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Glimpse: A Sneak Peek at 2022's Market Outlook

Michael Arone, CFA
Chief Investment Strategist
US SPDR Business

Cash (Don Cheadle): The way you intervened in the store last night, you did a good thing there, Jack. It was incredibly impressive.

Jack Campbell (Nicolas Cage): Please just tell me what's happening to me, in English, without the mumbo-jumbo.

Cash: This is a glimpse, Jack.

Jack: A glimpse? A glimpse of what?

Cash: You're gonna have to figure that out for yourself. You've got plenty of time.

"The Family Man" — 2000 film.

'Tis the season for watching sappy, feel-good holiday movies and writing market outlooks. "The Family Man" — starring Nicolas Cage, Téa Leoni and Don Cheadle — is an overlooked modern-day holiday classic dripping with predictable, heart-rending sentimentalism. Jack Campbell (Nicolas Cage) is an Armani suit-wearing, Ferrari-driving, Wall Street rainmaker and fat-cat bachelor living in New York City. In the opening scenes of the film, it's Christmas Eve and Jack is putting together a huge multibillion dollar merger deal. He's just ordered an emergency meeting on Christmas Day. Jack also receives a message to contact Kate (Téa Leoni), his college sweetheart from 13 years ago. Although he remembers her fondly, Jack doesn't seem interested in reconnecting with Kate.

On his way home from work, Jack stops at a convenience store. Cash (Don Cheadle) enters the store claiming to have won $238 on a lottery ticket. When the store clerk insists the winning lottery ticket is fake, Cash threatens him with a gun. To defuse the situation, Jack buys the ticket from Cash. Outside the store, Cash asks Jack if anything is missing from his life. Jack chuckles and assures him that he has everything he needs. As he walks away, Cash cryptically tells Jack that he has brought what is about to happen upon himself. Baffled, Jack returns home to his penthouse apartment and drifts off to sleep.

On Christmas Day, Jack wakes up in a suburban New Jersey bedroom with Kate and two children. Shocked, he hurries to his New York City penthouse and office, but nobody recognizes him. As he sprints into the street outside his office, Cash is there, driving Jack's Ferrari. Cash explains to Jack that he's getting "a glimpse" that will help him to figure out what's happening.

Jack slowly realizes that he is living the life he might have lived if he had stayed with Kate. He is a tire salesman for Kate's father, and she is a lawyer for a nonprofit. Despite a few setbacks, Jack begins to succeed at family life — bonding with his children, falling in love with his wife and working hard at his job.

Mercifully, this movie trailer is now over. I'm confident that you can figure out how this mushy holiday movie ends. However, to really enjoy all the laughs and tears, I suggest you gather the family, pop some corn, pour an eggnog, don your whacky Christmas onesie pajamas and watch "The Family Man."

Special Effects

By now, you're wondering what this amateur movie review has to do with the outlook for the economy and capital markets, especially for 2022. With holiday stress compounded by pandemic fatigue, you're probably thinking that I have finally lost my mind. Not so fast.

Email inboxes are overflowing with 2021 market forecasts. Wall Street experts are gazing deeply into their crystal balls and making bold predictions about the coming year. We do it too. However, if a year ago, 2020's market outlooks forecasted a global pandemic with far-reaching health, social and economic consequences, while markets continued to reach new all-time highs, they would have been quickly dismissed as outrageous. And, yet, that's exactly what happened this year.

Investors have struggled to reconcile their good fortune with the many hardships presented by the pandemic. In March, investors feared a repeat of the Great Depression. And, despite a brief recession and bear market, their worst fears never unfolded. For example, the unemployment rate failed to breach the 20% threshold, and the labor market rebounded swiftly. Although Federal Reserve (Fed) officials acknowledge the tremendous work that lies ahead to continue to repair the economy, they have expressed pleasant surprise at both the speed and depth of the rebound.

With the aid of massive fiscal and monetary stimulus programs, the economy and earnings were able to easily beat incredibly dire expectations. This empowered investors to look beyond the carnage of the second quarter to the blossoming economic and earnings recovery taking shape. Today, risk assets don't reflect the economic and earnings contraction of 2020, but rather a much stronger economy, improving earnings, sustained policy stimulus and the inevitable defeat of COVID-19 in 2021. After all, investors have been told time and again this year that the stock market is a forward-looking mechanism.

Let's take that logic one step further: If 2020's market rally was largely the result of much better expectations for 2021, then why do we spend so much time writing and reading 2021 market outlooks now? More importantly, evolving expectations for the economy, earnings, interest rates and inflation in 2022 are the primary ingredients to determine the likely path for risk assets next year. Admittedly, the longer the horizon, the cloudier the forecasts, but if we really want to determine what might happen to risk assets in 2021, we need to incorporate an assessment of the emerging dynamics in 2022.

