APOLLO

Perspectives

January 2022

Outlook for the Economy and Markets in 2022

Key Takeaways

- **Strong growth in consumer spending and CapEx spending will continue in 2022** driven by the economy reopening, high stock prices and home prices, and significant excess savings in the household sector and the corporate sector.
- **Inflation is expected to peak in early 2022, but strong growth will continue to put upward pressure on consumer prices throughout the year.** Temporary forces lifting inflation are supply chain problems and elevated energy prices. More permanent forces pushing inflation higher are rising home prices and rising wage inflation.
- On the back of solid GDP growth and elevated inflation, **the Fed is expected to increase interest rates three times in 2022.** Ten-year Treasury rates are likely to increase gradually and end 2022 at 2% because of elevated inflation uncertainty, the Fed raising rates, and the Fed ending their purchases of US Treasuries in 2022.
- With higher short-term interest rates and QE ending, **credit spreads are likely to widen for IG and HY, and the upside to equities looks limited given current valuations.** Loans and other floating-rate products are likely to perform well, as the Fed begins its tightening cycle. With higher interest rates in the US, and the ECB and the BoJ expected to stay on hold, the dollar is likely to appreciate in 2022.
- The broader backdrop for markets in 2022 is the Fed ending QE and raising interest rates. Asset allocation decisions, including for alternatives, should be based on the three broad themes for 2022: Inflation uncertainty, QE ending, and the timing of the first Fed hike. Importantly, **investors should keep in mind that once the Fed begins to tighten policy, the goal is to limit risk-taking in the economy and financial markets.**

Introduction and summary

In recent months, the number of new covid cases has increased globally, and the near-term outlook for the economy and markets continues to be dominated by the path of the virus, see Figure 1. If the omicron wave follows the pattern of previous waves, we are likely to see the virus subside after 2-3 months. With little appetite for new lockdowns and restrictions, the economic impact of the omicron wave is likely to be limited.

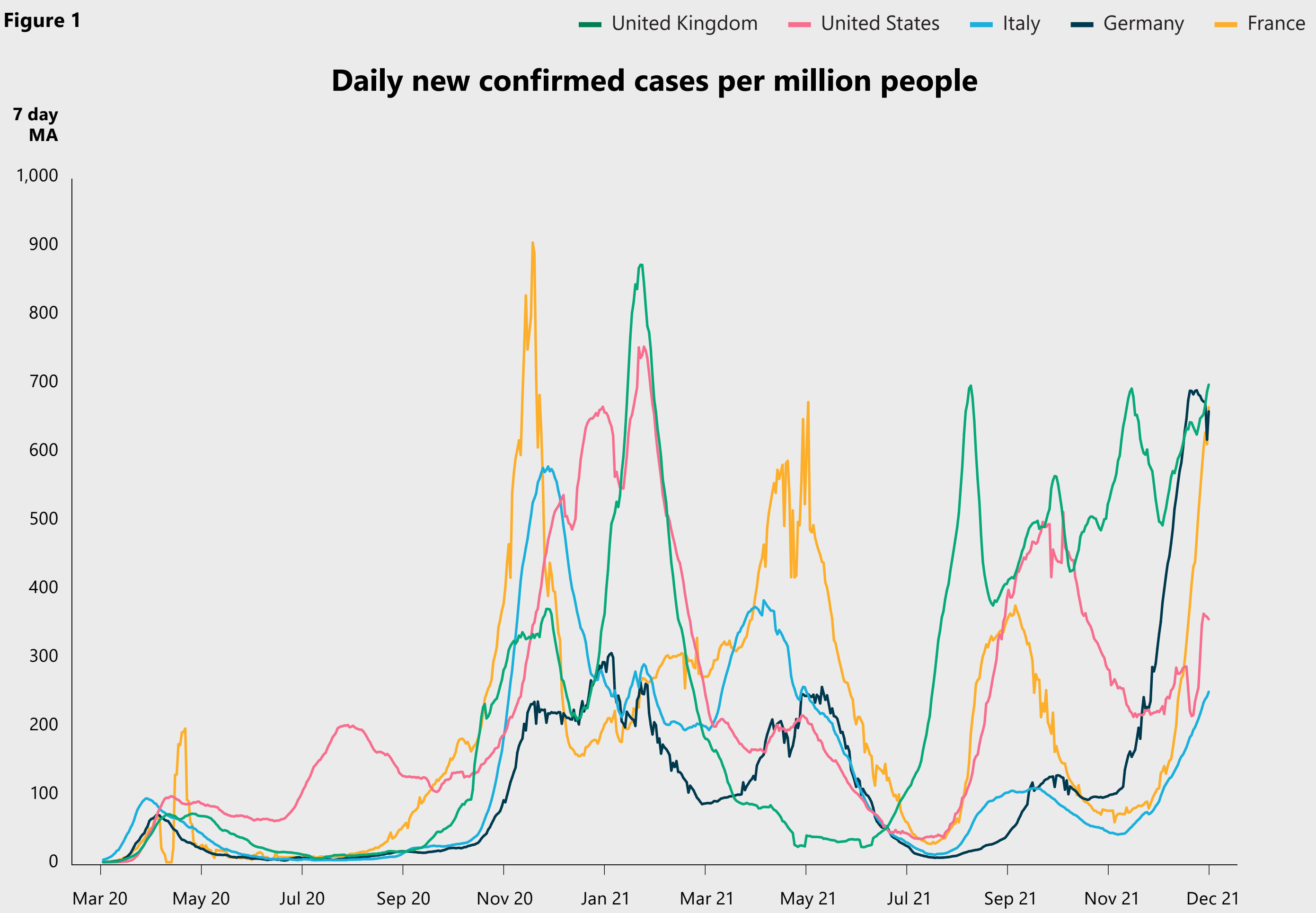
The consensus also sees the omicron wave as temporary. The current expectation is that in 2022 growth will be 4% and inflation will be 3%, see Figure 2. These consensus forecasts are higher than the historical performance of the US economy, which has been 2% growth and 2% inflation.

