



January 2022

# World Economic and Market Outlook

# SUMMARY

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Overall, 2022 looks likely to see heightened levels of market volatility, especially during the first quarter, as investors adapt to a withdrawal of the favourable liquidity conditions that have buoyed markets throughout the post Financial Crisis period and especially in the Covid-19 world. Longer-term investors should focus on equities continuing to outstrip the returns available from safe assets over the medium-term as long as they can live with periods of market turbulence. Volatility should not be confused with risk. Real risk is permanent loss of capital rather than short-term market moves. Even amongst some of the non-profitable technology names there are a number of these businesses which are likely to evolve over time into companies with a significant market share and many of these names have now been hit extremely hard and are likely to offer buying opportunities in coming months. Quantitative driven risk parity funds may also be contributing to market declines in certain stocks, together with forced selling from some leveraged private investors. In the first few days of the year, by way of example, Moderna shares had fallen by 20% despite the fact that they will sell every dose of vaccine they produce this year and, along with other mRNA vaccine producers, have announced a move into the flu vaccine market where their technology should allow more efficacious vaccines to be produced in a significantly shorter lead-in time compared to the traditional flu shot.

Technical support for markets is not as strong. The Nasdaq has fallen below its 200-day moving average. In today's world, market declines over short time periods can become self-feeding with forced selling from buyers hit with margin calls, activities of gamma trading and other quantitative driven market participants.

The inflation picture could see dynamics oscillate in 2022 with this resulting in outsize market moves and higher levels of volatility. There is also likely to be speculation about whether the Fed will need to do more such as a 50bp rise to restore its credibility. The next Fed meeting is at the end of this month. Rick Rieder the CIO Global Fixed Income at BlackRock has described the US labour market as red hot. While now there are strong cyclical forces driving inflation higher, as the effects of the pandemic pass through, the next question for investors will be whether the previous secular disinflationary forces, the three Ds can reassert. There are still high (higher post pandemic) debt levels, demographics (negative for demand) and technological disruption (the third D is for devices) reducing costs for consumers.

Shrinking labour forces on the one hand can see upward pressure on wages. previous pandemics saw labour forces shrink through deaths and for instance the Black Death in the UK saw wage levels rise in the 1300's). On the other hand, Japan has shown aging populations deliver reduced levels of demand. If Omicron burns through quickly as now seems likely and restrictions ease speedily there could be a further surge in demand adding to short term inflationary pressures - an example of good news being bad news for markets.

How investors should position themselves is not something that can be answered with certainty. If the Fed can engineer a 'soft landing' and deliver the extended and long economic cycle which Fed Chair Jay Powell clearly regards is vital for full employment including a much higher labour participation rate in the US economy, the market decline at the index level may not be that severe albeit with strong sector rotation and changes to market leadership. This would see a resumption of the bull market later this year. If, however inflationary expectations become embedded, and the Fed are forced to tighten to an extent which severely hits economic activity and hence corporate profitability, the market downturn could be more severe and longer lasting. With central banks globally still very much operating with a pro-growth bias, very negative real rates and economic growth strong, the likelihood of a milder setback remains the central case. The main risk to markets remains a significant and rapid rise in bond yields and if US 10-year Treasuries hit for example 3% equities would trade significantly below current levels.

investors who have had gains from markets over the last decade are faced with the quandary of where to place their money going forward with safe assets such as cash producing zero or, in many cases providing negative returns. While investors with cash to deploy should proceed with caution and look to average money in, outside of a significant economic downturn which appears unlikely over the forecastable future, investors should be prepared to sit out market volatility and some assets that had reached bubble territory in 2021 will be slower to recover all of the falls that have occurred in recent months.

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