



CIO OFFICE MORNING MARKET WRAP – 12th December, 2021. ALSO AVAILABLE ON ALEXA.

Global stocks came back strongly following the Omicron scare, with US equities recording their best week since February, in spite of still high inflation readings, and technology and consumer staples leading the advance. The 10year Treasury yield gained 13 basis points, the US dollar and gold were little changed, while Brent crude gained in the high single digits.

We are fast approaching year end, and this is the time when prominent strategists try their hand at guessing next year's returns. Uncertainty seems to be the word du jour now in this exercise, with the 2022 forecasts of the investment houses for the S&P 500 showing a gap of 20% between the lowest and the highest projection, the second largest divergence in a decade. And this is all too obviously stemming from the end of the era of suppressed macroeconomic volatility under the purview of the Fed after the Great Financial crisis. It is again the US Federal Reserve that is recently driving a major change in policy by letting the economy run hot under the new Average Inflation Targeting regime, whereby inflation is allowed to run above target for a while to allow for a stronger recovery. And this runs counter the previous goldilocks notion of 'neither too cold, nor too hot', hence rising macro volatility makes asset return forecasts way harder. We should now wonder if this narrative is already breaking down, following Powell's Congress testimony, where he confirmed hawkish tones, giving the clear impression that he is focusing more on price stability than full employment.

Unless the Fed has become insensitive to the possibility that the market crashes and the cost of servicing the fast-growing US debt balloons with too many rate hikes, we still hold the view that rate hikes for 2022 would be limited. For instance, two hikes next year, far from constituting a tightening, would just be removal of excess stimulus, which is overdue. Of course, the quarterly economic projections at next week's FOMC meeting will be putting any kind of view to the test.

All eyes this week were on the US CPI release, which printed basically in line with the already high expectations, at 6.8% the headline index, growing at the fastest pace since 1982, and at 4.9% the core gauge. A relief rally in equities followed soon after, while long dated yields slipped and the yield on the 2-year note was marginally down. Consensus expects US consumer inflation to peak in 4Q this year, and historically equity returns post peak have beaten average rolling returns. So, although inflation might end up not being a concern according to general forecasts, and bonds do not offer a viable alternative versus stocks, we are back to square one as to what kind of message Powell will be communicating at next week's policy meeting. According to Bank of America equity strategy research the S&P 500 can be now compared to a 35-year zero coupon bond, considering high valuations, and a low dividend yield alongside back-end loaded cash flows in heavy-weight growth stocks. Such high sensitivity to rates will not allow for an easy ride in 2022, once the Fed has come to the end of the tapering process and investors will be increasingly focusing on forthcoming rate hikes. And, even without hikes, periods of balance sheet stabilisation or contraction always sparked market corrections. Anybody remembers 2011, 2015 and 2018?

The inflation release was equally important and much awaited in China as well, where the Producer Price Index, at a 26-year high, was slightly below expectations, while the Consumer Price Index rose at the fastest pace since August last year, although it remained below consensus. The reducing gap between input costs and consumer inflation points to easing pressures for company margins and provides more breathing room for the Chinese authorities to stimulate the economy. The PBoC said on Monday that it would cut the reserve ratio, a shift in policy and the second such move this year, releasing reserves for bank lending. More economists now expect cuts to policy rates to follow next year, fuelling credit growth, after the sharp credit tightening in 2021. An inflection point in the credit impulse would be supporting Chinese equities and EM Asia HY credit more in general, a boon for EM investors.

Next week will be dominated by central bank meetings, with the FOMC meeting on Tuesday and Wednesday, and the ECB and the BoE communicating their decisions on Thursday. Policy divergence between the Fed and the ECB is expected to continue, as president Lagarde sees a rate hike in 2022 as unlikely. In China the important release of retail sales, industrial production and home prices will be on Wednesday. The EU leaders will discuss at the end of the week whether vaccine mandates are necessary, in case deciding on a joint approach. Next Friday will be the so-called 'quadruple witching day', when the simultaneous expiration on the US markets of stock index futures, stock index options, stock options and single-stock futures causes higher volatility.

Please take notice that this week sees the last Daily Note of the year, which will be then resumed in January 2022.

Stay safe.

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