.9% in 2022, with price pressures slightly moderating to a 5.3% clip, as supply gradually catches up to demand. The employment situation is also expected to improve, but to the extent to which a low unemployment rate is the result of workers leaving the labor force, wage pressures may intensify.

FIXED INCOME

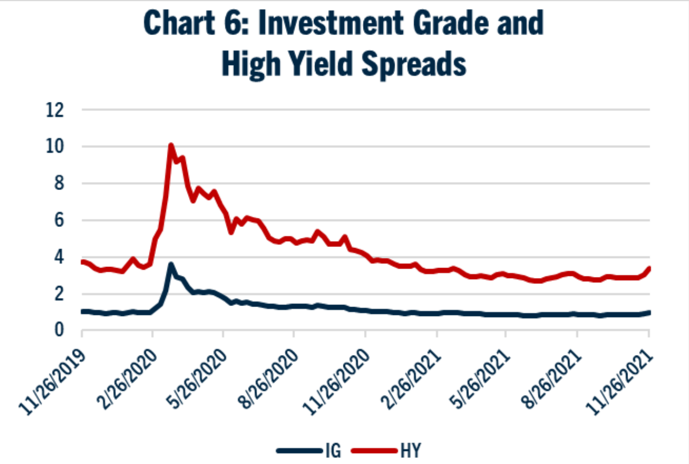
The bond market has experienced a variety of swings and emotions over the past year. The initial jump in yields during the first quarter was attributed to anticipation of economic recovery and the associated jump in prices. Yet, once inflation actually arrived, yields plunged over concerns about the Delta+ variant's impact on the rebound, along with a plethora of assurances from monetary policymakers about the transitory nature of inflation. Yields jumped again in late summer and early autumn, though, as inflation readings hit multi-decade highs.

The Fed's measured pronouncements about plans for reducing asset purchases, however, prevented a 2013-style taper tantrum. President Biden's decision to reappoint Jerome Powell as Chair of the Federal Reserve Board also improved investor confidence about the central bank's longer-term inflation fighting credentials. And the recent discovery of the new Omicron variant has already applied downward pressure on longer-term yields, further flattening the U.S. Treasury yield curve. See Chart 5.



Source: Bloomberg L.P.

After a 40+ year bull market in bonds, twin deficits in budget and trade, and a multi-decade high in price pressures, it stands to reason that next year will prove a tough slog in the fixed income markets. Yet, the aforementioned "fiscal drag" will result in less issuance of U.S. Treasuries. Moreover, the wide yield differentials between U.S. Treasuries and other global sovereign bonds may further sustain demand, as there remains more than $13 trillion in negative-yielding government debt globally. Finally, the lack of credit stress in the bond market, as evidenced by narrow spreads between the benchmark 10-year U.S. Treasury note and corporate investment grade and high yield bonds, suggests a better-than-feared degree of fundamental support for fixed income. See Chart 6.



Source: Bloomberg L.P.

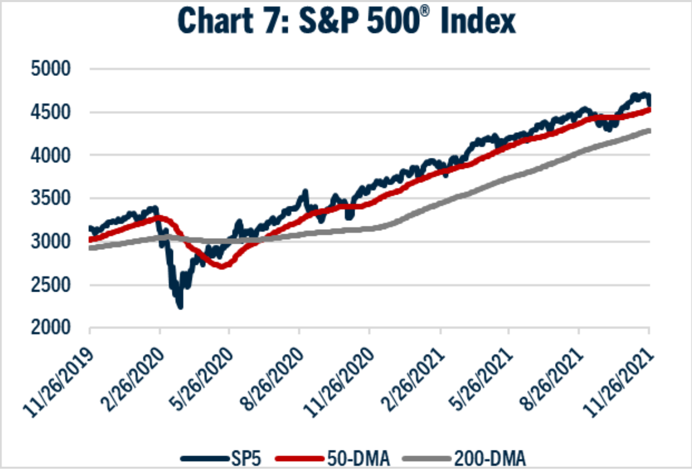
When positioning fixed income portfolios in this environment, prepare for gradually higher market interest rates. Though Omicron and election volatility may suppress yields, we suspect the persistent nature of inflation will lead to upward pressure on rates.

