Market Update

December 2021

All I Want for Christmas

...Is Supply Chain Normalization

As the holiday season is upon us, and the S&P 500® is delivering one of its best returns in 10 years, up 27% as of Dec. 10, we should be content with this year's strong market performance as our Christmas present. After all, the pandemic is showing no sign of slowing down, with the Delta variant still lingering and the new Omicron variant bringing back travel bans. Meanwhile, inflation levels are reminiscent of the Paul Volcker Federal Reserve era.

Nevertheless, as has become our annual tradition, we challenged ourselves to determine what could be the single-most important catalyst to drive markets higher in the New Year and put that at the top of our wish list for Santa. Last year, we asked Santa for a reacceleration in earnings growth and got it. In fact, Jolly Ol' Kris Kringle is on pace to deliver the best earnings growth in 15 years for the S&P 500® at more than 45%. We already resigned ourselves to the fact that growth is set to decelerate from the peak levels set in 2021, thus we focus our sights on other potential upside surprises for 2022, namely regarding inflation pressures. **For 2022, the top of our Christmas wish list is a normalization of supply chain shortages and bottlenecks.**

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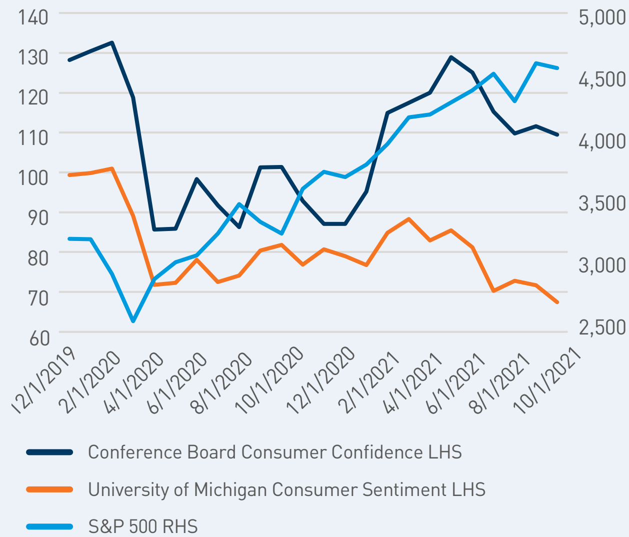
Do They Know It's Christmas?

At nearly two years into the pandemic, there continues to be a big distinction between the recoveries experienced by Wall Street and the lack thereof among everyday consumers. When the S&P 500 is having one of its strongest years of the past decade, you would not expect consumer confidence to still be below pre-pandemic levels (Figure 1). Markets and consumer confidence typically have a strong correlation over time; thus, the question is which one will adjust to re-couple with the other? Consumption is approximately 70% of U.S. GDP, so we must see those numbers improve to keep the market's positive momentum going.

We believe the primary driver keeping consumer confidence down is inflation expectations. Both the Conference Board and University of Michigan consumer confidence surveys show 12-month inflation expectations at or near the highest level in 10 years (Figure 2). Before we get to our conclusion that elevated inflation appears short-term in nature, we should acknowledge those survey concerns are certainly not unfounded:

