BRIDGES TRUST

MARKET COMMENTARY

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2022: LESS OF A SURE THING.

"It's tough to make predictions, especially about the future."

Yogi Berra

When you've been providing investment advice for as long as we have (76 years at last count), it's hard not to approach the future with a healthy dose of humility. While sell-side strategists blithely forecast the return of the S&P 500 to the decimal point, we prefer a broader brush when evaluating the opportunity set for our clients' capital.

Human nature being what it is, we understand why predictions make headlines. False precision can be comforting when one is confronted with uncertainty. But in our experience, the more specific a forecast, the shorter its shelf-life.

That being said, we work in an industry that measures itself in years, and when closing the books on one, it's customary to look to the next. While the future is always unknown, the outlook for 2022 seems unusually uncertain. Sell-side strategists (a breed known for their willingness to cluster), can't seem to agree on their outlook and have produced a range of price targets for the S&P 500 that is uncommonly wide[1]. Also absent is their persistent optimism. Among one recent sample, the best-case scenario was a year in which the S&P 500 appreciates 11%[2].

Of course, skepticism and variety of opinion aren't necessarily bad things. In fact, you can't have a market without them. But there are a number of headwinds confronting equity markets in 2022, many of which were tailwinds in 2020 and 2021. After three years where the S&P averaged a 26% total return[3], you don't need an advanced degree in statistics to forecast some mean reversion.

Where most do agree is that 2022 is unlikely to be as tranquil as 2021. This past year saw the S&P hit 70 all-time highs[4] with just one pull-back greater than 5%[5]. If you offered the average investor a choice between 'more volatility' and 'less volatility,' many would opt for the latter. A steadily rising market just 'feels better' and can lull the unsuspecting into complacency and increased risk tolerance.

But as our long-term clients know, volatility often presents opportunity and the chance to enhance prospective returns. Buying opportunities were scarce in 2021 and we suspect 2022 may look different. For starters, earnings growth will be less of a sure thing. After lapping a lockdown-suppressed 2020, fundamentals in 2021 were likely to be exceptional and did not disappoint. While companies have yet to report fourth quarter earnings, FactSet currently forecasts S&P 500 earnings growth of 45% for 2021[6]. Their outlook for 2022 is a much more pedestrian 9.2%[7].

A slowdown in earnings growth isn't by itself cause for alarm and 9% would be nothing to sneeze at, but the market's primary concern (and ours) is tighter monetary policy and a resulting increase in the cost of capital. We've previously discussed the negative consequences of interest rate suppression which can include inflation, excessive risk-taking and the potential for asset bubbles. Inflation was recently north of 6%[8], signs of speculation are rampant and housing prices are up almost 20% year over year[9]. None of these data points is consistent with a ten-year treasury yielding 1.5%[10]. The Fed realizes this, which leaves them the unenviable task of raising rates, unwinding their bond buying program and engineering a soft-landing. Not that it can't be done, but we'd be surprised if it were easy.

Slowing growth and rising interest rates aren't insurmountable but there's also a global pandemic that stubbornly refuses to go away. While the omicron variant appears to have milder symptoms than delta, it's also far more transmissible, and the US saw over 1,000,000 new cases on January 3rd, setting a new record[11]. The nationwide appetite for another lockdown seems low, but millions of people missing work risks further exacerbating an already stressed labor market and supply chain.

These three factors combined: growth slowdown, rising rates and the risk of further pandemic disruption leads us to anticipate more volatility in equity markets in 2022. Volatility isn't a bad thing, in fact, it often presents opportunities to buy exceptional businesses at a discount. But the equity markets have been extremely calm for the past three years, returns have been exceptional and we'd be very surprised if this continued. Consequently, we're approaching equity markets in 2022 with equal parts vigilance and opportunism. The 'everything rally' seems unlikely to continue. The good news is our strategy of buying exceptional businesses at reasonable valuations isn't one that requires a steadily rising market to work. We're more than willing to go back to making money the old-fashioned way, by picking our spots, assessing risk and deftly allocating your capital.

We hope you and your family are in good health, thank you for your continued support and as always, if you have any questions, please don't hesitate to reach out to your Relationship Manager.

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Sources: 1-Wang, L. Wall Street Strategist Forecasts for 2022 Differ by Second-Most in a Decade (12/8/21). Bloomberg L.P. 2-2022 US market outlook (12/15/21). FactSet. 3-S&P 500 Total Returns by Year (12/29/21). slickcharts.com. 4-Imbert, F. & Miao, H. S&P 500 posts 70th record close…(12.28.21). CNBC. 5-Sonenshine, J. The S&P 500 Went 227 Days Without a 5% Drop (9/30/21). Barron's. 6&7-Butters, J. S&P 500 CY 2021 Earnings Preview… (12/17/21). FactSet. 8-Smialek, J. Fastest Inflation in 31 Years Puts More Heat on Washington (11/14/21). The New York Times. 9-US National Home Price Index (10/21). Federal Reserve Economic Data. 10–10 Year Treasury Yield (12/17/21). FactSet. 11-Covid in the U.S… (1/3/22). The New York Times.

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