Omicron and Macro

Monthly Investment Strategy Oped

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Key points

- Omicron seems to be less severe, but "boosting the boosters" alone may not suffice to preserve healthcare capacity.
- The Federal Reserve and the European Central Bank take a different view on the inflation risk.
- Macro and technical factors have driven market returns
- Valuations remain rich and would be challenged if inflation remains elevated
- Watch real yields in 2022 – we expect a mild rise over the year

Assessing Omicron

We were very much hoping that for the last Op-Ed before the 2021 festive period we would not need to focus on the pandemic again. Unfortunately, the emergence of the Omicron variant forces us to consider a downside risk to our central scenario for 2022. Much is still unknown as we write, but some quantified, serious studies have now appeared, allowing us to draw some informed albeit tentative conclusions for the impact on the global economy.

The UK's Health Security Agency has conducted a study on 581 symptomatic cases of Omicron (without indication of their severity). Two doses of Astra Zeneca provide no statistically significant protection. Two doses of Pfizer provide weak protection. However, boosters seem to provide decent protection, albeit lower than with Delta. Accelerating the booster programme is the logical response. However, at 75% efficacy, even boosters would not allow to reach collective immunity (assuming the "vaccine hesitants" could be convinced). This is not enough to be reassured. Severity is the next issue to assess.

While Omicron spreads much faster than previous versions of the virus, so far in South Africa it has not triggered any significant rise in casualties. This empirical observation is now backed by a large-scale study by the insurance company discovery. According to an analysis of 78,000 test results attributed to the variant the "basic severity", i.e. the probability to be hospitalized, of Omicron is 29% lower than for the first version correcting for the vaccine status. Two doses of Pfizer would provide 70% protection against hospitalization – while the 30% protection against symptomatic infections confirm the message from the UK data. The study does not explore the impact of boosters, but the logical conclusion is that this would move the protection level against hospitalization even higher.

It is thus unsurprising that governments should focus on "boosting the boosters" and getting a third jab into as many arms as possible as quickly as possible, as an alternative to severe mobility restrictions. At the pace observed last week – which has already been exceeded – it would take 2 to 2.5 months to get a third dose to 75% of the population in Europe. This would take much longer in the US though (> 6 months). In addition, this would not deal with the fraction of the population which so far has rejected the vaccines. The introduction of restrictions conditional on individual vaccinal status seems to have had an impact on the take-up of first doses in Germany – where a significant minority of “vaccine-hesitants” had been holding out. It will however take until late into 2022 to get these “new converts” to the best protection level.

All in all, the combination of a high speed of propagation of the variant and a still significant number of people without any protection may mean that additional restrictive measures will be needed in the weeks ahead as a “circuit breaker” to preserve healthcare capacity – unless severity proves to be substantially lower than in previous waves. This would dent GDP growth this winter, even if it would likely be a mere pause in the recovery trajectory. We are not back to square one in the fight against the pandemic.

In this uncertain environment, central banks have displayed different attitudes. The Federal Reserve (Fed) has clearly “flipped”, expressing concerns that the current inflation spike could become “entrenched” and the result of the endogenous workings of the economy. The acceleration in tapering as such is not a surprise, but we thought this would merely allow the Fed to raise the possibility of a series of hikes starting early in 2022. That the median member of the Federal Open Market Committee (FOMC) now expects three hikes next year already suggests that we are no longer in the realm of possibility, but in the realm of intention. We suspect these hawkish moves, despite the Omicron risk, reflects a belief at the Fed that, as in previous waves, the tolerance to sanitary risk would be higher in the US and that a significant slowdown in economic activity could be avoided. What is reassuring is that the market continues to believe that this early monetary tightening will be enough to nip inflation in the bud, so that long-term interest rates remain low. We think that there is an “overkill risk” there though. We find it interesting that 10-year inflation expectations are now below the Fed’s target again. It seems the bond market is taking on board the risk of a too-steep slowdown.

