Janus Henderson
INVESTORS

MARKET GPS

EQUITIES OUTLOOK 2022

MATT PERON
Director of Research | Portfolio Manager

EQUITIES:

CAN THE EQUITY CYCLE ROLL ON?

Matt Peron
Director of Research

Inflation pressures, slower growth rates and tighter monetary policy have some worried that stocks will face a reckoning in 2022. But Matt Peron, Director of Research, believes the equity market cycle could prove resilient.

Key takeaways

- Inflation, tightening monetary policy and slower growth have raised concerns that the post-pandemic recovery in stocks could be coming to an end.
- But given the speed of the rebound so far, these trends could combine to help moderate and extend the market cycle in 2022.
- As such, equity investors may be well served by favoring areas of the market levered to an economy still on the upswing but that can weather shifting monetary policy, a tight labor market and the lingering presence of COVID-19.

The equity bear market that began with the onset of the COVID-19 pandemic turned out to be one of the fastest on record. Now, with inflation worries rising, central banks rolling back stimulus and economic growth proving to be uneven, investors may wonder if the subsequent rebound could be similarly quick. We recognize that this is no ordinary boom/bust cycle because of the global pandemic. But we also think the risk of the market cycle coming to a premature end is lower than some investors might fear. In fact, the trends causing uncertainty now may, on balance, help extend the cycle rather than finish it, with important implications for investors.

Risks to the market cycle: what has investors worried

In the post-World War II era, the average market cycle for the S&P 500® Index has lasted roughly 5.5 years, trough to peak.[1] So, using history as a guide, the benchmark of large-cap U.S. stocks would be expected to reach the midpoint of its current expansion about halfway through 2022, having bottomed in March 2020. But global equity indices already sit well above pre-pandemic highs (Figure 1), thanks to generous stimulus measures. At the same time, supply chain bottlenecks and labor shortages, along with the unleashing of pent-up demand, have raised prices throughout the economy, pushing inflation to levels not seen in more than a decade.

Rolling on: hitting speed bumps, not a wall

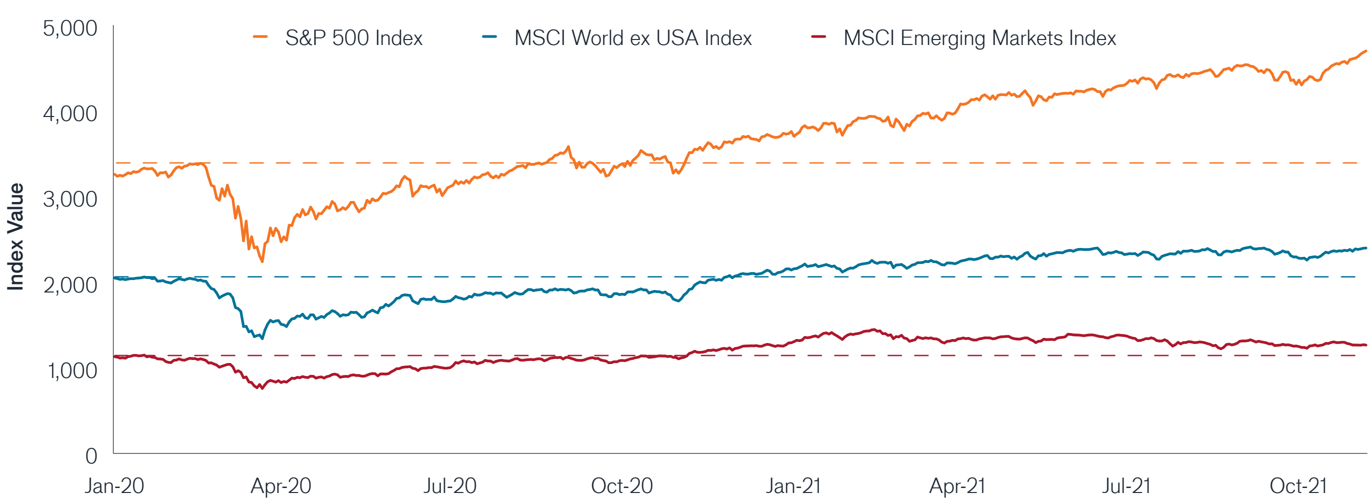
In our view, inflation has become the key risk to the market cycle in 2022 and warrants close monitoring. But while higher prices are likely to persist in the near term, some of the major drivers of inflation, such as rising wages and raw material costs, could begin to moderate. Pay gains, for one, could slow after an initial step-up as more people trickle back to the labor force; employers compensate with other benefits, such as work-from-home, or companies replace job functions with technology.

