PICTET
Asset Management

BAROMETER OF FINANCIAL MARKETS JANUARY INVESTMENT OUTLOOK
January 2022

Barometer: Omicron wave won't sink stocks

The Omicron Covid variant may have led to more restrictions but the economic recovery remains resilient nevertheless. Which means stocks don't appear vulnerable to a correction.

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Asset Allocation: Omicron unlikely to derail recovery

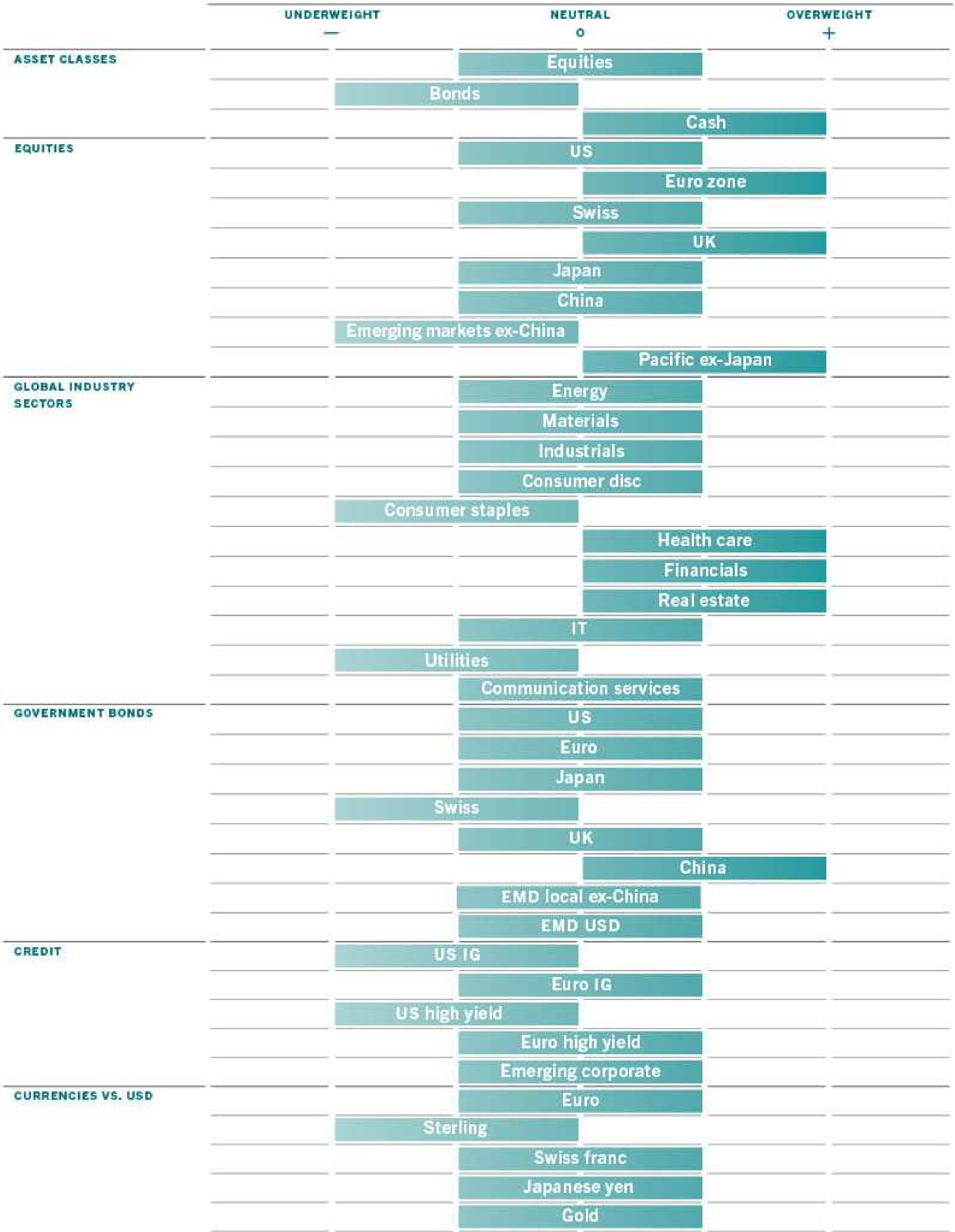
A new year, old problems? The rapidly spreading Omicron variant has triggered renewed mobility restrictions, leaving investors concerned about the economic fallout in some parts of the world.

