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Uncertainty Picks Up but Base Case Remains Constructive

Our weekly view on asset allocation.

06 December 2021

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Maintain and Monitor

The emergence of the Omicron COVID variant alongside a more hawkish pivot from the US Fed has raised uncertainty levels a notch as investors head toward year-end.

We maintain our moderate pro-risk stance, but we will be monitoring developments closely on both these fronts over the next few weeks.

Our base case remains for above-trend global and domestic economic growth in 2022 as pent-up demand is released and pandemic headwinds eventually fade. Inflation pressures should ebb as 2022 progresses. This should remain a supportive backdrop for risk assets.

Yet Another Pivot from Chairman Powell?

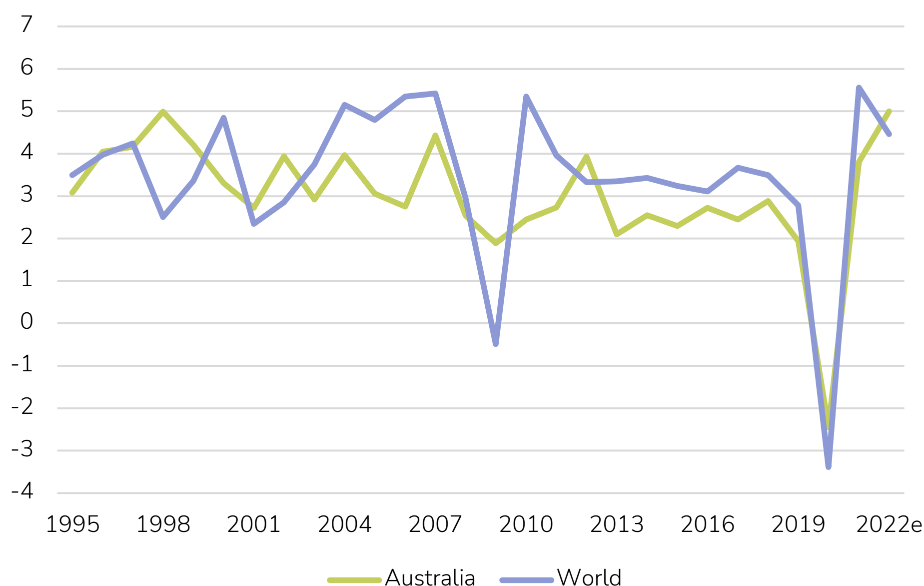
The Fed has unnerved markets in flagging the possibility of faster QE tapering; however, we still expect US inflation to drop significantly over the next 12 months as the US labour market and global supply chains normalise.

We have been flagging a tactical risk around investors getting impatient with the stickiness of inflation, but this does not mean current high inflation readings are structural.

We are somewhat surprised that the Fed appears to be pivoting in its messaging yet again. There is likely a political dimension to the Fed's apparent pivot with President Biden unnerved over the hip pocket impact of the recent inflation spike on the democratic base.

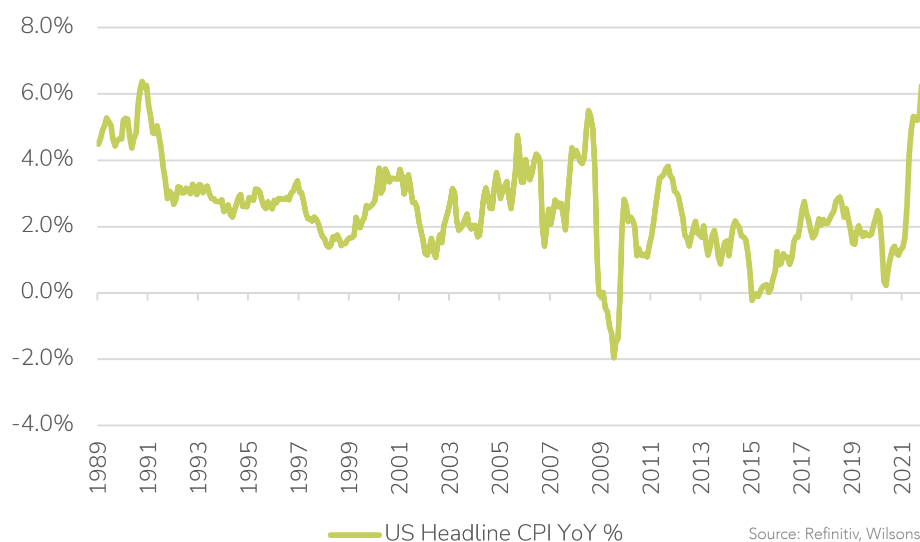
While faster tapering is negative at the margin for the investment outlook, it does not in itself signal that policy is about to get tight. Monetary policy is likely to remain broadly accommodative in 2022. Even if the Fed marginally accelerates the pace of tapering at the upcoming December meeting, our base case view is there will be enough easing in inflation over the coming year to keep the Fed to a couple of rate rises in 2022.

