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CIO Viewpoint

Fed shifts gear despite Omicron variant

Investment Solutions

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On 26 November, the World Health Organisation designated Covid's Omicron a 'variant of concern.' Amid uncertainties over the new variant's severity and market volatility, the US Federal Reserve said it plans to accelerate asset tapering and oil exporters reiterated a commitment to boost production. We believe that another economic disruption would delay, not derail demand, leaving growth, jobs and corporate profits less affected.

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Key takeaways

- The impact of the Omicron Covid variant may delay, but not derail, economic recovery
- The Fed plans to accelerate asset tapering as labour markets continue to mend
- Oil exporters (OPEC+) are pressing ahead with a production increase
- We expect economic activity and earnings to continue supporting risk assets.

The Omicron variant incorporates as many as 50 genetic mutations that may change the Covid virus' behaviour. Better understanding of its severity "will take days to several weeks," the WHO wrote on 28 November. The latest variant was first detected and reported five days earlier by virologists in South Africa and Botswana. There is no estimate yet of whether the variant creates a more severe form of the disease, nor whether current vaccines are effective.

In response to the WHO's classification, the fourth 'variant of concern' since the start of the pandemic, stock markets recorded their biggest single-day fall since the last was labelled 'Delta' on 11 May 2021. News of each of the Covid variants have driven volatility before markets recovered. Provided vaccines prove effective against Omicron, the current path to recovery should not be interrupted by this latest version. In addition, economies are becoming more efficient at coping with interruptions, whether logistical or remote working. The S&P 500 remains almost 24% higher than its opening at the start of 2021, and Brent crude oil has gained 28% year-to-date.

The Omicron variant has already increased economic uncertainty and short-term volatility as markets attempt to price the threat to the economic recovery. Many governments have reacted with additional restrictions, including travel bans, lockdowns or are mulling compulsory vaccination programmes where take-up has been low.

BioNTech Chief Executive Ugur Sahin, whose firm partnered with Pfizer to produce the first Covid vaccine, said last week that "it's likely" that its jab will provide "substantial protection against severe disease caused by Omicron." Moderna, another Covid vaccine maker, has said that it is working on two boosters "designed to anticipate mutations such as those that have emerged in the Omicron variant." Dr Sahin told Reuters that Pfizer and BioNTech have tweaked their vaccine to target the Alpha and Delta variants, and this experience should help to accelerate a regulatory approval process if needed. In addition, GlaxoSmithKline and Vir Biotechnology announced last week that one of their therapies shows promise against the new variant.

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OPEC's production, Fed tapering

The Organisation of Petroleum Exporting Countries, led by Saudi Arabia, the United Arab Emirates and Kuwait, plus Russia, confounded expectations when members agreed on 2 December to press ahead with a production increase of 400,000 barrels of oil per day. That drove the price of Brent to around USD 68 per barrel and suggests that the cartel, which prefers to respond to rather than to anticipate demand, believes that economies can cope with Omicron.

For now, the Fed has also put fears of Omicron's impact aside in favour of addressing inflation by planning to speed up cuts to asset purchases. The US central bank plans to discuss asset tapering "so that it wraps up a few months earlier" than initially planned when it next meets on 14/15 December, said Fed Chair Jerome Powell.

The Fed calendar has therefore accelerated rather than altered. If the Federal Open Market Committee doubled the pace of asset tapering to USD 30 billion per month starting in January, the process could be complete as soon as March. We see two rate rises in 2022, with a first increase of 25 basis points in June or September. This would start a hiking cycle with rates expected to peak at around 2.5% in 2024.

Retiring 'transitory'

Fiscal and monetary policy will have to adjust gradually and stay flexible in the face of continuing uncertainties. The job market and fuller employment remains a key Fed criteria for rate-hike "lift off". The US has recorded high levels of job vacancies and stubborn unemployment rates. November's data indicated that the labour market continues to recover, with unemployment falling to 4.2% from 4.6% a month earlier. While the 210,000 new jobs created last month was fewer than expected, wage growth is no longer accelerating. We expect the US labour market to reach full employment in the third quarter of 2022.

The US is also experiencing three-decade high annual inflation. American consumer prices rose 4.1% in October compared with a year earlier.

On 30 November Mr Powell dropped 'transitory' from his description of inflation for the first time since April 2021. It is "probably a good time to retire that word," Mr Powell told a Senate Banking Committee, a week after being nominated by the Biden administration to a second term at the head of the central bank. The Fed, explained Mr Powell, had expected inflation to prove transitory in the sense that "it won't leave a permanent mark in the form of higher inflation."

Inflation is likely to stay high over the next four months, however, we believe annualised inflation will reach 2.6% in 2022 and around 1.4% in the eurozone.

Asset implications

As the year-end approaches, inflation's trajectory and the threat posed by the Omicron variant to public healthcare and the global economy will become clearer. Meanwhile, we have seen a swift change in market mood. If this new strain proves more severe than the Delta variant, or existing vaccines do not offer protection, we would expect to see a significant but ultimately manageable knock to growth. So far, public health measures have adapted rapidly and the economic impact of restrictions is diminishing with each new variant. The lesson of the past 20 months is that economies are increasingly resilient and capable of managing, and then bouncing back from the pandemic's challenges. Recent market recoveries reflect that.

The combination of Omicron and the Fed's hawkish pivot has kept markets on edge. It is tempting - but risky - to react to shifting market sentiment without keeping the broader picture in sight. We expect economic activity and earnings to continue supporting risk assets and see indications that some market participants are buying price dips. While Omicron is a risk that has potential to disrupt the path of recovery, fiscal and monetary policy are likely to remain flexible and, if needed, offer further support to affected sectors. Last week underlined expectations at the Fed and OPEC that the recovery will stay on track.

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