

LPL RESEARCH PRESENTS

# outlook

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## PASSING THE BATON

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# Passing the Baton

## INTRODUCTION

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Our resurgent economy grew at over a 6% pace in the first half of the year and is on track for over 5% growth for the year when 2021 draws to a close. The current economic recovery, which started in May 2020, has benefited from widespread vaccine availability and additional fiscal stimulus.

While the economy continues to move forward, we're still feeling the aftershocks of the COVID-19 Delta variant, whether through elevated inflation, supply chain bottlenecks, or an imbalanced labor market. But 2021 also saw positives beyond economic growth, with schools opening their doors and extended family gathering around many Thanksgiving tables, activities that were far less common in 2020. At the same time, the S&P 500 Index continued to advance as corporate America faced this generational challenge with resiliency and saw earnings growth that surprised even the most optimistic pundits.

The recovery has been a testament to our ability to manipulate our world. Scientists developed several vaccines extraordinarily quickly. Central banks and policymakers found ways to insert themselves into the complex network of economic relationships to help bridge the worst of the economic crisis. But the same scale that multiplies our control of the world can

also multiply potential mistakes and make robust, complex systems more fragile. We've had a hand up that has helped us through a period of unique economic challenges. In 2022, the economy may be ready for a handoff, back to a greater emphasis on the individual choices of households and businesses. How smoothly that handoff is executed may determine the course of the recovery.

On a smaller scale, for many of us, those individual relationships that always sustain us have been that much more vital over the last two years. We managed to stay connected with friends and family. Found new ways to work together with our colleagues. And relied on our relationships with skilled professionals to navigate difficult decisions. Sound financial advice in particular has helped guide many through this period of uncertainty. LPL Research's *Outlook 2022: Passing the Baton* is here to provide insight and analysis for the next set of challenges the economy and markets may face. But for any investor, making progress toward your financial goals will continue to take a steady hand and a good plan. Please reach out to your financial professional for guidance on how to stay on track as we progress through 2022.



## Economy

As the U.S. economy moves more to mid-cycle, our 2022 forecast is for 4.0–4.5% gross domestic product (GDP) growth in 2022. Fiscal and monetary policies played big roles in the economic recovery in 2021, but we see 2022 playing out as a handoff—from stimulus bridging a pandemic recovery to an economy growing firmly on its own, with consumers, productivity, small businesses, and capital investments all playing a part in the next stage of economic growth.

As we move past COVID-19 globally, Europe and Japan could be ripe for potentially better economic growth in 2022. Meanwhile, emerging market economies may disappoint as growth in China could be constrained by regulatory crackdowns.



## Inflation

2021 was the year nearly everything was in a shortage, and it all translated to added inflationary pressures. Record numbers of ships waiting at ports, a lack of materials, unfilled job openings, higher commodity prices, and a myriad of supply chain disruptions have added to price pressures. While we believe these pressures will steadily decrease over the next year and we will eventually settle back to 2–2.5% inflation, it will likely be a gradual process.



## Stocks

We expect solid economic and earnings growth in 2022 to help U.S. stocks deliver additional gains next year. If we are approaching—or are already in—the middle of an economic cycle with at least a few more years left (our view), then we believe the chances of another good year for stocks in 2022 are quite high. A double-digit percentage increase in S&P 500 earnings per share (EPS) in 2022 is possible, but COVID-19-related supply chain issues, combined with materials and labor shortages, could lead to higher costs and constrain profit margins. We believe the S&P 500 could be fairly valued at 5,000–5,100 at the end of 2022, based on an EPS estimate of \$235 and an index P/E between 21 and 21.5. We favor U.S. over developed international, value over growth, and cyclical sectors over defensives.



## Commodities

One of the more surprising things about 2021 was that it saw both commodities and the U.S. dollar advance significantly. We don't expect this same dynamic to continue into 2022. We remain positive on industrial metals like copper and expect continued gains. Our precious metals view is neutral, and we see limited near-term upside for oil prices after such a strong rally along with rising risk of increased supply.



## Bonds

We expect interest rates to move modestly higher in 2022 based on near-term inflation expectations above historical trends and improving growth expectations once the impact of the COVID-19 Delta variant recedes. Our year-end 2022 forecast for the 10-year Treasury yield is 1.75–2.00%. However, an aging global demographic that needs income, higher global debt levels, and an ongoing bull market in equities may keep interest rates from going much higher over the next year. Nonetheless, with starting yields still low by historical standards, returns are likely to be flat to the low single digits in 2022. With credit spreads as low as they've been in years, we remain neutral on investment-grade corporate credit. We think equities continue to offer better return potential than high-yield bonds, while bank loans may make sense for appropriate income-oriented investors willing to take on more risk.



## Alternative Investments

With bond yields low and prospects of modestly rising rates, it may be an appropriate time to check back in with alternative investments, especially those that have historically acted as a way to diversify interest rate-related fixed income risk without simply acting like stocks. These strategies include global macro, multi-strategy, equity market neutral, and our preferred solution—event driven.

