



Monthly Update - December 2021

As at 30 November 2021

Summary: Omicron – curse or blessing?

- The new Covid 19 virus variant "Omicron" is unsettling financial markets.
- However, the general economic environment remains robust globally.
 Inflationary dynamics should also ease soon due an easing of energy prices.
- Omicron could be dangerous for economic growth and inflation, but positive effects for financial markets are also possible, due to accommodative monetary policy and new government stimulus programmes if necessary.
- The majority of Omicron infections are likely to be mild. This could result in an accelerated spread of infection across the population without overburdening the healthcare systems.
- A temporary dampening of equity and credit markets could offer buying opportunities in the medium term.
- The upward trend in interest rates is currently weakening, but structural upward pressures remain.
- Various negative factors continue to affect the euro for the time being, although we expect this to stabilise in the medium term.

Significant changes compared to the previous month

- The new Covid 19 variant "Omicron" brings an unexpected aggravation of the pandemic situation. Mutations in the virus appear to be causing a faster rate of infection and possible resistance to previous vaccinations and antibodies in those who have recovered.
- However, a number of positive factors are also emerging: the courses of infection may be mild and would allow a high level of contagion to reach the population without overburdening health systems. Omicron could thus make vaccination superfluous, at least in the unvaccinated, and paradoxically facilitate a faster end to the pandemic. According to the manufacturers, the antibody drugs (Merck, Pfizer) that have recently become available continue to work well even with the highly mutated virus variant.
- Based on a robust economic environment worldwide and already decreasing inflation dynamics due to lower energy prices, central banks and governments still have some leeway to ease monetary policy again and launch additional stimulus programmes. However, the Fed has just communicated a possible further tightening as of December, and thus does not seem to fear any negative economic consequences of a possible renewed pandemic wave at the moment.

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Supply chain problems are already beginning to ease globally. They are thus easing
inflationary pressures and favouring economic growth, although a possible deterioration
of the situation because of Omicron cannot be ruled out temporarily.

 Overall, it is thus very possible that the negative influences of the Omicron variant will remain somewhat limited. The US is also likely to be rather less affected than Europe due to a more open pandemic policy and higher vaccination and contagion rates.

Current situation and positioning

- At present, the general uncertainty about the further course of the Covid-19 pandemic is weighing on financial markets. The fundamental environment and monetary policy, on the other hand, remain very supportive globally.
- The negative effects of the new variant of the virus are likely to remain limited for the reasons mentioned above. As such, positive and negative factors on the stock markets will mostly cancel each other out. If the information situation improves, we expect the markets to calm down quickly.
- Due to base effects and an anticipated slight tightening of monetary policy, our macro model was already signalling a slight decline in economic momentum before the latest Omicron news. This leads to correspondingly lower scores in the neutral range for equity and credit markets. Accordingly, there was also a reduction in the forecasts for long-term interest rates. We continue to see upward pressure here, but less strongly than before. This assessment is also confirmed by weakening trend signals from our trend model.
- Nevertheless, a recession or stagflation is still not the most likely scenario. However, stagflation cannot be completely ruled out, especially if Omicron were to have a strong decelerating effect on the economy, while at the same time exacerbating supply chain issues and inflation. The high cash holdings of private households worldwide, which support consumption even in the event of a more severe pandemic, should prevent the worst from happening here.
- The Fed may refocus its monetary policy in the coming weeks on achieving full employment and less on the recently started moderate inflation targeting, if an escalation of the Omicron spread would require it. The eurozone already has lower inflation than the US, and thus the ECB can maintain its loose monetary stance. This also works against a potential global stagflation scenario. However, the effectiveness of central bank intervention is generally lower today than it was at the beginning of the pandemic.
- In the case of the euro, an expected stronger tightening of monetary policy by the Fed compared to the ECB tends to have a dampening effect on the exchange rate. In addition, Europe is more affected by a possible economic slowdown, especially in China. This also tends to have a negative effect on the euro in the near future. However, the currently low euro exchange rate should boost economic growth and inflation in the euro area relative to the US. This, together with a more restrictive monetary policy of the ECB and lower gas and oil prices, would argue for a stabilisation or even higher euro exchange rates in the medium term.

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Topics "on the radar"

Chart: Flattening yield curve at the long end signals low inflation expectations



Source TradingEconomics

The chart shows a very interesting development in interest rates for long-term government bonds in the US: Yields on 30-year bonds (green line, right-hand scale, 1.86%) have fallen significantly more in recent months from the highs in April than yields on 10-year bonds (blue line, left-hand scale, 1.44%). This means that the US yield curve has flattened considerably in the 10/30-year range.

Such a flattening signals that market participants have low or even falling inflation expectations for the next few years. After all, relatively low 30-year interest rates are a sign of high confidence in long-term monetary stability.

The short end of the US yield curve, on the other hand, remains steep, i.e. 10-year government bond yields are significantly higher than 2-year yields. And this in turn signals a robust economy. Overall, the US yield curve structure thus confirms a positive "Goldilocks environment" for the financial markets, i.e. solid economic growth with moderate inflation expectations.

This trend towards relatively low 30-year interest rates and thus declining inflation expectations could be reinforced at the next Fed policy meeting in mid-December. If the Fed were to tighten monetary policy further (i.e. tapering) due to better labour markets and still high current inflation rates, a further flattening of the yield curve at the long end is very possible.

Further tightening of monetary policy by the Fed is currently expected in December, but only as long as the Omicron variant does not have too strong a negative impact.

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Summary of FischView model outputs

	US	Europe	Japan	Asia ex- Japan	LatAm	CEEMEA	Key:	
Equities	0	0	0	0	0	0	++	Strong positive
Government Bonds	0 1	0 1	o 1				+	Positive
Credit IG	0	+ ↑		0	0	0	О	Neutral
Credit HY	0	0		+	+	+	-	Negative
Convertibles	0	0	0	0				Strong negative
Commodities	Fnergy	+ .1.	PrecMet	+ 1	InduMet	+		

Notes regarding the table: Changes from prior month are indicated with \downarrow or \uparrow . i.e. "O \downarrow " means that the output has weakened from a prior value of + or ++.

The methodology for calculating model outputs, and how the various pieces fit together to form the big picture, is explained **here**.

Within government bonds, we consider the most important bonds for each region, e.g. German Bunds in Europe, and a representative group of countries for Latin America, Asia ex-Japan and CEEMEA (Central and Eastern Europe, Middle East and Africa).

Cross asset class preferences

This table combines top-down views with bottom-up analysis at the portfolio level.

	Most preferred	Least preferred			
Convertible Bonds	Higher-rated companiesLiquid issues	Intl. Travel, (airlines, cruise lines)			
Global IG Corporates	FinancialsSpread duration 5 years"Rising Stars"	Real estate, capital goodsSpread duration > 15			
Global Corporates	Financials, healthcareSpread duration 5 years"Rising Stars"	Real estate, telecomsSpread duration > 15Emerging markets			
Global High Yield	'B' rating segmentTelecomsBasic industryEnergy	BankingTransportation			
Emerging Market Corporates - Defensive	– Indonesia	SingaporeTaiwan			
Emerging Market Corporates - Opportunistic	High yield commoditiesIndiaSub-Sahara Africa	BahrainQatar			

Note: Preferred sectors/regions may differ between asset classes owing to respective performance drivers. In particular, equity exposure is the key performance driver for convertible bonds and is not relevant for corporate bonds.

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