The implications for markets of this consensus view are important. An equity investor will look at 4% GDP growth and 3% inflation and conclude that nominal growth of 7% will be good for topline growth and hence also for earnings, and therefore one should buy equities going into 2022. Rates investors, on the other hand, will look at the consensus forecast and conclude that 4% growth and 3% inflation reflects an overheating economy, and that means the Fed will be raising rates, which means investors should be cautious on equities.

The conclusion for markets is that there is a disagreement between rates investors and equity investors about whether inflation will be a problem or not. Rates investors are pricing in more Fed hikes, and this is starting to show up in the form of higher implied rates volatility and wider credit spreads. This elevated tension between fixed-income and equity markets will likely continue in 2022.

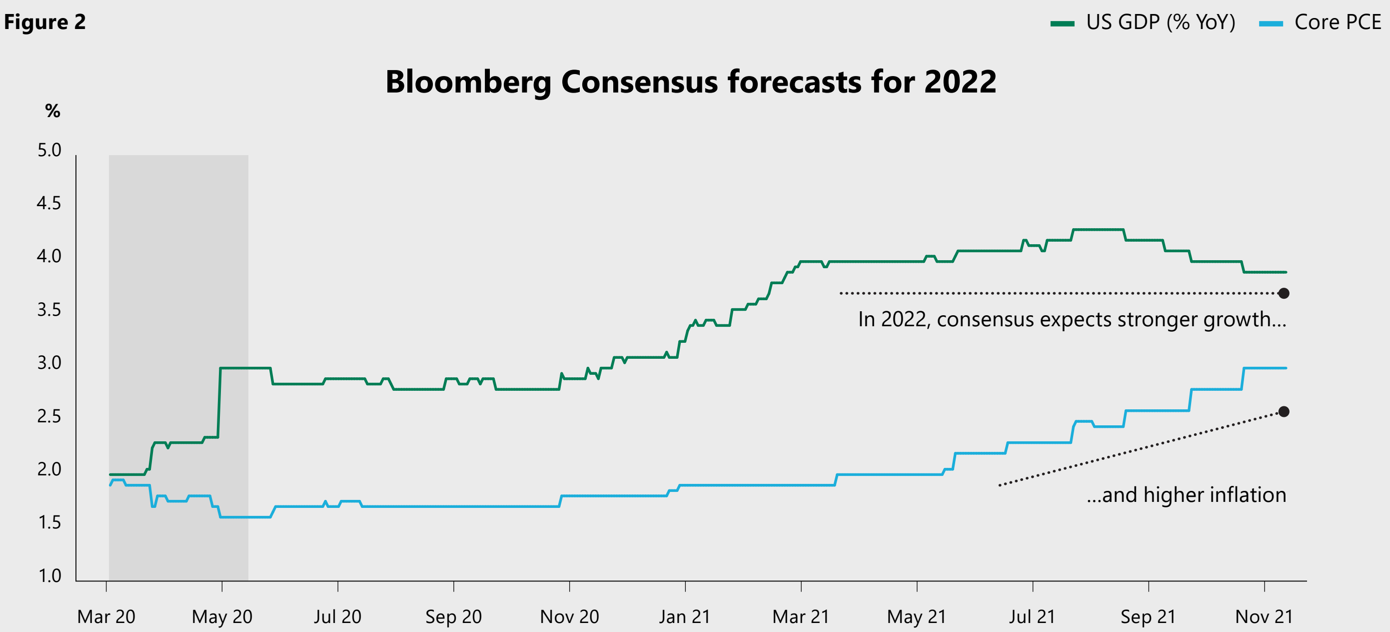
From a markets perspective, the fear is that the Fed, because of inflation and high home prices, high labor costs, high energy costs, and high costs for distribution and logistics, will increase interest rates faster than the market currently expects. If the Fed raises interest rates faster because of worries about inflation, it will likely generate an outcome in markets with higher rates, wider credit spreads, and downward pressure on equities.

