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Focus —

Is Omicron the new economic Boogeyman?

The discovery of the new Omicron variant has brought back fears and concerns around the global economic outlook, in an already sensitive context of surging Covid cases and rising restrictions across Europe.

In order to gauge the economic impact of this new variant, two key questions remain unanswered, at least for now:

- Will existing vaccines provide a decent level of protection against the Omicron variant?
- Compared to existing variants, does this new one cause similar, more or fewer severe conditions, hospitalization and deaths?

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The answers to those two questions can potentially bring very different outcomes for global economic activity in 2022, from relatively mild to quite severe ones. At this stage, we can try to imagine what would be the impact, should the Omicron variant prove to be as bad as previous variants in medical terms, and resistant to existing vaccines.

In a nutshell, our view is that it would represent a moderate direct risk for economic growth, but a larger potential risk of higher inflation. For financial markets, such scenario will certainly bring heightened volatility as it may put central banks in an uncomfortable position, but equity markets could ultimately maintain an upward trend supported by earning growth in several large sectors of the market. On the contrary, bonds would probably face a very unfavorable context and may not be the safe haven they were in the early stages of the pandemic.

The worst is never certain and, as information on the new Omicron variant become known in the coming days or weeks, the huge uncertainty created by its irruption will gradually dissipate. In the meantime, it seems urgent to wait and prepare for all potential outcomes.

A moderate direct risk for economic growth

Amid the current elevated degree of uncertainty, we believe that one should resist to the temptation of applying the "2020" template for the economic and financial impact. Governments, hospitals and health care systems, businesses, households are much better prepared and equipped to deal with a dreaded but potential return of large-scale social distancing measures. Even if they have already been deeply impacted by the pandemic over the past two years and their capacity to absorb another large shock is possibly reduced.

On this ground, we would expect a moderate impact on global economic growth, despite possibly significant divergences from a country to another. Work-from-home, Click-and-collect, mask wearing, testing, government pandemic support… They have unfortunately become usual features of our daily lives and can be instantly reactivated, unlike in 2020 when new ways of living and working had to be created and adopted. Even if the Omicron variant turns out to be resistant to existing vaccines (thus requiring to start from scratch with new vaccines) and as deadly as previous variants, a "full stop" scenario for economic activity like the one we saw in 2020 is therefore unlikely and the growth slowdown should be more moderate.

A larger potential risk for inflation and central banks

Another difference between today and 2020 lies in the ability of central banks to help contain a potential negative shock. Their capacity to act is much more limited than 18 months ago. Large central banks in developed economies still have their short-term interest rate to the floor (or even below), with little margin for lowering them any further. They are still injecting sizeable amounts of liquidity into financial markets. While several of them have signaled that they were about to start normalizing their policy, they could easily postpone it if the growth outlook deteriorates. But could they do much more? The hurdle for negative cash rates in USD or in GBP, or even more negative EUR and CHF rates, appears quite elevated and such measures could only be contemplated when faced with a very large shock.

Furthermore, the starting point for inflation dynamics is quite different from early 2020, i.e. much higher. The "transitory thesis" for inflation that has mostly prevailed in the past few months is predicated on a normalization of economic conditions in 2022, as the supply and demand shocks caused by the pandemic and vaccine rollout gradually dissipate. If, instead, the Omicron variant forces a new round of lockdowns, factory closures and supply chain interruptions, the global economy could be hit by another large supply shock that would fuel current inflationary trends as demand will, in all likelihood, continue to be supported by government support.

In the hypothesis of a supply and demand shock fueling persistently high inflation, central banks may be faced with a highly uncomfortable dilemma, one that they have not faced for decades. The "stagflation scenario" much discussed in 2021 could then become a real risk, with central banks forced to tighten financial conditions in order to contain inflationary pressures, despite economic activity being harmed by the resurgence of new variants.

While we had obviously not predicted the irruption of this new variant, we had stubbornly high inflation as one of our three bear risks for 2022. For the time being and even with this Omicron variant, we remain within the scope of our macro-economic outlook.

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