

## Monthly Flow

Esty Dwek, Chief Investment Officer

December 2021

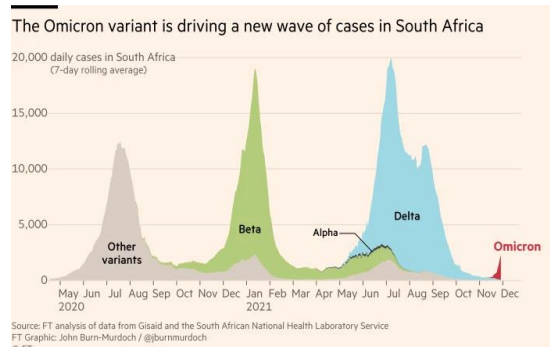
### 2022 Outlook – Recovery to carry over into next year

- Omicron does not change our outlook, for now
- Growth to stay solid & inflation higher for longer, but still “transitory”
- Risk assets should remain supported by strong fundamentals and booming earnings

While 2021 has thrown yet another curveball, investors are looking ahead to next year with strong market performances “booked” – barring a total market collapse into year-end, which we do not expect. As investors gear up for the holidays, a few major events remain on the calendar, though they may carry less weight until there is more clarity on the implications of the Omicron variant.

#### Covid impact diminishing

Every time we start to think this pandemic is (almost) behind us, reality fights back. The arrival of the Omicron variant has investors on their toes again, but it is too early to know if it will materially alter the outlook. Indeed, we have seen that both the Beta and the Delta variants ended up wreaking less havoc than initially expected, especially with vaccination proving highly effective against severe forms. Moreover, mRNA vaccine developers have said they could adapt vaccines to the new variant in a matter of months.



Source: Financial Times, November 2021

As such, we write this outlook with the view that Omicron will not reverse months of progress, though, like Delta, it could further delay the recovery.

#### Recovery on track

At this stage, Covid appears to be gradually becoming endemic and less pandemic, suggesting most countries will learn to live with it, much like flu season.

As such, we expect reopening to continue in 2022, and growth to remain solid, with potential December 2021 disruptions from Omicron boosting Q1 2022 prospects. So far, we are seeing renewed restrictions mostly in Europe, where countries have had a diminishing impact on growth over time.



Source: Google Mobility, FlowBank, November 2021

In our view, unless Omicron presents a much more serious threat than Delta, the US will continue to push for vaccination and avoid any curbs.

With midterms just around the corner and Democrats set to lose their majority, they are unlikely to impose highly unpopular measures that would give ammunition to Republicans, and possibly impact growth. The recovery might therefore lose some steam but will continue next year. Indeed, we expect democrats to manage a USD1.75 trillion Build Back Better package and a new reconciliation bill to raise the debt ceiling, adding some ongoing spending, even if not on the 2020/2021 scale.

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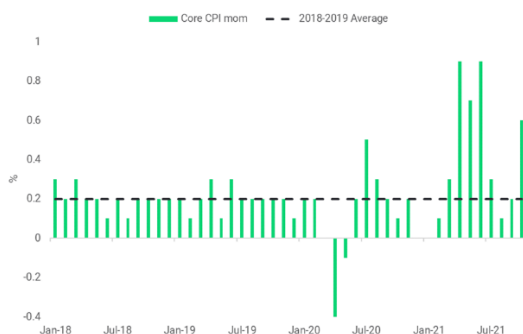
## Bottlenecks to abate, but later

While most countries are trying to limit containment measures, China has reaffirmed its push for Zero Covid, which is set to keep supply chain bottlenecks present for some time – in addition to weighing on growth.

Nonetheless, with most of Asia gradually learning to live with the virus, and vaccination accelerating around the world, we believe these disruptions should gradually dissipate over the first half of 2022. Already, we are hearing anecdotal improvements across a number of sectors, though these will take time to materialise more broadly. In the meantime, while they complicate the equation, they are unlikely to derail the economic recovery.