Figure 1



Source: Apollo Global Management, Bloomberg Finance LP

Figure 2

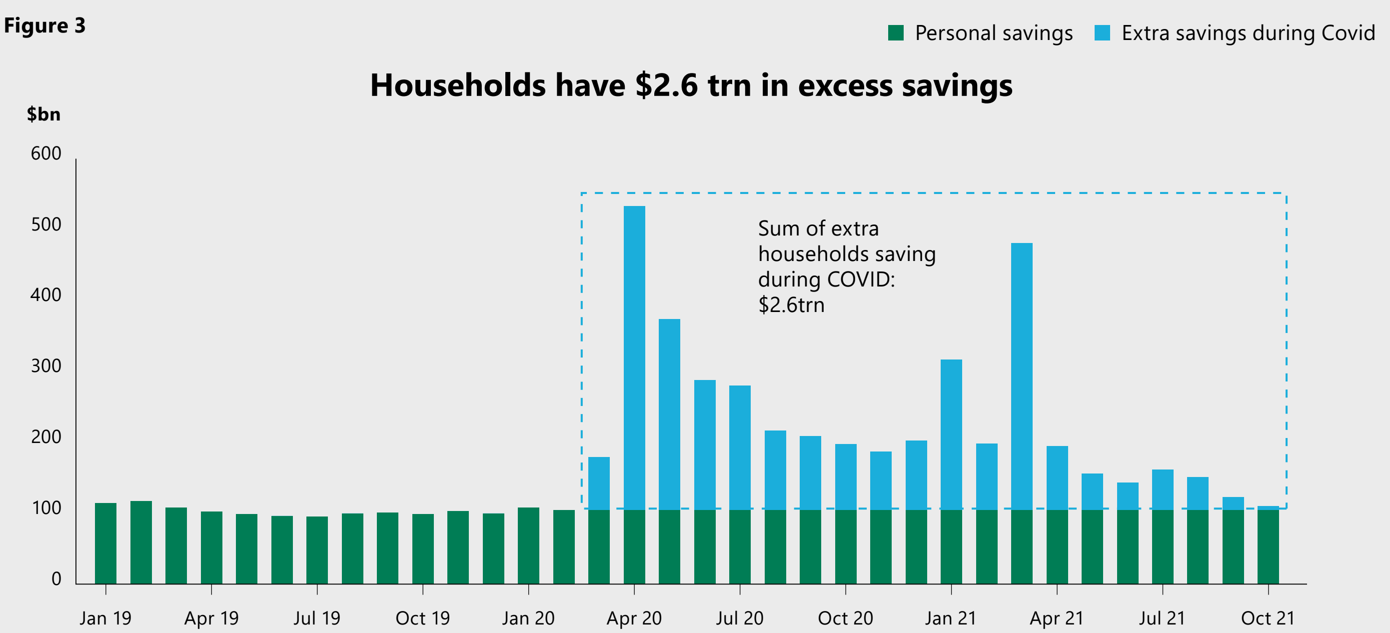


Source: Apollo Global Management, Bloomberg Finance LP

Outlook for consumer spending and CapEx spending

Consumer spending is likely to grow at a robust rate in 2022. Factors supporting the household sector are solid job growth driven by reopening, high wage growth caused by widespread labor shortages, and high levels of wealth driven by high stock prices and high home prices. One unique factor fueling consumer spending is excess savings in the household sector, which has reached $2.6trn, see Figure 3. Savings increased during the pandemic because of stimulus checks, higher unemployment benefits, and lower consumer spending during lockdowns on restaurants, travel, and other consumer services. It is unusual for the household sector to come out of a recession with significantly elevated savings. The stock of excess savings will continue to provide a tailwind to consumer spending for the coming 12-18 months.