Exhibit 1: Global and Australian GDP growth should remain well above average in 2022 with Australian growth accelerating



Source: OECD (World), Wilsons (Australia)

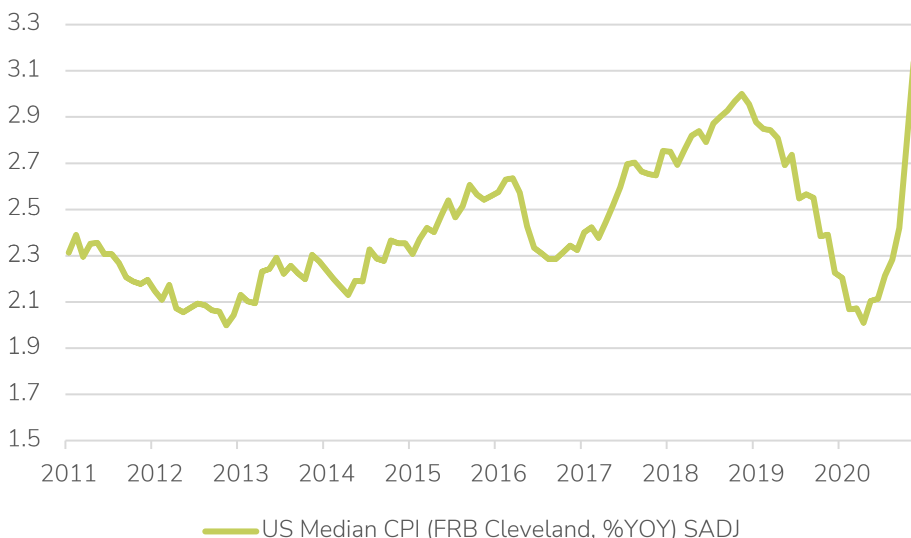
Exhibit 2: The recent spike in US inflation - dragging the Fed off the sidelines?



Source: Refinitiv, Wilsons.

Faster tapering and sticky near-term inflation numbers pose some tactical risk to equity markets, but we do not see the likely 12-month monetary policy backdrop turning overtly unfriendly to risk assets.

Exhibit 3: Inflation pressures have broadened but inflation still "moderate" on broad measures



Source: Refinitiv, Wilsons.

Exhibit 4: Surging demand for "goods" has added to inflation pressures but consumption should rebalance

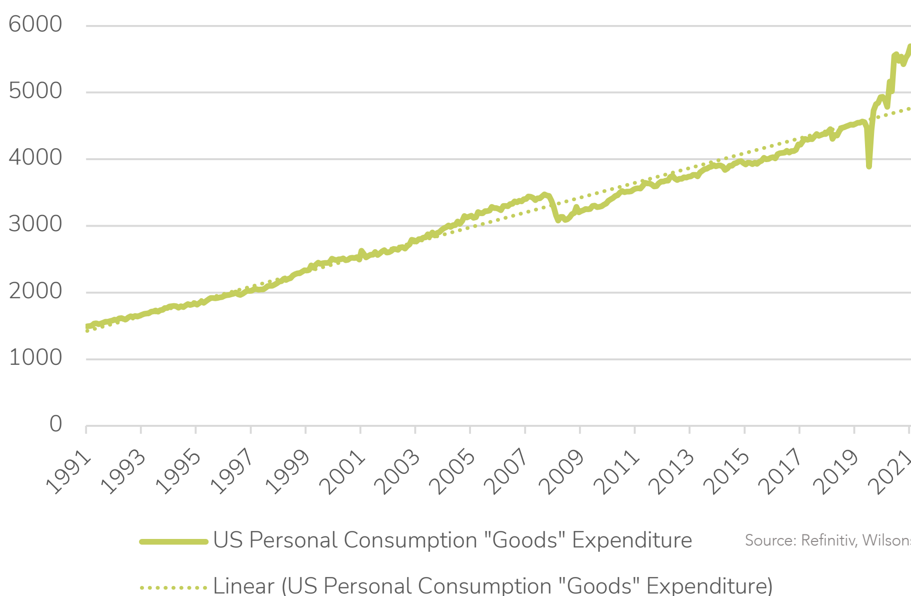


Exhibit 5: Supply side bottleneck price pressures are starting to ease

Source: Refinitiv, Wilsons.

Our base case 12-month view of strong growth but moderating inflation suggests equities will solidly outperform bonds, with the US 10-year Treasury yield likely to rise to 2% at least, but probably not much beyond those levels given the expected fade in inflation.

Our central case total return expectation for global equities is in the high single-digit to low double-digit range. We are particularly bullish on the outlook for the Australian economy, which should support the Australian equity market. The heavy skew of big cap equities to banks and miners may not give optimal leverage to a strong local economy, so an overweight to small caps appears warranted.

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Does Omicron Change the Investment Outlook?

We still have only limited information on the new variant. The factors that will determine its importance to the outlook are 1) its contagiousness, 2) its ability to cause severe disease, and 3) its resistance to vaccines.

According to early evidence it is more contagious than the Delta variant, but we do not yet know if it poses the same health risks as Delta. There has been some initial commentary out of South Africa that most cases tend to be mild, but it is too early to be definitive on this. An easing in the severity of the virus as it continues to mutate would be broadly in line with the typical behaviour of viruses, but it is premature to count on this outcome.

