US Equities

Although the US economy is set to grow in 2022, higher costs and wage pressures could squeeze profit margins.

The combination of a healthy US consumer segment, higher government spending on infrastructure and social programs, and increased corporate capital expenditure (capex) could lead to higher growth over the next few years for the US economy. We believe growth will be broader-based and focused on improving supply chains, automation to tackle dependence on a tight labor market, and emerging areas of the market to address climate risk.

This is in stark contrast to the last decade or so since the 2008 Global Financial Crisis, which was characterized by low growth and monetary stimulus coupled with government policy and regulatory uncertainty.

The post-COVID-19 economy in the US has been driven by consumer spending. However, we expect this to change as we move into 2022.

While the savings rate remains strong, the US consumer has spent their way down to a more normal level of savings from the post-pandemic historical peak. The US consumer will need to take on debt if the recent consumer-spending trends are to continue. We also expect to see a shift from spending on goods to services as the reopening of the economy continues.

Companies Set to Invest More Due to Low Cost of Capital

The capex cycle being experienced in the US is noteworthy; it's been a number of years since companies have had the confidence to deploy long-term capital. Instead, excess cash was used to buy back shares, which provided a short-term boost to valuations but lacked the ability to compound.

Companies may spend more due to the low cost of capital coupled with the fact that increased visibility around future growth prospects has boosted confidence in boardrooms.

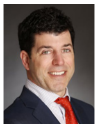
In addition, companies are now more circumspect about their global-supply chains, which could mean more focus and investment in the US and in nearby countries such as Mexico. Given the measures taken during the pandemic to ensure availability of capital, we think there will be political pressure to invest rather than buy back shares or pay dividends.

Small and Mid-Cap Companies May Benefit Most

In this environment, US small- and mid-cap companies may benefit more than large-cap companies. This is partly due to the greater choice of companies participating in both the domestic US economy, as well as more broad-based growth opportunities that didn't exist the past few years. As growth broadens out, we believe the greater breadth and diversity of the small- and mid-cap market will provide more ways to access that growth.

The future, however, is not all rainbows and unicorns because higher growth prospects come with the risk of more cost inflation. Although the supply-chain bottlenecks and raw-material cost inflation seen in 2021 may prove transitory, wage pressures could be more persistent as both skilled and unskilled labor remains scarce.

Insight from sub-adviser Schroders Investment Management



Bob Kaynor
Head of US Small and Midcap Equities

Key Points

- The US economy is growing at a structurally higher rate than before COVID-19, driven by consumer spending, government infrastructure investments, and corporate capital spending.
- Companies may be able to achieve higher revenue growth, and we believe those that can protect their profit margins will be the biggest winners.
- In this environment, we believe the best opportunities may be found in small- and mid-cap companies where growth and valuations are more attractive.

Protecting Profit Margins Will Be Key As Costs Rise

Companies may enjoy higher revenue growth, but we believe those that can protect profit margins will be the biggest winners. Looking forward, valuations of companies will depend more on profit metrics and returns than simply nominal growth. This will require a lot of analytical skill to differentiate winners and losers.

We believe the small- and mid-cap segment of the market is poised to achieve superior earnings growth in 2022 relative to large caps. Although this has happened consistently for the past few years, large caps have outperformed small caps in recent years. This conundrum has left us with some of the most attractive valuations in small cap vs. large cap since the 2008 financial crisis.

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Higher Interest Rates Could Test Some Expensive Valuations

The pendulum is likely to shift in 2022. A possible change in the interest-rate cycle in response to higher inflation could test some expensive valuations for larger companies. Such elevated valuations are not so prevalent for smaller companies.

This apart, we see better growth anticipated by small caps in 2022, and if we're right about GDP growth remaining above trend, this could come to fruition.

It's difficult to envision markets generating the same level of returns experienced in 2021—which have been extraordinary—but the investment case could still be strong for investors to make money.

Talk to your financial professional to learn more about potential opportunities in equities in 2022.

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