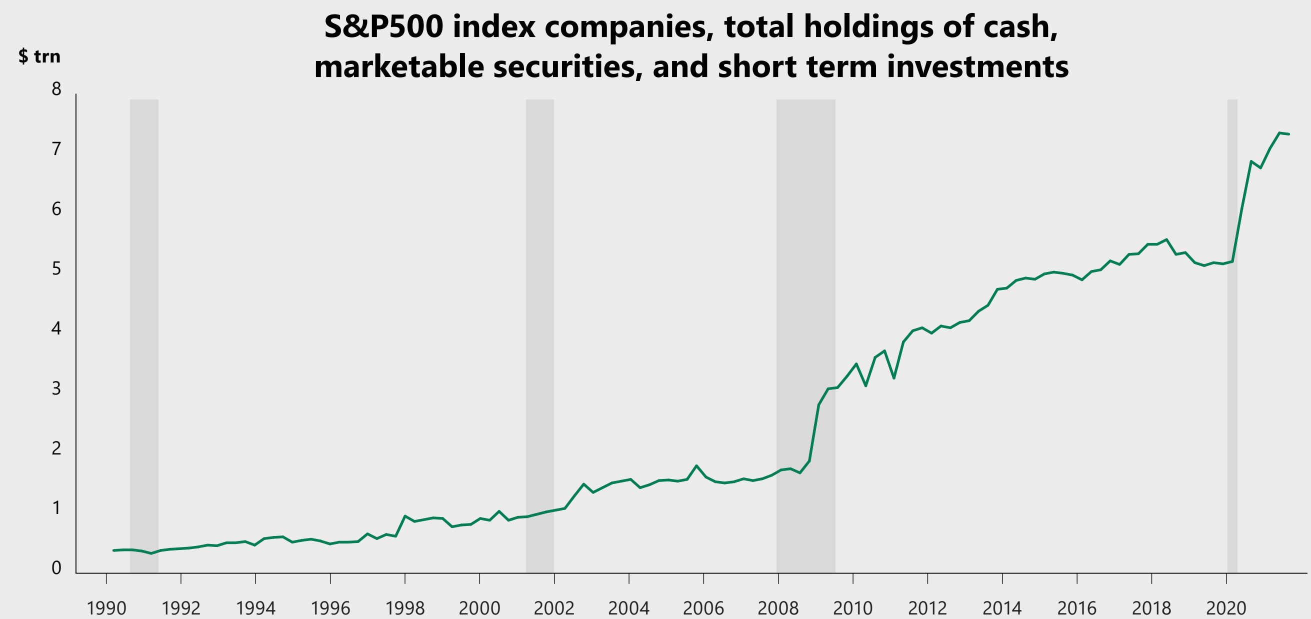
Figure 3



Source: Apollo Global Management, U.S. Department of Commerce

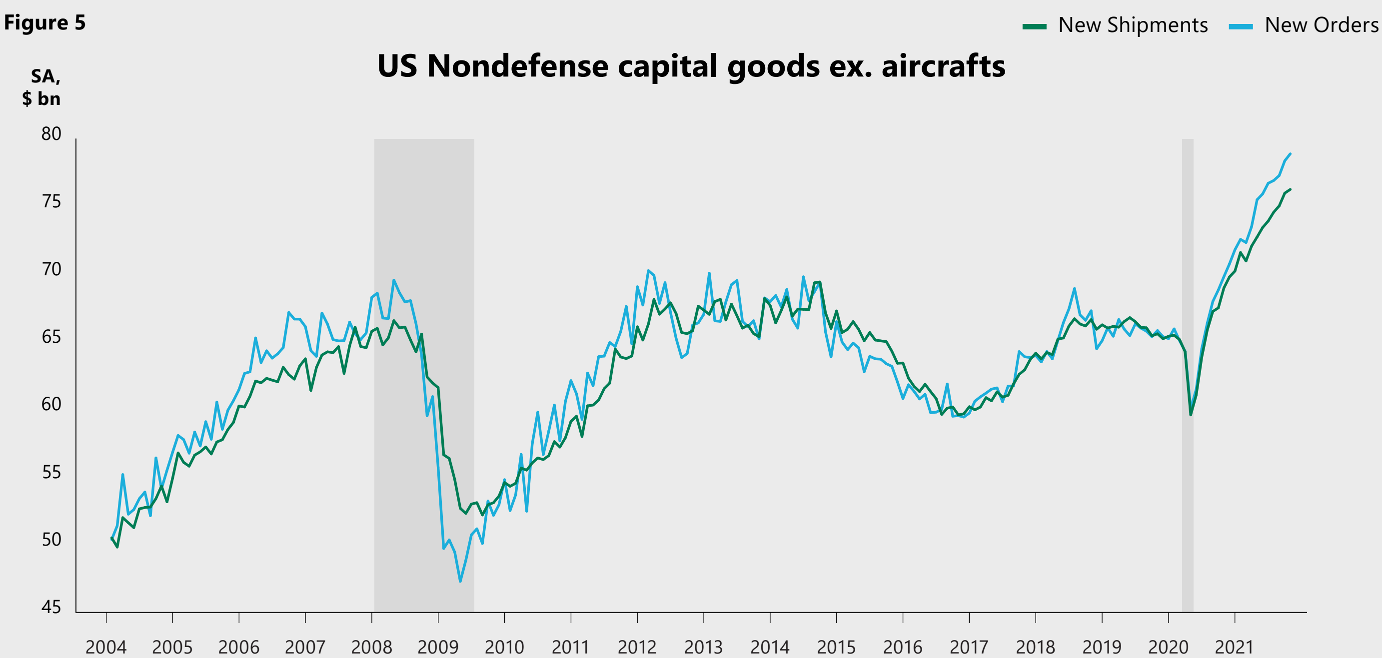
CapEx spending is also likely to be strong in 2022, driven by solid corporate earnings, record-high levels of corporate cash holdings, and considerable investment needs to adjust to a post-covid world. Firms are holding substantial amounts of cash, which is also unusual when coming out of a recession. S&P500 companies have more than $7trn in cash, marketable securities, and short-term investments, see Figure 4. As we go through 2022, companies are likely to spend their excess cash on hiring more employees and investing in new technologies and increased R&D. These tailwinds should keep the current CapEx boom going, see Figure 5 and 6.

Figure 4



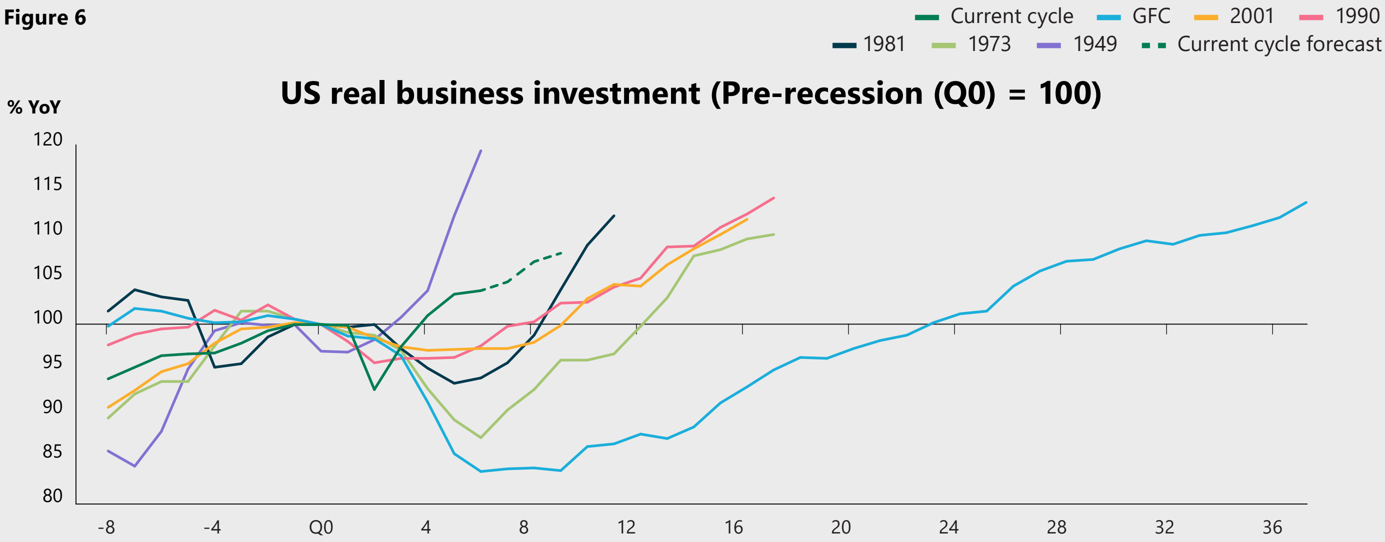
Source: Apollo Global Management, Bloomberg Finance LP