So, let me play the part of Cash to your Jack Campbell and together let's take "a glimpse" into 2022.

Coming to a Theater Near You

Nearly all economists are anticipating a sharp improvement in the economy next year. According to the International Monetary Fund (IMF) World Economic Outlook, global GDP growth is estimated at 5.2% in 2021. That's following an expected 4.4% decline this year. Substantial inventory rebuilding, a revival in airline travel and hotel bookings, combined with massive government spending programs and an improved trade environment should all bolster economic growth next year.

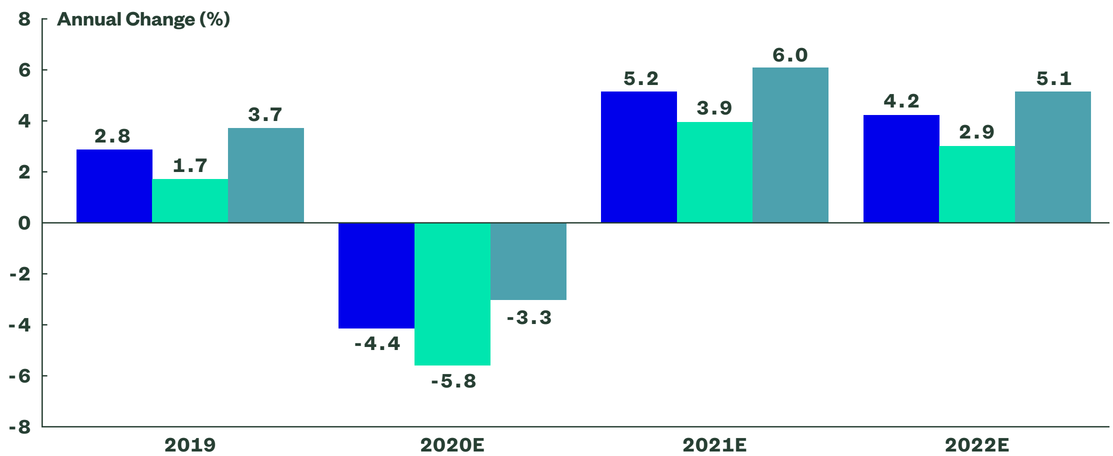
But what about 2022? The IMF forecasts a still healthy, albeit slower, 4.2% global GDP growth estimate for 2022. However, without an obvious catalyst on the horizon, it's difficult to envision the economy growing much faster than the pre-pandemic level of 2.8%. What happens to GDP growth after the global economy recoups all that's been lost in this pandemic-plagued year?

The economy will be saddled with more debt and wider deficits. The global population isn't getting any younger. As a result, aging demographics in developed economies will still limit consumption. The benefits from extraordinary fiscal stimulus to combat the pandemic will eventually fade. And as the economy, markets and inflation accelerate, the Fed will be forced to normalize interest rates and reduce the size of their balance sheet, possibly cooling growth.

The expected rebound in global economic growth next year will be a welcome relief after the contraction in 2020. Yet, there remain considerable downside risks to the much-loftier economic growth expectations of 2022, which could weigh on prospects for risk assets next year.

Figure 1
GDP Growth Projections

- World
- Advanced Economies
- Emerging Market and Developing Economies



Source: IMF, *World Economic Outlook,* October 2020.

Consistent with improving economic conditions in 2021, earnings-per-share (EPS) growth is expected to soar next year. According to FactSet, companies in the S&P 500 Index could generate EPS growth of nearly 22%, while international developed and emerging market stocks could produce EPS gains of 29.7% and 33.4%, respectively.

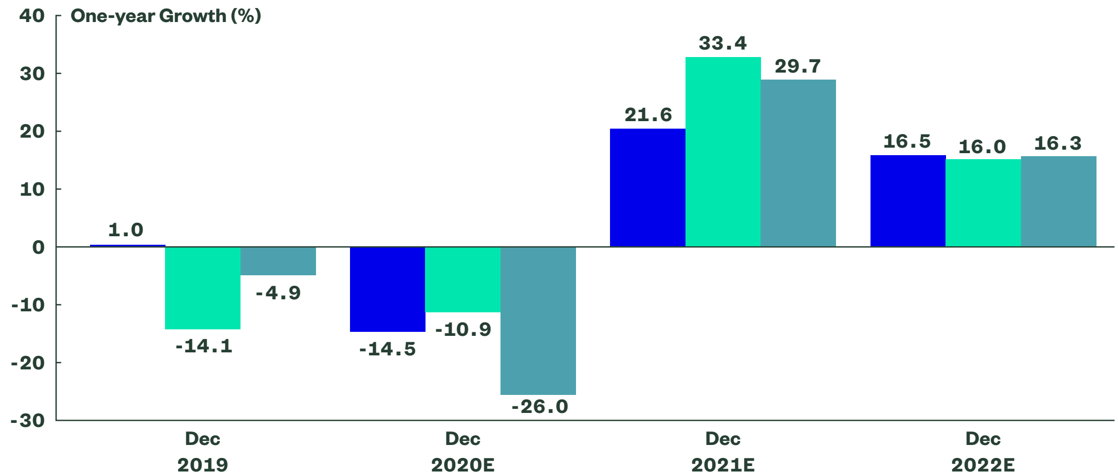
Despite the gaudy EPS predictions, many sectors and industries still remain below absolute profit levels reached at the end of 2019. Given the tremendous damage inflicted by the pandemic in a handful of industries, some could see their year-over-year earnings percentages increase by more than 100%, masking the true underlying earnings reality.