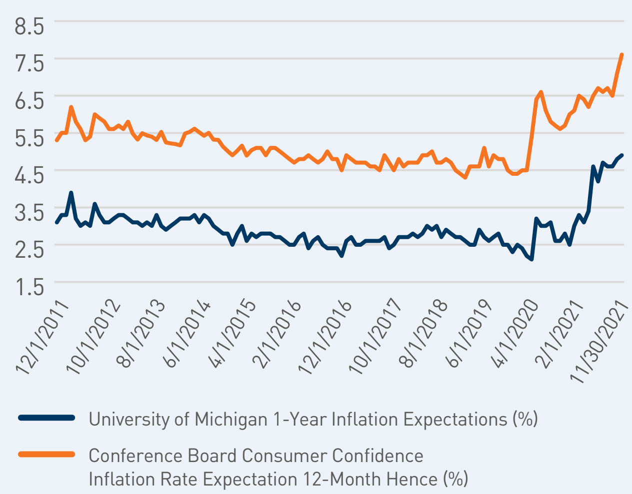
- The Bloomberg Commodity Index, which tracks a basket of commodity prices such Energy, Agriculture, and Metals is having its best-performing year since 2000, up nearly 24%.
- The Baltic Dry Index, a composite of dry bulk shipping costs across the globe, reached the highest level since 2008 in October 2021.
- U.S. new car and truck inflation is up 11.1%, which may seem high but it's not in the same league as used car and truck inflation, up a 31.4%. That should be an indicator to investors that supply chains are not running smoothly when a used car is theoretically selling for more than a new one!
- The latest ISM Manufacturing report reading of 72.2 for business supplier deliveries indicates slower delivery times, well above the 10-year average reading of 56.3. Similarly, the Empire State Manufacturing Survey Delivery Time Index reached an all-time high in October.

Figure 1. Consumer Confidence Surveys vs. S&P 500
The market and consumer confidence have diverged
As of 11/30/2021



Source: Bloomberg, L.P.

Figure 2. Consumer Confidence Inflation Expectations
Consumer inflation expectations have trended higher throughout the year
As of 11/30/2021



Source: Bloomberg, L.P.

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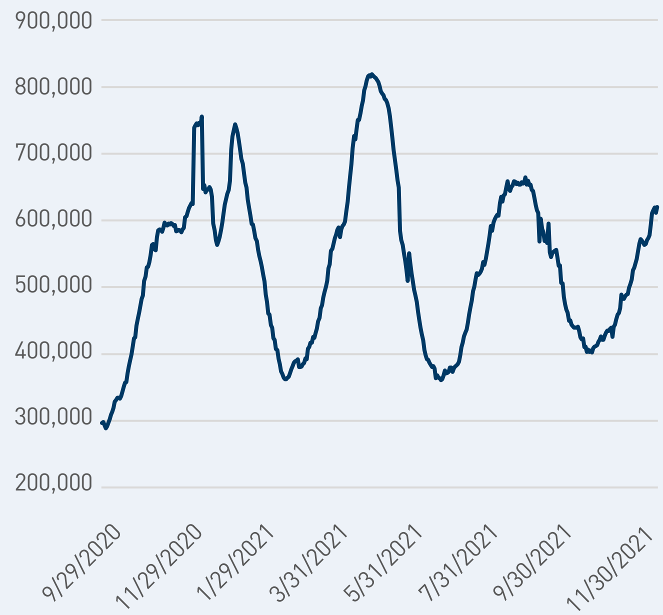
- Semiconductor lead time is a contributing factor to overall stretched delivery times as semiconductors are a critical component to numerous durable goods. That lead time — the gap between order and final delivery — is a record 22.3 weeks according to Bloomberg data. Before the pandemic in late 2019, the lead time was approximately 12 weeks.
- Producer Price Index (PPI) readings in the United States, Germany and China are all double digits. Even Japan, which has negative consumer price inflation, experienced PPI of 8.0% in the latest reading. The common theme among these rising PPI reports is spiking prices in commodities like steel, lumber and energy.

Clearly supply chain bottlenecks across the globe are having an outsized impact on the producer/supplier side of the economy. So why is this not leading to a significant hit to economic growth? In our view, part of the answer is that PPI in these regions remains well above the consumer price index (CPI), the traditional measure of inflation, suggesting companies are not passing on rising costs to end-users. That dynamic is particularly unusual considering operating margins across the globe are at 10-year highs despite elevated input costs.

