DECEMBER 2021

Flash —

Global equities: can bad news become good news again?

While many investors were expecting a year-end rally, equity volatility is on the rise as markets need to digest central bank tightening and fears over the impact of the Covid-19 omicron variant - among others. Should we interpret recent equity market weakness as a sign that the bull market is running out of steam or should we rather look at it as a healthy correction?

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Amid rising volatility and fears about Omicron, some signals may offer a silver lining.

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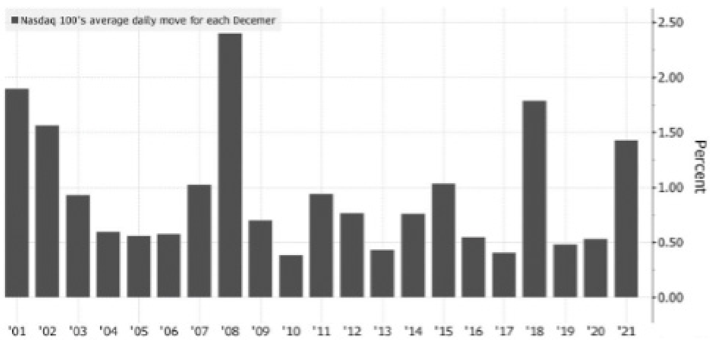
As we headed towards the year-end, the market outlook was quite supportive: global economic growth was reaccelerating, inflation was expected to stay high but signs of "peak supply bottlenecks" were emerging and developed markets central banks seemed to stubbornly stick to an "uber-dovish" monetary policy.

However, as we get closer to the last trading days of the year, risk assets are going through some turbulence. The Nasdaq 100 index is heading for one of the wildest Decembers in 13 years while the VIX index has jumped above 25.

Year-End Turmoil

Nasdaq 100 is heading for onr of the wildest december in decades



Source: Bloomberg

Indeed, everything must go right for the "goldilocks" scenario to persist. But the last few weeks have been challenging the consensus.

First, the emergence of the Omicron variant is bringing uncertainties on two fronts: global growth expectations as more restrictions could impact global trade and consumer spending, as well as the inflation outlook as lockdowns might create additional supply constraints.

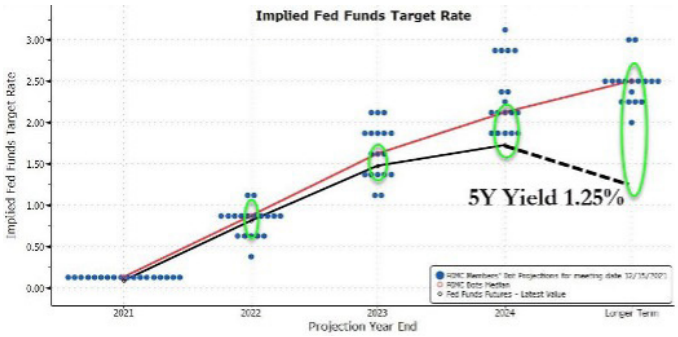
Second, the hawkish pivot by the Fed and BoE brings investors to a new reality: the start of a new tightening cycle. The last one (2017-2018) proved to be painful for most asset classes and is still in many investors' mind. Last but not least, the week-end headlines have also cast doubt on the fiscal support the US economy was expected to receive next year.

Should these latest developments lead us to change our positive stance on risks assets? We don't think so. Indeed, while we expect volatility to be higher in 2022 than this year, we also believe that the global context remains favorable to risk assets. We also think that bad news could become good news. Below we share our view on each of these risks and our main investment conclusions.

The Fed "hawkish pivot"

On Wednesday, the Federal Reserve provided multiple indications that its run of ultra-easy monetary policy since the beginning of the Covid-19 pandemic is coming to a close, speeding the tapering of their monthly asset purchases program and signaling three rate hikes next year, in response to rising inflation.

To the surprise of many, the entire US yield curve has been moving down since the announcement. And while the market has been more hawkish than the Fed throughout most of the year, we are now in the opposite situation: while the median forecast of the Fed's dot-plots showed that policymakers expect to raise the benchmark interest rate eight times (to 2.125%) by the end of 2024, the swap curve signal investors are anticipating that borrowing costs will peak a full year earlier, at about 1.25%. Moreover, the US 10 year yield is trading below 1.4%.



Source: Zerohedge.com

OUR TAKE

For many investors, the Fed's hawkish pivot is a source of concerns as it signals the end of the ultra-loose monetary policy. On the other hand, while we believe that the tapering of quantitative easing and the start of a rate hike cycle should bring more volatility and put a cap on equity multiple expansion, the message from the bond market is quite interesting. It signals that the scope to raise rates is very limited. It also means that although inflation is expected to stay high for a while, markets believes that the response to inflation might be the most muted in decades. This means that real bond yields are likely to stay negative, which should lead investors to favor risk assets.