# The U.S. economy

**bounced back from its worst year since the Great Depression in 2020 with one of the best years of growth in nearly 40 years in 2021.**



A combination of record stimulus, a healthy consumer, an accommodative Federal Reserve (Fed), vaccinations, and reopening of businesses all contributed to a big year in 2021. In what amounted to the shortest recession on record, only two months in March and April 2020, the economy

came roaring back to produce what is currently expected to be over 5% GDP growth in 2021, more than making up for the 3.4% drop in GDP in 2020. Of course, there have been hiccups along the way. You can't shut down a \$20 trillion economy and then expect it to get going again without warming up

first. Supply chain backlogs, materials and labor shortages, and higher prices all held the economy back to varying degrees. The good news is, demand is still very strong, and as the backlogs unwind (which could take years in some cases), we expect above-trend economic growth and see low risk of a recession in 2022.

With various measures of output matching or exceeding pre-pandemic levels, it's clear last year's recession is in the rearview mirror, and it may go down as the shortest one in history—even shorter than the six-month recession from the early 1980s.

As the U.S. economy moves more to mid-cycle our 2022 forecast is for 4.0–4.5% GDP growth in 2022 [Fig.1]. While a slowdown from 2021, it's still a very solid number. We expect inflation to tame from 2021 levels to a little above 3.0% with core inflation numbers lower, a step in the right direction, although it may still be on an upward trajectory the early part of the year.

Globally, Europe and Japan were hit especially hard by the pandemic in 2021. But as COVID-19 cases potentially fall globally, those areas could be ripe for better economic growth in 2022. Meanwhile, emerging

## Continued strong growth expected for U.S.

GROWTH FORECASTS	2021	2022
United States	5.5%	4.0 – 4.5%
Developed ex-U.S.	4.6%	3.5 – 4.0%
Emerging Markets	6.4%	4.75 – 5.25%
Global	5.7%	4.25 – 4.75%

## Inflation is expected to calm down

U.S. ECONOMIC FORECASTS	2021	2022
Inflation (YoY%)	4.5%	3.7%
Unemployment (end of year)	5.4%	4.0%
10-Year Treasury Yield	1.5 – 1.75%	1.75 – 2.0%

Source: LPL Research, Bloomberg 11/22/21. Economic Forecasts may not develop as predicted and are subject to change. 2022 GDP forecasts for all regions and the 10-year Treasury yield forecasts provided by LPL Research. All other forecasts are the Bloomberg-surveyed economists' consensus as of 11/22/21. Inflation measured by the Consumer Price Index (CPI).

*You have to give the U.S. consumer credit for continuing to drive the economy forward, and 2022 shouldn't change that.*



market economies may disappoint as growth in China could be constrained by regulatory crackdowns.

### KEYS TO THE HANDOFF

Fiscal and monetary policies played big roles in the economic recovery in 2021, but we see 2022 playing out as a handoff—from stimulus bridging a pandemic recovery to an economy growing firmly on its own, with consumers, productivity, small businesses, and capital investment all playing parts in the next stage of economic growth.

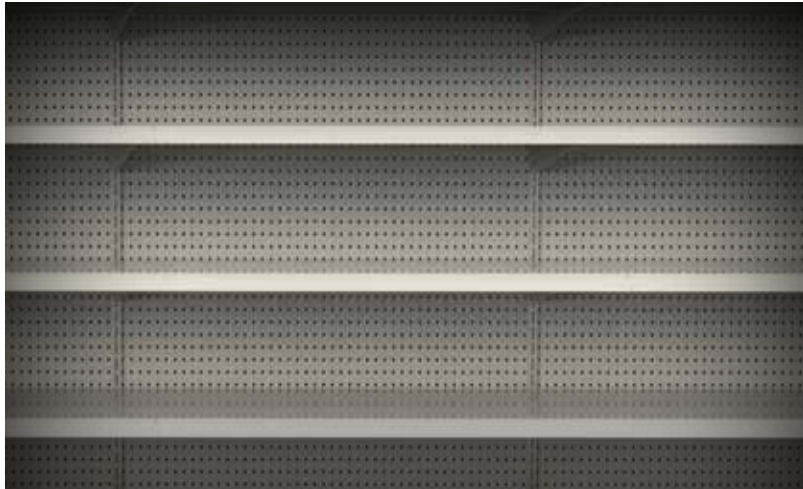
You have to give the U.S. consumer credit for continuing to drive the economy forward, and 2022 shouldn't change that. Don't forget, it took retail sales only five months to get back to pre-COVID-19 levels after the lockdowns in March and April 2020. Bottlenecks and the Delta variant surge have done little to slow an eager consumer. With likely still low interest

rates, increased equity in people's homes, nearly \$3 trillion in money markets (retail and institutional), and another \$3.5 trillion in excess liquidity in bank accounts, the consumer should remain quite healthy in 2022.

Like every other time in history, those who adapt will survive. Businesses have already started to adapt to the new world, which may help productivity increase in 2022, as efficiency gains flow through to economic output. Productivity allows for stronger growth and can help contain inflation, since more goods and services are produced. The 1970s was known as a time of high inflation, but it was also a time of very low productivity—fortunately a scenario we don't see happening this time around.

Another key to the economic transition may be capital expenditures (capex). These include business investment in property, plants,

buildings, technology, and equipment. These investments could boost overall productivity and overall output, but might take time to build, so the results could be years away in some cases. Additional capex spending would be one of the best ways to see if corporate America is indeed over the shock of the pandemic and ready to invest for future growth opportunities. Standard and Poor's data shows capital expenditures are expected to have grown an impressive 13% in 2021 and likely even more in 2022. In fact, the capex rebound in this recovery has already been faster than previous downturns, with plenty of room to go in our view. And it isn't just a U.S. theme, as 2021 was likely the best year for European capex since 2006, and the global chip shortage has led to major investments in Japan and South Korea as well.