U.S. Treasuries, therefore, are expected to struggle as a return leader for diversified portfolios. Inflationary pressures are likely to provide support for Treasury Inflation Protected Securities (TIPS). As the Fed accelerates its tapering program, mortgage-backed securities (MBS) will also encounter at least one less, though sizable, buyer, while also experiencing lengthy durations (interest rate sensitivity) and narrow spreads. Corporate investment grade and high yield bonds, though challenged by lofty valuations, should continue to see some fundamental support, and we continue to encourage investors to place an emphasis on credit quality. Given their high valuations, the tax-exempt municipal bonds may have a more difficult time next year. Clarity on tax rates and the degree of issuance will help determine performance in 2022.

EQUITIES

The equity markets have performed well in 2021, boosted by the combination of favorable policy tailwinds, low interest rates, economic reopening, and stronger than expected corporate profits. Market leadership wavered during the year, though, as alternating trends supporting the stay-at-home and reopening trades periodically surfaced. Risks that sometimes weighed on sentiment include questions over the sustainability of the economic expansion, potential changes in policy, spread of the Delta+ variant, inflation, taxes, and geopolitics.

Despite these concerns, the S&P 500® exhibited solid technical strength over the past year. Regardless of the challenge, the Index managed to bounce off primary support, the 50-day moving average (DMA) in just about every instance but for September, before recovering to more new highs. See Chart 7.



Source: Bloomberg L.P.

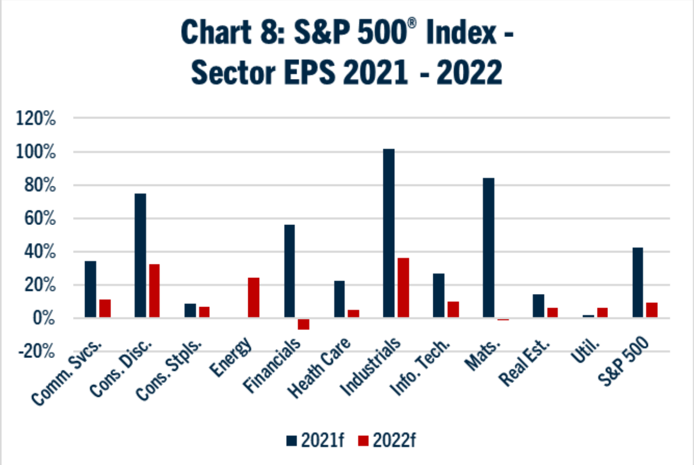
In addition to the technical strength, fundamentals remained supportive, with generally low market interest rates (despite inflationary pressures) and record-breaking corporate profit growth. To be sure, operating leverage remained solid, as higher revenue gains combined with lower costs for labor and debt servicing to support the bottom line. Operating earnings for companies in the S&P 500® surged more than 90% in the second quarter and up to 40% for the third quarter, both exceeding consensus projections by a wide margin.

Corporate Profits and Valuation

We have admittedly been cautious on our forecasts for corporate profits in 2021 and 2022. In our *Quarterly Market Update* (10.6.21) we highlighted our concerns about "TNT" – taper n' taxes – to pose a threat to corporate profit margins. Yet, as mentioned earlier in this report, the policy landscape has been dynamic, with a few important developments leading to what we now expect to be more favorable outcomes for margins over the next year. A potentially more dovish Fed will likely support market interest rates, and the lack of an increase in the corporate tax rate in 2022 should also enable margins to hover near levels we previously viewed as unsustainable.

As a result, we are raising our 2021 forecast for S&P 500® profits from $200 to $205, representing an increase of 45% from the $140 earned for the Index in 2020. Better than expected revenue growth of 15.0% helped sustain the net profit margin in the 13.0% range for the S&P 500® through the third quarter.

Our earnings projection for 2022 has also increased, from $210 to $225, based on our expectations for decreased margin risk from taxes and debt servicing costs. This represents EPS growth potential of 9.0% to 10.0% for the full year. We look for the costs of materials and labor to remain elevated but experience a gradual decline from current levels as supply catches up to demand over the course of the next twelve months. Revenues should rise about 7.0% for the index, with the net profit margin of the S&P 500® holding above 12.0% in 2022. See Chart 8.



