Commonwealth

2022 Midyear Market and Economic Outlook

Moving into the second half of the year, prospects remain good. But some economic indicators appear to be slowing down. Consumer confidence has pulled back on rising gas prices, and the housing market has slowed notably. Still, we believe the economy has enough momentum to keep growing into 2023.

As the Federal Reserve (Fed) gets closer to ending this cycle of tightening monetary policy, interest rates should stabilize—and may come down. With oil prices high, U.S. production may increase, which could bring prices down. Other global headwinds, such as Russia's war on Ukraine and the ongoing supply chain problems, could improve. Overall, some of the existing economic headwinds might abate, resulting in faster growth.

None of these outcomes are guaranteed. Nonetheless, despite the worries causing the economy and markets to respond, the prospects ahead are more evenly balanced than the headlines would suggest. So, while the risks are real, we remain cautiously optimistic for the rest of the year.

The data below highlights our forecast for the rest of 2022. As we weigh the impact of the big four economic drivers, we expect continued economic growth, which should support the financial markets' recovery from the current environment.

The Big 4 Economic Drivers

1 Consumers

The consumer remains the engine that keeps the economy going. Strong job and wage growth in Q1 and Q2 have given workers the ability to spend. Consumer confidence is higher than it was in 2015–2016, when the economy seemed near recession, and well above rates during the height of the pandemic. Although there are risks that job growth may slow, it's currently poised to keep going up through year-end, continuing to drive consumer confidence and spending.

New Jobs
500K
monthly average

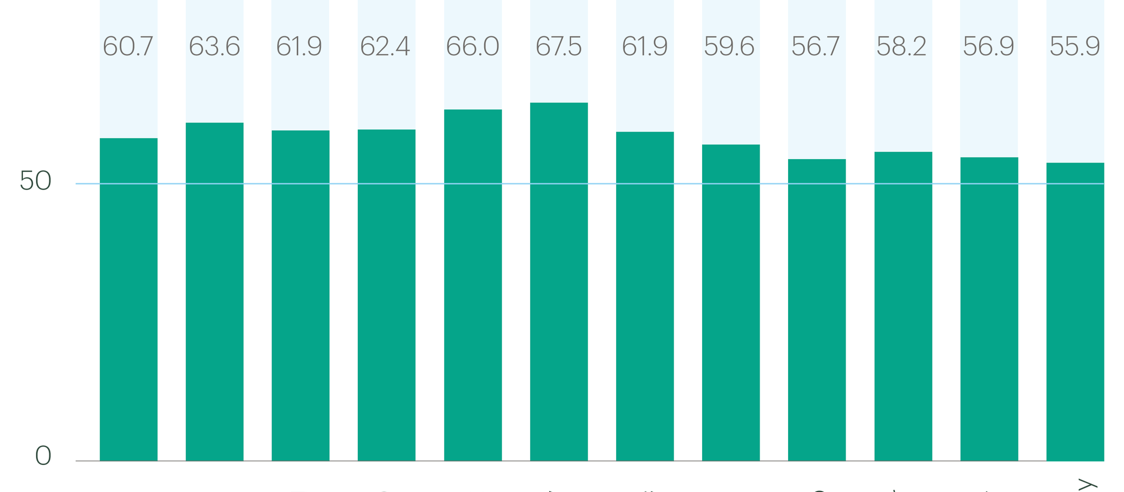
Wage Growth
5.25%
up from 4% in late 2021

Consumer Spending Growth
10%
per year, holding steady
Up from 3%–5% pre-pandemic

2 Business

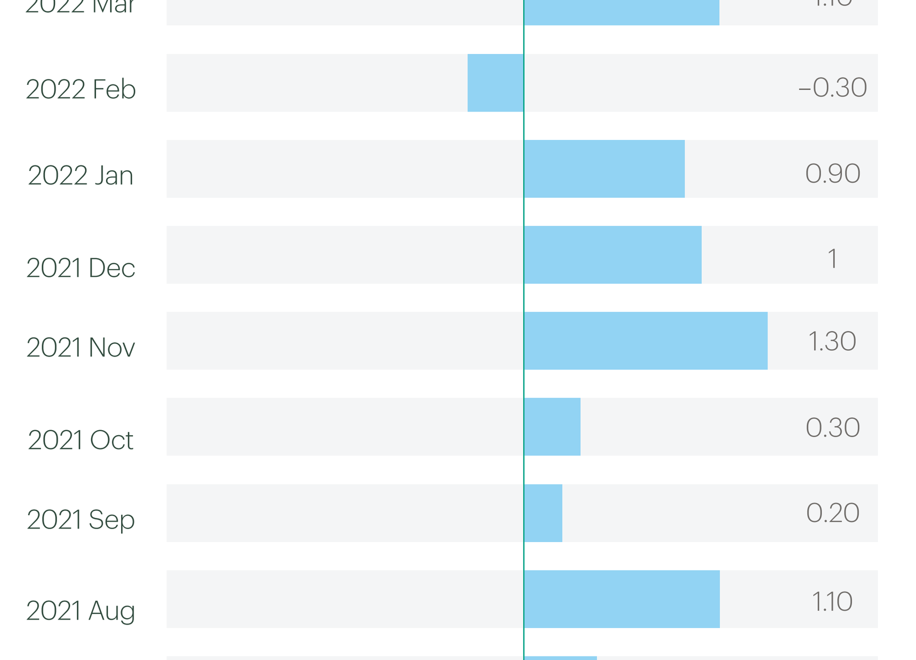
With consumers spending, businesses are eager to do what's necessary to increase sales. Companies are hiring as many workers as possible. To fill hiring gaps, they're also investing in equipment or technology to make current workers more productive. These trends may slow down, but, overall, business expansion should continue through the second half.

