Sanctum Wealth

Sanctum View

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The Omicron Edition

- **Omicron, the new COVID strain overwhelmed markets last week, but concerns appear misplaced as of now**
- **The initial impression about the new variant is still sketchy and clarity will likely emerge over the coming days**
- **For European equities, already grappling with ECB's inflation stance and spiking infection levels, Omicron appeared to have complicated the problems**
- **Tech stocks, having had a decent run after April 2020, will be somewhat on a sticky wicket if things go south**

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New coronavirus strain rattles markets, but panic seems misplaced: Stock markets took a tumble last week after reports surfaced that a more infectious new strain of COVID had been found in Southern Africa. Other countries including Belgium, Egypt and Israel also reported finding patients infected with the new strain (Omicron), which the World Health Organization immediately labelled a variant of concern. We believe at this (early) stage it would be wise to heed the lesson that the pandemic has taught thus far, i.e., to not draw conclusions too early but wait for full confirmation of the relevant facts. However, overreacting will not be profitable either.

Not much clarity about Omicron's characteristics: The new strain reportedly has many more spike proteins than other variants, which potentially enhances its ability to evade immune systems. Yet, there is little by way of information on how it behaves in the presence of vaccines: does it evade them or not? While the initial impression is still sketchy, it does appear from reports that it does not cause more severe symptoms than any other variant.

Governments are (again!) going for lockdowns: Some countries, such as Israel, have opted for complete international travel bans. Others have imposed stricter border controls from certain countries and have signaled that they are considering further restrictions.

Markets did not like the surprise, but just how much has changed? It is a no-brainer that markets don't thrive on uncertainty. Nasty surprises even less so. Further clarity on just how damaging the new variant is will emerge over the following days and weeks. Looking at fundamentals and market drivers, it will be more appropriate to wonder if it will change the trajectory that markets were on before the news broke in the first place.

European equities were the worst performers, apart from Russia, which, media reports quoting intel said had mobilized troops to the border with Ukraine. While that raised the spectre of what many considered a looming war, the reports said European leaders were already engaging in parleys with the Russian president. The EuroStoxx Index dropped more than 5%, and many financial stocks had an even steeper fall. The resource-heavy UK Index also fell sharply. Meanwhile, the Omicron variant further complicated the problems for European equities, which were already grappling with two pressing issues:

First, the ECB is increasingly finding itself in a tight spot as it steadfastly holds that the historically high inflation readings it is recording are still no reason to ease off on tapering or starting to hike rates sooner than planned. Throughout November, 10Y bund yields have been declining; the move accelerated only to some extent late last week.

Second, it is well-known that Europe was facing a rough winter with spiking energy costs and escalating COVID infection rates in many countries. New lockdowns were being mooted even before the news of Omicron broke. When previous waves hit Europe, the economy was somewhat better off than the wave before as businesses found ways to adapt and consumer spending patterns changed to take account of the need to shop remotely.

US stocks have had two bad days, but the S&P500 is down 2.7% for the month to the end of last week – hardly an earth-shattering outcome compared to the mayhem of March 2020. Across sectors, there were no clear winners, but Energy stocks were the hardest hit as crude oil retreated sharply. WTI dropped to $68 on Friday from above $80 per barrel earlier in November.

A distinct feature of the strong market rally after April 2020 was the outperformance of Technology stocks, as the market was willing to pay an expanding premium for the certainty of the income stream provided by these stocks in the face of the uncertainty brought about by COVID. Even if governments resort to further lockdowns, the starting level of valuations on Tech this time around will provide the sector with a challenge. Furthermore, inflation is now elevated, unlike 20 months ago when it was very low. The outlook for many sectors will be starkly different as a result.

Bond yields have provided a short-term safe haven. US 10Y yields had declined to 1.47% by the end of last week from the highs of close to 1.7% the week before. To an extent, it is understandable that investors take shelter in the comfort of US government credit in times of stress. That said, the bond market was digesting persistently higher inflation numbers and looking poised for further weakness. We question whether Omicron will materially alter the inflationary dynamic.

Wider credit spreads may be an opportunity: Credit spreads, and the yield on lower-quality paper widened out in synch with the rally in government bonds. On many occasions earlier, we have noted that any credit outlook is benign if it is constrained purely by the low level of spreads and outright yields. If the dust settles quickly on this episode, the approximately 60-80bps widening between high yield and emerging market spreads could signal a neat opportunity. If that scenario plays out, one can rotate out of government bonds and into credit – for those who were fast enough to buy government bonds – or apply cash balances to re-enter credit positions.

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