Source: FactSet

Considering the recent closing high of the S&P 500® above 4700 and index earnings forecast of $205 for 2021, investors are willing to pay a P/E (price-to-earnings) multiple of approximately 23 times profits over the trailing twelve-month (TTM) period. Of course, this is high when viewed on an absolute basis, but with market interest rates remaining near historic lows, the Index P/E ratio does not appear as threatening for valuations. Indeed, inflation-adjusted interest rates (real rates) are still negative, providing a tailwind for stocks. Given our expectation for gradually higher market interest rates next year with inflation declining from peak levels, we look for a TTM PE of 22.5 times our S&P profit forecast ($225) suggesting the Index would be fairly valued in the 5000 range by yearend 2022. Though we suspect P/E multiple growth has topped out this cycle, the combination of earnings and income can be a powerful driver of performance for long-term portfolios.

Portfolio Positioning

When positioning portfolios, we continue to recommend fully diversified, long-term strategies emphasizing a balance among exposures relative to size/market capitalization, investment style, sector, and region.

Large vs. Small

Market capitalization also plays an important role in diversification when weighing exposures against their respective benchmarks. Over the course of the past year, small cap stocks have been mixed relative to large caps, with variations favoring the better quality and more profitable names in the S&P 600® Small Cap Index relative to the broader Russell 2000® Index. We prefer quality small caps in the coming year, as they are more levered to the domestic rebound and tend to benefit from a steepening yield curve. Earnings growth projections and valuations are also attractive.

Growth vs. Value

This relationship has wavered during the course of 2021. Initially, value had the performance edge as investors priced in the recovery. Yet, an escalation of Delta+ variant cases combined with expectations for a more dovish Federal Reserve, placing a tailwind behind growth. We still maintain our preference for value given the global recovery and our expectation that supply catches up with demand in 2022. Valuation, EPS gains and income opportunities also support this position, though the introduction of Omicron may temporarily support growth until clarity emerges on the medical solution.

Cyclical vs. Defensive Sectors

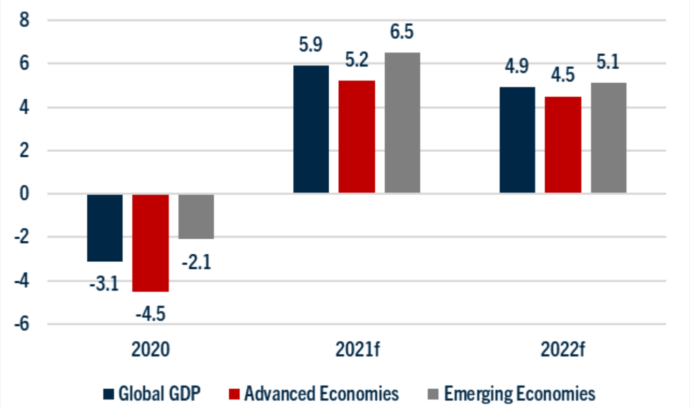
Similar to the dynamic between value and growth, cyclicals vs. defensives also experienced alternating periods of market leadership in 2021 as investors priced in the potential for recovery, inflation, Delta spread, and monetary policy, sometimes within the same week! Considering valuations, global recovery, infrastructure spending and EPS potential, we continue to prefer a cyclical sector tilt in diversified portfolios favoring the Industrials, Energy, Materials and Financial Services sectors.

GLOBAL

Similar to the experience of the U.S., the global economy is expected to moderate in 2022 from the rapid recovery pace over the past year. As the post-lockdown rebound fades and policy support decreases, economic activity will be dependent on the ability of global supply to catch up with global demand, lessening inflationary pressures next year. Of course, the pandemic will play a role, and to the degree that the new Omicron variant leads to plant closures and port delays, the shortages in supply and labor that have driven up costs may persist. Conversely, any decrease in demand from new restrictions would offset pricing pressures on supply chains.

After expanding by approximately 6.0% in 2021, we look for global GDP to moderate within the range of 5.0% in 2022. The ability of supply to catch up with demand should also result in lower inflationary pressures in the coming year. **See Chart 9.**

Chart 9: Global GDP Forecasts - IMF



Source: International Monetary Fund

Advanced Economies

According to the International Monetary Fund and consistent with our belief, the developed world should see real GDP decline to approximately 4.5% in 2022 from this year's 5.2% pace of output growth. Also, inflationary pressures should decelerate, with consumer prices falling from 2.8% in 2021 to 2.3% next year.