But the global recovery remains resilient, thanks to a strong labour market, pent-up demand for services and healthy corporate balance sheets. Ample household savings can also cushion the blow: the IMF forecasts that the global gross savings ratio will hit an all-time high of 28 per cent in 2022.

Weighing the Omicron threat against this economic picture, we leave our asset allocation unchanged for the time being, with a neutral stance on equities and an underweight position in bonds. Given our positive outlook for the economy, we are looking for opportunities to raise our weighting in stocks in 2022.

Fig. 1 - Monthly asset allocation grid

January



Source: Pictet Asset Management

Our **business cycle** indicators show the global economy is on track to grow 4.8 per cent in 2022.

We raised our GDP forecast for the US as the world's biggest economy is experiencing a strong recovery in both manufacturing and services.

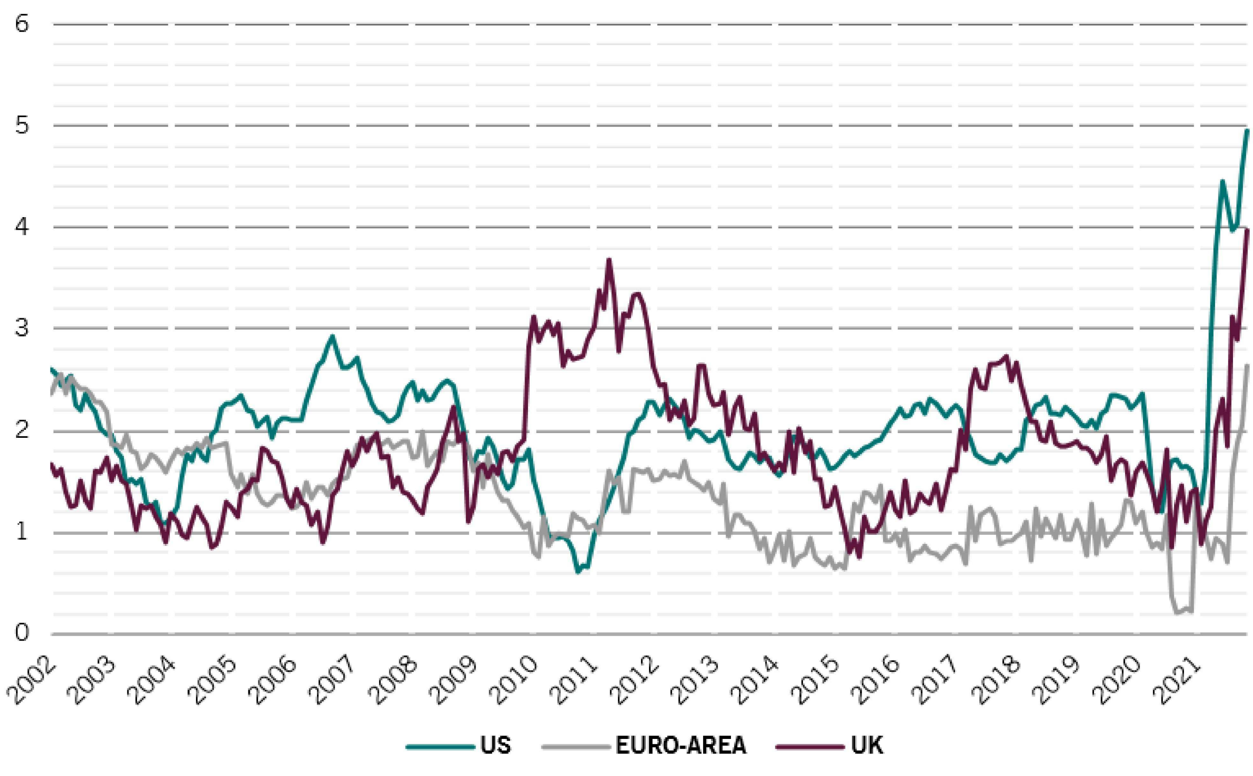
Buoyant consumer sentiment and excess savings of some USD2.2 trillion should also lead to robust jobs growth in the coming months.

