The Quarterly Perspective

After a Series of Market Extremes, Could Action in 2022 Return to "Normal?"

There's been nothing ordinary about the market's path over the last four years.

While most investors are quite attuned to the wide-swinging stock market since the COVID outbreak started in March of 2020, fewer are aware of the extremes witnessed since 2018. A quick recollection will recall:

- In 2018, the S&P 500 index suffered two distinct market corrections. The first was a -10.2% decline in February and a second saw a -19.8% slide during the fourth quarter.[1]
- The S&P 500 finished 2018 year down -4.4%. It was the first negative return in a year where the U.S. saw both GDP and corporate earnings growth since 2000.[1]

> *"Although tough to see when living through it, investors have incurred four years of extremes, both good and bad, to market returns and volatility."*

- A resounding market rebound in 2019 on the back of interest rate cuts. The S&P 500 finished up +31.5%,[1]
- The COVID fallout of 2020, with a -33% slide in March followed by a jolting reversal and recovery.[1]
- For 2021, an unusually calm, low volatility market climb into the high twenties. The steepest intra-year decline was only -5.2% and recovered within twelve trading days.[1]

Although tough to see when living through it, investors have incurred four years of extremes in both directions, good and bad, to market returns and volatility.

Could 2022 Be a Return to Normal?
With this collection of extremes in the rear-view mirror, it is perhaps timely to revisit what a normal market could even look like in 2022.

Since 1960, the average return for the S&P 500 index in the first year following a recession is +25.4%. So, in perspective, returns in 2021 were very much in line with historical standards. But, what about the second year? Across those same post-recessionary episodes, the second year saw U.S. large cap returns produce a more modest +12.8%.[1]

What about volatility? Since 1982, when the economy is in growth mode, the S&P 500 typically incurs a price pullback of -5% to -10% for two to three episodes per year. In spite of some popular beliefs, markets are not characterized by dramatic volatility as the norm.[1]

In the wake of the tumultous COVID recession and all the disruptions that followed, there is recognition the world economy is now moving in the direction of more stability, the kind of stability that can lead to more normalized markets.

So, What's It Mean For Investors?
Healthy investor behavior starts with sound and realistic expectations. Therefore, investors should understand recent patterns were clearly outside of historical norms. After such an extended run, it is a great time for investors to reground their expectations for 2022. Start with realizing strong fundamental growth is carrying into 2022. Investors can be hopeful for positive markets returns, but shouldn't be disappointed with a more modest +8% to +12%. Likewise, it is highly unlikely the coming year will repeat the low volatility climb seen in 2021. Instead, it would be wise for investors to emotionally prepare for the more normal -5% to -10% pullback on a two-to-three times per year basis.[1]

Source:
[1] www.stockcharts.com

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ABOUT

Harman Wealth Management

At Harman Wealth Management, we provide private, advanced, independent planning and investment management to individuals, families, and institutional clients.

We value in-depth economic research, evidence-based investment methods, and rigorous risk management. We are committed to insightful, objective solutions, and always working solely for the best interest of our clients.

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Growth Trends Remain Steady Heading into 2022

Demand boom set to continue.

Even after achieving remarkable progress in the first year of the recovery, U.S. growth momentum continues to look robust at year-end. On many fronts, growth trends aren't just stable, they are notably strong. The direct effect from massive stimulus measures means both consumers and corporations have ramped up demand. Add improved demographics and low household debt-ratios, and the case for growth sustainably above long-term trends is strong. Even with elevated inflation, demand has shown no signs of faltering soon. Consider the following:

"On many fronts, growth trends aren't just stable, they are notably strong."

Retail Sales
excluding autos
$$
Up +19.5%
Since Last November

Americans have been on a torrid spending spree, surpassing pre-pandemic highs for retail spending in July of last year. Even so, shoppers have kept going. As of November, the annual growth rates for retail sales exceeds 19%.[1]

Also, proving it's not just stuff, spending on services is up 11.7% annually.[2] Even restaurant spending is 11.4% higher than pre-pandemic levels.

"Huge demand has been followed by a vigorous response from home builders. The number of new homes in construction is up more than 28% annually, a rate not seen since the early 1980's."

Home Construction
Single family homes
Up +28.3%
Since Last November

The explosion in home-buying has been no secret. Huge demand has been followed by a vigorous response from home builders. The number of new homes in construction is up more than 28% annually, a rate not seen since the early 1980's.[3]

Because home building carries a multiplier effect, expect growth in durable goods to maintain a healthy pace well through 2022.