**THE EVERYTHING SHORTAGE**

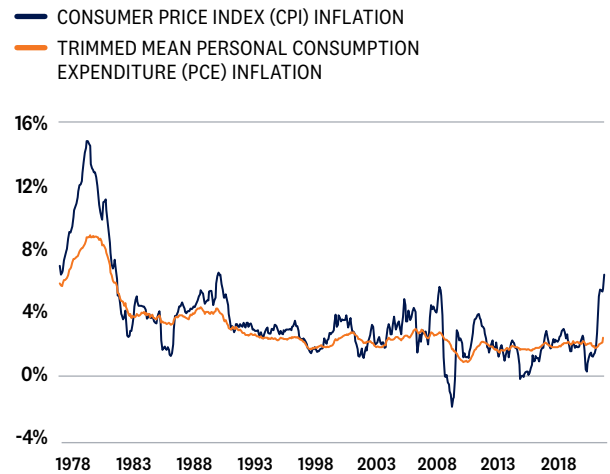
2021 was the year nearly everything was in a shortage, and it all translated to added inflationary pressure. Record numbers of ships waiting at ports, a lack of materials, unfilled job openings, higher commodity prices, a lack of truck drivers, major backlogs, and supply chain disruptions all added to the larger price increases seen essentially across the board in 2021.

While we do believe these pressures will steadily decrease over the next year and inflation will eventually settle back to 2-2.5%, it will likely be a gradual process. Inflation remains near its historic run

rate after removing the most volatile, pandemic-influenced prices [Fig.2]. This more stable measure of inflation has historically tended to pull broader readings of inflation towards it over time. Still, supply chains may take a year or two to be fully addressed, depending on the product and the scale of the problem. Despite challenges around supply chains, hiring, and prices, if the demand is there it should help drive continued improvement as businesses adapt to address challenges. That is likely to leave us with a positive economic backdrop for at least 2022, and maybe much longer, despite current inflation levels.



**Inflation tends to align with more stable price changes over time**



CPI and PCE inflation are both measures of consumer inflation. CPI is the more well known measure while PCE is the Federal Reserve's preferred measure.

Source: LPL Research, U.S. Bureau of Labor Statistics, Federal Reserve Bank of Dallas 11/22/21

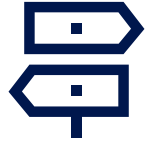


**How much time is left?**

Let's face it, this wasn't your average recession. Some industries actually did better during the pandemic, while segments of other industries were severely constrained. Spending patterns shifted. Stimulus was delivered quickly on a massive scale. How strange did that make it? This was the first recession in history that saw FICO scores go up. Recessions are necessary to wash out the excesses, but some imbalances weren't worked off this time around. For this reason, we think this economic expansion could be mid-cycle much sooner and likely won't be as long as the record 10 years we saw last cycle. The average expansion since World War II has been just over five years, suggesting there are still potentially several years of growth remaining, especially since we don't see typical recessionary warning signals right now. Far from it, we anticipate above-trend growth in 2022. But we'll be on watch early.



# Check back in with alternative investments



With bond yields low and prospects of modestly rising rates, it may be an appropriate time to check back in with alternative investment strategies (alts), especially those that have historically acted as a way to diversify interest rate-related fixed income risk without simply adding stock-like exposure. These strategies include global macro, multi-strategy, equity market neutral, and our preferred solution—event driven. While these strategies all have their own characteristics, they’ve historically provided a risk/return profile similar to that of core fixed income, while having limited exposure to equity market movement. In contrast to core fixed income allocations, which struggle to play their traditional defensive role during periods of rising rates, these strategies may help protect portfolios in the current environment and act as a source of ballast.

Event-driven strategies generally seek to profit from the outcome of specific corporate transactions such as mergers and acquisitions, significant changes in capital structure, spin-offs, or even bankruptcies. There are three main macroeconomic tailwinds that may help support event-driven strategies in 2022: high corporate cash balances, low borrowing rates, and the private equity industry’s dry powder. Of late, these tailwinds have helped drive merger and acquisition volume to near all-time highs. A robust deal flow environment like this allows event-driven strategies to be more selective in choosing underlying transactions and also moderates position crowding within the industry. Risks associated with event-driven strategies include the negative price impact from transactions failing, regulatory risk, and the potential impact of changes in the tax landscape.

# Commodities and currencies may fall out of sync



One surprise in 2021 was that it saw both commodities and the U.S. dollar advance significantly. Typically, commodities and the dollar move in opposite directions, and commodities’ ability to climb higher—despite the dollar headwind—highlights the strength of their move in our view. While we don’t expect this same dynamic to continue into 2022, we remain positive on industrial metals like copper and expect continued gains.

However, we are more neutral on precious metals like gold and silver, which have stagnated over the past year and would likely be hurt by rising real (inflation-adjusted) interest rates. The near-term technical trend of the dollar is positive, but we see less upside than in 2021, and 2022 may be a year of muted dollar movement. Higher interest rates in the U.S. than other major developed economies may continue to drive dollar flows, but that may potentially be offset by the longer-term negative impact of the trade deficit and expanding government debt levels.