Price pressures, however, been stronger and more persistent than expected. November CPI rose at the fastest pace since 1982 at 6.8 per cent, with core inflation running at an above-trend 4.9 per cent.

Even after stripping out Covid-sensitive items and base effects, inflation is still running way above the central bank's official target at 3.6 per cent.

We expect core inflation to peak at 5.8 per cent in early 2022, which should prompt the US Federal Reserve to raise interest rates by as early as June 2022; it recently announced its intention to end asset purchases by March.

Fig. 2 - Inflation: a global problem
US, euro zone and UK core CPI



Source: Refinitiv, data covering period 15.01.2002 – 15.11.2021

The euro zone economy remains resilient but the outlook is becoming less clear because of the economic impact from renewed mobility restrictions and persistent supply chain disruptions.

Nevertheless, we still expect the region's economy to grow 4.4 per cent, higher than the market consensus. We have become more optimistic on Japan; its economy is recovering from a sharp but brief Covid wave.

The country's vaccine rollout is progressing well while consumer and business confidence indicators and housing market data have been encouraging. A weaker yen and a fresh fiscal stimulus should support growth in the coming months.

Our **liquidity** indicators lend weight to our neutral stance on equities.

Liquidity conditions for the US are turning negative as the Fed moves to rein in a surge inflation with tighter monetary policy. The picture is very different in China after the People's Bank of China cut its reserve requirements ratio by 50 basis points in December.

The latest PBOC easing should release about RMB1.2 trillion of long-term monetary stimulus according our calculations, equivalent to 1 per cent of GDP. The PBoC is creating liquidity at a quarterly rate of USD232 billion, by far the fastest pace among all major central banks.

Our **valuation** signals are more favourable than a year ago for both equities and bonds: price-earnings multiples for world stocks are down some 10 per cent from this time last year while bond yields across developed economies have risen by as much as 50 basis points.

Even so, it is difficult to find good value in any major asset class. We expect equities' price-earnings ratios to contract some 5-10 per cent again this year in response to rising real bond yields.

Our expectations for earnings growth this year stand at 16 per cent, however, more than double the market's consensus.

Technical indicators have turned negative for equities due to seasonal factors.

Balanced against this is the fact that investors sentiment is much less bullish than a few months ago, suggesting some more upside for riskier assets.

02

Equities regions and sectors: earnings a bright spot

Notwithstanding our neutral tactical stance on equities, our outlook is positive. The bull market remains firmly in place, supported by a positive outlook for economies emerging from the pandemic, which should more than offset downside risks like the possibility the Fed errs by being panicked by inflation into tightening policy too aggressively.

Yes, the Fed is turning more hawkish – yet real policy rates are likely to remain substantially accommodative for some time to come and commercial banks appear to be prepared to lend more. And if Omicron turns out to be a mild variant, growth could once again lurch ahead. While corporate earnings growth has clearly peaked and consensus 12-month forward earnings for the MSCI All Country World Index now discount a mere 5 per cent annual increase in profits compared to a peak of 55 per cent in the spring, strong US growth, resilient margins leave us feeling far more positive than the market.

Chinese equities could yet set the pace. They are attractively valued following their losses during 2021. China's monetary policy is turning cautiously expansionary and the country's growth outlook is expected to improve as the worst of the construction crisis may well behind us. However, signs of recovery on all three fronts are still tentative and warrant a wait-and-see approach for a month or two longer. For now we remain neutral on China, although we are overweight Asia, excluding Japan.

Fig. 3 - Reopening uncertainty

Basket of sectors likely to benefit from post-Covid reopening vs sectors that performed well during the pandemic compared to MSCI value vs growth stocks, rebased 01.01.2020 = 100

*Reopening plays: Airlines, Office and retail REITs, Aerospace and Defense, Transportation infrastructure, Hotels and Leisure. Lockdown plays: FAANG (equal weighted), home improvement, leisure products, household products, food and staples retailing. Source: Refinitiv Datastream, Pictet Asset Management. Data from 01.01.2020 to 16.12.2021.

By contrast, we are underweight emerging markets outside of Asia amid deteriorating economic momentum, an acceleration in the pace of rate hikes and political risks such as building tensions between Russia and Ukraine. We are also underweight selected defensive sectors such as consumer staples and utilities.