Moreover, we should remember that unlike previous tightening cycles (2013-14 and 2017-18), the Fed is coming from an absolute position of strength. Real GDP Growth is expected to stay above potential, US consumer spending and unemployment is doing great, the markets are well prepared and the Fed has somewhat reduced the uncertainty on monetary policy. By signaling six rate hikes before the end of 2023, they even opened the door to some positive surprises (i.e less rate hikes) should growth disappoint (because of Covid-19 or less fiscal support for instance – see next points).

Last but not least, let's not forget that not all rate hike cycles have negative implications for equity markets. Looking at history, when the rate hike cycle was slow and inflation was at a reasonable level, the S&P 500 performance was positive.

Omicron variant

Omicron casts a shadow over winter holidays as countries consider implementing serious restrictions. The Netherlands entered full lockdown from Sunday until mid-January, leaving only supermarkets and essential shops open. In the U.K., the government is also refusing to rule out further restrictions over Christmas as cases skyrocket. In the US, Chief Medical Officer Anthony Fauci said on Sunday that it was clear omicron was already "raging through the world." Meanwhile, Wall Street firms have put new office restrictions in place in response to a surge in cases. While the true health and economic impact of the new variant will not become known before days or weeks, the huge uncertainty created by its appearance is sparking fears about the economic recovery and triggering market volatility.

OUR TAKE

As we wrote in our Focus note "Is Omicron the new economic Boogeyman?", we believe that one should resist the temptation of applying the "2020" template for 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 basis, we would expect a moderate impact on global economic growth, despite possibly significant divergences from one country to another. Even if the Omicron variant turns out to be resistant to existing vaccines, thus requiring to development of new drugs and as deadly as previous variants (both of which seem unlikely at this point), 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.

The biggest question mark is on the impact on inflation and central banks. On the one hand, lower economic growth could incite the Fed (and other developed markets central banks) to postpone or cancel some of their planned rate hikes. On the other hand, should the Omicron variant force 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 strong thanks to government support. This would increase the risk of a stagflation scenario. So in this specific case, bad news is not necessarily good news.

US Fiscal policy

Over the week-end, Senator Joe Manchin announced he will not support the president's Build Back Better (BBB) legislation, which is the centerpiece of the 1.75 trillion Biden spending and tax package. The BBB bill had passed in the House of Representatives earlier this year, but has been stalled in the Senate for weeks. As a remainder, the US Senate is split 50-50 between republicans and democrats which means that objections by one senator can abort the passing of a law.

The key reasons behind Senator Manchin's opposition to the legislation are inflation (the highest CPI reading in 39 years) and the ballooning US debt (the true cost of the spending is 5 trillion dollars over 10 years according to the Congressional Budget Office). These headwinds are unlikely to be resolved any time soon which means that the current version of BBB and tax package is likely dead.

This is a major event which has broad investment implications for taxes on high-net worth individuals to global companies to sectors such as renewable energy, healthcare, and consumer discretionary. The rejection of the bill should also lead to a reduction of US economic growth forecasts. According to some estimates, the policy-induced slowdown in the economy could be as much as 1% in Q1, 0.5% in Q2 and 0.25% in Q3.

OUR TAKE

While the bill in its current form is dead, it does not mean that another form of the bill cannot be adopted. Indeed, sometimes legislation has to fail before it can succeed (e.g Obamacare died 3 times before ultimately passing). Manchin is a friend of Biden and he wants him to be reelected. So the likelihood of the bill eventually passing with some amendments is high.

In a scenario of lower than expected fiscal support, bad news could become good news. Indeed, less stimulus should translate into lower growth, which could oblige the Fed to turn less hawkish than expected. This might ultimately be seen as a positive by the markets.

Investment Conclusions

From a tactical perspective, we are maintaining a positive bias on equity markets. In the current environment of positive economic growth and negative real bond yields, equities remain clearly the most attractive asset class.

As mentioned above, the set of bad news currently hitting the newswire could at some point become good news for the market. There are also some technical factors to keep in mind. For instance, institutional tax-loss selling have sparked aggressive sell-off on some often most speculative segments of the market, precisely those that have been exhibiting negative price actions over the last few months. This includes unprofitable tech stocks, SPACs, “meme” stocks, etc. The traditional Santa-Claus rally and January effect could spur some short covering and thus reverse the current negative momentum.

Still, the risk of correction is increasing with central banks normalizing monetary policies at a time of demanding equity valuations. We are thus expecting the markets to become more volatile and have been adding some protections to the portfolios. We also believe that our agile tactical asset allocation process which will help us navigate through a more volatile and uncertain market environment.

For further information

Banque Syz SA
Quai des Bergues 1
CH-1201 Geneva
Tel +41 58 799 10 00
Fax +41 58 799 20 00
syzgroup.com

Charles-Henry Monchau, Chief Investment Officer
charles-henry.monchau@syzgroup.com