The year 2022 could also mark when COVID-19 starts to transition from being a public health crisis to an endemic disease that can be managed without economic shutdowns. In July, for example, a steep jump in COVID-19 cases in Southeast Asia, a hub for apparel and semiconductor manufacturing, led to months-long lockdowns. In countries such as Vietnam, policies lowered case numbers but also led to a sharp fall in gross domestic product (GDP), threatened foreign investment and curtailed exports. In the aftermath, Vietnam's prime minister conceded the country could not "resort to quarantine and lockdown measures forever.[2]"

Rising vaccination numbers and promising new medicines that have been shown to limit the severity of infection could make it easier for countries to "live with COVID" in

Figure 1: Stocks rebound

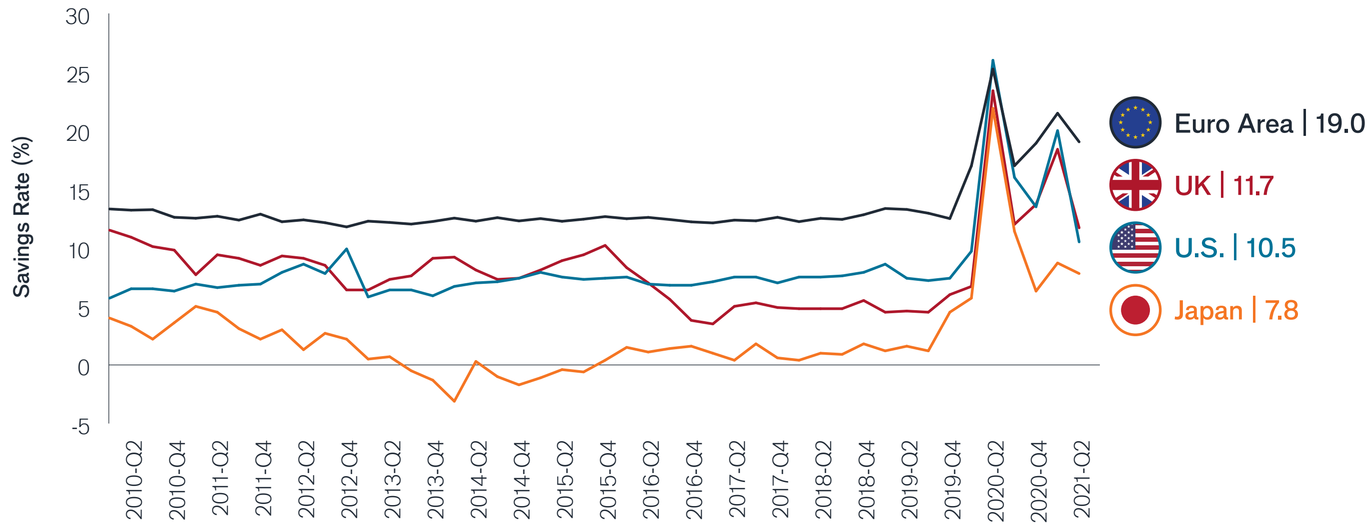
Equity indices have already exceeded their pre-pandemic highs, raising concerns the recovery may have come too far too fast – particularly in the U.S.



Source: Bloomberg, from 2 January 2020 to 5 November 2021.
Note: Dashed lines reflect pre-pandemic peaks for respective indices.

Figure 2: Household and personal savings rates

Thanks to pandemic-related government assistance programs and deferred spending, consumers have more purchasing power.



Source: Office for National Statistics (as of 30 September 2021); Federal Reserve Bank of St. Louis (as of 29 October 2021); Cabinet Office, Government of Japan (as of 15 October 2021); and Eurostat (as of 15 October 2021).

Note: Data are quarterly.