We continue to prefer cyclical value markets and sectors, such as the euro zone, the UK, financials and real estate. We find US small caps very attractive now, given their historically low valuations versus large caps, their tilt towards cyclical value and their exposure to what we expect to be one of the most dynamic economies in the world next year.

One notable development in the equity market is how closely the relationship between value and growth stocks is mirrored by that between sectors that stand to benefit from post-Covid normalisation and those that were winners during the pandemic (see Fig. 3). In other words, post-Covid recovery sectors share characteristics with value stocks, while those that performed well through lockdown look a lot like growth stocks. Broadly speaking, the market remains unconvinced that the pandemic is over.

03

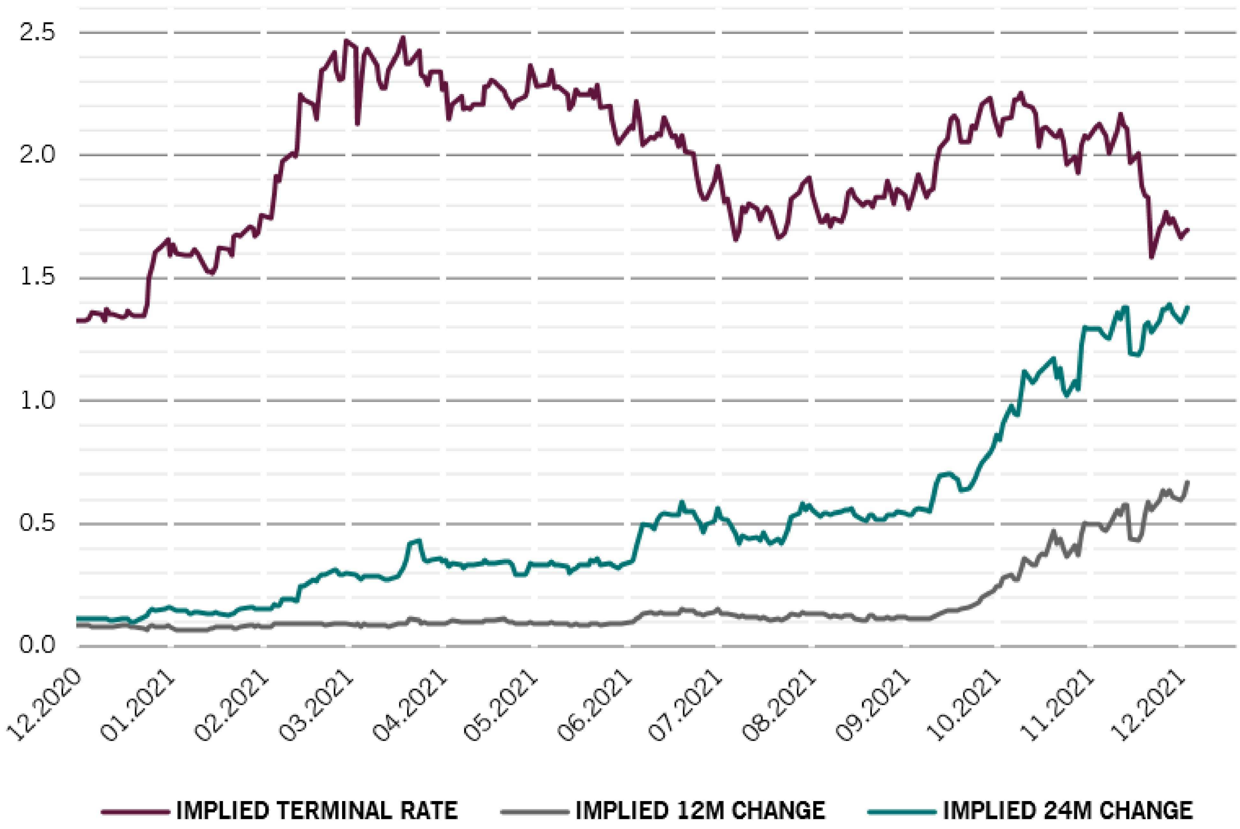
Fixed income and currencies: little value outside China

At a time when monetary policy is tightening across the developed world in response to surging inflation, government bonds continue to look very vulnerable and unlikely to deliver positive returns. Attractive opportunities are in short supply.