New Orders
Total Manufacturing
Up +15.3%
Since Last November

Ordinarily, a climate with high inflation tends to dampen consumer appetite. However, a glimpse into overall new orders prove that demand remains resilient.

Even with a strong growth year in 2021, new orders are still showing a 15% annual growth rate. This includes demand for both consumer and commercial goods.[1]

Source:
1 U.S. Census Bureau
2 U.S. Bureau of Economic Analysis
3 U.S. Dept. of Housing and Urban Development

“Transitory” Inflation Has Overstayed Its Welcome, What’s In Store For 2022?

Observations about inflation heading into 2022.

In addition to an aggressive consumer recovery, the other leading economic story is inflation. Already, fears of 1970’s-style inflation are being tossed around. While the causes of today’s inflation appear to be very different, investors will likely still be discussing inflation a year from now.

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In hindsight, the federal reserve's initial assessment for rising inflation was clearly miscalculated. Described as “transitory,” they explained elevated numbers were a mere one-time caused by the economic re-start. The statistical glitches and short-term bottlenecks would eventually pass, and inflation would soon start trending back toward 2%. As the year progressed, not only did inflation resisting fading, it climbed to a much higher than expected 6.9% in the November release.[1]

So, how should investors view current inflation trends now? Let’s explore three key points to help make sense of one the most watched topics of 2022:

1. **THIS VERSION OF INFLATION IS REAL, NOT JUST A STATISTICAL QUIRK.**

Early reassurances that inflation was temporary focused on a few underlying categories with wide-swinging price adjustments. The problem now is inflation appears to be broadening well beyond these categories. CPI numbers for food just hit a thirteen year high. Clothing and apparel are amidst the largest annual climb since 2012.[1]

“Early reassurances that inflation was temporary focused on a few underlying categories with wide-swinging price adjustments. The problem now is inflation appears to be broadening well beyond these categories.”

2. **THE ROOT CAUSE STARTS WITH LABOR SHORTAGES.**

While demand surged in the wake of the pandemic, so did the need for workers. But, even with the largest calendar year growth in jobs in U.S. history, the labor force still couldn’t keep up with demand. By October, the numbers showed where job openings exceeded unemployed workers more than 3.7 million.[1]

3. **INFLATION LIKELY STABILIZES AT A HIGHER NORMAL.**

At some point mid-year, inflation is likely to turn. The distorted price moves in new and used autos will become less pronounced. The flattening of oil and gasoline prices will also soften its effect on headline inflation.

Yet, the path of a “new normal” inflation likely won’t go back to the soft inflation of the last decade. Severe labor shortages have fed into a wage-price spiral, a much sticker form of inflation than other varieties. Furthermore, strong consumers have absorbed recent price increases without a pullback in demand. In combination, it likely means the discussion on inflation will still be prominent a year from now.

Consumer Price Index

Up +6.9%

Since Last November

Highest since 1982

Job Openings

3.7 Million

More Openings Than People Unemployed

Source: All data from Federal Reserve Bank of St. Louis.

Source:
[1] Federal Reserve Bank of St. Louis

Increased Limits for Company Retirement Plans in 2022.

Maxed out savers should take action.

In late November, the IRS announced increased limits for company retirement plan contributions in 2022. Participants in 401(k), 403(b), and 457 plans can now contribute up to $20,500 for the plan year. This is a $1,000 increase over 2021. [1]

For participants age 50 or older, you can still make catch-up contributions up to $6,500 per year, for a total contribution of $27,000 for 2022.[1]

Limits across other taxed-deferred retirement accounts were left unchanged.

Plan Contribution Limits

	2021	2022	Change
RETIREMENT SAVINGS			
401(k)/403(b)/457(b) Plan Elective Deferral Limit	$19,500	$20,500	+$1,000
401(k)/403(b)/457(b) Plan Catch-Up Limit	$,6500	$,6500	—
SIMPLE IRA Limits	$13,500	$14,000	+$500
SEP-IRA Contribution Limits	$58,000	$61,000	+$3,000
Traditional & Roth IRA Limits	$6,000	$6,000	—
Traditional & Roth IRA Catch-Up Limits	$1,000	$1,000	—
HEALTH SAVINGS ACCOUNTS			
Health Savings Account (HSA) Contribution Limits	$3,600 for individuals/ $7,200 for family	$3,650 for individuals/ $7,300 for family	+$50/ $100
Flexible Savings Account (FSA) Contribution Limits	$2,750	$2,850	+$100

Source:
[1] www.irs.gov

"Expectations for 2022 project U.S. real GDP to be the second highest of the last twenty years."