Figure 5



Source: Apollo Global Management, U.S. Census

Figure 6



Source: Apollo Global Management, U.S. Department of Commerce

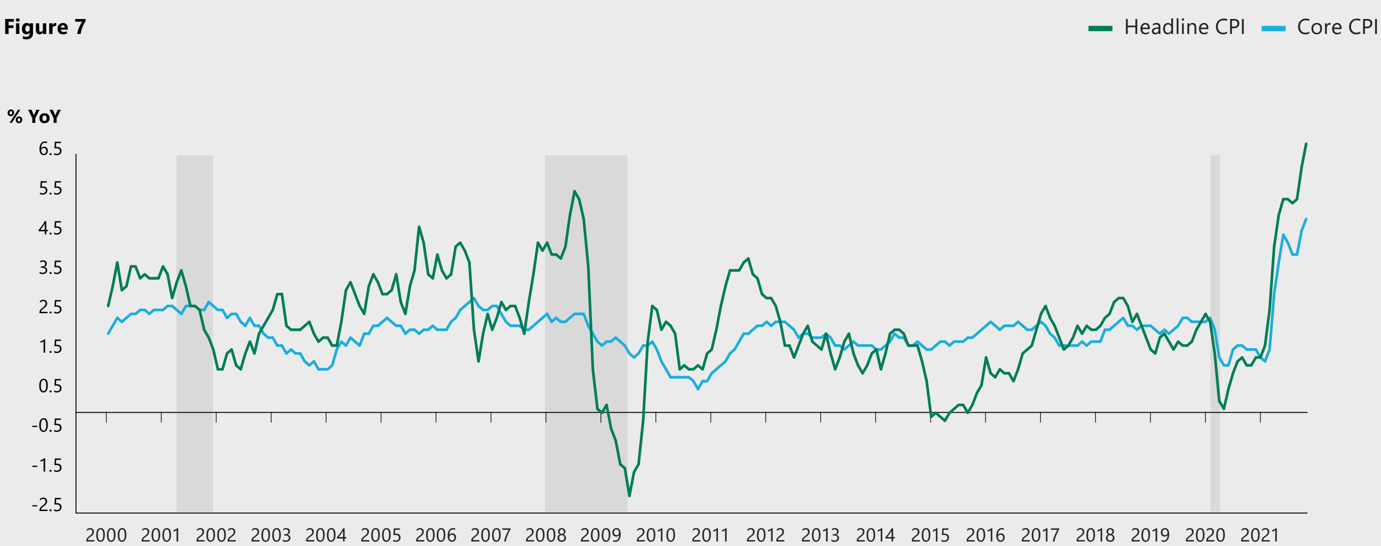
Outlook for inflation

Over the past year, inflation has increased significantly, see Figure 7. Inflation during the pandemic has been lifted temporarily by supply chain problems and shortages in the energy sector. These challenges will likely get resolved as we go through 2022, see Figure 8.

More permanent factors boosting inflation are rising home prices and rising wage inflation. With interest rates at very low levels and strong job growth and strong wage growth, housing demand is likely to stay strong. Shelter costs make up around 1/3 of the CPI inflation basket and strong home price growth is going to continue to boost headline and core inflation over the coming 12-18 months, see Figure 9.

A second force putting more permanent upward pressure on consumer prices is wage inflation. High wage growth is a risk not only to inflation but also to corporate margins. With the virus still not eliminated, we are unlikely to see a quick increase in the labor force participation rate. With limited potential to increase the labor force participation rate, we are likely to see additional upward pressure on wages in 2022.

Figure 7



Source: Apollo Global Management, Bureau of Labor Statistics

Figure 8

Inflation outlook

Inflation pressures coming from:

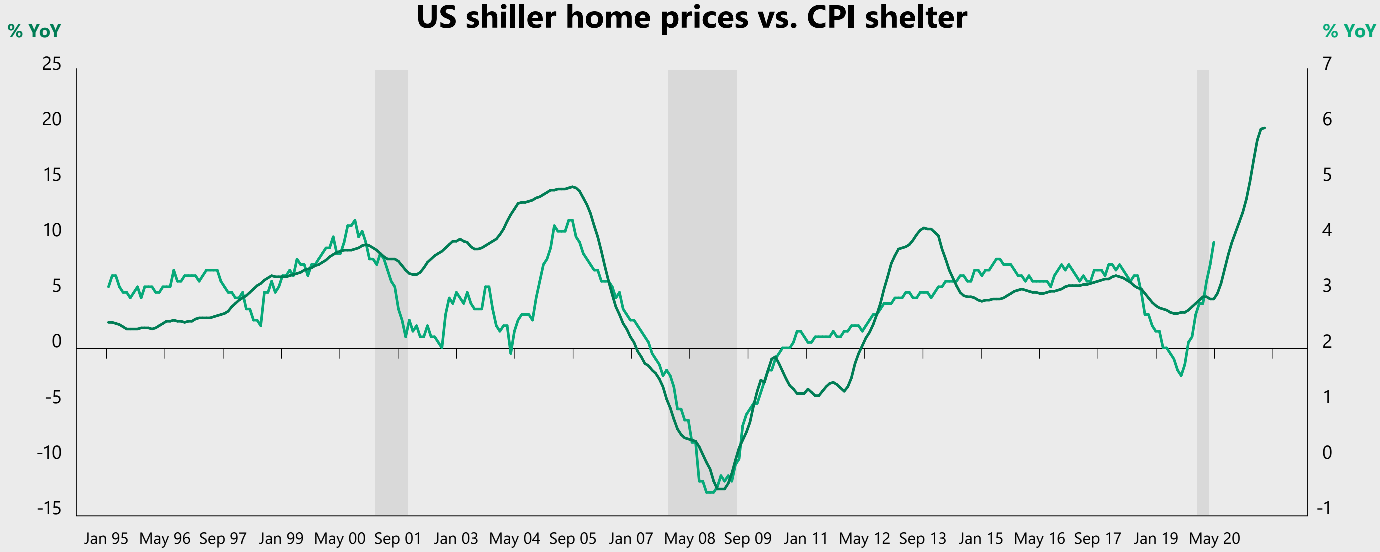
1. Supply chain problems – a temporary problem
2. Higher home prices and rents – a temporary problem
3. Higher energy prices – a more permanent problem
4. High wage inflation in most sectors – a more permanent problem