Nominal economic growth in the US is close to 10 per cent, and the Fed is eager to withdraw monetary stimulus, having turned increasingly hawkish since September (see Fig. 4). This in turn is being reflected in market expectations of near term rate hikes. We see Treasury yields rising to 2 per cent by year end. Inflation-linked bonds (TIPS), the star performers of 2021, now offer less protection than 12 months ago, given the decline in yields and inflation breakeven rates hovering at cyclical highs.

Fig. 4 - Rising expectations

Implied changes in US Federal Funds Rate, ppts



Data covering period 16.12.2020-15.12.2021. Source: Refinitiv Datastream, Pictet Asset Management.

We also remain underweight US investment grade and high yield bonds. Spreads are still very tight and investors are starting to wake up to the risks, with high yield bonds seeing outflows in recent weeks.

The outlook for bonds in Europe looks even more challenging given their extremely low yields. Such valuations look hard to justify when the region is experiencing above-average growth and its central banks are reducing stimulus, if not hiking rates already, as the Bank of England has recently done.

One of the few bright spots is Chinese government bonds. And for a number of reasons. First, the PBOC is now easing monetary policy in both actions (RRR cuts) and guidance – bucking the trend in the rest of the world. Second, inflation remains under control, and we don't expect it to exceed PBOC's 3 per cent target thanks to more muted demand than elsewhere and a strong currency. The third buy signal is valuation. China's government bond yield remains attractive compared to what is on offer elsewhere, hovering at around 3 per cent.

When it comes to currencies, our models suggest that in the short-term the US dollar is likely to appreciate a bit further, with a potential cyclical peak at around 100 on the DXY index (which currently trades at 96). Over the longer term, though, the economic growth gap between the US and the rest of the world will start to shrink, undermining the greenback.

We remain negative on sterling. The UK economy is lagging the rest of the world, and activity is still 1 per cent below pre-Covid levels. Sterling also faces negative seasonality and weakening technical trends. The recent rate hike by the BoE was a surprise in terms of timing but we doubt that three or four more hikes will follow in 2022, which is what the market is currently discounting.

04

Global markets review: stellar year for stocks

Global equities delivered stellar performance in 2021, with the value of the MSCI All Country World Index increasing by more than a fifth in local currency terms. After a circa 4 per cent decline in November, developed market equities hit a new record high at the end of December brushing off worries of the new Covid variant Omicron – which appears to be more transmissible but less virulent than Delta.