In Europe, labor shortages may be less severe than in the U.S., but high energy prices and materials shortages should keep activity robust, and inflation elevated, until midyear. As the recovery moderates, the European Central Bank (ECB) is unlikely to tighten policy in 2022. Japan has had several false starts on the road to recovery, but recent fiscal stimulus by the new government and relatively milder pricing pressures suggest the BOJ will also remain on the sidelines next year.

Emerging Economies

GDP in the emerging world is also set to decelerate next year, though by a wider margin than in advanced economies. Emerging GDP is projected to decline from approximately 6.5% in 2021 to a 5.1% pace in 2022. Inflation, however, is still expected to hover within the range of 5.0% next year.

China's regulatory crackdown on technology, internet commerce, and property developers has had a major impact on global activity and financial markets this past year. Even as services bounce back in 2022, the downturn in construction and industry is already underway. Growth is expected to decline from ~8.0% in 2021 to ~5.5% next year, with possibilities rising for further monetary and fiscal support. High inflation in other areas, such as Emerging Europe and Latin America, should result in further tightening of monetary policy. These trends have led to the underperformance of Emerging Markets relative to their Developed counterparts. See Chart 10.

Chart 10: Emerging Markets / Developed Markets

Source: Bloomberg L.P.

Financial Markets

After the impressive policy-driven recovery in global economies from the depths of last year, investors around the world are reassessing future growth prospects, helping to drive recent volatility. In addition, the recent discovery of the Omicron variant adds complexities to the outlook for economic activity, interest rates and corporate profits.

Bond yields around the world attempted to climb in recent months, as investors priced in the costs of extraordinary policy intervention, supply bottlenecks, labor shortages, and the likelihood of persistent pricing pressures. Yields for the German Bund and the Japanese Government Bond (JGB) made valiant efforts higher, only to back up as monetary policymakers diminished expectations for imminent rate hikes. The discovery of the Omicron variant has further weighed on global yields.

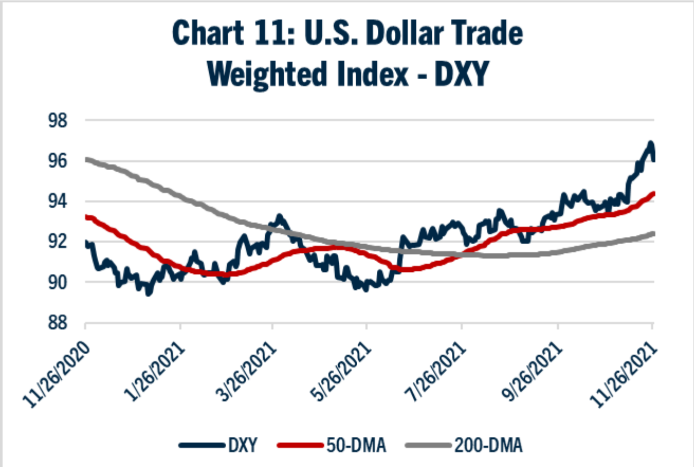
We continue to look for an increase in global yields, albeit at a lesser rate than initially thought, as economic growth moderates and central banks in developed markets hold off on interest rate increases.

The lower discount rate should help support global equities, as a muddled profit outlook is less complicated by more reasonable valuations. For example, in a Bloomberg analysis, Developed Markets, as defined by the MSCI EAFE® Index, shows profits flat to slightly down next year with a P/E of 14. Emerging Markets, the MSCI EM Index, offer slightly better profit growth of 4.5% next year and a P/E ratio of just 12.

Given the combination of the pandemic, political risks, and persistent supply chain disruptions, global equities have underperformed the U.S. in 2021. We continue to position for a global cyclical recovery, but the potential for a drawn-out expansion has increased, leading to our preference for benchmark weightings to developed and emerging equities within diversified portfolios.

CURRENCIES AND COMMODITIES

The U.S. dollar has enjoyed surprising strength in 2021 as global investors looked past deficit spending and instead focused on the relative attractiveness of the U.S. recovery. Interest rates are also higher in the U.S., further catching a global bid. The reappointment of Jerome Powell also gave the greenback support, as global investors gave their approval for consistency in policy. As a result, the trade-weighted U.S. Dollar Index (DXY) managed to climb through technical resistance in recent weeks. See Chart 11.

