Market Compass

December 2021

MARKET OUTLOOK

- Omicron is unsettling markets and uncertainty will remain high until the variant's impact on Covid deaths and hospitalisations becomes clearer.
- Central banks may delay their withdrawal of policy accommodation. But given the deteriorating growth/inflation mix and persistent global supply bottlenecks, the scope for monetary policy support is limited.
- Short term, we favour a very prudent tactical stance amid high uncertainty. But with the earnings outlook still decent and valuations supported by low real yields, the recent market correction may justify a cautious overweight in risk assets.
- We still expect yield to rise but background risks will limit the upside.

Edited by

MACRO & MARKET RESEARCH TEAM

A team of 13 analysts based in Paris, Cologne, Trieste, Milan and Prague runs qualitative and quantitative analysis on macroeconomic and financial issues.

The team translates macro and quant views into investment ideas that feed into the investment process.

US

- (+) Firms signal willingness to prop up capex and inventory, which will support growth in 2022
- (−) Inflation remains higher and more widespread than expected
- (+) But consumption continues to grow steadily
- (!) With no new Covid outbreaks, the Fed will end bond purchases next spring and raise rates twice

UK

- (+) Pmis better than expected
- (+) IP and retail sales improved
- (−) Headline CPI inflation rose to 4.2% yoy
- (!) New Omicron variant raises uncertainty with regard to BoE policy

EUROZONE

- (+) ECB withstands market pressure and signalled no rate hike in 2022
- (+) 2022 draft budgets and NGEU funds signal supportive fiscal stance
- (−) New Covid wave plus Omicron variant dent growth
- (−) Base effects, commodities and supply chain disruptions are pushing inflation to record highs

CHINA

- (+) China's October data were slightly better than expected
- (+) NBS manufacturing PMI returned to slightly above 50
- (−) Real estate sector keeps cooling

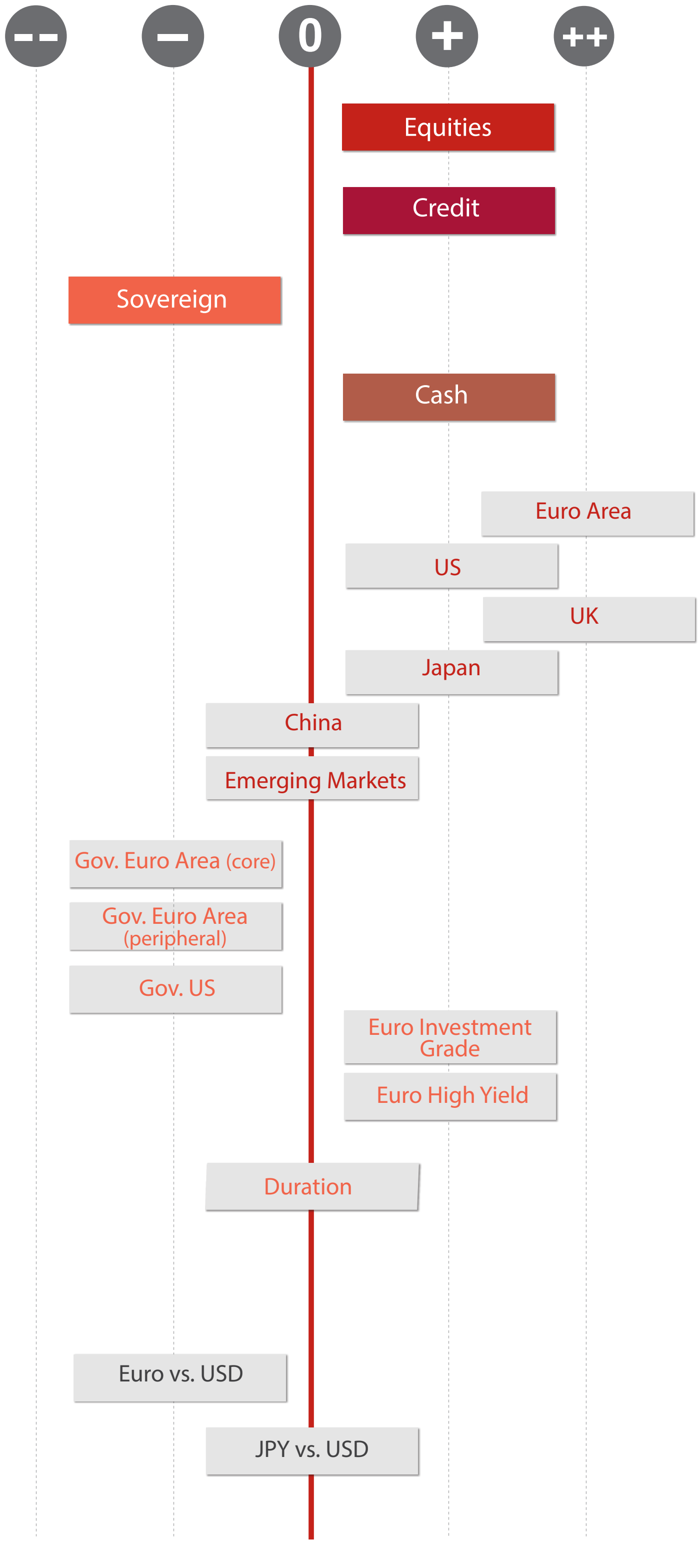
EMERGING MARKETS

- (−) EM activity in Q4 will improve marginally as vaccination accellerates
- (−) Inflationary pressures keep mounting leading to further monetary tightening
- (!) Pressure on EM assets eased temporarily but volatility remains high with expected rising US yields