Source: Apollo Global Management

Figure 9

S&P case-shiller home prices (ls) — CPI Shelter (18m lag) (rhs)

US shiller home prices vs. CPI shelter



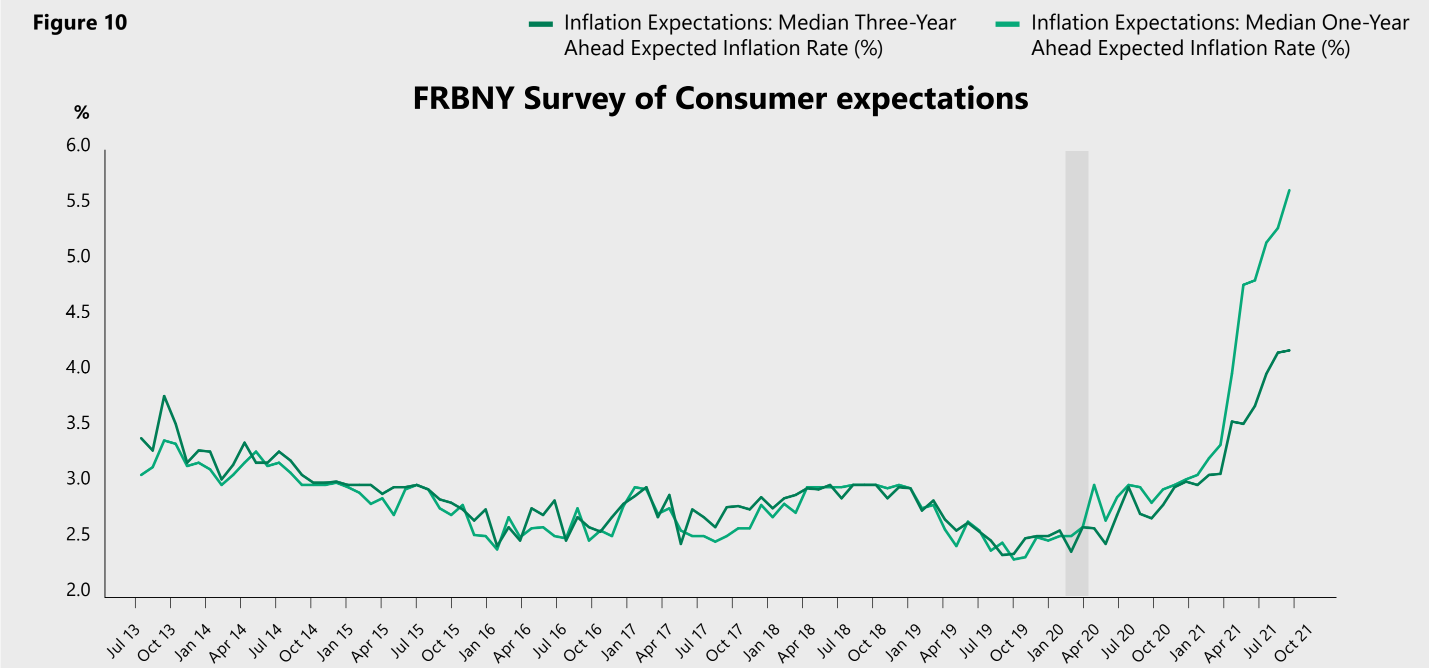
Source: Apollo Global Management, Bloomberg Finance LP

Outlook for the Fed

The Fed has a dual mandate to achieve full employment and inflation at 2%. With upside risks to inflation in 2022 and the unemployment rate at 4.2%, the Fed has started to turn more hawkish. A key worry for the Fed is if inflation expectations become unanchored as they did in the 1970s. We should not expect this to happen, but it is worrying from a Fed perspective that inflation expectations continue to trend higher, see Figure 10.

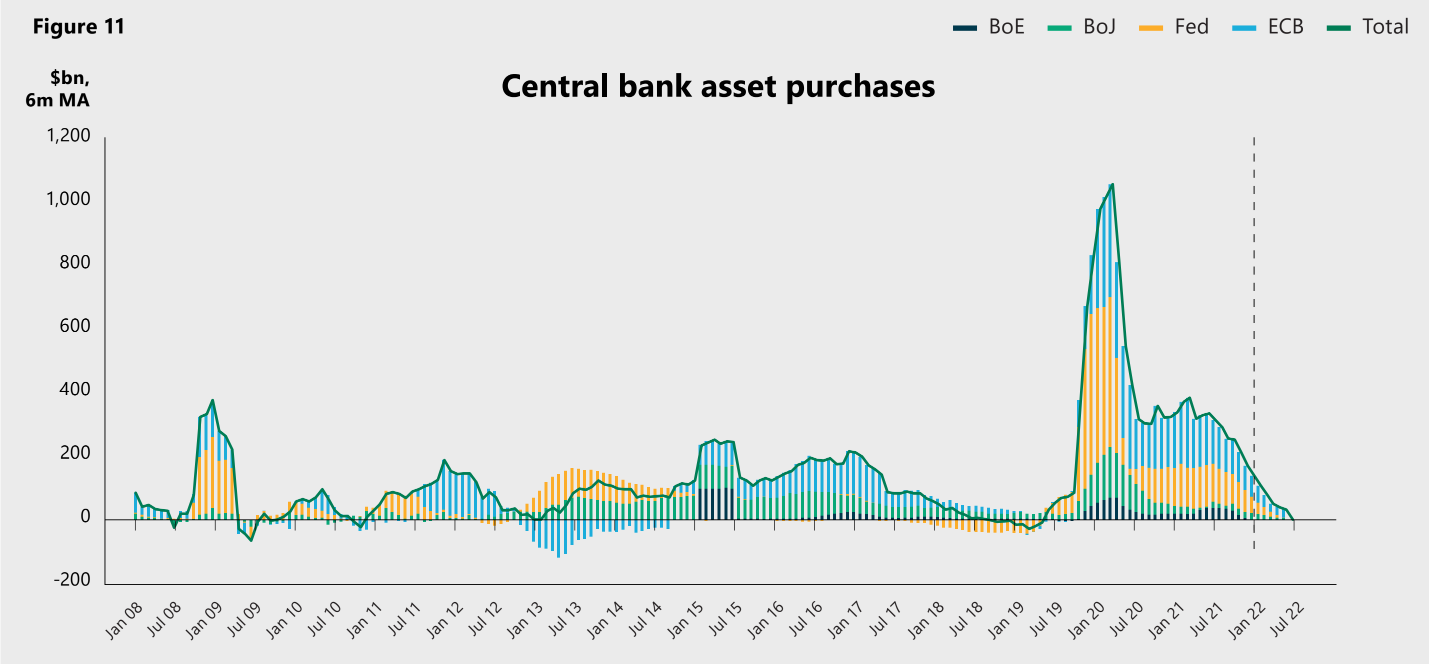
With the backdrop of high inflation and low unemployment, the Fed has signaled that they will taper their asset purchases faster than originally expected. The implication is that rate hikes are coming faster than expected, and financial markets will get less support via QE. In fact, with QE ending in 2022, see Figure 11, we could see some turbulence in rates, credit, and equity markets, as markets later in the year will no longer be supported by the $120bn in asset purchases every month that the Fed has provided until recently.