2022. But the transition is likely to unfold at varying speeds. It will also take time for the supply issues that have already built up in the economy to sort themselves out. As such, we think investors should be prepared for choppy growth. In the U.S., real GDP increased at only a 2% annualized rate during the third quarter in 2021, down from 6.7% in the second quarter, as worries about the Delta variant, supply shortages and the end of government assistance programs weighed on consumer spending.[3]

If temporary, the slowdown could prove a welcome step toward a sustainable rate of growth for the economy. Plenty of fuel remains to keep the expansion going. The generous stimulus programs rolled out during the pandemic have led to a sharp increase in personal savings rate, as shown in Figure 2, giving consumers spending power even as prices climb. (Rising home prices, strong capital markets and wage gains have also helped.) In Europe, households are estimated to have accumulated excess cash reserves worth 2.7 percentage points of GDP (€300 billion) in 2020, the balance of which was likely added to in early 2021.[4] Those reserves are forecast to bolster purchases until the savings rate normalizes, sometime in 2022.

Spending has room to grow, too. While consumers loaded up on autos, appliances, clothing and other goods during the initial phase of the recovery, consumption of dining and travel lagged. Tourist arrivals in Spain during the region's summer months, for example, were only about 50% of those of 2019, and hotel occupancy rates in France were 20 percentage points lower for the same time period.[5] As social restrictions ease, those trends should begin to reverse. The rotation in consumption from goods to services could help the economy continue to expand in 2022, while also allowing inventories time to rebuild and pricing pressures to cool.

What about central banks?

Meanwhile, the ultra-loose monetary policies that bolstered savings and turbocharged asset prices during the pandemic are coming to an end. Already, central banks have started winding down monthly purchases of bonds and other securities. The next step is interest rate hikes.

At first blush, rising rates may seem like a negative for risk assets such as equities, as higher yields reduce the present value of future cash flows, dividends and earnings. But what tends to be more important for stocks is the rate of change. To avoid making a cycle-ending policy mistake, regulators must strike the right balance: hike too quickly and economic growth could be snuffed out; move too slowly and inflation risks accelerating.

As shown in Figure 3, historically, the S&P 500 has delivered price gains of roughly 10% or more over a 12-month period when inflation averaged 3% or less. But as inflation moved higher, the benchmark's ability to advance diminished.

So far, policy makers have moved cautiously. The Reserve Bank of New Zealand lifted its cash rate a quarter of a percentage point in October to 0.5%, but did so a month after economists expected, preferring to wait out a COVID outbreak. In November, the Bank of England held its benchmark rate steady on concerns about the labor market. And European Central Bank (ECB) President Christine Lagarde said the ECB was "very unlikely" to lift rates at all in 2022, arguing tightening would be counterproductive when higher food and energy prices were already squeezing purchasing power.

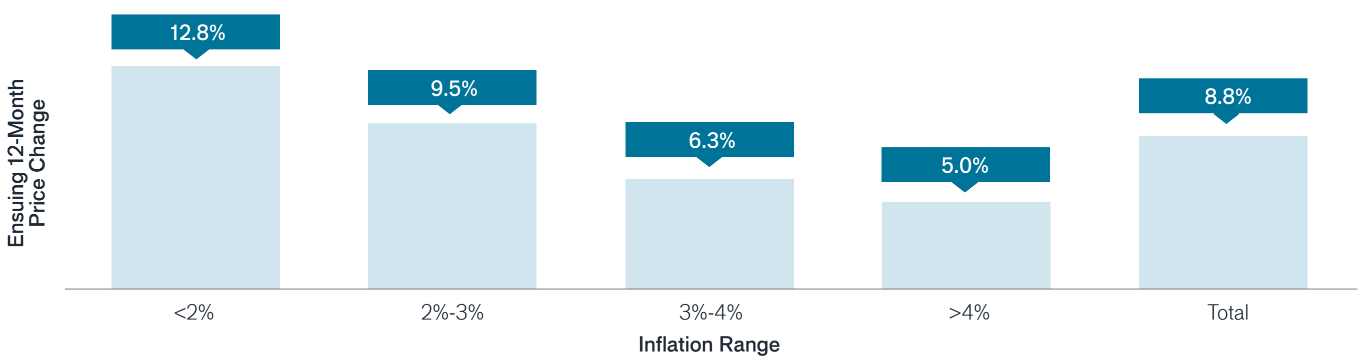
No matter what central bankers decide in 2022, it's worth remembering that there are powerful trends besides monetary policy that can help keep prices in check, drive growth and support equity valuations. Digitalization, a disinflationary force, is growing rapidly. Even with monetary tightening, it will take years to "normalize" central bank balance sheets and rates. (In the U.S., for example, inflation-adjusted 10-year Treasury yields remain firmly in negative territory.[6]) And new fiscal stimulus is coming down the pike, including the recently passed US$1 trillion infrastructure bill in the U.S. and the €750 billion NextGenerationEU recovery plan.