Finally, oil prices surged significantly in the past year, pushing above \$80/barrel for the first time since 2014. We see limited near-term upside for oil prices after such a strong rally along with rising risk of increased supply.

We expect solid economic and earnings growth to help

# stocks deliver gains in 2022.



When forecasting stock market performance, we start with the economic cycle. We believe we are currently approaching—or are already in—the middle of an economic cycle with at least a few more years left. Historically, if this holds true, then we believe the chances of another good year for stocks are quite high, which is an important added factor for our positive outlook for stocks in 2022 [Fig.3].

## THE MID-CYCLE PUSH

Looking more closely, in a mid-cycle economy, recession fears do not typically cause stocks to fall in a given year, nor do stocks typically surge as investors celebrate emerging from the prior recession. Over the past 60 years, the S&P 500 Index was up an average of 11.5% during the 30 mid-cycle years we identified, with gains in 80% of those years [Fig.4]. As you can see, stocks rose during

most of these mid-cycle years, with 1966 and 1977 the only two years with double-digit losses.

The Fed, which we expect to start raising interest rates in early 2023, can also help us gauge the cycle because the central bank typically begins to raise rates when the economy is exhibiting mid-cycle characteristics. That also characterizes 2022 as a likely mid-cycle year. Historically, stocks have



## Higher earnings support further gains for stocks

2022 U.S. MARKET FORECASTS	
S&P 500 Fair Value	5,000 – 5,100*
2022 S&P 500 Earnings per Share	\$220

\*Our year-end 2022 fair-value target range for the S&P 500 of 5,000-5,100 is based on a price-earnings (PE) ratio of 21 – 21.5 and our 2023 S&P 500 earnings per share (EPS) forecast of \$235.

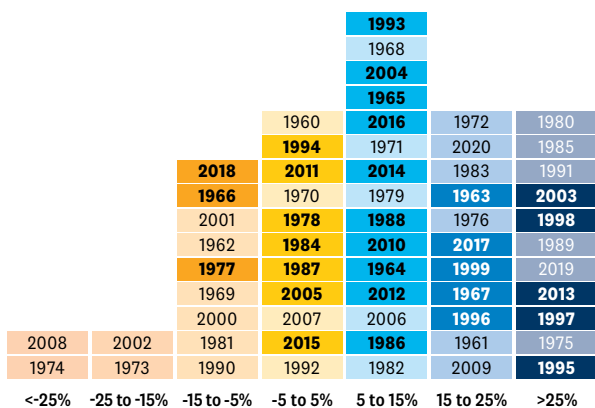
Source: LPL Research 11/22/21. All indexes are unmanaged and cannot be invested into directly. Economic forecasts may not develop as predicted.



# 4

## Mid-cycle economies tend to be good for stocks

ANNUAL S&P 500 GAINS/LOSSES EXCLUDING DIVIDENDS  
MID-CYCLE YEARS ARE HIGHLIGHTED



Source: LPL Research, FactSet 11/22/21. All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

done very well during the 12 months leading up to the Fed’s initial rate hike, with gains in each of the past nine instances and an average gain of 15% [Fig.5].

We expect stocks to follow this mid-cycle pattern and potentially deliver double-digit gains next year as the economy continues to expand at a solid pace.

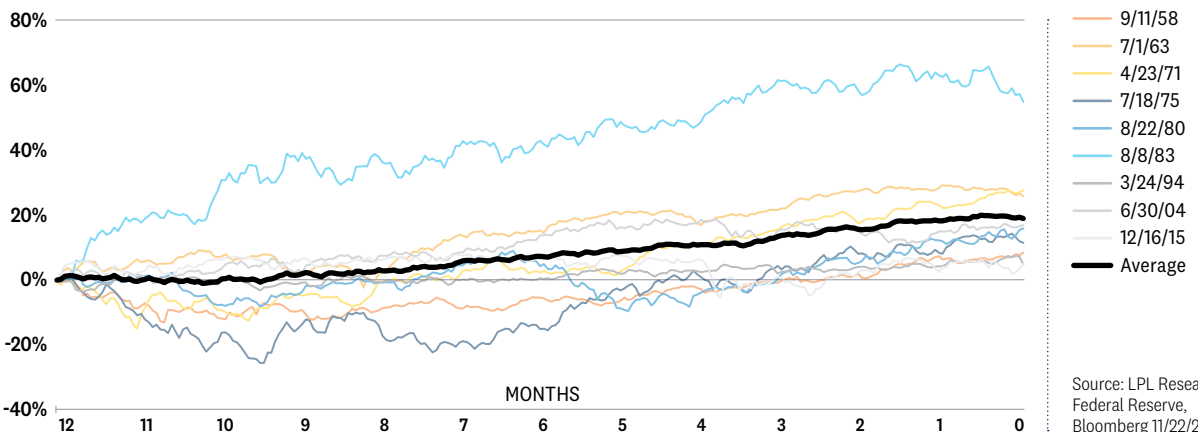
### EARNINGS ARE THE ANCHOR

An expanding economy is a great start, but stocks fundamentally derive their value from earnings. On

the top line, the environment for companies to grow revenue next year should be excellent, with potential for above-average economic growth and some pricing power from elevated inflation. Revenue growth has historically been well correlated to nominal GDP growth, which is simply real GDP growth (the inflation-adjusted number that’s normally reported) plus inflation. Our 4–4.5% real GDP growth forecast for next year plus perhaps 3% inflation (about the consensus forecast for the increase in the

# 5

## Stocks tend to rise the year before the first Fed rate hike



All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

Source: LPL Research, Federal Reserve, Bloomberg 11/22/21



*Is the S&P 500 Index knocking on the door of 5,000?*

Consumer Price Index) puts a 7% revenue increase in play.