We also do not know how effective existing vaccines will be against it. The large number of mutations in the virus has led to some opinion that effectiveness will fall, but we do not know by how much, and it is once again too early to be definitive.

Scientists should probably have a reasonable understating of these three parameters by as early as mid-December.

It does seem likely to replace the Delta variant fairly rapidly, as Delta did with previous variants. In South Africa, Delta has been almost completely replaced within the past two weeks. The Omicron scare in southern Africa also serves as a reminder of how low vaccination rates are in many poorer countries. This may not be the last variant to emerge.

Governments have already reacted by restricting travel, but the virus seems well seeded around the world. In a best-case scenario, Omicron will turn out to be mild and vaccines will provide a degree of protection against it while it replaces Delta as the dominant strain. This could indeed usher in a more benign tone to the pandemic, which would, all things equal, be a bullish backdrop for equities.

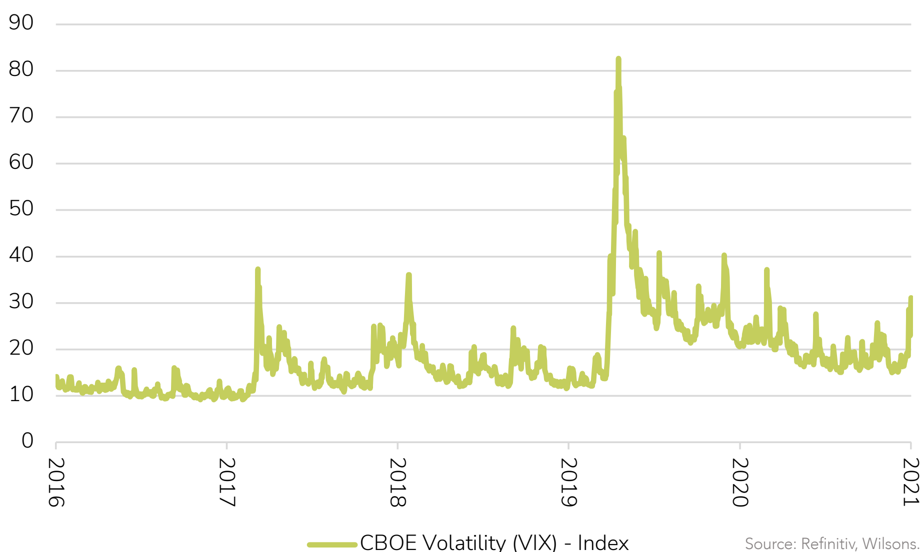
Of course, best-case outcomes might not prevail. As we discussed last week, COVID-19 cases have spiked in Europe, with a similar scenario potentially playing out in the US over winter. This was a somewhat worrying development even before considering Omicron.

Read Markets Getting Another COVID Test

In a close-to-worse-case scenario, where Omicron is partially vaccine- resistant and has a similar mortality rate to Delta, there would be downside for risk assets, although nowhere near the magnitude of 2020.

Drug companies believe they could roll out a tweaked vaccine within 100 days. New and highly effective anti-viral drugs are also now available. Central banks would also delay any shift in monetary policy.

Exhibit 6: A cloudier outlook has seen implied equity volatility spike"moderately"



Source: Refinitiv, Wilsons.

Exhibit 7: High yield bond spreads have edged up but are not suggesting significant stress

Source: Refinitiv, Wilsons.

The Fed has made its mid-December decision "Omicron dependent", so in a worse than hoped for virus scenario, faster tapering would be off the table.

So, a significant near-term economic disruption from Omicron (or Delta for that matter) cannot be completely ruled out, although that would likely just condense a growth rebound into later in the year given the likelihood of an MRNA vaccine solution by March (subject to approval). So, any risk of asset fallout would likely be contained.

In short, the range of possible outcomes around the path of the pandemic is still wide. If the evidence builds over coming weeks that Omicron is turning out to be reasonably benign, equities could bounce, though this scenario puts accelerated Fed tapering firmly in play. Upside and downside seem capped to some extent over the next couple of months.

Risks Bear Watching but we Remain Constructive on Equities

We still see 6-12-month scenarios for risk assets tilted toward upside as growth turns out to be good, inflation ebbs, and the pandemic fades. Overall, equity valuations remain attractive relative to bonds, with the market equity risk premium in most countries attractive compared to history.

At this stage, we would advise investors to stay moderately overweight equities (and underweight bonds), even if there is the possibility of a correction over the next month or so caused by either Omicron or accelerated Fed tapering.

The spike in uncertainty around the pandemic and the Fed makes sector, region, and style calls more difficult. Recent events in respect of the risk of COVID disrupting the expansion does at the margin dent our confidence in value/ cyclical leadership, though pre-emptive tapering arguably raises risks for growth stocks. On balance, our base case still sees value and cyclicals prevailing over growth on a 6-12 month view. The middle ground of quality defensive exposures takes on some appeal, given rising risks around the base case. Outside of equities, alternative assets continue to appeal as a risk diversifier and a source of uncorrelated return.

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