What it means for investors

All of which is to say that in 2022, we think the recovery has more room to go and equity investors may be well served by positioning for the early to mid-part of a market cycle, rather than get too defensive. That means favoring areas levered to an economy still on the upswing but that can navigate shifting monetary policy, a tight labor market and, of course, the lingering (but hopefully waning) presence of COVID-19.

Figure 3: S&P 500 change during past inflation environments (1945 – 2021)

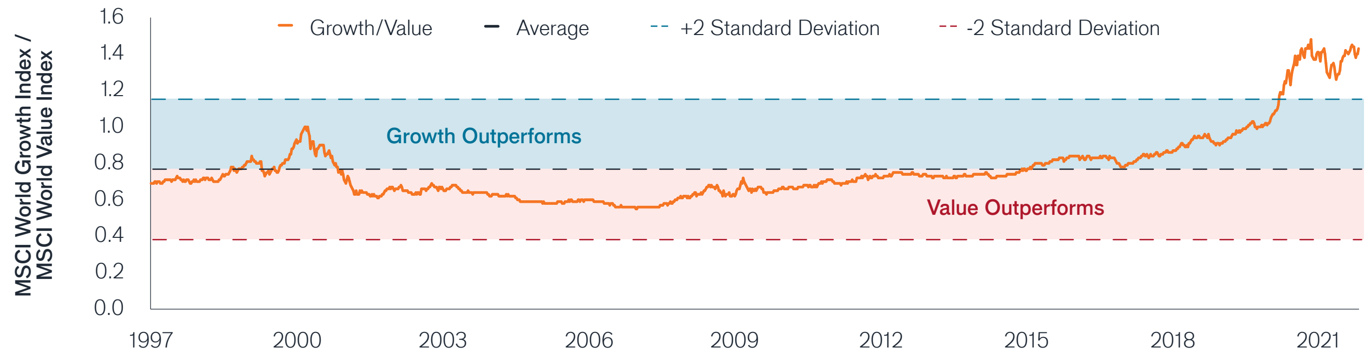
Historically, the S&P has been a good hedge against inflation – but only to a point, underscoring what's at stake when it comes to central bank policy in 2022.



Source: Robert Shiller, Yale University; Bloomberg, as of 30 September 2021.
Note: Data reflect S&P 500 Index's rate of price appreciation over ensuing 12-month period.

Figure 4: The growth/value gap

Growth stocks had the upper hand during the pandemic, but that could change if the economic recovery continues and rising rates put pressure on valuations.



Source: Bloomberg, as of 31 October 2021.

The value trade – take two

Earlier in 2021, stocks of companies tied to the economic cycle – broadly categorized as value equities – began outperforming growth stocks, which dominated during the pandemic as demand for technology soared. That trade reversed after the Delta variant put the recovery in doubt (Figure 4). But if GDP continues to expand as we expect in 2022 (short-term setbacks notwithstanding) and interest rates inch higher, value-oriented sectors such as financials, industrials, materials and energy might once again take the lead.