With stable profit margins and increasing share buybacks likely next year, a double-digit percentage increase in S&P 500 earnings per share (EPS) is a possibility. But COVID-19-related supply chain issues and materials and labor shortages are risks that could lead to higher costs in 2022, weighing on profit margins. Many

companies warned of such pressures during third-quarter earnings season. As a result, we are forecasting slightly below-average S&P 500 earnings growth of 6% in 2022, which should result in earnings of \$220 per share [Fig.6]. Higher corporate taxes could eat into some of those earnings gains next year, though that may be widely anticipated and likely at least partly reflected in valuations.

# 6

## Earnings have experienced a post-pandemic surge

S&P 500 INDEX EARNINGS PER SHARE

2019	2020	2021 (est.)	2022 (est.)
\$163	\$140	\$205	\$220

Source: LPL Research, FactSet 11/22/2021  
Estimates may not materialize as predicted.

### VALUATIONS MAY NOT PROVIDE THE ASSIST

Forecasting a year ahead is tough enough, but predicting where stocks might be at the end of 2022 actually requires us to look ahead to 2023. The 2023 earnings outlook will determine where valuations are likely to be at the end of 2022.

Strong earnings gains in 2021 have prevented the price-to-earnings ratio (P/E) for the S&P 500 from going much above 20. In fact, stocks are actually more reasonably priced as 2022 approaches than they were at the start of 2021, because 2021 earnings are tracking more than 20% above the estimate when the year began. While a 21 P/E is above the long-term average of around 16, we believe still low interest rates justify current valuation levels. But P/E multiple expansion will likely be difficult if interest rates rise in 2022, potentially leaving earnings growth as the primary driver of any stock market gains.

### S&P 500 KNOCKING ON THE DOOR OF 5,000

5,000 on the S&P 500 will be a nice round number for investors to celebrate. But will that celebration take place in 2022 or later?

If we assume S&P 500 EPS growth improves in 2023 to around its long-term average at 8% (\$235 in EPS), while the P/E stays about where it is between 21 and 21.5, the S&P 500 could be fairly valued at 5,000–5,100 at the end of 2022. Note, however, that stocks can stay above (or below) fair value for an extended period of time due to market sentiment, so we would not necessarily view reaching that target as a sell trigger. If interest rates stay lower for longer and support P/E multiple expansion, stocks could potentially exceed this target by year-end 2022. But if profit margins face more intense pressure than anticipated, possibly from wages, earnings may have a hard time growing at all in 2022.

**THE RACE CONTINUES IN 2022**

Prospects for above-average economic growth and accompanying earnings gains in 2022 point to another potentially good year for stock investors. While the pandemic is not completely behind us and there are several other risks to watch, particularly inflation, stocks have historically done well in mid-cycle economies. We do not expect 2022 to be an exception.

# Equity asset allocation recommendations



## Market cap

We favor small and mid cap stocks over large caps as 2022 begins, but as the economic cycle matures, large caps may be better positioned and balanced exposure across the market cap spectrum relative to benchmarks may be more appropriate.



## Sector

We favor the cyclical value sectors, particularly financials and industrials, over the defensive value sectors such as consumer staples and utilities. We're neutral on the big technology-focused growth sectors for steady earnings and innovation. We find the real estate sector attractive for its rich yields, benefits of the economy reopening, and tendency to effectively manage inflation. Healthcare is attractively valued and a sector to watch.



## Style

We maintain a slight preference for value over growth to benefit from potentially above-trend economic growth in 2022. Rising interest rates and higher inflation are conditions that have historically been favorable to value-style stock performance.



## Region

We favor the U.S. over developed international markets (primarily Europe and Japan) as we enter 2022 because of the relatively healthier U.S. economic growth outlook and the strong U.S. dollar, but international equities may become increasingly attractive as COVID-19 restrictions are removed globally. Our emerging markets equities recommendation remains negative due to ongoing regulatory risks in China, which could slow earnings growth expectations while increasing uncertainty.

# Coming into 2021, we expected Treasury yields to move higher.



And they did. Higher inflation expectations, less involvement in the bond market by the Fed, and a record amount of Treasury issuance were all reasons we thought interest rates could end 2021 between 1.50% and 1.75%. For 2022, near-term inflation expectations above historical trends and improving growth expectations

once the Delta variant recedes are reasons why we believe interest rates could move moderately higher from current levels. In 2022, we expect the 10-year Treasury yield to end the year between 1.75% and 2.00%. However, an aging global demographic that needs income, higher global debt levels, and an ongoing bull market

