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CIO Viewpoint

Pandemic to endemic; living with infection, inflation and higher rates

Investment Solutions

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Six weeks after the World Health Organisation labelled Omicron a 'variant of concern,' data suggests it is more contagious but less likely to need intensive care or prove lethal. As a result, the new strain may do little more than slow, rather than stall further economic growth, as markets focus on high inflation and the end of central banks' asset purchases.

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Worldwide, confirmed Covid cases are around three-times higher than the previous peaks registered in 2020, reflecting both Omicron's much higher pace of infection as well as higher testing levels. Daily cases reached a new peak of 2.6 million on 6 January, according to the WHO. On 22 December, research by Imperial College in London estimated that Omicron patients were as much as 45% less likely to end up in hospital than those with the earlier Delta variant infection.

Nevertheless, higher transmission rates are a two-edged sword. Each time a virus infects us, it creates copies of itself that includes errors, or mutations. Omicron's silver lining may prove to be an increase in herd immunity, at the risk of generating another new variant. South Africa's experience in recent weeks may be illuminating. While just 27% of the country is fully vaccinated and infections reached a record in mid-December, daily mortality is six-times lower than a year ago.

That is not to downplay the seriousness of Omicron, which should not be considered a mild variant, warned the WHO last week. Of the world's severe cases, 90% were unvaccinated, the Geneva-based organisation said. The impact of Covid therefore still depends whether existing treatments continue to prove effective. It is still too early to know whether the variant will accelerate the transition from a pandemic virus to one that is endemic in populations and is managed more like a seasonal flu.

More treatments

Last month, the WHO increased its list of Covid vaccines to nine, with the latest Indian-made inoculation aimed at reaching populations in lower-income countries. In addition, two new antiviral pills have recently become available to supplement existing treatments for patients at risk of severe forms of the virus.

Key takeaways

- The Omicron variant is highly infectious but less lethal, and may slow rather than stall economic growth
- New antiviral pills are becoming available to reinforce treatments, and governments are adjusting quarantine rules to ease short-term labour shortages
- Job markets are healing and central banks are accelerating policy normalisation; bond yields rose last week
- We believe the balance of market drivers is positive, supporting risk assets, while uncertainties over the pandemic and policy normalisation will keep volatility high.

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The treatments, developed by Pfizer Inc. and Merck, are approved for use in the UK and the US. The European Medicines Agency has advised that the drug is available for emergency use for at-risk adults who don't require oxygen, and supplies are reaching patients in some areas of the US and UK. The antivirals are designed to complement existing public health tools, including vaccinations, and above all limit hospital admissions. The US Food & Drug Administration explicitly says that the new pills are not a substitute for vaccination.

The greatest economic challenge from Omicron now looks increasingly like its infectiousness, not its severity. High case numbers are creating significant workforce shortages as people quarantine, leading to thousands of cancelled flights globally, new pressures on healthcare systems and additional supply-chain disruptions.

Healing job markets

Faced with labour shortages, the public health approach to infections is evolving. Last week, the UK government asked the public sector to prepare for the absence of as much as one quarter of staff, and some nations, including the US, France, Spain, Ireland and Greece, have all reduced the length of time that a positive Covid case must isolate from others.

Beyond short-term absences due to Covid cases, broader labour markets in western economies are healing and on track to return to their pre-pandemic levels. In the US, labour indicators point to jobs reaching that threshold this year, supporting the Federal Reserve's monetary policy changes. Total US jobs and jobless rates are already close to definitions of full employment. The only indicator that trails pre-pandemic levels is the labour participation rate, which may reflect the changing nature of work that people are looking for. The much-discussed 'Great Resignation' appears to reflect only employees with low-skilled jobs in the leisure and hospitality industries looking for better paying work.

How will Omicron affect our economic growth expectations? For developed western economies, the variant's impact should prove transitory and concentrated in the first few weeks or months of this year. Unless we see further variants with more severe symptoms that don't respond to treatment, there is no reason at this stage to expect more lasting economic damage. Any damage is also tempered by economies becoming more efficient at coping with interruptions, thanks to logistical or digital working tools, as well as adjustments to quarantine and testing restrictions.

One factor difficult to quantify at this stage is any additional drag on the US economy as a result of declining fiscal support, which to date has been generous. With the Biden administration's 'Build Back Better' ambitions under threat, the decline in fiscal support may be worse than initially expected this year.

In the world's second biggest economy, China's authorities have taken a different approach to managing Covid with a 'zero-tolerance' policy. That makes growth more sensitive to case numbers, and generated de-facto lock downs. Still, for now the worst-affected region of Xi'an is not a key economic centre, and has not undermined activity nationally. In addition, China's authorities have consistently shown their willingness to loosen monetary and fiscal policy to offset any negative impacts. Overall, our outlook for the Chinese economy, which already factored-in some Covid disruptions, remains unchanged at an annualised 5% growth for 2022.

Normalisation focus

The first week of the year saw an acceleration of the interest rate normalisation process. The minutes of the Fed's December meeting reinforced expectations that the US central bank will accelerate its cuts to asset purchases, and that 2022 will see three interest rate hikes, starting as early as March. The European Central Bank is scheduled to end its emergency asset purchase programme in the same month, as the region saw a record 5% annual inflation in December. Last month, the Bank of England announced its first post-pandemic interest rate hike to 0.25%.

Sovereign bonds in developed markets saw yields increase. Benchmark 10-year US Treasuries recorded a 28 basis point rise in yields last week to 1.78%, while real rates were up 25 bps to -0.76%. The equivalent German Bund also rose 25 bps to -0.037%. Stock markets saw a strong rotation towards value names, especially energy and the financial sector, while technology firms suffered.

On balance, we see positive market drivers further supporting our pro-risk portfolio positioning. We remain optimistic that in an inflationary environment there is still room for corporate earnings to grow and drive equity indices further. In fixed income, in line with normalising US monetary policy, we underweight sovereign and investment grade bonds in favour of Asian credit and renminbi-denominated Chinese government debt.

Our exposure to gold remains below our strategic benchmark, as we expect the precious metal to come under pressure from rising real rates.

Markets' attention is now focused on central banks' hawkish shifts on the back of strong economic activity and high inflation. With no road map to exit a pandemic, the risk of a monetary, or fiscal policy miscalculation, suggests that markets will remain volatile.

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