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An Epic 2022 Battle – Earnings vs. Inflation

By Mike Skoric

In recent weeks, we received new confirmation that consumer (CPI) and producer (PPI) inflation is running at levels not seen in decades. It is now clear that the Federal Reserve ("the Fed") dropped the ball by not starting with tighter monetary policy earlier in 2021 based on the belief that the increasing inflation was temporary or "transient". So now The Fed has to not only move quickly, but also engage in a multifront war on inflation – starting with "tapering" or reducing asset purchases that helped keep long-term interest rates low in order to support the economy during the pandemic slowdown. While this tapering is already in progress, the Fed is also now considering three or even four interest rate hikes this year, whereas just a few weeks ago the consensus was that there would be none until 2023.

The Fed is now looking to start reducing the size of its balance sheet later this year by selling assets. This sequence of tapering, raising rates, and then selling assets should have a meaningful impact on interest rates. The process will likely slow risk-taking across the economy, drain liquidity out of the system, and eventually result in lower inflation.

All of these factors create risk for the economy. While this article focuses mostly on stocks, the asset class hurt most by rising rates is bonds where even achieving a 0% can be viewed as "success" in this kind of macro environment. Meanwhile, growth stocks and other risky assets can react negatively when interest rates are rising. Although earnings rose a phenomenal 45% for the S&P 500 in 2021, most of this was just recovering to pre-pandemic levels.

We need to have decent earnings growth in 2022 in order to achieve modest high single-digit returns. Current consensus estimates are for earnings growth to be in the 10-12% range which may be good enough to support the stock market at current and hopefully somewhat higher levels. But as the title of this commentary suggests, the case will be largely dependent on the Fed's ability to control inflation. The trick is to achieve this by raising rates enough to slow inflation, but not to levels that throw the economy into recession. This fine balancing act between inflation and earnings will be worthy of our closest attention in 2022 and a definite catalyst of financial market performance.

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