The pandemic required businesses to get creative in effectively managing their operations this year. As a result, despite the ongoing revenue challenges, profit margins for many businesses are expected to expand again next year, for the first time since mid-2018.

Curiously, FactSet indicates that analysts are forecasting about 16% EPS growth for S&P 500, international developed and emerging markets companies in 2022. That suggests that these figures are, at best, guesstimates and paint a far rosier picture than is likely to materialize. Typically, earnings estimates start off high and are persistently cut, so companies can easily beat the lowered expectations. However, with many markets at all-time highs, valuations stretched, corporate guidance absent and pandemic earnings distortions, there's no telling how investors might react to sizable earnings reductions for 2022. The potential for earnings disappointments in 2022 could be a risk to stock prices next year.

Figure 2
EPS Growth

S&P 500 Index
MSCI Emerging Markets Index
MSCI EAFE Index

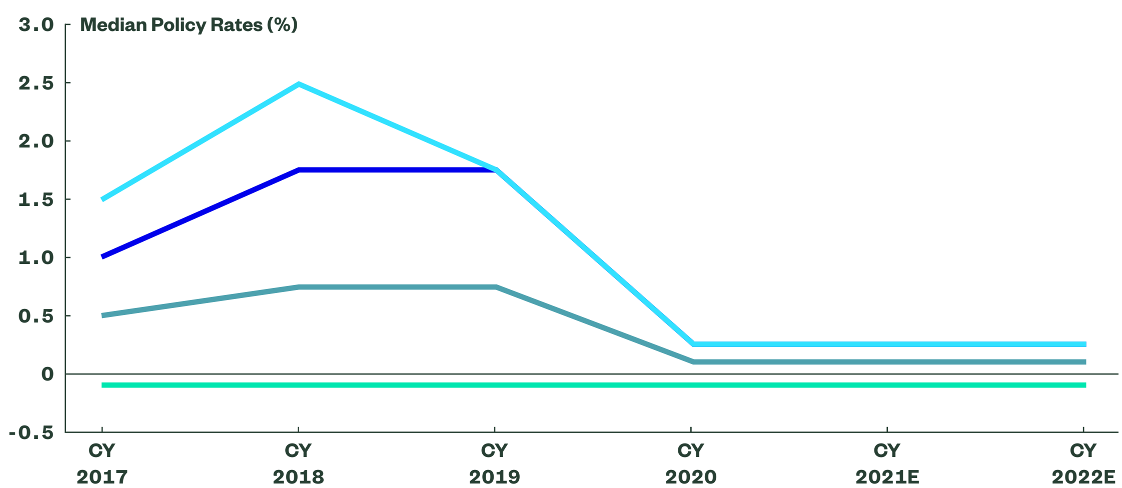


Source: FactSet as of 12/14/2020.

Perhaps a silver lining from possible economic and earnings letdowns is that both interest rates and inflation expectations will remain tempered for 2022. Interest rates and inflation measures have slowly started to creep higher to reflect a more robust economic and earnings recovery next year. If they rise too quickly, rates and inflation could become problematic for markets. Lower interest rates and benign inflation support higher than normal valuations and bolster financial asset prices.