"Even with elevated inflation, consumers have not pulled back on their appetite for more goods."

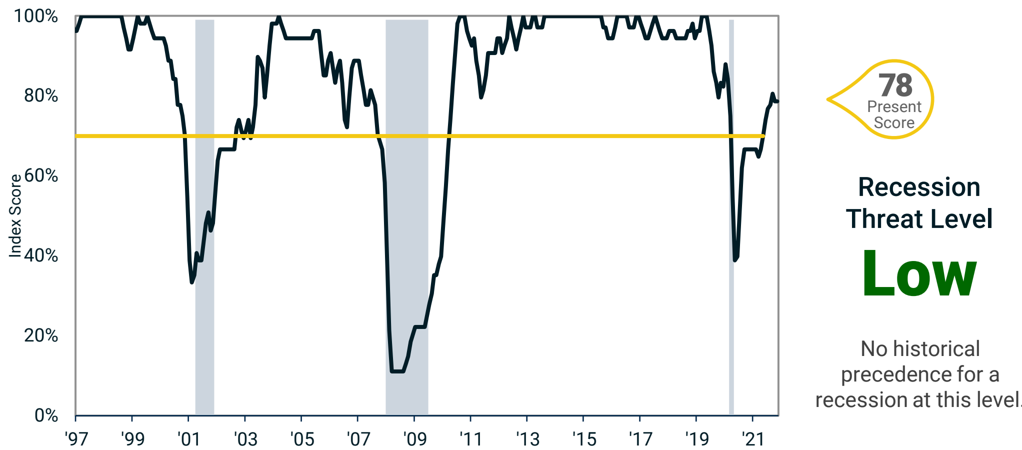
Business Cycle Risk Profile

- Overall, the U.S. economy profiles highly consistent with further growth. Expectations for 2022 project U.S. real GDP to be the second highest of the last twenty years. [1]
- Consumer strength continues to fuel growth. [2]
- Similar to conditions in 2003, the U.S. economy is working through post-recession issues related to inflation. Even with elevated inflation, consumers have not pulled back on their appetite for more goods.[2]
- The economy has reached an astonishing unemployment rate of 3.9%. Tight labor markets are leading to wage inflation. [2]
- Manufacturing and construction show positive signs of growth momentum as production attempts to catch up to demand. [2]

Source:
1 U.S. Bureau of Economic Analysis
2 NBER Federal Reserve Bank St. Louis

Alphalytics Research Economic Systemic Risk Index

Three Month Average, Weighted Diffusion Index



Shaded areas represent U.S. recessions.
Signal line represents historical mark where economic factors signaled imminent risk of recession.
Source: NBER, Federal Reserve Bank of St. Louis.

Interpreting the Index Score:

- The index score measures nine economic factors that have demonstrated co-movement with the deteriorating conditions of the past seven recessions dating back to 1970.
- When the index score is at 100, it means all nine of the factors are measuring at levels consistent with past economic expansion.
- When the index score is below 100, it means that one or more of the weighted factors has moved to a level consistent with past economic contractions.
- In aggregate a score of 70 or higher is interpreted as a composite profile consistent with past economic expansion. A score lower than 70 is interpreted as a composite profile consistent with past economic contraction.
- Markets can, and sometimes do, demonstrate volatility even though the economic factors are measuring consistent with expansion.

Interested in Adaptive Business Cycle Investing?

Today's markets, economies, and policies are more complex than ever, challenging investors on what to watch and when to take action.

At Harman Wealth Management, we understand sound investments are uniquely supported by the conditions that favor them. And, when conditions change, so do the investments that benefit.

That's why we conduct rigorous and disciplined tracking of the U.S. business cycle. We also track the cyclical factors that shape our investing environment, like currencies, commodities, and rates. We embrace a world where investing dynamics are constantly evolving and believe it's imperative to have an investment strategy that adapts with it.

With Adaptive Business Cycle Investing we invest consistent with business cycle forces, aligning investments with the conditions driving returns in the present, rather than chasing what worked in the past.

About Harman Wealth Management

At Harman Wealth Management, we provide private, advanced, independent planning and investment management to individuals, families, and institutional clients.

We value in-depth economic research, evidence-based investment methods, and rigorous risk management. We are committed to integrative advanced planning by aligning investment objectives with business cycle opportunities and risks.

At Harman Wealth Management, our aim is to help clients realize their goals within a disciplined, insightful, and rewarding relationship.

For more information about Harman Wealth Management or investing with the business cycle, contact us at 281-719-8601.

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