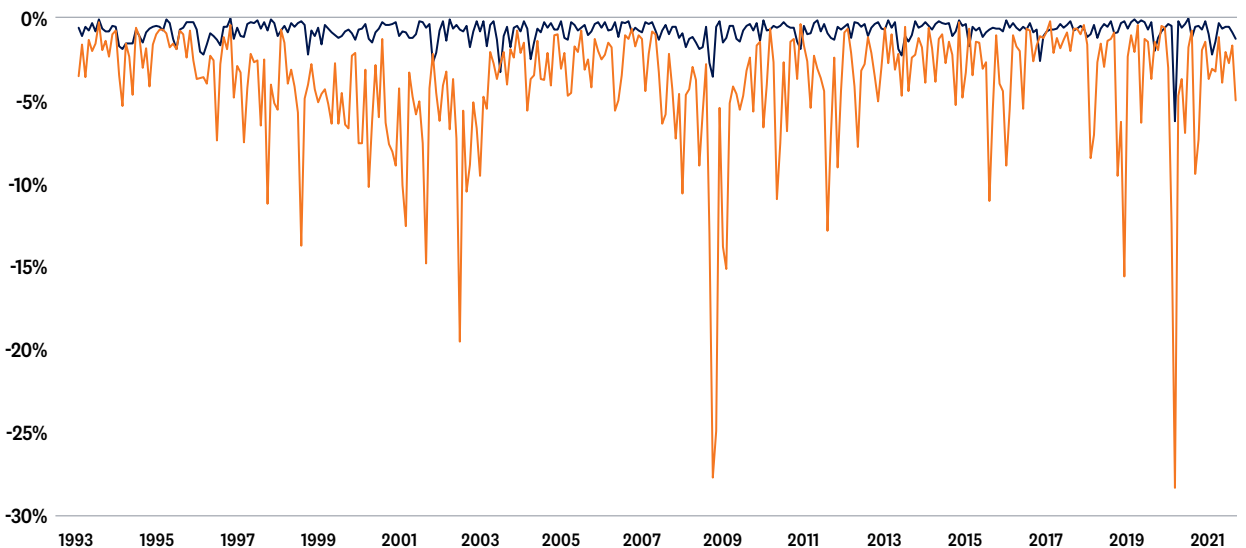
in equities (which potentially means more frequent rebalancing into fixed income) may keep interest rates from going much higher in 2022.

While we don't expect interest rates to move much higher next year, because starting yields for core fixed income are still low by historical standards, returns are likely to be



## Core fixed income provides stability to portfolios

MAXIMUM PERCENTAGE DRAWDOWN BY MONTH  
 — BLOOMBERG U.S. AGGREGATE INDEX  
 — S&P 500 INDEX



Source: LPL Research, Bloomberg, 11/22/21. All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

*With the economy likely transitioning to mid-cycle, the need for high-quality bonds increases in our view.*



flat to the low-single digits in 2022. Not a great year but we should see an improvement over the negative fixed income returns we have seen in 2021.

**THE ROLE OF FIXED INCOME**

With long-term interest rates close to what we think will be cycle highs, it's important to revisit the case for fixed income within a broader asset allocation. Core bonds have historically provided capital preservation, diversification, and liquidity to portfolios, which we think are important portfolio construction objectives and help clients remain committed to their investment goals. With the economy likely transitioning to mid-cycle, the need for high-quality bonds increases in our view. Moreover, the need to offset potential equity market volatility remains an important role for core fixed income.

Bonds, particularly core bonds, have been less volatile than stocks and have historically provided ballast to portfolios during equity market

drawdowns, which as we know, are normal occurrences from time to time. The maximum drawdown for bonds, in any given month, has been dramatically less severe than stocks [Fig.7]. While the worst drawdown in a month for equities was -28%, the worst bonds have done during a month was down 6%, and those losses were quickly reversed. So, when combined with equities, bonds help reduce total portfolio volatility, which makes for a smoother investment experience for clients.

**WHAT'S NEXT FOR CREDIT?**

As interest rates increased during 2021, investment-grade corporate debt was negatively impacted as the sector, perhaps surprisingly, is among the most interest rate sensitive fixed income asset classes. U.S. high-yield investors, however, were rewarded for owning riskier debt. During the year, credit risk was rewarded as opposed to interest rate risk. As the economy transitions into mid-cycle, credit



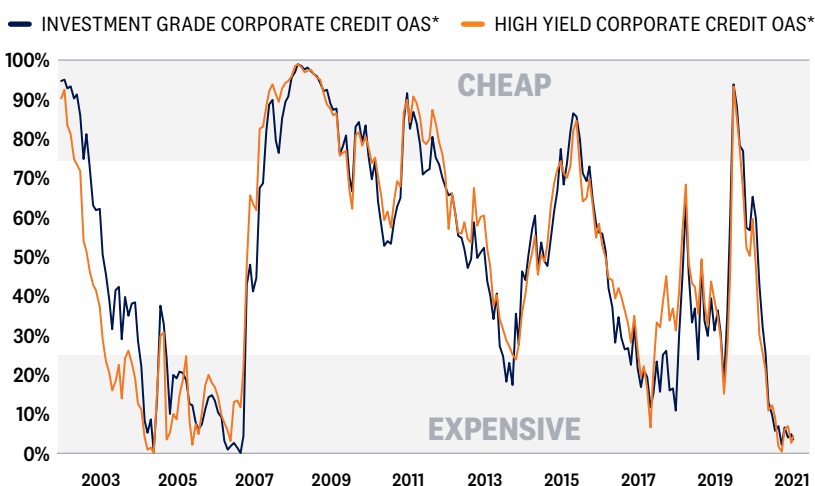
**The Federal Reserve**

**WILL FED TAPERING LEAD TO A FASTER INCREASE IN INTEREST RATES?**

We expect the Fed to taper asset purchases through mid-2022. Given how well the Fed has communicated its plans, we do not expect a sharp rise in rates (nor a sell-off in Treasuries or mortgage-backed securities). However, we do expect rates to move gradually higher. If Treasury yields rise, investors may then want to reevaluate portfolio positioning. At higher rate levels, we would consider starting to incrementally reduce underweights to Treasury securities and adding back some interest-rate sensitivity to bond portfolios.

