The Hanover Advisor

HANOVER ADVISORS

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2022 Market Outlook

As we end 2021, it is worth noting how remarkable the stock market's pandemic rebound has been. The bull market that began in March 2020 has already seen the S&P 500 gain more than 114%, meaning that the current rally has already outperformed the market's 2002 to 2007 rally in just a quarter of the time. As impressive as this year has been, with the S&P 500 climbing more than 20%, the general consensus is that we are unlikely to see a repeat next year. With the economy moving from the recovery phase to the expansion phase, growth is expected to slow, and the markets face several headwinds, not the least of which is the pandemic, which will soon be entering its third calendar year.

The emergence of the highly contagious Omicron variant has many Americans nervously watching case numbers climb, but most economists feel the new variant will have a limited impact on the economy. Early indications suggest the variant results in more mild illness and the current wave is projected to burn itself out quickly. Consumers and businesses have also had two years' experience adapting to the pandemic's changing conditions. There is little political appetite for the widespread lockdowns that would do the most harm to the economy. As we head into 2022, the biggest potential risks facing investors are surging inflation and the Federal Reserve's efforts to combat it.

How quickly prices rise and for how long remains the million-dollar question for both consumers and investors. Rapidly rising prices have U.S. consumers feeling more pessimistic, as evidenced by consumer sentiment falling to the lowest level in more than a decade. Despite this more pessimistic outlook, consumers have thus far been willing to tolerate higher prices. U.S. consumers are well-positioned to weather a period of high inflation. Households have accumulated roughly $2.6 trillion in excess savings over the course of the pandemic, which bodes well for the economy, though recent surveys have found a growing unwillingness to make big-ticket purchases like appliances and vehicles. If consumer spending, which accounts for 70% of real GDP, begins to drag in the face of higher prices, the Fed could be incentivized to act aggressively, potentially roiling the markets.

Investors have largely shrugged off the recent bout of inflationary pressure. There have been some concerns that increased costs would begin to diminish corporate profit margins, but most U.S. and international corporations exceeded earnings projections this year, and stocks have continued to move higher. Still, the bond market is signaling much higher inflation expectations in the coming years.

The unfortunate reality is that the Fed is likely already behind the curve with regard to inflation. After insisting that the current bout of higher prices was “transitory” for much of the year, the Fed has belatedly acknowledged the reality and signaled its intention to act aggressively. The Fed has already accelerated the end of its pandemic-era asset purchases, currently on track to end by March, paving the way for the Fed to begin raising interest rates. Most analysts expect between two and three rate hikes next year. Thus far, the markets have reacted well to the Fed’s actions, which have been signaled well enough to avoid a repeat of the “taper tantrums” that roiled the markets when the Fed normalized policy after the 2008 financial crisis. Still, with so many unknowns, the Fed may be forced to act more aggressively if inflation proves to be severe or persistent or delay their plans if Covid causes economic growth to slow substantially, either of which could impact the markets significantly. In a recent CNBC survey of institutional investors, 55% of the respondents said the Fed getting the timing of its rate hikes wrong was their biggest investment worry in the coming year.

Despite uncertainty and headwinds in the coming months, we are cautiously optimistic about the equity markets over a longer time horizon. Corporate earnings have been stellar, and while they have likely peaked, are expected to remain strong. Economic growth will slow from the lofty heights in the initial rebound, but likely remain robust. Lofty stock valuations, coupled with the year’s speculation around meme stocks, cryptocurrencies and special purpose acquisition companies (SPACs) have some observers wondering if the market has lost touch with reality. While the level of speculation is some cause for concern, most lofty stock valuations are justified by strong earnings. In fact, stocks are actually more reasonably priced as we head into 2022 than they were at the start of 2021, because 2021 earnings are tracking so far above the estimate that were made when the year began.

With interest rate increases on the horizon, the bond market looks to be a risker proposition. In this environment, we are diversifying away from U.S. corporate and government bonds and toward stocks. One of the few attractive opportunities in the bond market is Treasury Inflation-Protected Securities (TIPS) and other inflation-protected bonds. These are not only a good hedge against already-elevated inflation, but if inflation proves to be more persistent and severe than current estimations, which we feel is likely, they will generate higher returns.

I Bonds as an Emergency Savings Alternative

There is an old rule of thumb in financial planning that says you should always keep six months of living expenses in an emergency savings fund that will be readily available and secure. There is a downside to keeping too much in your emergency savings, however, as there are opportunity costs for any assets you keep out of the market. In today's low interest environment, comparatively safe investments like CDs, money market funds, and savings accounts forego any type of meaningful returns, and with inflation surging, you may actually be diminishing the purchasing power of your savings by keeping it in the bank.

Any properly managed investment portfolio will take into account the need for liquidity and will be structured according to the level of risk you are comfortable with, but many investors rest more easily knowing they have a rainy-day fund readily available and free from the volatility of the market. For these investors, Series I Savings Bonds, known as inflation bonds or I bonds, may be a great alternative to traditional savings options.

I bonds earn two types of interest: an interest rate that is fixed for the life of the bond and an inflation rate that is adjusted each May and November based on changes in the consumer price index (CPI). The fixed rate is generally very low, currently at 0%, but with inflation surging, new I bonds issued between November 2021 and May 2022 with earn a rate of 7.12%. That represents the second-highest initial rate ever offered on the bonds, and is much higher than other secure fixed income or savings options.

As attractive as the returns on I bonds are, the limits on how much you can purchase mean they cannot be a substantial part of your investment portfolio. I bonds must be purchased directly from the Treasury Department, and the most you can buy is $10,000 a year per

person, though you can buy an additional $5,000 in paper bonds if you direct your tax refund toward the purchase. Still, having $10,000 in emergency funds earning 7.12% is far better than keeping $10,000 in a savings account that earns only 2%.

There are some important caveats to keep in mind if you intend to use I bonds as your rainy-day fund. The first is that I bonds must be held for at least one year, so be sure you have an alternative emergency fund for the first year of ownership. Also, if you hold your I bonds for fewer than five years, when you sell them you will not receive the last three months' worth of interest. Another important thing to keep in mind is that checks cannot be written directly against your TreasuryDirect account, which is what you use to purchase I bonds, so in a true emergency, it may still take a few days to liquidate and transfer money to another bank account to cover an emergency expense. Nevertheless, I bonds can be a great way to attain the peace of mind that comes from an emergency fund while avoiding the anemic returns of most money market alternatives.

Hanover Advisor Bulletins

Special Reminders to all Hanover Clients

- **IRS Reminder:** Required minimum distributions (RMDs) must be made by December 31, 2021. If you hold a traditional IRAs or an employer-sponsored retirement account, and you have reached the age of 72, you must make the IRS-mandated withdrawal or you may be subject to a tax penalty. Information about can be obtained from Pershing or your previous custodian if the account was transferred this year. If you have any questions or concerns, please contact Hanover.

- The Hanover Advisors website can be accessed at hanoveradvisorsinc.com. There you will find our latest newsletter and investment commentary, articles, our blog, and videos. You can also learn more about our services, access both the Black Diamond performance reporting system and your Pershing brokerage account(s).

- We want to invite all clients to contact our office to schedule a portfolio review. We would be happy to coordinate a sit down meeting, a conference call, or an online meeting at your convenience. Please call our office to schedule an appointment.