Figure 3
Interest Rate Forecasts

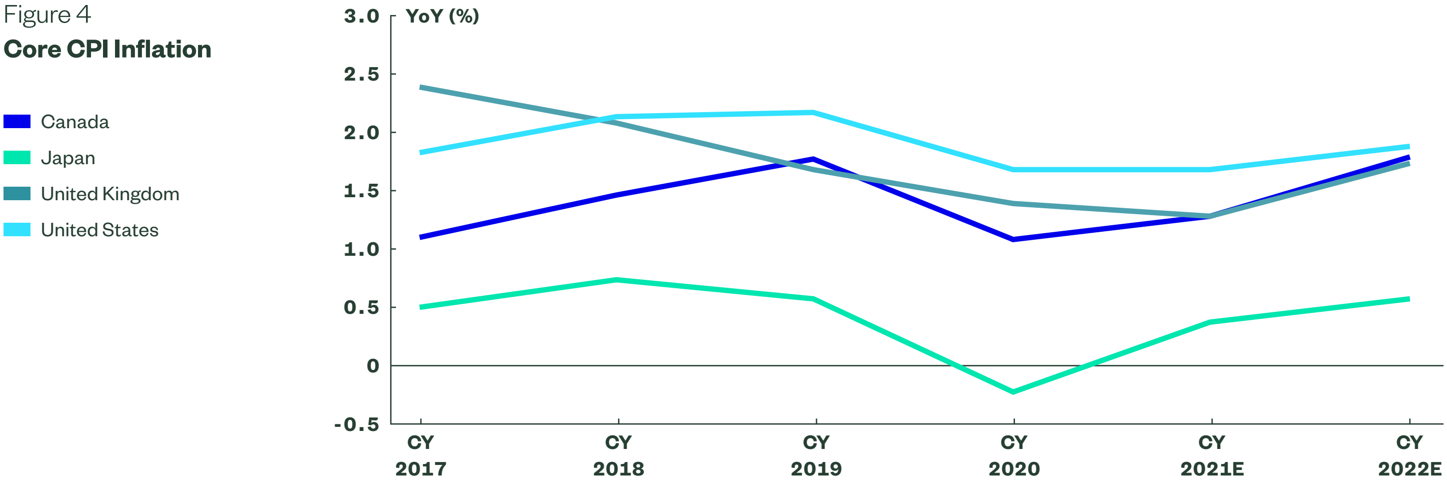
Canada
Japan
United Kingdom
United States



Source: FactSet as of 12/14/2020.

Thankfully, the Fed is in no hurry to raise rates, and policymakers have committed to letting inflation run hot. Recent economic data also reveals that the recovery is losing some steam. So, despite the challenges from lofty economic and earnings expectations next year, disappointments regarding 2022 figures may keep rates and inflation low, further supporting risk assets in the future.

Figure 4
Core CPI Inflation



Source: FactSet as of 12/14/2020.

Lights, Camera, Action!

It's a Christmas miracle! Somehow I've managed to successfully link sweet holiday movies and market outlooks. Investors spend entirely too much time and effort digesting next year's predictions. One of the enduring investment lessons from 2020 might just be that markets are indeed forward-looking mechanisms. Therefore, getting a glimpse into the shifting expectations for the economy, earnings, interest rates and inflation in 2022 is likely way more important to next year's financial asset performance than any 2021 market outlook.

Prevailing forecasts for both the economy and earnings in 2022 are sky high. The post-pandemic recovery of 2021 is expected to gain further momentum the following year. In many respects, the economic rebound, earnings recovery, sustained policy response and inevitable defeat of COVID-19 are already reflected in today's asset prices. Without additional catalysts, I'm concerned that investors may be expecting too much good news from the economy and earnings. Failing to exceed higher expectations could lead to investor disappointments in 2021. However, a variety of circumstances should keep interest rates low and inflation benign, supporting financial asset valuations and possibly offsetting some of the negative impacts from the economic and earnings disappointments.

Following the adversity and challenges of this pandemic-filled year, this holiday season may feel more stressful and chaotic than seasons past. We may not be able to celebrate in the same way, surrounded by our usual family and friends. Many of us are eager to just get it over with and let a difficult 2020 mercifully end. But, that's exactly why we should cherish this holiday season even more. Mothers are the guiding lights of the holiday season. My mother loved Christmas. Although not related to COVID-19, years ago, my mother suffered from her own health struggles. She was an incredible example of resilience and strength in the face of discomfort. And we always celebrated the holidays — no matter what. Today, my wife carries the holiday torch each year for our family. In a year with so much struggle and loss for so many, I'm incredibly grateful and humble to be spending the holidays with my wife and two teenage children.

Thank you for giving me the gift of your time each month. Happy Holidays & Happy New Year!

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Glossary

Earnings per share (EPS) A figure describing a public company's profit per outstanding share of stock, calculated on a quarterly or annual basis. EPS is arrived at by taking a company's quarterly or annual net income and dividing by the number of its shares of stock outstanding.

Gross Domoestic Product (GDP) the total value of goods produced and services provided in a country during one year.

S&P 500 Index The Standard & Poor's 500 Index is a market-capitalization-weighted index of the 500 largest US publicly-traded companies. The S&P is a float-weighted index, meaning company market capitalizations are adjusted by the number of shares available for public trading.

Important Risk Information

The views expressed in this material are the views of Michael Arone through the period ended December 15, 2020 and are subject to change based on market and other conditions. This document contains certain statements that may be deemed forward looking statements.

Please note that any such statements are not guarantees of any future performance and actual results or developments may differ materially from those projected.

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