## Still “transitory”?

Until the news of the Omicron variant, the big worry was inflation. The question will not vanish of course, but growth worries might resurface, reducing fears of runaway inflation and aggressive tightening by the Federal Reserve.



Source: Bloomberg, FlowBank, November 2021

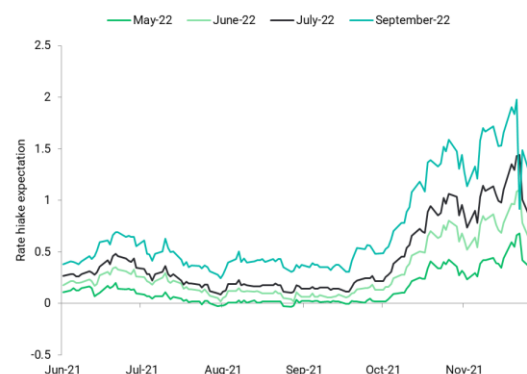
The debate surrounding the “transitory” nature of inflation has been raging for six months, and it might go on for six more. However, much depends on the definition of transitory, which investors do not seem to agree on. In fact, if prices were to drop back to 2020 levels, we would be facing deflation, so the objective should be a stabilisation after a “one-off” Covid-related jump. We look to the month-on-month increases in core CPI, where the 2018-2019 average was ~0.2% per month. In our view, by the middle of

2022, we should be back closer to those levels, in line with Fed expectations.

## Hawks vs reality

Ultimately, it really is all about the Fed. US Treasury yields climbed on the re-nomination of Jerome Powell, who is seen as more likely to act if inflation proves more ‘persistent’ than previously anticipated.

However, we do not believe in the early summer hike scenario, even without the added Omicron concerns. With less fiscal support despite the Biden spending agenda, and with the bulk of the post-lockdown rebound done by next summer, growth will likely be slowing in the second half of the year, removing a reason for the Fed to hike. Moreover, as stated, we and the Fed expect inflation to gradually fade next year, as supply chain disruptions slowly abate, inventories are rebuilt, and pent-up demand recedes.



Source: Bloomberg, FlowBank, November 2021

In fact, interest rate hikes might not be the solution to today’s challenges. The current inflationary pressures are supply driven, which cannot adequately be addressed with rates. In addition, consumers are sitting on trillions in excess savings, so increasing the cost of credit might not have such a strong impact – higher prices might impact demand more easily. Finally, the Fed does not usually like to play politics. With the midterms set for November, will the Fed start aggressively hiking just before?

If inflation remains at recent levels for months, the Fed might need to show it is not asleep at

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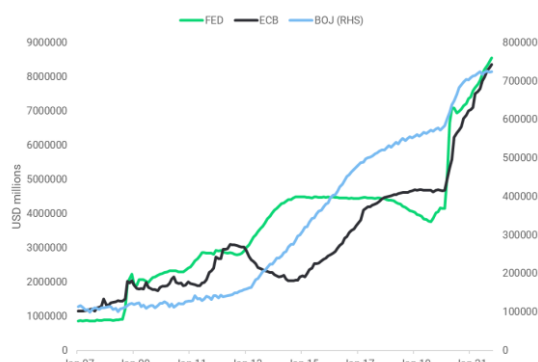
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the wheel, potentially accelerating the pace of tapering in Q1, but we do not expect a hiking campaign to start over the summer.

## Higher yields ahead

The question of bond returns remains the biggest challenge for asset allocators. With negative real yields in the US and negative nominal yields across much of the developed world, return prospects remain poor for the coming years. In addition, from the current starting point, yields should only go in one direction: up.

We remain cautious on sovereign debt, though we do not expect yields to climb rapidly, given the aforementioned factors. Still, with growth solid and reopening set to continue, we prefer taking credit risk rather than duration risk. Credit spreads have proven resilient throughout most of the equity volatility periods this year, a trend which we expect will continue into next year.



Source: Central Banks, FlowBank, November 2021

## Risk on

Equity returns may not be as strong for the coming years as they have been in recent years, but we still see upside. Fundamentals remain solid, and earnings should remain very strong into 2022, with companies demonstrating impressive adaptability given the changing context.