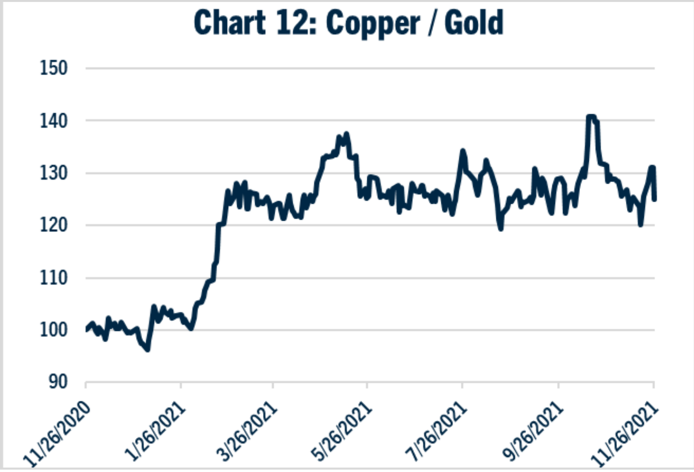


Source: Bloomberg L.P.

Dollar performance has had mixed impact on commodity pricing this year, which has also been affected by other factors. Global reopening has been supportive for industrial commodities, while inflationary fears periodically boosted precious metals, including gold.

Weak for much of the year, gold gained traction this past quarter on growing inflation concerns, as the Fed's favorite inflation indicator, the core Personal Consumption Expenditures Index (+3.6%, YOY) rose to the highest level in 30 years through the end of the third quarter.

Copper continued to gain strength relative to gold, though, as investors maintained positive sentiment regarding the global economic recovery. See Chart 12.



Source: Bloomberg L.P.

Oil prices also surged this year through October, as reopening of the global economy led to increased demand worldwide. Yet, OPEC+ dithered relative to output quotas, and the Omicron news led to a plunge in oil prices of almost 20% in the last few weeks of November.

We continue to believe the twin deficits (trade and federal budget) will weigh on the dollar next year, and tax increases have historically been a currency negative. In addition, the global economic recovery, though moderating, should lead to steady demand for commodities. Our preference remains for exposures emphasizing industrial over precious metals in diversified portfolios.

We wish you all health, happiness, peace, and perspective in the coming year!

Happy Holidays!

IMPORTANT DISCLOSURES

Comerica Wealth Management consists of various divisions and affiliates of Comerica Bank, including Comerica Bank & Trust, N.A; Inc.; Comerica Securities, Inc.; and Comerica Insurance Services, Inc. and its affiliated insurance agencies. Comerica Securities, Inc. is a federally registered investment advisor. Registrations do not imply a certain level of skill or training.

Comerica Bank and its affiliates do not provide tax or legal advice. Please consult with your tax and legal advisors regarding your specific situation.

Non-deposit Investment products offered by Comerica and its affiliates are not insured by the FDIC, are not deposits or other obligations of or guaranteed by Comerica Bank or any of its affiliates, and are subject to investment risks, including possible loss of the principal invested.

Unless otherwise noted, all statistics herein obtained from Bloomberg.

This is not a complete analysis of every material fact regarding any company, industry or security. The information and materials herein have been obtained from sources we consider to be reliable, but Comerica Wealth Management does not warrant, or guarantee, its completeness or accuracy. Materials prepared by Comerica Wealth Management personnel are based on public information. Facts and views presented in this material have not been reviewed by, and may not reflect information known to, professionals in other business areas of Comerica Wealth Management, including investment banking personnel.

The views expressed are those of the author at the time of writing and are subject to change without notice. We do not assume any liability for losses that may result from the reliance by any person upon any such information or opinions. This material has been distributed for general educational/informational purposes only and should not be considered as investment advice or a recommendation for any particular security, strategy or investment product, or as personalized investment advice.

Diversification does not ensure a profit or protect against a loss in a declining market. Past performance is no guarantee of future returns. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index. The material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. The investments and strategies discussed herein may not be suitable for all clients.

SUBSCRIBE

To receive investment insights and commentaries.