3rd December 2021

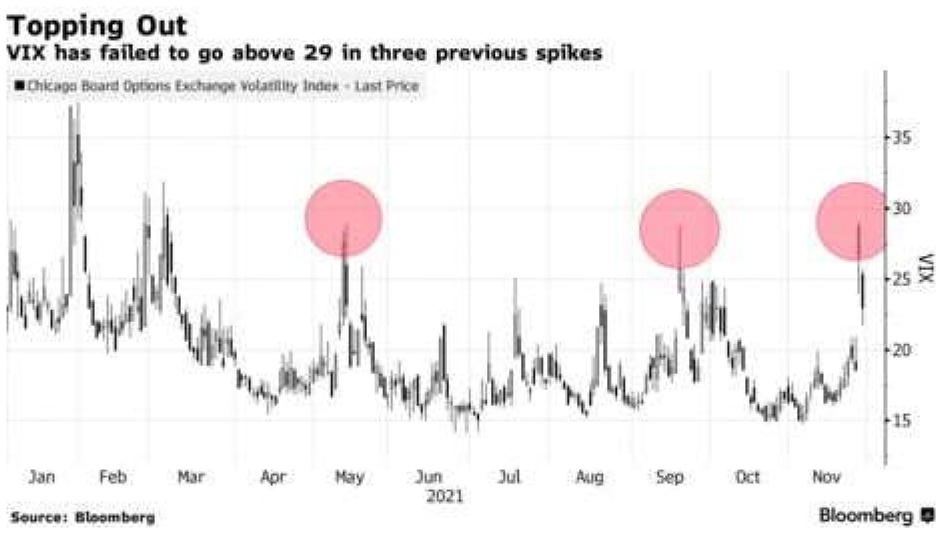
Triple whammy: Omicron, Inflation & Tapering

- Triple whammy of external factors saw market risk spike
- Each concern is interdependent
- Resilience required

Triple whammy of external factors saw market risk spike

The emergence of the Omicron Covid variant spooked markets last Friday as a growth scare, with a knock-on effect of increased supply chain disruption and inflationary pressure. But as material were the Fed Chair, Jerome Powell's statements on bringing forward tapering, partially in (some might say, belated) response to inflation risk.

The dramatic "risk off" down-swing was illustrated by a spike in the "VIX" volatility index – Wall Street's fear gauge – although it did not breach the key level of 30.

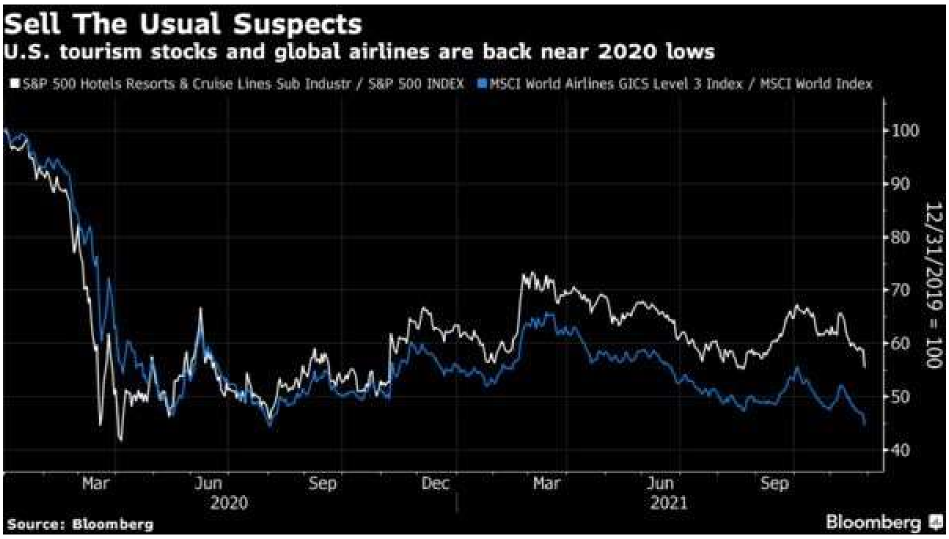


Omicron

Covid risk had receded from investor risk considerations as a risk factor: focus lately has been more on interest rate risk and inflationary pressure.

However the emergence of a highly infectious Omicron variant triggered concern not only because of the additional health risk, but also the potential risk of a policy response that re-introduces or scales up travel restrictions, hard/soft lockdowns and also disrupts economic activity as events are cancelled and the return to a "new normal" way of living post-Covid gets derailed once again.

