Quarterly Market Update: Fourth Quarter 2021

Executive Summary

Lisa Emsbo-Mattingly, CBE
Director, Asset Allocation Research

Dirk Hofschire, CFA
Senior Vice President, Asset Allocation Research

Jake Weinstein, CFA
Research Analyst, Asset Allocation Research

Jenna Christensen
Research Associate, Asset Allocation Research

Andrew Garvey
Research Associate, Asset Allocation Research

The following is an executive summary for the "Quarterly Market Update: Fourth Quarter 2021" report by Fidelity's Asset Allocation Research Team.

Market Summary: Supply Challenges, Peaking Growth, and Policy Support

Prices for most asset categories finished largely unchanged from where they started the quarter. Commodities, however, posted strong gains, ranking as the top-performing category year to date, supported by solid industrial demand and restrained production. Emerging-market equities declined on concerns around China's regulatory tightening and slowing growth. Year to date, U.S. stock performance remained strong, while bond returns were lackluster.

The broadening global expansion faced numerous crosswinds. Global vaccination progress continued, but supply disruptions due to virus outbreaks, along with labor-market constraints and severe weather, restrained growth and sustained inflationary pressures. The cyclical backdrop remains favorable, but a move to a less accommodative stance by policymakers likely would challenge asset returns.

Economy/Macro Backdrop: Global Expansion Still Broadens amid Growing Crosswinds

The broad trend of mid-cycle expansion continued for many major economies, including the United States and Europe, with economic reopening generally supporting activity. However, supply constraints and disruptions sapped some of the growth momentum, and many developing countries remained inhibited by their more limited vaccination and reopening progress. China slipped into a growth recession amid significantly decelerating activity.

In China, regulatory actions intended to contain leverage and financial risks, tame property speculation, and promote social goals and greater equality dragged on Chinese growth across several economic sectors. Activity measures of China's large and influential real estate market dropped, raising key risks to the outlook. Officials have refrained from broad stimulus, but policy easing is likely to be necessary to stabilize the economy's slide.

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U.S. consumers, broadly speaking, are in solid shape, having experienced the highest net worth and lowest debt-service obligation on record. Historic monetary and fiscal stimulus boosted housing and financial asset prices, drove interest rates downward, and delivered direct fiscal transfers that helped generate record savings gains. Higher inflation and inequality are challenges, but pent-up demand may offer a steadying mid-cycle influence.

Corporations posted their highest rate of job openings in two decades, but unemployment rates remained elevated. Job gains continued, and worker shortages should ease further with extra jobless benefits having expired and childcare and schools closer to full reopening. However, some of the three million people who left the labor force during the pandemic—especially older workers—might not return, implying some of the supply-demand gap may persist.

Corporate earnings surprised to the upside for the fourth quarter in a row. Sales growth accelerated amid faster nominal growth and greater corporate pricing power. Market expectations for 2021 earnings were revised upward to a robust 45% year-over-year growth rate, but expectations for 2022 ticked down. The ability to maintain high margins amid rising wage and input costs remains key to the corporate earnings outlook.

The market's near-term inflation expectations remain much higher than pre-pandemic levels but also point to the belief that inflation pressures are transitory and should diminish in the years to come. While inflation rates are likely to drop in 2022 due to base effects, we believe acute supply-side pressures—supply-chain disruptions, depleted inventories, high order backlogs—are likely to keep inflation elevated for some time.

Over the long term, policymakers' use of low interest rates and high fiscal deficits appears entrenched, creating a more inflationary policy backdrop. While technology and other factors have kept inflation in check, we believe greater policy experimentation and de-globalization trends will eventually cause long-term inflation to rise faster than expected. Rising long-term inflation expectations can further reinforce inflation pressures.

Abundant financial market liquidity has supported asset prices so far in 2021, fueled by global central bank asset purchases and a $1.4 trillion drawdown of the U.S. Treasury's general account. However, the Federal Reserve has signaled QE tapering and that rate hikes are drawing nearer; also, favorable Treasury-account dynamics are reversing. Liquidity growth and monetary support likely have peaked, raising the prospect of higher market volatility.

After nearly $3 trillion of emergency stimulus in fiscal year 2021, considerably less fiscal support is expected for 2022. The budget deficit is set to shrink substantially next year, but other factors are expected to largely offset any resulting fiscal drag. Raising effective corporate tax rates back closer to 2017 levels would dampen corporate earnings but still leave rates near historic lows. If higher taxes on corporations and high-income individuals were used to fund spending on infrastructure and other proposals, it could add a slightly pro-growth flavor to near-term fiscal policy.

Most major economies face deteriorating demographic trends. With fewer new workers to support a growing number of retirees, we see greater fiscal pressures ahead due to rising spending on pensions and health care. The dramatic worldwide rise in public and private debt in recent decades has been sustained by extraordinary levels of monetary accommodation, leaving the system more dependent than ever on low interest rates.

Asset Markets: China Concerns Dragged Emerging Markets Down

Stocks registered relatively muted performance during Q3, with U.S. sector gains led by financials; meanwhile, small cap stocks lagged. International equities posted modest losses, as emerging markets suffered from growth and regulatory fears in China. Most fixed income categories also saw little movement over the quarter.

The sharp rebound in earnings growth reached decade-high rates on a year-over-year basis across all major global categories—U.S., non-U.S. developed markets, and emerging markets. Forward expectations indicate analysts believe earnings may converge to a lower rate over the next 12 months, but earnings across all regions are expected to maintain double-digit growth rates.

Global equity valuations moved lower during Q3 as strong earnings growth outpaced stock-price gains. Trailing and forward-looking price-to-earnings (P/E) ratios remain elevated for U.S. equities relative to their historical averages, but valuations for developed and emerging markets are more reasonable relative to their long-term histories.

The business cycle can be a critical determinant of asset performance over the intermediate term. Stocks have consistently performed better earlier in the cycle, whereas bonds tend to outperform during recession. While we believe a business cycle approach to actively managed asset allocation can add value, portfolio returns are expected to even out over the long term.

Authors

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The Asset Allocation Research Team (AART) conducts economic, fundamental, and quantitative research to develop asset allocation recommendations for Fidelity's portfolio managers and investment teams. AART is responsible for analyzing and synthesizing investment perspectives across Fidelity's asset management unit to generate insights on macroeconomic and financial market trends and their implications for asset allocation.

Fidelity Thought Leadership Director David Risgin, CFA, provided editorial direction for this article.

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