First Trust
Monday Morning OUTLOOK

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Sticking to Our Targets, For Now

Late last year we unveiled our stock market forecast for 2022, projecting the S&P 500 would rise to 5,250 and the Dow Jones Industrials average would climb to 40,000. Since then, however, equities have dropped, with (now realized) fears about Russia invading Ukraine and the recognition that inflation is a more persistent problem than the Federal Reserve had previously let on, which means some combination of faster rate hikes or a higher ultimate peak for short-term interest rates, or both.

Reaching our year-end equity targets would now take a steeper climb than we previously thought: 20.7% for the S&P 500 and 17.4% for the DJIA, from Friday's close. But we still like those targets and don't see enough reason to change them.

As we wrote last week, Russia would likely invade Ukraine by soon after the Olympics ended, but that such an invasion is unlikely to change the long-term outlook for corporate profits. As a result, any drop in equities would end up being a buying opportunity.

Sure, the Biden Administration might try to exert pressure on Russia through economic and financial sanctions. But other countries, like China and Germany, have strong interests in continuing to exchange freely with Russia. Ultimately, right or wrong, we think the Biden Administration is more concerned about managing its image involving the Russia-Ukraine conflict, for purposes of domestic politics (like, not "appearing weak"), than trying to alter the outcome of the conflict itself.

Meanwhile, and for the time being, inflation is likely to be equities' friend, not their foe. Companies with pricing power, commodities' companies, and materials' firms, in particular, should do well.

In addition, the message from our Capitalized Profits Model hasn't changed, at least not yet. The cap profits model takes the government's measure of profits from the GDP reports, discounted by the 10-year US Treasury note yield, to calculate fair value. Corporate profits for the third quarter were up 19.7% versus a year ago, up 21.2% versus the pre-COVID peak at the end of 2019, and at a record high.

The key question then becomes what discount rate should we use? If we use 1.90%, roughly the current 10-year Treasury yield, our model suggests the S&P 500 is still grossly undervalued. But, with the Fed about to embark on a series of rate hikes and inflation likely to keep running relatively hot, the 10-year yield is likely to keep rising, although with fits and starts.

So, to be cautious, we plug in some alternative higher long-term interest rates. Using third quarter profits, it would take a 10-year yield of about 3.00% for our model to show that the stock market is currently trading at fair value. And that assumes no further growth in profits. With a 10-year yield of 2.50% all it would take is profits 3% above the level in Q3 for our model to estimate fair value at 5,250, which is what we projected for the end of 2022.

The bottom line is that the winds of change are blowing hard in 2022: COVID is winding down, borders are in flux, and monetary policy is in for a major and long-overdue shift. In spite of these changes, we think equities are likely to rebound from recent strife and work their way higher this year. The bull market in stocks won't last forever. But, for now, it isn't at an end.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
2-24 / 7:30 am	Initial Claims – Feb 20	235K	**237K**		248K
7:30 am	Q4 GDP Second Report	7.0%	**7.1%**		6.9%
7:30 am	Q4 GDP Chain Price Index	6.9%	**6.9%**		6.9%
9:00 am	New Home Sales – Jan	0.803 Mil	**0.849 Mil**		0.811 Mil
2-25 / 7:30 am	Durable Goods – Dec	+1.0%	**+2.3%**		-0.7%
7:30 am	Durable Goods (Ex-Trans) – Dec	+0.4%	**+0.2%**		+0.6%
7:30 am	Personal Income – Jan	-0.3%	**-1.0%**		+0.3%
7:30 am	Personal Spending – Jan	+1.6%	**+1.6%**		-0.6%
9:00 am	U. Mich Consumer Sentiment- Feb	61.7	**61.7**		61.7