This triggered extreme market moves on Thanksgiving, with airline and tour operators particularly hard hit, returning to their March 2020 lows.



Whereas in 2020, the growth shock was deflationary in nature, the combination of a growth shock and inflationary pressure would be an adverse outcome.

Hence all the focus on the severity of the variant and the efficacy of vaccines against the new strain, and furthermore, against the broader growth backdrop, the assumption is that any restrictions would be limited and targeted and not as sweeping as the original 2020 pandemic. In that respect, this would be less disruptive than previously, suggesting that the market sell-off was potentially overdone.

Inflation is broadening

Headline US CPI has hit a recent high of +6.2%, but the latest Personal Consumption Expenditure figures – a broader inflationary indicator[1] closely watched by the Federal Reserve – implied that inflation is broadening as it also hit a three-decade high.

[1] The CPI measures the change in the out-of-pocket expenditures of all urban households and the PCE index measures the change in goods and services consumed by all households, and nonprofit institutions [businesses] serving households (Source: U.S. Bureau of Labor Statistics)

The broadening of inflation risk and its persistency is forcing the Fed to respond.

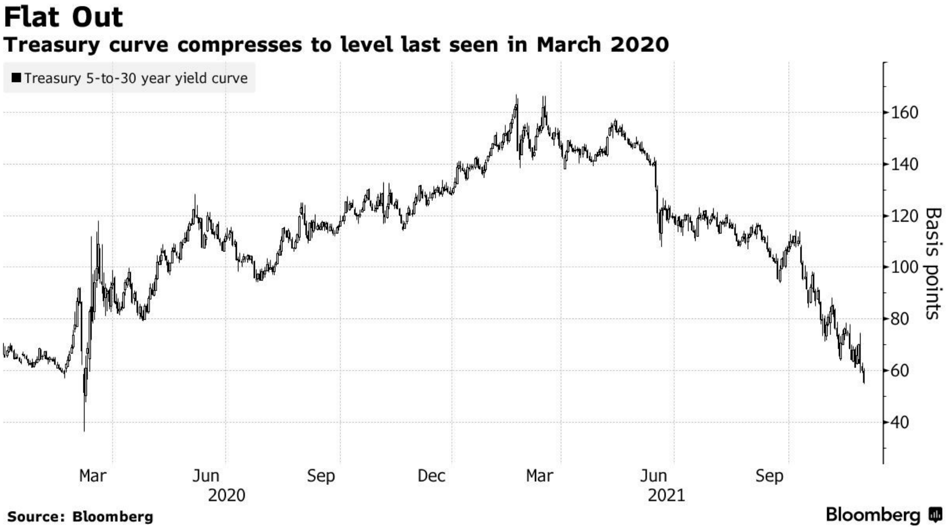
Taper timing

With unhelpful timing given fears around the new variant, the Fed Chair, Jerome Powell said on Wednesday that accommodative monetary support that has characterised the pandemic policy response should start to be withdrawn and that the word "transitory" should no longer be used with respect to inflation (a capitulation of sorts). This paves the way for earlier-than-expected US rate tightening, triggering gyrations at the short-end of the US yield curve.

As it stands, the asset-purchase program is due to end in mid-2022, with the rate at which assets (such as corporate and government bonds) are purchased by the Fed to provide liquidity to slow by US$15bn per month.

At the next policy-setting FOMC meeting on 14-15 December, there may be a decision to accelerate that tapering – ie, reducing the level of supportive monthly asset purchases more quickly.

This triggered a further volatility in equities and a flattening of the US yield curve and short-end rates rose.



The Fed has arguably been behind the curve on inflation. If it now catches up with its policy response, then the risk of rising interest rates is brought forward, which is negative for longer-duration bonds and positive for floating rate notes whose interest rates move in tandem with policy rates.

Resilience required

In summary, whilst the advent of Omicron is unwelcome and has triggered a short-term shock, it carries less market risk than the persistency of inflation and the potential for reduced monetary policy support.

Navigating periods of market turbulence requires steady nerves and portfolio resilience. Our Market Indicator has been suggesting that markets were relatively overbought, so we advocate a tactically lower allocation to risk assets.

Within a portfolio, we believe nominal bonds remain under pressure whilst real yields are negative and interest rates are on the rise. Investors should therefore consider strategies to mitigate both interest rate risk and inflation risk.

Henry Cobbe, CFA

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