INFORMATION FOR INVESTMENT PROFESSIONALS

Market updates

Investment team updates | 7 January 2022

Fixed income

News

- In the US, Federal Reserve minutes show it will consider balance sheet reduction post the next rate rise. The market is currently pricing in three rate rises this year, with the first set for May. The Fed also thinks the US will achieve maximum employment relatively soon.
- Also in the US, December's Employment Report is expected to show around 600,000 new jobs and a fall in the rate of unemployment to 4.1%. The ISM Services PMI index on 4 January was weaker than expected – 62 against 67.
- In the euro area, the revised Composite PMI for December fell to 53.3 from 55.4 in November, its lowest since March but still reasonably OK.
- In Germany inflation came in at 5.3% for December, which was slightly ahead of estimates and is the highest level since 1992. Unemployment, meanwhile, fell to 5.2% from 5.3% in November – better than expected.
- Turning to Covid, this week global Omicron cases continued to spread to record levels. In the US on Tuesday 4 January there were 1.1 million cases, and in the UK 219,000, although towards the end of the week the numbers in London – which bore the initial Omicron brunt – were slowing, as were hospitalisations. In France cases hit 323,000 on 5 January, again hospitalisations and intensive care cases haven't followed the same upward trend.

Markets

- This week, in government bonds drifted higher over the week, five days in a row. This saw the US 10-year treasury yield start the week (4 January) at 1.51% and end it (6 January) at 1.73%. Germany started the week at -0.20% and ended it at -0.06%, while the UK started at 0.95% and ended at 1.15%.
- In credit markets, based on BofA Merrill Lynch Bond Indices, have seen Global IG tighten year-to-date, ending the week (6 January) at 97bps. There has been heavy new issuance, especially from banks, so far this year in IG. Global High Yield was following suit until it weakened somewhat on 6 January to 377bps from 368bps the day before.
- The oil price has climbed all week, from $77.1 a barrel on 4 January to $79.9 on 6 January.
- In FX, the US dollar started the week at 1.354 versus the Euro and ended it at 1.131.

US equities

- US equities were trending slightly higher in the week after Christmas before selling off this week, particularly the highly valued growth names, as the market digested the release of the US Federal Reserve minutes from December. Over the past two weeks, the S&P 500 has made a return of -0.6%, while the tech-heavy Nasdaq has declined 3.3%. Reflecting this picture, value has strongly outperformed growth over the same period by more than five percentage points.
- The US market rounded off 2021 with an impressive total return of nearly 29%, with Q4 contributing 11%, founded on a combination of robust earnings and a broad-based recovery in the economy. This was the third straight year of double-digit gains. Despite the threats the economy has faced, the equity market has continued to ascend to new heights: the S&P 500 made 70 record closes in 2021. Growth and value leadership oscillated throughout the year with growth finishing the year slightly ahead after a better Q4. Value and cyclicals had a much better time in the early part of the year. Given the rapid growth in earnings in 2021, the stock market return did not actually keep pace, which has led to a contraction of the P/E multiple. We go into 2022 with US inflation at a four-decade high, which is a large part of the reason why the Fed has been forced into action relatively soon into the recovery.
- News from the Fed moved the markets this week after it laid out a timetable which could see the first rate rise as early as March. A combination of high inflation and a tight labour market has seen the Fed concede it may have to lift rates sooner and at a faster pace than previously expected. Some Fed members also suggested it may go further and choose to unwind its vast pile of accumulated assets which amounts to nearly $9 trillion. Since the early days of the pandemic it has been rapidly adding to its balance sheet by buying up bonds and treasuries, so the suggestion it might start to shrink this, having already started to decrease the rate at which it buys assets, was another surprise. The market reaction was a rising 10-year yield which went back above 1.7% and a sharp sell-off in equities, especially in the Nasdaq and among tech stocks whose valuations are generally more dependent on future earnings and so more susceptible to higher rates, as the latter mean the former are worth less to investors. The Nasdaq ended Wednesday 5 January down 3.3% for its worst daily sell-off since February 2021.
- Stock news has been light through the Christmas season with tech stocks among the notable fallers, amid a general move towards cyclicals. Software companies in particular have had a tough six-12 months. Salesforce, as one example, is down more than 25% from its one-year high as customers looks to rein in spending for 2022. Adobe has also been caught up in the recent sell-off as, like Salesforce, users may pull back on spending following increased activity in 2021.

European equities

- Markets started the year on a positive note, but hawkish comments in the Fed's December minutes caused a setback. It remains to be seen whether higher interest rates in the US – likely to be a short- to medium-term phenomenon – will feed across to Europe.
- Focus remains on the virus – Omicron is raging, but appears to be less severe in terms of medical impact than previous variants, and the higher infection rate means that some form of herd immunity may be achieved early. Vaccination rates remain variable across countries, and Europe's tough stance is unpopular with some.
- Higher energy prices will continue to affect inflation, and geopolitical tensions are a concern – in particular in Ukraine and Kazakhstan.
- Hard company news is thin on the ground as markets gather momentum in the new year.

Multi-asset

- Our economic forecasts continue to point to peak growth and inflation in Q1. While our longer-term inflation outlook still suggests the pick-up is transitory due to ongoing structural disinflationary trends such as technology and demographics etc, the sharp price increases in areas where bottlenecks and supply chain disruptions continue warrant careful monitoring. A key indicator will come during the start of the year when base effects reflecting lockdowns move out of inflation prints, and the extent to which increased inflation has become self-sustaining through the labour market without government support will become clearer. In accordance with our transitory view, we don't expect any Fed rate rises delivered in 2022 to mark the beginning of an extended hiking cycle. Over the year we expect growth and inflation to slow towards trend levels and remove the pressure to raise rates. A continuation of historically relatively easy policy and our optimistic earnings growth forecasts should continue to deliver decent, positive returns from risk assets like equities and credit over the next 12-18 months. Indeed, despite prior market concerns around loss of momentum over Q3, the latest set of corporate results demonstrated broad ongoing strength across regions.
- The Bank of England (BoE) remains the core central bank where most rate rises are expected. We have continued to lean against this, driven by a view that the underlying UK economy is less robust than the inflation figures would suggest; we don't expect the BoE base rate to increase beyond 0.5% this year. While more persistent inflation remains a key risk to our dovish rates forecasts, strength in experienced inflation continues to be concentrated in areas where demand rose quickly as economies reopened, and supply has struggled to keep up. We maintain our expectation that these will fade over the coming quarters as supply chains adjust.
- Over the past month, volatility has picked up on the back of the emergence of the Omicron Covid variant. We are currently in a phase marked by an absence of clear and full data. Based on the anecdotal evidence we have, however, the negative take is that it is more contagious and potentially vaccine-evading to some extent, while the positive is that it has the potential to become "natures vaccine", spreading through unvaccinated populations with potentially lower severity and building antibodies across the globe.
- While the pace of the global economic recovery is showing some signs of easing off, and the Omicron variant adds near-term risk as governments reimpose activity restrictions, we believe there is still value to be found in select cyclically sensitive areas. No asset allocation changes were made over the past month.

Note: all data as at 6 January 2022, unless otherwise specified. Source: Bloomberg.