Figure 10



Source: Apollo Global Management, Federal Reserve Bank of New York

Figure 11



Source: Apollo Global Management, Bloomberg Finance LP

Outlook for rates, credit, equities

The forces driving markets in 2022 are elevated inflation uncertainty, the Fed raising rates, and the Fed ending QE. The broader backdrop for these themes is that valuation metrics are more and more stretched, especially for equity markets. For example, the Shiller CAPE (Cyclically-Adjusted P/E ratio) is approaching the all-time highs seen in 2000, see Figure 12.

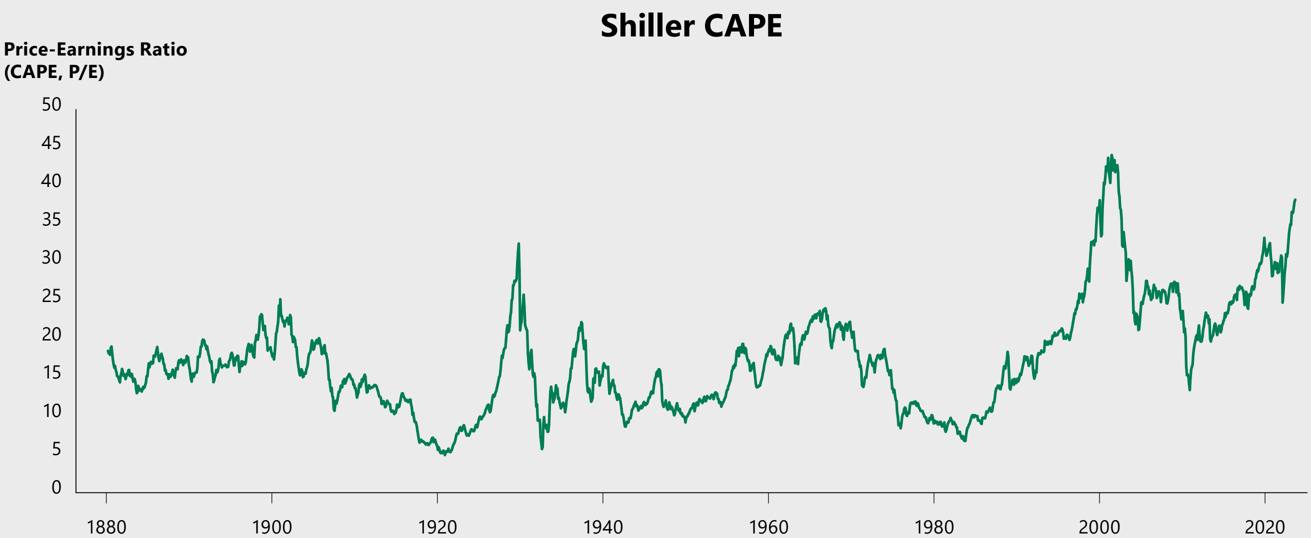
The combination of high inflation and high valuations and a more hawkish Fed argues for higher rates, wider credit spreads, and caution on equities. Rates will likely move higher because of growing Fed worries about inflation. Credit spreads will likely widen further because tighter Fed policy means lower growth, which means lower earnings. Furthermore, higher policy rates mean a higher risk-free rate, which means less appetite for investors to buy risky assets such as credit and equities.

For equities, not only are valuations elevated but higher labor costs will also continue to negatively impact profit margins.

The simplest way to look at the outlook for markets in 2022 is the Fed's gradual move toward raising rates. The goal for the Fed with increasing interest rates is to cool the economy down and limit risk-taking in financial markets. From this perspective, a more hawkish Fed should be expected to have a negative impact on Treasury markets, credit spreads, and the stock market. And credit markets appear particularly vulnerable to rising rates given the current record-high duration for the IG index (Figure 13).