## 8

## Corporate credit markets are expensive relative to history



Source:  
LPL Research,  
Bloomberg, 11/22/21.  
All indexes are  
unmanaged and  
cannot be invested  
into directly. Past  
performance is no  
guarantee of future  
results.

\*Option-adjusted spread

investors need to be more cognizant of downside risks. While the economy should still be conducive to credit risk and corporate balance sheets generally remain in good shape, credit spreads are among the lowest they've been in years, which means compensation for the added risk of corporates is low.

Both investment-grade corporate credit spreads and high-yield credit spreads are in the bottom 5% compared to history, which means valuations have been cheaper 95% of the time over the past 20 years [Fig. 8]. Corporate credit markets, both investment grade and high yield, are currently priced near perfection, so any unforeseen event—either

related to the economy or at the corporate level—could negatively impact credit markets. We remain neutral on investment-grade corporate credit, but we think equities continue to offer better upside return potential than high-yield bonds, where we remain underweight. For income-oriented investors willing to take on more risk, we think bank loans still make sense, where appropriate.

### THE FED TAKES A STEP BACK

Since March 2020, the Fed has supported the economy and financial markets by purchasing \$120 billion in Treasury and mortgage securities each month, and by keeping short-term interest rates near zero. As

the economy continues to recover, however, the need for continued monetary support wanes. As such, the Fed is expected to fully end its bond buying programs by mid-2022 with interest rate hikes, in our view, likely starting in early 2023. The big wildcard remains how “sticky” inflation will be throughout 2022. If inflation continues to run hotter than the Fed is comfortable with, we could see a rate hike take place towards the end of 2022. Right now, Fed officials are pretty evenly split on if rate hikes should begin in 2022 or 2023.

A still open question is what the make-up of the Federal Open Market Committee (FOMC) will look like in 2022. Due to resignations and term limits, there are a number of seats yet to be filled. We do think that once those open seats are filled, the Committee will lean a bit more dovish, which should mean continued monetary support for longer. Additionally, given the open seats, we expect changes that result in stricter ethics rules for members of the Federal Reserve System and potentially increased banking supervision from a newly appointed vice chair of supervisory. We do not expect these changes to have an immediate impact, but they may result in longer-term changes to supervision over the banking system and monetary policy, including more of a focus on financial inequality and climate change.





# Conclusion

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A relay race combines stretches of extraordinary individual effort with brief moments of coordinated teamwork, in which fractions of a second can be equivalent to the physical difference between a champion and an also-ran. Success requires ability, precision, and of course, teamwork.

Federal, state, and local governments—usually better suited for the role of timekeepers or race officials—have run a strong leg for the economy over the last two years. In 2020 and 2021, government policies arguably had a more profound effect on the economy than any time since World War II, not always for the better but in the right direction overall. The level of government borrowing was certainly similar to a war effort. Central banks created new initiatives to support the economy and keep the financial system running smoothly. But it didn't stop there. We needed state-level decisions about appropriate restrictions that still allowed the economy to function; local decisions

about how to keep schools open and allocate resources; as well as constant coordination among scientists, public health experts, federal agencies, and our elected officials. No one would find this level of government involvement ideal under anything close to normal circumstances, but it was necessary to some degree in the face of the pandemic.

The private economy was by no means on the sidelines while this was happening. The upside of our economy contracting 3.4% in 2020 is that more than 96% of the prior year's level of output stayed in place. That 3.4% contraction is huge when it comes to the impact on many people's lives, but it certainly goes against the narrative that the economy came grinding to a halt. And in 2021, the economy topped its pre-recession output peak. While some service-based industries were devastated by the pandemic, businesses on the whole innovated, adapted, and evolved. They have positioned themselves well to take the handoff and run the next leg, and

our market views reflect that. We are watchful of the risks associated with government passing the baton in 2022, but we believe that ultimately the economy will be healthier while still managing to create opportunities for investors.

As investors, we are part of running that leg too. We help provide the capital that entrepreneurs need to turn ideas into action. That's what investing fundamentally is. Of course, we all want to invest wisely. So, we build our teams around us, establishing personal and professional relationships that we turn to for sound advice. Mid-cycle years aren't as exciting as the early-cycle boom, but they tend to strike a nice balance between risk and opportunity. We expect 2022 to be a year that can help you make progress toward reaching your financial goals, and a little good coaching can help. Check in with your financial professional about setting your long-term goals and determining the pace that will get you there for 2022 and beyond.