The Gift that Keeps on Giving

We might sound like a broken record to Santa at this point, but we remain steadfast believers that earnings drive prices in the long run. Unfortunately for investors in 2022, the market's path forward has a symbiotic relationship between the trajectory of earnings growth and the pandemic. We believe a vicious feedback loop is occurring where the elevated inflation backdrop is caused by supply chain bottlenecks, which continues to be affected by various "waves" of COVID-19. From the perspective of global cases, the curves look remarkably consistent, with each wave lasting approximately four months (Figure 3).

Figure 3. Global New COVID-19 Cases, 7-day Moving Av.
Cases appear to move in four-month waves
As of 12/7/2021



Source: Bloomberg, L.P.

Zooming in further, we see each wave is driven by different parts of the globe. The Beta variant wave largely affected developed markets in the United States and Europe; the Delta variant wave that began in the Spring primarily affected emerging markets in Asia and then shifted to developed markets where cases are back on the rise (Figure 4, page 4). This zoomed-in look at various regions changes how to look at the global case curve, in our view. If case growth was uniform around the world, that would present a different picture. Unfortunately, there is no chance for global trade to normalize because the pandemic keeps causing disruptions just as activity is set to fully come back online!

A look at manufacturing PMI data also shows a similar trend. The JPMorgan Global Manufacturing PMI has stayed above 50 — implying activity is expanding — since mid-2020. At the surface, it would appear global manufacturing has been firing on all cylinders the entire time. However, looking at countries such as India, its Manufacturing PMI dipped below 50 in June just as the Delta variant was in decline. Likewise, the Manufacturing PMI for Vietnam also fell below 50 in June, but then stayed in contraction territory for another three months as Delta continued to spread. Again, zooming out at the global level misses these nuances that have significant impact on global supply chains.

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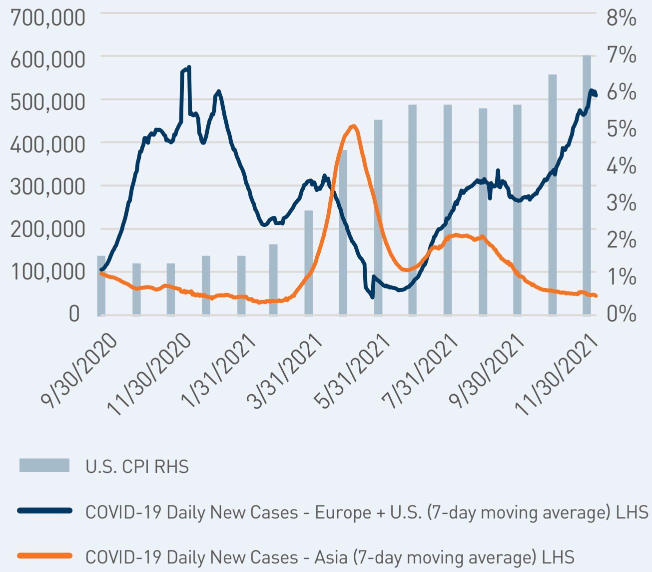
Figure 4. Regional New COVID-19 Cases vs. U.S. CPI
Increasing CPI has somewhat tracked new infections
As of 12/8/2021



Source: Bloomberg, L.P.

Figure 5. MSCI Index Total Return
Europe lagged other regions during the Delta wave
As of 12/8/2021

Index	4/30/21-12/8/21	YTD
MSCI United States	12.61%	22.34%
MSCI Vietnam	8.24%	25.09%
MSCI India	19.79%	24.94%
MSCI Europe	4.85%	14.36%

Source: FactSet®. FactSet® is a registered trademark of FactSet Research Systems, Inc., and its affiliates.

While U.S. markets may notoriously diverge from economic growth from time to time, a comparison with other country markets shows the impact the pandemic is having on returns (Figure 5). From the peak of the Delta variant on April 30 through Dec. 8, the MSCI India Index outperformed the U.S., Europe and Vietnam indices. The MSCI Europe Index was a notable laggard; at first, it kept pace with the U.S. index, but as Delta variant cases kept climbing, performance subsequently diverged.