The European Central Bank (ECB) is taking the opposite approach. While quantitative easing (QE) will be reduced in 2022, it’s still quite clear that the Governing Council does not want to hike before 2023. We think this makes sense. The macroeconomic conditions on the two sides of the Atlantic are very different. In the Euro area, inflation remains essentially an exogenous phenomenon expected to fade by 2023 and the output gap remains negative. Contrary to the US, there is no excess demand which the central bank could afford to curb in order to keep inflation in check.

Could valuations adjust?

Inflation is running at multi-decade highs in developed economies. Markets have priced in the beginning of an interest rate hiking cycle in 2022. Yet long-term bond yields remain low. They are low relative to current inflation rates and low relative to where they were prior to the COVID-19 pandemic. If bond yields can’t go up on the back of higher inflation and monetary tightening does this give investors the green light to remain aggressively exposed to risk-assets in credit and equity markets?

With our portfolio management teams we regularly assess return prospects through a framework that considers macro, valuations, investor sentiment and technical drivers of markets. Macro trends have been supportive as the policy environment has allowed growth to recover quickly and has supported corporate fundamentals. This has been manifesting in strong earnings-per-share growth across equity markets and low default rates in corporate credit. A second important driver has been technical. This is most obvious in bond markets where central bank buying of bonds has been a key reason why yields remain so low. For years now, the dominance of central banks has pushed return seeking investors towards credit and high yield, helping contain borrowing costs for business. We can also see how sentiment has played a role in driving markets since 2020. The development and execution of vaccination programmes boosted optimism in the outlook and was reflected in rising stock markets on numerous occasions.

All these positive drivers of markets overwhelmed the one thing that has continued to sit uncomfortably with investors – valuation. Looking forward some of the other drivers will be less supportive. Growth will remain positive, but the derivative of growth will weaken – in both GDP and earnings terms. Technical support for bonds will also deteriorate as the Federal Reserve reduces its bond buying. Sentiment is already being challenged by the emergence of the Omicron variant.

Bond and equity markets are arguably very expensive relative to the prevailing inflation environment, especially in the US. If inflation remains higher than is currently expected, then some valuation adjustment grows more likely – meaning higher yields and lower price-earnings multiples. So far, the consensus view is for an easing of inflation in 2022. Under such a scenario, current interest rate expectations look appropriate and markets can continue to focus on positive spreads in credit markets and still historically solid earnings growth in the equity world. Returns may not meet 2021 levels but an exposure to carry in fixed income and to global equities is justified.

The key metric to watch for a potentially systemic adjustment in valuations is real yields. They remain very negative but are likely to rise over the next year. This should be mild, in line with a modest Fed tightening cycle. Shorter-dated real yields – in the 5-year area in the US market for example – have already started to firm up. A modest increase in real yields should not be too damaging but would allow nominal bond yields to start to peak above the top of the 2021 trading range and may limit any further multiple expansion in US equities. There is a risk of a bigger shock to real yields, but in recent times this was only seen in 2013 when the Fed then shocked and surprised the market in what has become known as the “taper tantrum”. Hopefully, the Fed has prepared the market accordingly this time.

Slightly weaker macro and technical factors together with some risks on the valuation side should combine to result in flattish returns in core government bonds, modestly positive in credit and high yield and high single digit returns from global equities. For now, our views remain constructive on risk assets but the evolution of real yields will be key as we get into the meat of a rate hiking cycle next year.

Download the full slide deck of our “December” Investment Strategy

Recommended asset allocation

Asset Allocation	Negative	Neutral	Positive
Key asset classes			
Equities			■
Bonds	■		
Commodities	■		
Cash			■
Equities			
Developed			
Euro area			■
UK		■	
Switzerland		■	
US			▲
Japan		■	
Emerging & Sectors			
Emerging Markets		■	
Europe Cyclical/Value		■	
Euro Opening basket		▼	
Euro Financials			■
US Financials		■	
US Russell 2000			▲
Fixed Income			
Govies			
Euro core	■		
Euro peripheral		■	
UK	▼		
US	■		
Inflation			
US		■	
Euro		■	
Credit			
Euro IG		■	
US IG		■	
Euro HY		■	
US HY		■	
EM Debt			
EM bonds HC		■	