Business Confidence Down from Peak but Still Strong
Composite Index, >50=Expansionary



Source: Institute for Supply Management

Business Investment Humming Along
Core Durable Goods Orders Growth



Source: U.S. Census Bureau

3 Government

Since the start of the new year, government policy has switched from an economic tailwind to a strong headwind. This pivot reduced federal deficit spending, taking down pandemic-related fiscal stimulus measures. And the Fed's rate hikes have placed an additional drag on economic growth.

Federal Funds Rate
YTD (June 2022)

UP 150
basis points (bps)

Projected Range at Year-End
Fed funds rate

3.25% ⟷ 3.5%

4 Trade

Serving as another significant headwind, the U.S. international trade deficit widened to a record $109.8 billion in March 2022. Throughout the first quarter of 2022, strong demand in the U.S. pushed imports up, while slower economic growth elsewhere in the world kept exports weaker.

Q1 Imports/Exports

7.59%
Imports

2.84%
Exports

Q1 Trade Deficit

–3.2%
Hit to annual GDP growth

Financial Markets

Equities

Tech P/E Ratio Near Historical Averages
18.32x
Forward P/E ratio as of 6/16/22

U.S. equities. In the U.S. equity space, value stocks have outperformed growth stocks so far this year. While rising interest rates should continue to provide a tailwind for value stocks, the data also supports a positive outlook for growth stocks. Price/earnings (P/E) multiples have become more attractive in certain growth sectors, including technology and consumer discretionary. This year saw a substantial drop in the forward P/E ratio for technology.

MSCI ACWI ex USA Index as of 6/16/22
12.2x
Trailing P/E ratio, below 20-year average of 13.2

International equities. In 2022, the global economic recovery has not matched the rebound in the U.S. due to inflation, supply chain disruptions, slowing growth in China, and higher geopolitical risk related to the ongoing crisis in Ukraine. Rising prices for oil and natural gas have also dampened the global outlook. And the recent strength of the U.S. dollar has hindered the attractiveness of international stocks.

Overall, the long-term case for international equities is mildly positive, as dropping P/E ratios have resulted in relatively favorable valuations. The MSCI ACWI ex USA Index is a case in point.

Fixed Income

The first half of 2022 was possibly the most challenging environment ever for fixed income investors. In response to the Fed's interest rate hikes, yields surged higher across the maturity curve, suppressing prices for existing bonds. As a result, the 10-year U.S. Treasury yield surged close to 3.5 percent in June—its highest level since 2011.

Short-term rates
The Fed is expected to keep raising short-term rates to combat inflation.

Inflation
The Fed's chances for success in combating inflation look reasonable.

Long-term rates
If rising prices are checked, long-term rates should remain steady in Q3 and Q4.

Fixed income
Taking a longer duration bias for fixed income may be supported, particularly if inflation moderates.

We believe a fully diversified fixed income portfolio should continue to suit investors over the long term. Accordingly, we caution against eliminating interest rate exposure.

In the Spotlight: Energy

After a banner year for energy demand in 2021, global inventories for crude oil and natural gas were low heading into 2022. The year has seen strong global demand pressured by limited reserve capacity among the top energy producers, notably the U.S., OPEC, and Russia. Following Russia's invasion of Ukraine, oil and natural gas prices spiked. They subsequently eased due to news of Covid-19 lockdowns in China, which lowered demand forecasts, and the sizable releases of strategic oil reserves from the U.S. and other countries, only to spike again in mid-June.

In the second half of 2022, moderate production growth from the U.S. and OPEC is expected.

Oil Production in Q3 and Q4*

United States	OPEC
11.9M Average barrels/day in U.S.	~400K Monthly increases of barrels/day by OPEC

*Source: U.S. Energy Information Administration

Despite these increases, energy prices are expected to remain elevated. Meanwhile, the global transition to renewable energy is a megatrend that bears watching in the latter half of 2022 and beyond.

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