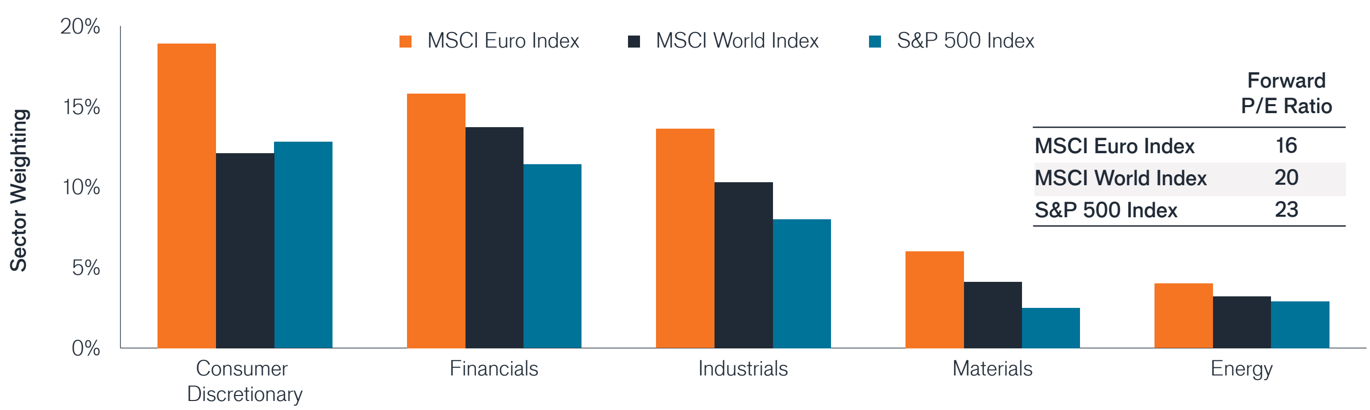
Stock multiples could also tempt investors to the value side. The 12-month forward price-to-earnings (P/E) ratio for the MSCI World Value Index was 15 as of early November. For the MSCI World Growth Index, the P/E was more than twice as high at 33.[7] Legitimate reasons exist for this gap, such as the fact that many growth stocks benefit from long-duration tailwinds. But in a period of tightening monetary policy, investors often become valuation-sensitive, which could drive up the appeal of value stocks in the near term. (Later in the cycle, as policy turns more neutral, secular growth drivers return to the fore, which is more supportive of growth stocks.)

Global opportunities

Applying this thinking geographically, certain regions of the globe start to stand out. While we remain positive on the outlook for U.S. equities, the eurozone has a cyclical tilt, with sectors such as consumer discretionary, financials and industrials making up a large percentage of the MSCI Euro Index on a market-capitalization basis. The benchmark also trades at a lower P/E ratio relative to the developed market average (Figure 5). And the eurozone

Figure 5: The eurozone's value tilt

Eurozone equities are weighted toward cyclical sectors and trade at a discount relative to peers.



	Forward P/E Ratio
MSCI Euro Index	16
MSCI World Index	20
S&P 500 Index	23

Source: Bloomberg, MSCI and S&P Global. Sector weightings as of 29 October 2021. P/E data based on estimated, 12-month forward earnings and as of 5 November 2021.

has not experienced the same level of labor shortages as in the U.S. or UK,[8] which could mean the ECB will take a slower approach to policy tightening.

In emerging markets, COVID outbreaks along with regulatory changes and debt restructuring in China weighed on stocks in the second half of 2021.[9] But as with Europe, we think the group could benefit from continued growth in the global economy in 2022, especially if demand for the region's commodities and exports rise. Already, emerging market value stocks have outperformed growth peers for four consecutive quarters, and that momentum could continue.[10] In particular, Southeast Asia could see a sharp rebound as factories get back online and if local governments adopt less draconian measures to manage COVID cases. China's outlook is more complex in light of ongoing policy changes and may require a tactical approach in the near term.

Price makers and innovators

With input costs and wages rising and supply and labor constraints limiting production, companies are having to find efficiencies. Those that do so successfully should be better positioned to preserve and grow their bottom line – and justify a higher stock valuation. These firms could also set themselves up for improved long-term returns.

For example, spending on technology that enables hyperautomation – which helps companies identify and automate processes – is forecast to rise more than 10% in 2021 across the globe and more than 12% in 2022, according to research firm Gartner. And by 2024, firms that combine hyperautomation technologies with new processes could lower operational costs by 30%.[11] In addition, companies that have invested in building competitive brands and/or powerful network effects should be better able to pass on price increases.

In our view, such firms can be found throughout the economy – both those tied to the economic cycle and those with more secular growth drivers – and will likely be a key component of equity returns regardless of what comes next in 2022. Indeed, value-oriented stocks may see periods of strength throughout this next phase of the recovery. But in the long term, we believe innovation will remain a primary driver of growth, with innovative companies potentially compounding free cash flows at a rate faster than markets – and inflation – can keep up with.

