Quarterly Market Update: First Quarter 2022

Executive Summary

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The following is an executive summary for the "Quarterly Market Update: First Quarter 2022" report by Fidelity's Asset Allocation Research Team.

Market Summary: Strong Q4 Rally Caps off Banner Year for U.S. Stocks

Large cap U.S. stocks staged a year-end upswing, underpinning another positive year for global stock prices, but performance was mixed across categories. Investment-grade bonds finished the year in the red amid the modest rise in interest rates, while non-U.S. equity categories lagged as emerging-market stocks dropped due in part to China's downturn. Real estate stocks, commodities, and high-yield bonds all posted solid 2021 returns.

Asset prices experienced some intra-quarter ups and downs as markets grappled with an uneven global expansion, high inflation, and the beginning of a shift toward less accommodative monetary policy. We expect the constructive U.S. mid-cycle backdrop to prevail during 2022, but less favorable monetary policy and a host of other uncertainties raise the odds of higher market volatility.

Economy/Macro Backdrop: Past Peak Growth, but Global Expansion Should Persist

The global economy may have passed its peak rate of growth, but a sustained expansion appears likely. The trajectory of the pandemic will be crucial to the global outlook, with emerging-market economies generally more susceptible to health-related setbacks.

China's industrial cycle appears to be bottoming, and monetary and fiscal policies are gradually shifting to a more accommodative stance. Activity continues to decelerate in the all-important real estate sector, where slowing construction activity and weak sales remain a key source of risk. The lagged impact of China's slowdown implies the peak in global industrial activity is behind us, and we are seeing initial signs that some of the most extreme supply-related pressures are easing. Leading indicators measuring the gap between new-order demand and the supply of inventories remain positive but have shrunk and likely represent a mid-cycle headwind for some developed markets.

The U.S. consumer is bolstered by record-high net worth, pent-up savings, and strong employment markets. However, high inflation has weighed on sentiment as the percentage of consumers viewing the current backdrop as a good time to purchase large household goods hit its lowest point in four decades. Consumer strength supports the mid-cycle backdrop, but more persistent inflation may inhibit real economic growth.

Despite lingering virus-related issues, labor force participation stabilized during 2021, as the strong job market enticed people to rejoin the workforce. We expect worker shortages will lessen as more employees re-enter the labor force. However, some of the 2.5 million people who left the labor force during the pandemic—especially older workers—might not return, implying some of the supply-demand gap may persist.

The nearly 50% rebound in corporate earnings during 2021 far exceeded expectations amid accelerating sales growth and greater corporate pricing power. With profit margins back to all-time highs and having already outpaced typical mid-cycle gains—and facing unusually high wage pressures—it may prove more challenging to expand them going forward. Investors expect slower, but still solid, high single-digit profit growth in 2022.

Base-year effects will help mechanically reduce inflation rates from current 30-year highs, but categories where price changes tend to be more persistent, such as housing and food, now account for a larger portion of inflationary pressure. Demand-side factors—where the Federal Reserve can exert its influence—also are major contributors to price pressure.

The market's near-term inflation expectations remain well above pre-pandemic levels but also indicate belief that inflation pressures should abate rapidly in the coming years. While the Fed tends to give greater credence to the more muted long-term inflation projections of professional forecasters, consumers' expectations have jumped from 2020 lows, and rising consumer expectations have a history of reinforcing inflation pressures.

After nearly $3 trillion of emergency stimulus in the U.S. during FY 2021, the budget deficit is set to shrink considerably and offer less fiscal support in 2022. Legislation approved in Q4 provides more than half a trillion dollars of extra multi-year spending on infrastructure, which traditionally has a high multiplier effect on near-term growth. Any additional multi-year spending or tax increases will depend on negotiations among congressional Democrats.

Trillions of dollars of asset purchases by global central banks in 2021 resulted in abundant financial market liquidity, supporting asset prices and subduing volatility. However, global monetary policy is shifting toward normalization, as 16 central banks raised interest rates and the Fed accelerated the end of its QE program to early 2022. Liquidity growth may switch to a headwind, raising the odds of higher market volatility.

Many of the secular trends suggesting that long-term risk are on the rise risks have been exacerbated during the pandemic. Inflation risks appear higher given the entrenched use of low interest rates and high fiscal deficits, the manifestation of supply-side pressures from de-globalization trends, and the exit of older workers from the labor force that underscores that aging demographics are not inherently deflationary. Most major economies face deteriorating demographic trends. With fewer new workers to support a growing number of retirees, greater fiscal pressures are ahead due to rising spending on pensions and health care. The dramatic worldwide rise in public and private debt in recent decades has been sustained by extraordinary levels of monetary accommodation, leaving the system more dependent than ever on low interest rates. Long-term inflation, policy, and profit risks warrant high levels of strategic portfolio diversification.

Asset Markets: Inflation-Resistant Categories Led 2021 Gains

Asset categories that tend to do well during periods of higher inflation topped the performance board in 2021, including energy, real estate, and Canadian equities, as well as commodity prices. Treasury Inflation Protected Securities (TIPS) proved the best-performing fixed income category. A strong Q4 rally for U.S. large cap, technology, and quality stocks completed a strong year for those areas.

The sharp rebound in earnings growth reached decade-high rates on a year-over-year basis across all major global categories: U.S., non-U.S. developed markets, and emerging markets. Forward-looking earnings expectations are that earnings may converge to a lower rate over the next 12 months, with consensus forecasts for U.S. earnings growth slightly above the others.

Non-U.S. equity valuations moved lower during Q4 as strong earnings growth outpaced stock price gains, and forward-looking estimates indicate analysts expect international equity valuations to fall further below their historical long-term averages. Both trailing and forward-looking price-earnings ratios remain elevated for U.S. equities relative to their historical averages.

The business cycle can be a critical determinant of asset performance over the intermediate term. Stocks have consistently performed better earlier in the cycle, whereas bonds tend to outperform during recession. While we believe a business cycle approach to actively managed asset allocation can add value, portfolio returns are expected to even out over the long term (20 years), regardless of the starting point of the cycle phase.

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The Asset Allocation Research Team (AART) conducts economic, fundamental, and quantitative research to develop asset allocation recommendations for Fidelity's portfolio managers and investment teams. AART is responsible for analyzing and synthesizing investment perspectives across Fidelity's asset management unit to generate insights on macroeconomic and financial market trends and their implications for asset allocation

Fidelity Thought Leadership Director David Risgin, CFA, provided editorial direction for this article.

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