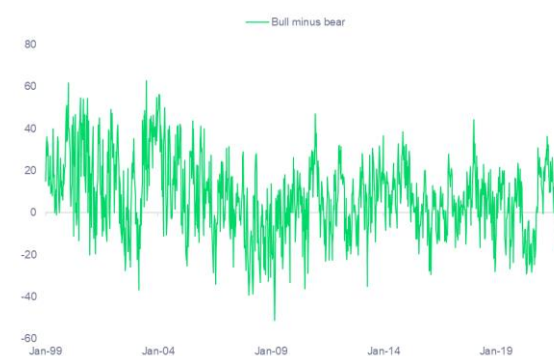
There is still a lot more reopening to come, that is not yet priced in, which should support cyclicals, as those sectors have plenty of room to catch up. Energy, materials and financials should

all benefit, especially with a cold winter ahead and recovering industrial output, as demand improves, and yields drift higher.

This should boost European assets as well, given their structural *value* bias, although given the stronger growth and earnings picture in the US, it might prove difficult to outperform the US over the whole year. Indeed, margins also have less room to compress than in the US. European markets need strong Chinese growth, which may prove lacking in the coming quarters, though Chinese policymakers could ease the reins a bit once the Winter Olympics have passed.

Emerging market equities are in a similar situation. They are a play on the global recovery, but they remain dependant on China, where the crackdown continues to weigh on sentiment. Moreover, a number of idiosyncratic stories, including Turkey, Russia and Brazil, suggest limited foreign appetite for the region.

We maintain our preference for a barbell approach with cyclicals on one side and tech on the other. The sustainability of US tech earnings growth and their defensive nature in a more volatile environment should remain attractive to investors.



Source: Bloomberg, FlowBank, November 2021

In addition, while valuations are expensive, sentiment is far from complacent and there is still a lot of cash on the sidelines. And while central banks and governments will be pulling back support compared to pandemic emergency spending, support remains present, whether through the bipartisan infrastructure package,

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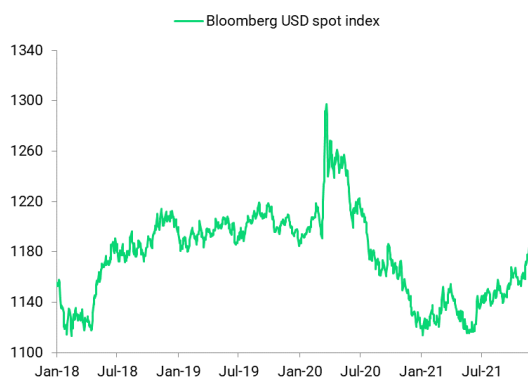
Build Bank Better, the EU Recovery Fund and the reinvestment of QE proceeds by central banks.

## Rounding out the portfolio

Despite a slowdown in Chinese growth, commodity prices remain underpinned. This is especially the case for oil, as demand recovers, and supply remains constrained by OPEC+. While a surplus is expected in 2022, we still see upside for prices if Omicron does not lead to generalised lockdowns, especially as knee-jerk travel bans will likely prove short-lived with the variant already on all continents.

Base metals should see sustained demand as production catches up to demand, but it could fade later in 2022. Precious metals have not benefitted from inflation and inflation fears as would have been expected, and we expect more range trading ahead.

We like the dollar smile theory, and given worries about the outlook, stronger US growth than elsewhere, and expectations for quicker tightening compared to other major central banks, the US dollar should remain supported, though the bulk of the move might be behind us.



Source: Bloomberg, FlowBank, November 2021

With demand for cryptocurrencies increasing – including from institutional investors –, and the asset class becoming ever more accessible, prices should rise, though large bouts of volatility and sharp corrections should be expected.

## Conclusion

There are some clouds in the outlook, not limited to the arrival of the Omicron variant. The transition to a post-Covid world will probably not be entirely smooth, but with strong fundamentals, buoyant earnings and ongoing policymaker support, we remain confident in risk assets into 2022.

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