Heading into 2022, CPI across developed markets is expected to decelerate from the 2021 figure of 3.2% down to 2.9%; however, it is still higher than any of the previous five years leading up to the pandemic. Fast forward to 2023 and estimated CPI decreases further to 1.9%, which would more closely resemble the prior business cycle trend of low inflation across developed markets. For 2022, we are not asking for inflation to come down — that would be far too simple of a wish. It is not as simple as asking for a new computer, we want the Meta Quest 2 VR headset with 256 GB of storage to be exact! While we wait impatiently to join the metaverse, we instead ask for supply chain normalization, which would bring an abrupt end to elevated inflation, in our view. If Santa can agree to our wish, we believe it could be a very strong upside surprise for markets in 2022, particularly earnings.

Time for the Eggnog?

Given the state of markets and our expectations for 2022, is the market solely dependent on containing the pandemic to ease supply chain disruptions and inflationary pressures, or are there any other tailwinds should Santa skip our house this year? With consumer confidence out of sync with equity prices, we go back to our investment process for insight.

Business Cycle

As fiscal and monetary stimulus and the base effects from the pandemic fade, growth is expected to slow in 2022 and shift the business cycle from a broad market accelerating expansion toward a more narrowly driven slowing expansion. The International Monetary Fund forecasts global GDP to slow from 5.9% in 2021 to 4.9% in 2022 (Figure 6, page 5). Likewise, the consensus earnings growth estimate for the MSCI All Country World Index, representing approximately 85% of global equities, is expected to drop from 47% in 2021 to 6% in 2022 (Figure 7, page 5). However, a slowing expansion is still reflective of positive growth and thus should remain a tailwind for global markets into 2022.

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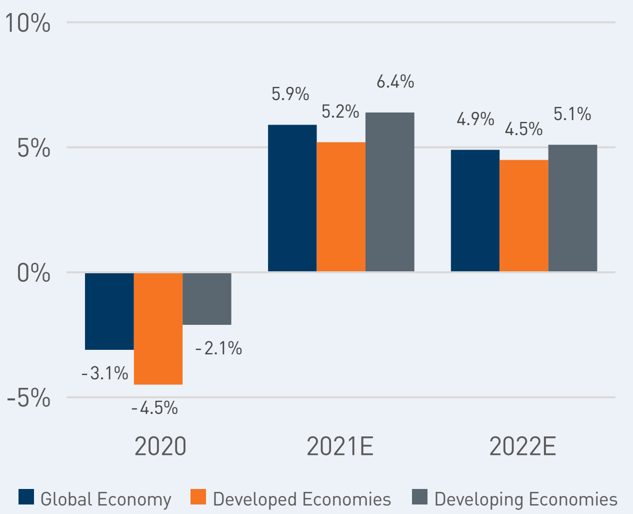
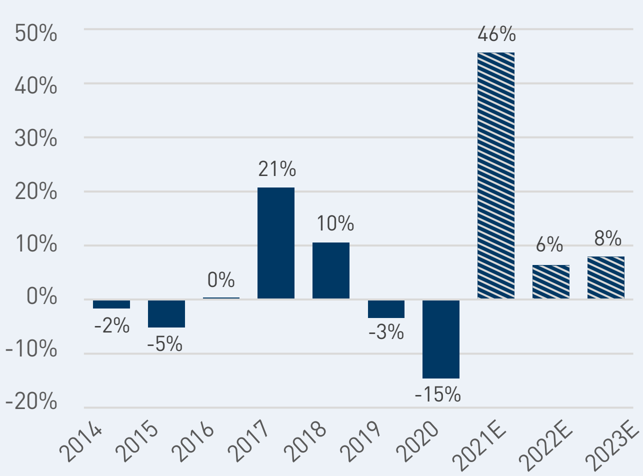
Figure 6. Annual GDP Growth, YoY
Global GDP growth is expected to moderate in 2022
As of October 2021