[1] National Bureau of Economic Research, as of 19 July 2021.
[2] Think Global Health, "Vietnam Ends "Zero-COVID"—Is It Too Soon?" 14 October 2021.
[3] Bureau of Economic Analysis, advanced estimate, as of 28 October 2021. Real GDP measures the rate of economic growth adjusted for inflation.
[4] SPG Global Ratings, "Economic Outlook Europe Q4 2021: A Faster-Than-Expected Liftoff," 23 September 2021.
[5] SPG Global Ratings, "Economic Outlook Europe Q4 2021: A Faster-Than-Expected Liftoff," 23 September 2021.
[6] U.S. Department of Treasury, as of 5 November 2021.
[7] Bloomberg, as of 5 November 2021. The MSCI World Value Index and the MSCI World Growth Index capture large- and mid-cap securities exhibiting value and growth style characteristics, respectively, across 23 developed-market countries.
[8] SPG Global Ratings, "Economic Outlook Europe Q4 2021: A Faster-Than-Expected Liftoff," 23 September 2021.
[9] Bloomberg. From 30 June 2021 to 05 November 2021, the MSCI Emerging Markets Index delivered a total return of -7.12%.
[10] Bloomberg. Data based on returns for the MSCI Emerging Markets Value Net Total Return Index and the MSCI Emerging Markets Growth Net Total Return Index from 30 September 2020 to 30 September 2021.
[11] Gartner, "Gartner Forecasts Worldwide Hyperautomation-Enabling Software Market to Reach Nearly $600 Billion by 2022," April 2021.

How should investors prepare for 2022? The Janus Henderson Market GPS Investment Outlook helps set the course with a video summary, three focused outlooks and our portfolio managers' views on what to expect in the year ahead.

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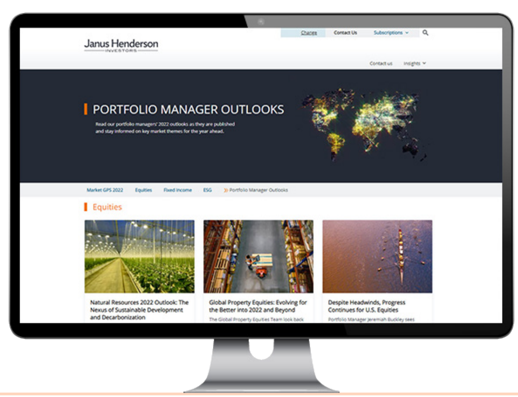

Glossary

Bear market: A financial market in which the prices of securities are falling. A generally accepted definition is a fall of 20% or more in an index over at least a two-month period.

Cyclical sectors: Sectors comprised of companies that sell discretionary consumer items, such as cars, or industries highly sensitive to changes in the economy, such as miners. The prices of equities issued by cyclical companies tend to be strongly affected by ups and downs in the overall economy, when compared to non-cyclical companies.

Disinflationary: Contributing to a decrease in the rate of inflation.

Fiscal policy/fiscal stimulus: Government policy relating to setting tax rates and spending levels. It is separate from monetary policy, which is typically set by a central bank. Fiscal austerity refers to raising taxes and/or cutting spending in an attempt to reduce government debt. Fiscal expansion (or 'stimulus') refers to an increase in government spending and/or a reduction in taxes.

Gross domestic product: The value of all finished goods and services produced by a country, within a specific time period (usually quarterly or annually). It is usually expressed as a percentage comparison to a previous time period, and is a broad measure of a country's overall economic activity.

Inflation: The rate at which the prices of goods and services are rising in an economy. The CPI and RPI are two common measures. The opposite of deflation.

Monetary policy/monetary stimulus/monetary tightening: The policies of a central bank, aimed at influencing the level of inflation and growth in an economy. It includes controlling interest rates and the supply of money. Monetary stimulus refers to a central bank increasing the supply of money and lowering borrowing costs. Monetary tightening refers to central bank activity aimed at curbing inflation and slowing down growth in the economy by raising interest rates and reducing the supply of money.

Price-to-earnings: A popular ratio used to value a company's shares. It is calculated by dividing the current share price by its earnings per share. In general, a high P/E ratio indicates that investors expect strong earnings growth in the future, although a (temporary) collapse in earnings can also lead to a high P/E ratio.

Secular growth: Strong growth potential driven by long-term investment themes or fundamental change within a sector or industry.

Stock multiples: a generic term for various indicators that can be used to value a stock.

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Price-to-Earnings (P/E) Ratio measures share price compared to earnings per share for a stock or stocks in a portfolio.

S&P 500® Index reflects U.S. large-cap equity performance and represents broad U.S. equity market performance.

MSCI World Growth Index℠ reflects the performance of growth stocks from global developed markets

MSCI World Value Index℠ reflects the performance of large and mid cap equity securities exhibiting value style characteristics across global developed markets.

MSCI Europe Index℠ reflects the equity market performance of developed markets in Europe.

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