The opinions, statements and forecasts presented herein are general information only and are not intended to provide specific investment advice or recommendations for any individual. It does not take into account the specific investment objectives, tax and financial condition, or particular needs of any specific person. There is no assurance that the strategies or techniques discussed are suitable for all investors or will be successful. To determine which investment(s) may be appropriate for you, please consult your financial professional prior to investing.

Any forward-looking statements including the economic forecasts herein may not develop as predicted and are subject to change based on future market and other conditions. All performance referenced is historical and is no guarantee of future results.

References to markets, asset classes, and sectors are generally regarding the corresponding market index. Indexes are unmanaged statistical composites and cannot be invested into directly. Index performance is not indicative of the performance of any investment and does not reflect fees, expenses, or sales charges. All performance referenced is historical and is no guarantee of future results.

Alternative investments may not be suitable for all investors and should be considered as an investment for the risk capital portion of the investor's portfolio. The strategies employed in the management of alternative investments may accelerate the velocity of potential losses.

Event driven strategies, such as merger arbitrage, consist of buying shares of the target company in a proposed merger and fully or partially hedging the exposure to the acquirer by shorting the stock of the acquiring company or other means. This strategy involves significant risk as events may not occur as planned and disruptions to a planned merger may result in significant loss to a hedged position.

Any company names noted herein are for educational purposes only and not an indication of trading intent or a solicitation of their products or services. LPL Financial doesn't provide research on individual equities.

All index data from FactSet.

All information is believed to be from reliable sources; however, LPL Financial makes no representation as to its completeness or accuracy.

#### GENERAL RISK DISCLOSURES

Investing involves risks including possible loss of principal. No investment strategy or risk management technique can guarantee return or eliminate risk in all market environments. There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not protect against market risk. Investing in foreign and emerging markets debt or securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks.

#### GENERAL DEFINITIONS

**Gross Domestic Product (GDP)** is the monetary value of all the finished goods and services produced within a

country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

**The PE ratio (price-to-earnings ratio)** is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

**Earnings per share (EPS)** is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

**The Standard & Poor's 500 Index** is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

**The Bloomberg U.S. Aggregate Bond Index** is an index of the U.S. investment-grade fixed-rate bond market, including both government and corporate bonds.

#### EQUITY RISK

Investing in stock includes numerous specific risks including the fluctuation of dividend, loss of principal and potential illiquidity of the investment in a falling market. Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies. Value investments can perform differently from the market as a whole. They can remain undervalued by the market for long periods of time. The prices of small and mid-cap stocks are generally more volatile than large cap stocks.

#### EQUITY DEFINITIONS

**Cyclical stocks** typically relate to equity securities of companies whose price is affected by ups and downs in the overall economy and that sell discretionary items that consumers may buy more of during an economic expansion but cut back on during a recession. Counter-cyclical stocks tend to move in the opposite direction from the overall economy and with consumer staples which people continue to demand even during a downturn.

**Growth stocks** are shares in a company that is anticipated to grow at a rate significantly above the average for the market due to capital appreciation. A value stock is anticipated to grow above the average for the market due to trading at a lower price relative to its fundamentals, such as dividends, earnings, or sales.

**Value stocks** are anticipated to grow above the average for the market due to trading at a lower price relative to its fundamentals, such as dividends, earnings, or sales.

**Large cap stocks** are issued by corporations with a market capitalization of \$10 billion or more, and small cap stocks

are issued by corporations with a market capitalization between \$250 million and \$2 billion.

#### FIXED INCOME RISKS

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price. Bond yields are subject to change. Certain call or special redemption features may exist which could impact yield. Government bonds and Treasury bills are guaranteed by the US government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. Corporate bonds are considered higher risk than government bonds but normally offer a higher yield and are subject to market, interest rate, and credit risk, as well as additional risks based on the quality of issuer coupon rate, price, yield, maturity, and redemption features. Mortgage-backed securities are subject to credit, default, prepayment, extension, market and interest rate risk.

#### FIXED INCOME DEFINITIONS

**Credit Quality** is one of the principal criteria for judging the investment quality of a bond or bond mutual fund. As the term implies, credit quality informs investors of a bond or bond portfolio's credit worthiness, or risk of default. Credit ratings are published rankings based on detailed financial analyses by a credit bureau specifically as it relates to the bond issue's ability to meet debt obligations. The highest rating is AAA, and the lowest is D. Securities with credit ratings of BBB and above are considered investment grade. The credit spread is the yield the corporate bonds less the yield on comparable maturity Treasury debt. This is a market-based estimate of the amount of fear in the bond market. Base-rated bonds are the lowest quality bonds that are considered investment-grade, rather than high-yield. They best reflect the stresses across the quality spectrum.

**The Barclays Aggregate U.S. Bond Index** represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment-grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

**International debt securities** involve special additional risks. These risks include, but are not limited to, currency risk, geopolitical and regulatory risk, and risk associated with varying settlement standards. These risks are often heightened for investments in emerging markets.

**High yield/junk bonds** (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

**Municipal bonds** are subject to availability and change in price. They are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise. Interest income may be subject to the alternative minimum tax. Municipal bonds are federally tax-free but other state and local taxes may apply. If sold prior to maturity, capital gains tax could apply.

**Not Insured by FDIC/NCUA or Any Other Government Agency | Not Bank/Credit Union Guaranteed  
Not Bank/Credit Union Deposits or Obligations | May Lose Value**

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