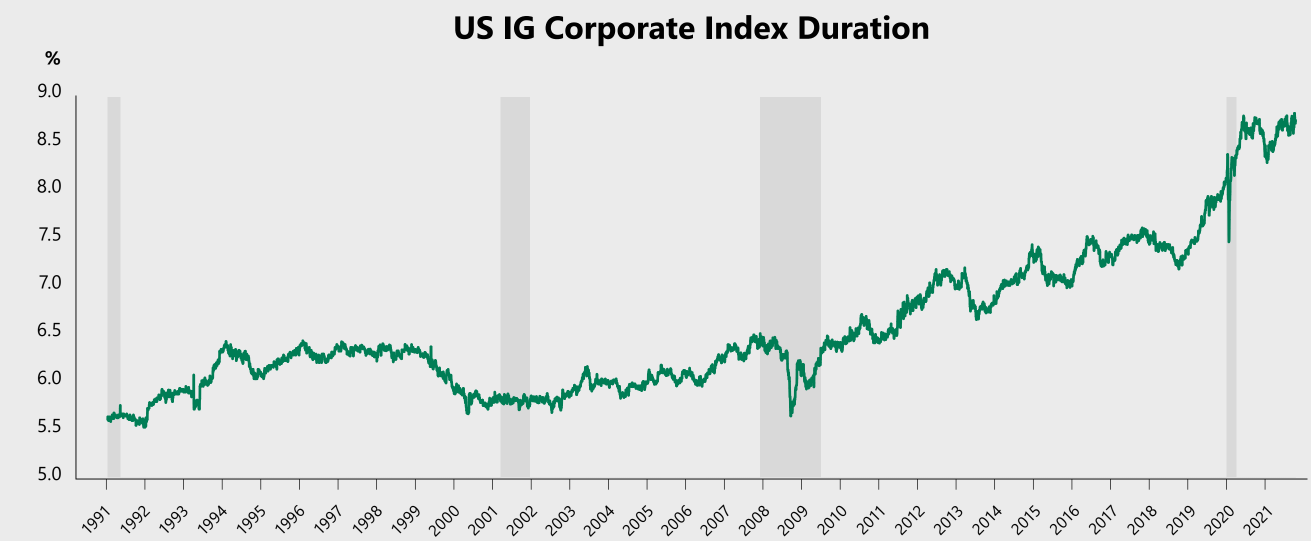
For alternative assets, the asset allocation implications depend on how serious the inflation problem will be. If inflation is a more permanent problem, then real assets such as real estate and infrastructure should do well. If interest rates move higher and stay higher, then credit strategies should perform well and generate higher yields for credit investors. Under all scenarios, opportunistic private equity and credit strategies, including hybrid value strategies, should perform well.

Figure 12



Source: Apollo Global Management, Bloomberg Finance LP

Figure 13



Source: Apollo Global Management, Bloomberg Finance LP

Apollo's US economic outlook

	1Q21	2Q21	3Q21	4Q21	1Q22	2Q22	3Q22	4Q22	1Q23	2Q23	3Q23	4Q23	1Q24	2Q24	3Q24	4Q24	2021	2022	2023	2024
YoY																				
Real GDP	0.5	12.2	4.9	4.9	4.3	3.6	3.8	3.3	2.8	2.4	2.1	1.9	1.9	1.9	2.0	2.0	5.6	3.7	2.3	1.9
QoQ SAAR																				
Real GDP	6.3	6.7	2.0	4.6	4.1	3.7	2.7	2.7	2.1	2.0	1.7	2.0	2.0	2.0	2.0	2.0	5.6	3.7	2.3	1.9
Personal Consumption Expenditures	11.4	12.0	1.6	4.1	3.8	3.3	2.2	2.4	2.3	2.3	2.0	2.0	2.0	2.0	2.0	2.0	8.1	3.7	2.3	2.0
Govt Consumption Expenditures & Gross Investment	4.2	-2.0	0.8	1.3	2.5	2.0	1.8	1.6	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	0.7	1.5	1.6	1.5
Gross Private Domestic Investment	-2.3	-3.9	11.7	9.6	6.7	6.3	5.1	4.7	2.2	2.1	2.1	3.4	3.4	3.4	3.4	3.4	8.6	6.8	3.3	3.2
Exports	-2.9	7.6	-2.5	5.0	6.0	6.1	6.0	5.5	5.0	4.0	3.0	2.0	2.0	2.0	2.0	2.0	4.7	4.8	4.7	2.2
Imports	9.3	7.1	6.1	5.0	5.0	4.9	4.9	4.5	4.1	4.4	4.0	3.0	3.0	3.0	3.0	3.0	14.2	5.2	4.3	3.2
CPI (% YoY)	1.9	4.8	5.3	6.2	5.8	5.0	3.5	2.5	2.3	2.1	2.0	2.0	2.0	2.0	2.0	2.0	4.6	4.2	2.1	2.0
Core PCE (%YoY)	1.7	3.4	3.6	4.2	4.0	3.2	2.8	2.4	2.3	2.2	2.1	2.0	2.0	2.0	2.0	2.0	3.2	3.1	2.2	2.0
Unemployment rate	6.2	5.9	5.1	4.3	4.1	4.0	3.9	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8	5.4	4.0	3.8	3.8
AHE	4.3	3.7	4.6	4.8	4.5	4.3	4.0	3.9	3.6	3.4	3.2	3.2	3.2	3.2	3.2	3.2	4.3	4.2	3.4	3.2
Fed funds rate	0.25	0.25	0.25	0.25	0.25	0.50	0.75	1.00	1.00	1.25	1.50	1.75	1.75	2.00	2.00	2.25	0.25	1.00	1.75	2.25
10 year yield	1.74	1.45	1.52	1.75	1.80	1.85	1.90	1.95	1.95	2.20	2.45	2.70	2.75	2.90	2.95	3.00	1.75	1.95	2.70	3.00

Source: Apollo Global Management

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The "Standard & Poor's 500 ("S&P 500") Index is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies by market value. The S&P 500 is a market value or market-capitalization-weighted index and one of the most common benchmarks for the broader U.S. equity markets.

Additional information may be available upon request.