

S&P 5,250 – Dow 40,000

We were bullish in 2021 and bullishness obviously paid off. As of the Friday close, the S&P 500 is up more than 25% so far this year. Meanwhile, a 10-year Treasury Note purchased at the end of 2020 has generated a negative total return, as interest earnings have been more than offset by capital losses.

The reason we were bullish a year ago even amid widespread fears about COVID-19, is because we stick to fundamentals, assessing fair value by using economy-wide profits and interest rates, what we call our Capitalized Profits Model. And, one year, later, we are still sticking with fundamentals. Our year-end 2022 call for the S&P 500 is 5,250 (up 11.4% from last Friday), and we expect the Dow Jones Industrial Average to rise to 40,000.

The Capitalized 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 20.7% versus a year ago, up 22.3% 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 1.50%, roughly the current 10-year Treasury yield, our model suggests the S&P 500 is grossly undervalued. But, with the Federal Reserve still holding short-term interest rates at artificially low levels, the 10-year yield might be artificially low, as well.

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 2.75% for our model to show that the stock market is currently trading at fair value. And that assumes no further growth in profits.

We expect the 10-year Note yield to finish 2022 in the vicinity of 2.00%. Nonetheless, we have chosen to use a more conservative discount rate of roughly 2.50%. Using third quarter 2021 profits, that creates a fair value estimate for the S&P 500 of 5,250. And this does not take into account higher profits in the year ahead.

The bottom line is that although we remain bullish, we are not quite as bullish as in recent years, projecting an increase in stocks of 11.4% from Friday’s level. We haven’t had a 10% correction in 2021, and, although we never try to time the market, we wouldn’t at all be surprised by one happening at some point in 2022. Moreover, the stock market is likely to grapple with either higher short-term rates in 2022 or, in the alternative, a Federal Reserve that is even further behind the inflation curve, risking a higher peak for short-term rates sometime in the future.

Another issue is the battle between fading fiscal stimulus and a gradual return to normalcy. The budget deficit will still be very large this year even if the Democrats-only “Build Back Better” proposal doesn’t pass. But the deficit will be much smaller than the past two years. That will generate a short-term headwind for growth. Meanwhile, more businesses should be getting back to normal and small business start-ups gradually replacing businesses that were killed off by overly strict COVID rules.

On net, this adds up to a scenario that is likely to be constructive for equities. We’ve been bullish since 2009 but we are not perma-bulls. There are clouds on the horizon, and at some point in the next few years, we may be (temporarily) bullish no more. In the meantime, though, the clouds are on the horizon, not overhead. Equities have further to run.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
12-14 / 7:30 am	PPI – Nov	+0.5%	+0.6%		+0.6%
7:30 am	“Core” PPI – Nov	+0.4%	+0.3%		+0.4%
12-15 / 7:30 am	Retail Sales – Nov	+0.8%	+0.8%		+1.7%
7:30 am	Retail Sales Ex-Auto – Nov	+0.9%	+1.1%		+1.7%
7:30 am	Import Prices – Nov	+0.7%	+0.3%		+1.2%
7:30 am	Export Prices – Nov	+0.5%	+0.8%		+1.5%
7:30 am	Empire State Mfg Index – Dec	25.0	27.3		30.9
9:00 am	Business Inventories – Oct	+1.1%	+1.2%		+0.8%
12-16 / 7:30 am	Initial Claims – Dec 12	198K	194K		184K
7:30 am	Housing Starts - Nov	1.565 Mil	1.570 Mil		1.520 Mil
7:30 am	Philly Fed Survey – Dec	30.0	27.6		39.0
8:15 am	Industrial Production – Nov	+0.7%	+0.7%		+1.6%
8:15 am	Capacity Utilization – Nov	76.8%	76.9%		76.4%