(+) Positive
(−) Negative
(!) Topics to watch

DIRECTION OF TRAVEL

- Limited and selective equity and Euro area High yield overweight (OW).
- Maintain sizeable OW on euro area Inv. Grade bonds
- Rising inflation and looming tapering back underweight (UW) on core bonds
- Limited OW in EM debt: prefer BBB and quality BB
- Keep OW cash to protect from inflation



Equities

- Omicron represents a risk but so far news hints at mild hospitalization risk.
- Earnings growth to be at least +7% in 2022, more than offsetting the PE compression we expect in the year.
- The low real yield environment will help to achieve positive total returns of at least 5% in 12 months, with EMU possibly outperforming US and Japan.
- Uncertainty keeps weighting on EM.

Bonds

- Government bond markets remain hostage of Covid-19 worries. This is seen to prevent a lasting increase in yields short term. As soon as vaccine efficacy is ensured broadening US inflation to trigger a rise in global yields.
- Scaling back of ECB support to pave the way to wider EA non-core government bond spreads.

Duration

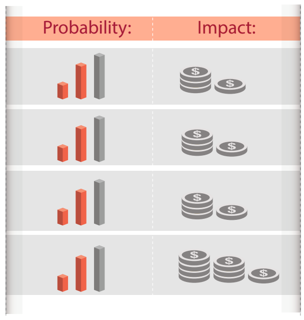
- Moderately short duration recommended.

Currencies

- Monetary policy divergence will keep the USD underpinned, but on various valuation yardsticks the advance of the USD looks increasingly stretched.
- We see some moderate downside risks to EUR/USD prevailing into 2022.

TOPICS TO WATCH!

- Longer supply disruptions and energy crunch hurt growth yet support rate hike fears
- China property market crisis worsens, spreads to broader economy and credit markets
- Withdrawal of policy support triggers stronger growth slowdown
- Mutations challenging vaccine effectiveness, new shutdowns



Probability: High ⟷ Low

Impact: High ⟷ Low

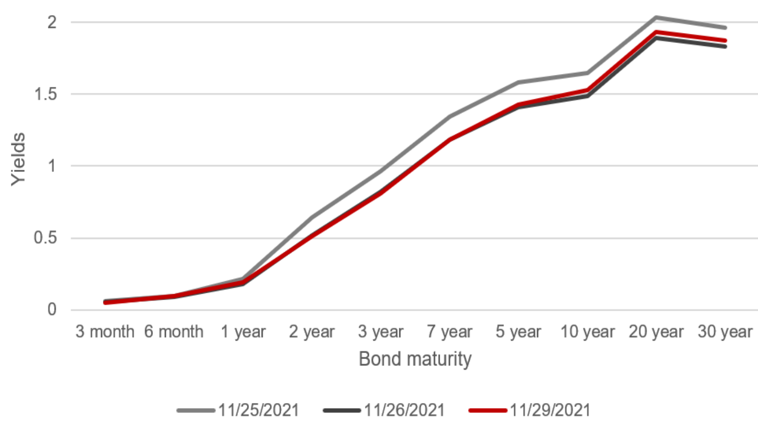
SPECIAL FOCUS

Risk sentiment has still legs, but uncertainty increases

Worries about the new Covid variant Omicron have more than wiped out earlier November advances of equities amid the deepest daily drop in over a year on Nov. 26. But so far little is known about the prospective health damage. Policy makers may help to cushion the market impact in case renewed lockdowns become necessary. Central banks may pause in removing their strong monetary accommodation. Yet aggravating supply disruption and prolongation of crowded global demand for goods will increase the inflation headache at central banks, preventing a particularly strong kind of support.

Over the very short term, we thus favour a prudent approach to risk-taking. But unless the variant's health impact turns out to be a game-changer in vaccines' efficacy, the recent market correction may still provide opportunities in cautiously overweighting risk assets in the portfolios. First, with consumers sitting on large savings, firms still enjoy high pricing power, allowing them to pass higher input prices.

Limited impact of Omicron on the US yield curve



Source: Refinitiv as of end of November 2021

This protects margins and supports the earnings outlook. Central banks will proceed more carefully, helping ultra-low real yields to underpin valuations. Governments and firms have also learned to better cope with renewed restrictions over the pandemic. And ultimately there is more optimism than a year ago on the rapidly grown capacity of vaccine innovation to help tackle even disruptive new Covid mutations.

IG Credit in Europe looks favourable, not least because non-financial papers will remain a key policy tool for the ECB for longer. While we expect higher yields into 2022, we caution against an overly strong short duration bias, as concerns about growth will compress core yield. The USD looks dear after its almost 7% (in trade-weighted terms) advance since early June, but policy divergence and global Covid worries may still underpin the greenback short term.

GLOSSARY

YIELD CURVE

A yield curve is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity. The three key types of yield curves include normal, inverted, and flat. Upward sloping (also known as normal yield curves) is where longer-term bonds have higher yields than short-term ones. While normal curves point to economic expansion, downward sloping (inverted) curves point to economic recession.