Legends: Negative | Neutral | Positive — Last change: ▲ Upgrade | ▼ Downgrade

Source: AXA IM Macro Research – As of 15 December 2021

Macro forecast summary

Real GDP growth (%)	2020	2021*		2022*		2023*	
		AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
World	-3.2	5.7		4.2		3.6	
Advanced economies	-5.0	4.9		3.8		2.4	
US	-3.4	5.5	5.5	3.5	4.0	2.7	-
Euro area	-6.7	5.0	5.0	3.9	4.3	2.1	-
Germany	-4.9	2.6	2.7	3.5	4.3	1.9	-
France	-8.0	6.7	6.5	3.6	3.8	2.0	-
Italy	-8.9	6.2	6.1	3.7	4.2	1.9	-
Spain	-10.8	4.3	5.0	5.5	5.9	3.0	-
Japan	-4.9	1.9	2.2	3.5	3.0	1.6	-
UK	-10.0	6.8	6.9	5.0	4.7	2.3	-
Switzerland	-2.5	3.5	3.4	3.0	3.0	1.6	-
Canada	-5.3	4.4	5.0	3.7	4.1	2.6	-
Emerging economies	-2.0	6.2		4.4		4.3	
Asia	-0.8	6.8		5.1		5.1	
China	2.3	7.9	8.0	5.0	5.1	5.3	-
South Korea	-0.9	4.0	4.0	2.6	3.1	2.1	-
Rest of EM Asia	-4.6	5.8		5.5		5.3	
LatAm	-7.1	6.2		2.6		2.5	
Brazil	-4.1	5.1	4.9	1.2	1.1	2.0	-
Mexico	-8.5	6.0	5.9	2.6	2.9	2.2	-
EM Europe	-2.1	5.9		3.8		2.8	
Russia	-3.0	4.5	4.2	3.2	2.6	2.0	-
Poland	-2.7	5.1	5.1	5.0	5.0	3.6	-
Turkey	1.8	9.5	8.9	3.6	3.5	3.0	-
Other EMs	-2.4	4.2		4.1		3.9	

Source: Datastream, IMF and AXA IM Macro Research – As of 16 December 2021 * Forecast

CPI Inflation (%)	2020	2021*		2022*		2023*	
		AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	0.7	3.1		3.1		2.2	
US	1.2	4.7	4.4	4.1	3.7	2.9	-
Euro area	0.3	2.6	2.4	2.7	2.3	1.8	-
Japan	0.0	-0.2	-0.2	0.7	0.7	0.6	-
UK	0.9	2.4	2.4	3.8	3.7	1.9	-
Switzerland	-0.7	0.5	0.5	0.6	0.7	0.7	-
Canada	0.7	3.4	3.3	3.1	2.9	2.3	-

Source: Datastream, IMF and AXA IM Macro Research – As of 16 December 2021 * Forecast

These projections are not necessarily reliable indicators of future results

Forecast summary

Central bank policy
Meeting dates and expected changes (Rates in bp / QE in bn)

		Current	Q4-21	Q1-22	Q2-22	Q3-22
United States - Fed	Dates	0-0.25	2-3 Nov 14-15 Dec	25-26 Jan 15-16 Mar	3-4 May 14-15 June	26-27 July 20-21 Sep
	Rates		unch (0-0.25)	unch (0-0.25)	unch (0-0.25)	unch (0-0.25)
Euro area - ECB	Dates	-0.50	28 Oct 16 Dec	20 Jan 10 Mar	14 April 9 June	21 July 8 Sep
	Rates		unch (-0.50)	unch (-0.50)	unch (-0.50)	unch (-0.50)
Japan - BoJ	Dates	-0.10	27-28 Oct 16-17 Dec	17-18 Jan 17-18 Mar	27-28 April 16-17 June	20-21 July 21-22 Sep
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	0.10	4 Nov 16 Dec	3 Feb 17 Mar	5 May 16 June	4 Aug 15 Sep
	Rates		+0.15 (0.25)	unch (0.25)	+0.25 (0.50)	unch (0.50)

Source: AXA IM Macro Research - As of 16 December 2021

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Our Research is available online:

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