CIO OFFICE MORNING MARKET WRAP – 16th December, 2021. ALSO AVAILABLE ON ALEXA.

In spite of a sharp policy pivot, Jerome Powell at the end of yesterday's FOMC meeting managed to deliver a message not more hawkish than the consensus was already expecting, hence markets ended the session with a relief rally. The S&P 500 gained 1.6%, the tech-laden Nasdaq outperformed, the yield on the 10-year note edged higher, though the yield curve once more barely budged, real rates came down and being so far unchanged for the week spurred a rebound in gold, while the US dollar was little changed. It is important to take notice that the market continues to underprice future rate hikes, not believing the Fed will be able to implement the full plan.

In one of the sharpest pivots of the decade the Fed sped up the pace of the tapering of asset purchases as expected to USD30bn per month, setting up a wind-down by March next year. The dot-plot projections of policy rates signaled three rate hikes for 2022, followed by three in 2023 and only two in 2024, whereas consensus was projecting three for 2024. The yield curve did not react much and longer-dated yields were only mildly higher, with the yield on the 10-year note settling at 1.45%. Inflation was depicted by Powell as public enemy No. 1 for the recovery and PCE forecasts were raised to 2.7% from 2.3% for next year, to 2.3% in 2023 from 2.2%, while 2024 was left unchanged at 2.1%. The term 'transitory' was phased out and price pressures were put down to 'supply and demand imbalances'. Inflation forecasts suggest the Fed remains confident that the 2022 tightening will do the job in bringing it under control, in the spirit that more now means less later. The economy was characterised as strong and the role of the new Covid-19 variant was played down. Overall, Powell gave to the markets what they wanted, convincing investors that the Fed can pull off a soft landing still having price pressures under control.

We maintain our pro-cyclical TAA positioning, thinking that new Fed stance for now does not warrant a defensive allocation. At the same time, being cognizant that central balance sheet contraction has historically been a source of heightened market volatility, at some point next year we might have to somewhat temper our optimism.

US retail sales were weaker than forecasts, as consumers pulled forward November-December purchases pre-empting supply-chain slowdowns that could hamper last-minute purchases. Hence, sales for the last quarter overall, now that two months out of three are available, have remained strong, so far surging more than 11% quarterly annualised. To be sure, sales are reported in nominal terms and higher inflation may be starting to take a toll, though it is too soon to say to what extent price pressures could dampen sentiment. It is most logical to assume that consumption patterns should continue to remain very robust, on falling unemployment, accelerating wage growth and still elevated savings.

Inflation is not only a central bank issue, but is also driving leadership in equity markets. Investors kept on piling money into companies which are able to pass price gains onto consumers and have a light labor burden. A Goldman Sachs basket of high-pricing-power companies as of the end of November recorded its best performance since March 2020 against the low-pricing-power basket. With inflation pressures still going on, this trend seems set to continue in equities, all the more so now that margins are at record highs and it won't be anyway easy for corporations to keep on surprising to the upside.

Policy divergence between the US and China is going to grow wider, with November data confirming that the Chinese economy is still under strain. While the production side was hinting to stabilisation, the demand side fell short of expectations under the effects of the zero-tolerance Covid policy. Industrial output was in line with forecasts and above the previous month, fixed asset investments continued to slow down, while growth in retail sales missed and got weaker in November. Stripping out the effect of rising inflation, real consumer demand was in the very low single digits, and it continues to be clear that China will have to count on more fiscal support or external demand for a while. And policy is turning as per our expectations, with indications from the annual Central Economic Work Conference pointing to forthcoming fiscal stimulus. Also, the central bank just eased the reserve ratio by 50 basis points and economists expect that policy rates will be cut in 2022. Chinese risk assets and EM Asia HY credit should be the main beneficiaries of easier financial conditions.

Congress voted to raise the national debt limit, just days before a potential US default. Under new Senate rules approved after a bipartisan deal the Democrats could raise the limit on their own by a simple majority. The limit was raised to $31.4tr, bringing an end to a months-long row between the parties. Also, the debt ceiling was suspended until early 2023, so well after the November midterm elections that could see a shift in power.

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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