Source: International Monetary Fund

Figure 7. MSCI ACWI Earnings Per Share Growth, YoY
EPS Growth is set to decelerate, but remains positive in 2022 and 2023
As of 11/30/21



Source: FactSet®

We continue to believe the key catalyst for 2022 is the path of COVID-19. Not only is it going to dictate inflation and supply chain bottlenecks, but also the trajectory of earnings growth. With global cases back in an uptrend as the Omicron variant spreads, a lingering pandemic could hinder the normalization of supply chains and pressure inflation. Despite this uncertainty, the business cycle component of our investment process remains firmly positive heading into 2022.

Valuations

Valuations remain well above pre-COVID-19 levels across the multiasset class universe, with earnings yields, credit spreads and interest rates all near historically low levels. Forward earnings multiples also remain well above pre-pandemic levels across the multiasset class universe (Figure 8, page 6). With inflation expected to act as a governor on earnings multiples, the backdrop suggests there is less room in 2022 for equity markets to run based on multiple expansion; like 2021, year-over-year returns would need to be driven by earnings growth.

We continue to believe upward revisions in 2022 earnings estimates are necessary across the board to justify valuations at their current levels. A slowdown in global economic activity or persistently higher levels of inflation due to a lingering pandemic could call these earnings growth expectations into question, thus pressuring valuations.

Technicals

Technicals continue to be supportive for markets, reaching all-time highs earlier this month as volatility remains elevated. In fact, the S&P 500 has not had more than a 5% pullback in over a year, bouncing off its 50-day moving average 10 times this year. However, intra-stock correlations have begun to rise heading into year-end, and market breadth has moved lower, indicating a smaller concentration of stocks have been driving returns. In our view, the high-volatility regime is prevalent not only in price swings, but in market leadership, which is reflective of fresh COVID-19 concerns and the shift in monetary policy.

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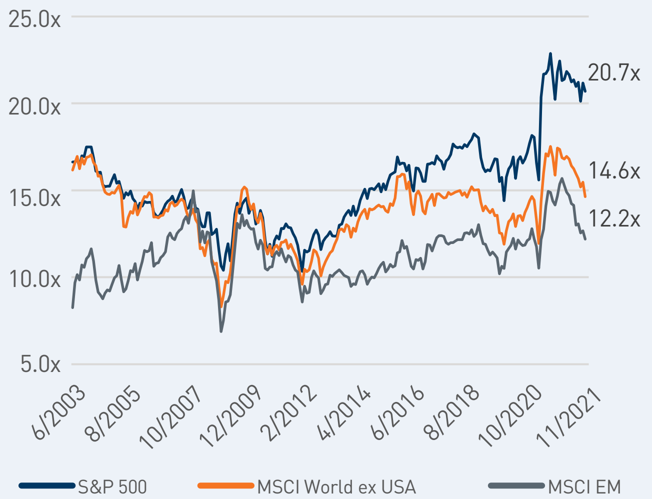
Figure 8. Next 12 Month Price/Earnings Ratios

Valuations across the globe remain at the high end of historic ranges

As of 11/30/2021



Source: FactSet®

Will It Be a Happy New Year?

We believe there are enough positive indicators to suggest 2022 may indeed be a happy year. Global economic growth, while moderating, is still positive and could move higher if we get our Christmas wish of easing supply chain bottlenecks, which will ultimately help ease inflationary pressures. The future persistence of these issues still depends on many uncertain factors, such as the degree that workers return to the labor market, or the extent that future COVID-19 surges add to supply chain bottlenecks. Nonetheless, the prospects for global equity markets remains favorable, in our view, supported by solid earnings growth.

For more details, stay tuned for our first-quarter *Strategy Insights* publication "Coming Down the Mountain in 2022," which provides our outlook for the new year.

For more information, please contact your PNC advisor.