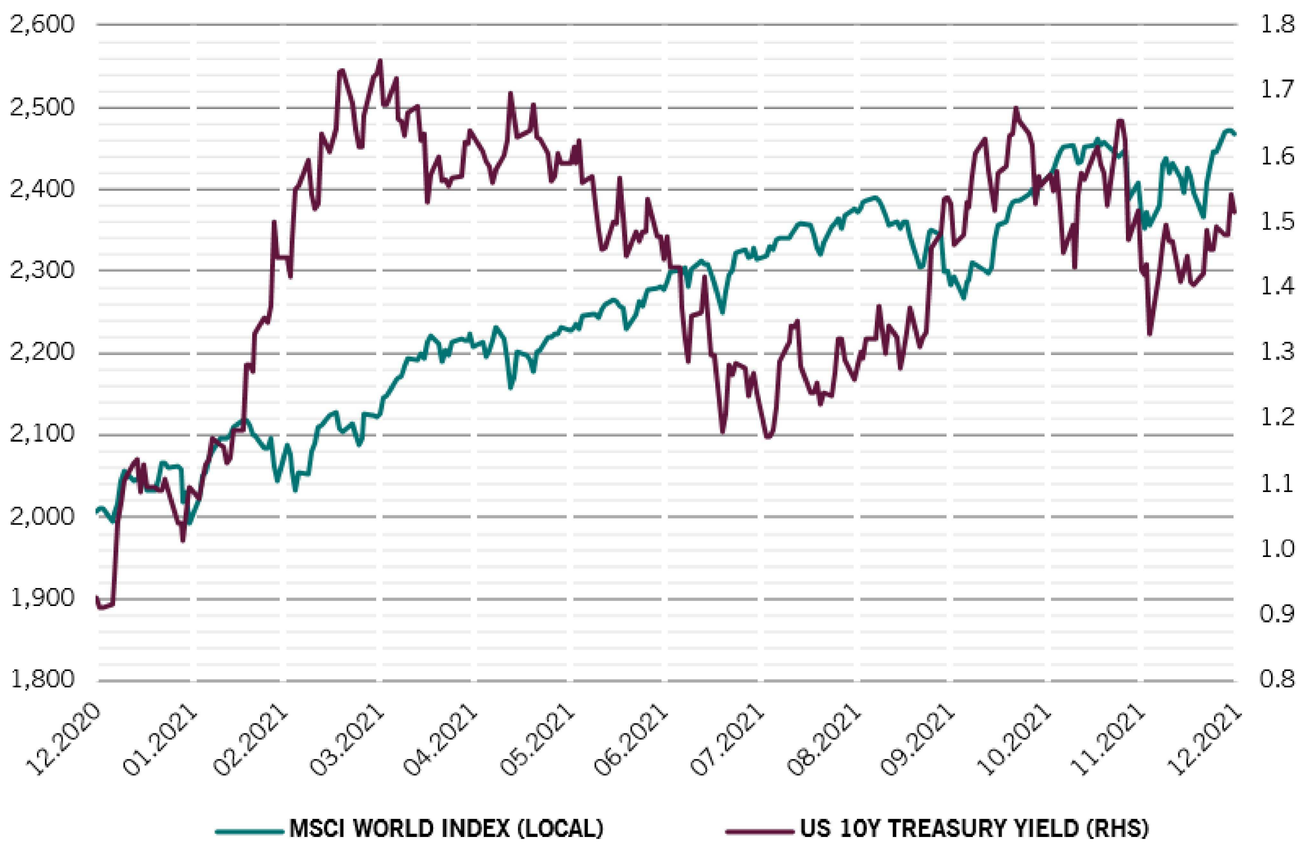
In the US, both the S&P 500 index and the Dow Jones Industrial Average set fresh record highs during December as investors welcomed reports of strong retail sales over the holiday season and lower jobless claims. Britain's FTSE 100, meanwhile, rose to levels last seen in February 2020, before the pandemic took hold, notching up its biggest annual gain in five years.

China was a notable outlier, with its stock market losing 5 per cent amid plans for further regulatory crackdowns – this time on overseas listings – and uncertainty over lockdowns. A last-minute rally in beleaguered Chinese tech stocks was not sufficient to drag them out of the red for the year.

Among sectors, defensive ones, such consumer staples, healthcare and utilities were the star performers for December. Value stocks outperformed growth stocks and energy delivered the best returns for the year as a whole, up some 40 per cent. Global economy recovery pushed up demand for oil and gas, while major producers curbed output – a combination which propelled prices higher.

Fig. 5 - Stock gains

MSCI All Country World Index (in local currency) and 10-year US Treasury yield



Data covering period 30.12.2020-30.12.2021. Source: Refinitiv Datastream, Pictet Asset Management.

In contrast, gold had its worst year since 2015, losing around 4 per cent and temporarily slipping below USD1,800 an ounce, largely due to a strong US dollar and rising interest rate expectations.

Fixed income also had a tough time in 2021, in the face of rising global inflation and tighter monetary conditions. Yields on short-dated US Treasuries hit levels last seen in March 2020, and the yield curve flattened on expectations that inflationary pressures will prompt the Fed to raise interest rates. According to the Fed's preferred PCE measure, inflation hit a four-decade high in November.

Government bond yields rebounded strongly in the euro zone and in Britain during December. The Bank of England delivered a surprise rate hike in the final weeks of the year and the ECB announced a much slower pace of asset purchases in the months ahead. Yields on China's government bonds continued to fall, ending the year below 2.8 per cent – an 18-month low.

The dollar was unchanged against a basket of currencies in December but finished the year up nearly 7 per cent, the best year since 2015, thanks to a strong performance of the US economy. Among major currencies, only the Chinese renminbi managed to appreciate against USD in 2021 (up 2.7 per cent).

05

In brief

BAROMETER JANUARY 2022

Asset allocation

Weighing the Omicron threat against this economic picture, we retain a neutral stance on equities and an underweight position in bonds.

Equities regions and currencies

We remain cautiously optimistic, maintaining overweights for euro zone, UK and Pacific ex-Japan stocks.

Fixed income and currencies

China offers some of the best potential within fixed income. We remain cautious on US credit, both high yield and investment grade.

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