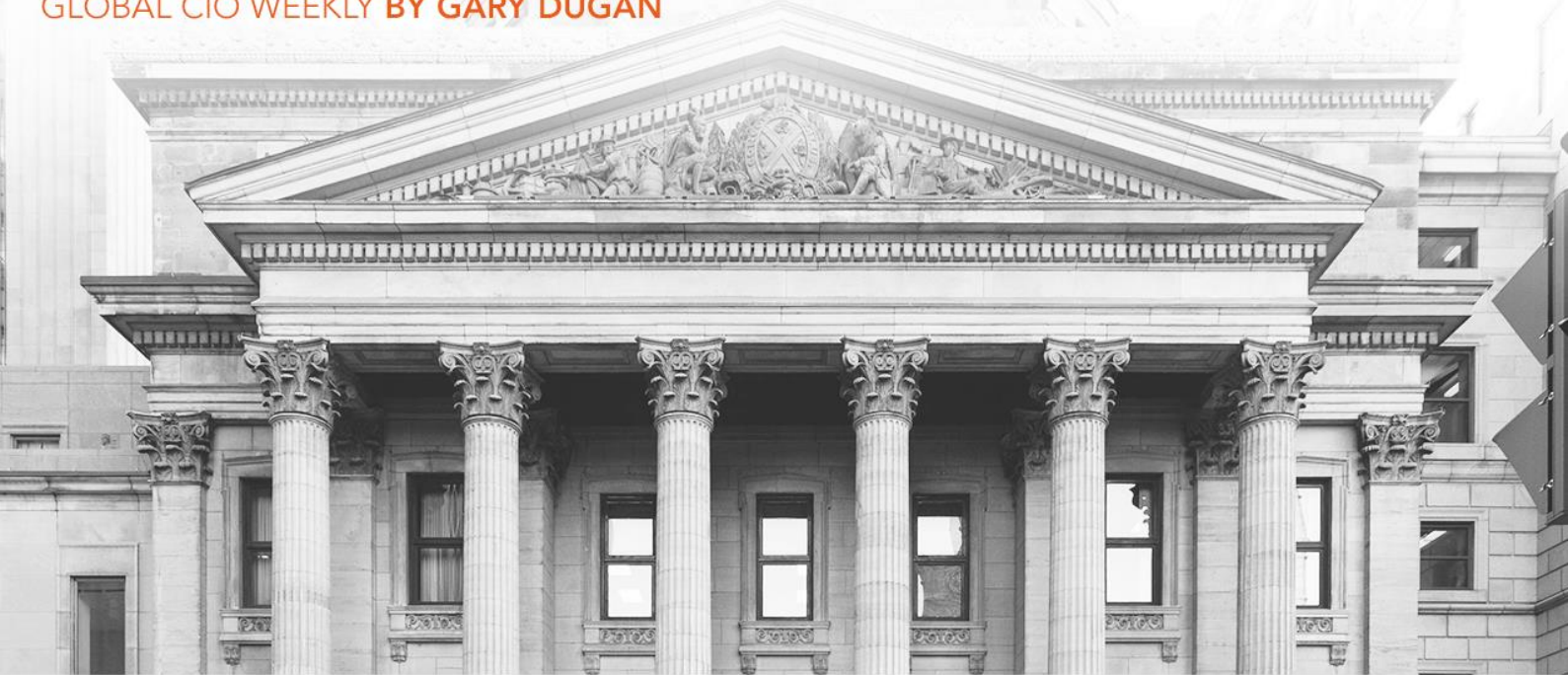


THE BIG PICTURE OF GLOBAL ECONOMICS

GLOBAL CIO WEEKLY BY GARY DUGAN



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Central Banks in Action Mode

- Central banks are raising rates and paring bond buying in their attempt to rein in inflation
- The market now expects the Fed to institute three rate hikes in 2022
- The Bank of England, in an unexpected move last week, voted overwhelmingly in favor of a rate hike
- The ECB, meanwhile, appears to be on a different path, expecting inflation to remain more or less under control through 2023
- With central banks turning hawkish, equities now appear headed for a fall with Morgan Stanley expecting US equities to plunge 20% anytime
- Nevertheless, positives galore particularly in Asia where economic data points to some resilience.

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Global central banks are on the move against inflation. Several countries in the Emerging Markets have had to act to rein in inflation, but the US Fed's recent decisive pivot away from patience to action has set the stage for firmer action from many others, too.

In its last meeting of the year, the Fed pivoted to a quicker tapering of bond-buying and an aggressive pace of interest rate increases in 2022. It is targeting an end to new bond purchases by March 2022. Chairman Powell also indicated that discussions have started about the central bank eventually running down the size of its balance sheet. In the market's view, three hikes in interest rates in 2022 are now a clear possibility. If one adds in the stronger dollar's effect, three strong anti-inflationary forces will be in play in the US economy in 2022.

The Bank of England raised interest rates last week in an abrupt U-turn. At the previous meeting, the BoE's monetary policy committee had voted 7-2 in favour of no action. But in an unexpected shift in their stance last week, policymakers voted 8-1 in favor of a hike of 15 basis points. The committee also signalled to the market that further rate increases were likely. The overwhelming vote in favor of a hike was clearly swayed by the recent higher-than-expected inflation data: a 5.1% year-on-year growth in headline consumer price inflation, a 7.1% surge in the Retail Price Index, and a whopping 9.1% increase in producer prices.

In addition, signs of a tighter labor market outweighed the committee's concerns over the impact of the omicron virus. Nevertheless, the new variant's spread, if not its severity, has authorities worried and there is a growing risk that the UK government will be forced to impose renewed movement restrictions in the country. Fiscal policy is less likely to be as supportive as before, opening the risk that hindsight will find this hike a bit hasty. What is not in doubt, though, is the very high inflation reads.

The European Central Bank is on an entirely different track. Its forecasts for inflation justify its stance to remain on a policy easing path for the foreseeable future. November CPI was 4.9%, which was a record high, but the ECB expects inflation to be at 1.9% in 2022, 1.7% in 2023, and 1.8% in 2024. Considering that the ECB's inflation target is 2%, these forecasts suggest that it still has some work to be done to increase inflation. The current guidance from the ECB is for official interest rates to rise only by late 2023.

Two other banks in the news for policy actions were Norges Bank and the Turkish Central bank, but for opposite reasons. The Norges Bank upped its policy rate by 25 basis points to 0.50%. We expect the bank to institute another interest rate hike in March, provided the expected COVID restrictions do not cause too much of a growth drag.

Turkey, by contrast, continued to ignore developments on the inflation front, cutting its benchmark rate by another 100 basis points to 14% and bringing its official rate to -7% in real (inflation-adjusted) terms. Apart from causing a near-100% depreciation in the Turkish Lira from September to last week, markets will view the Turkish central bank's credibility as very low.

Equity markets appear to have been stopped in their tracks by the more aggressive central bank action, particularly by the Fed. As Callum Thomas pointed out in his weekly ChartStorm newsletter, the S&P500 is "sandwiched between support and resistance...buy the dip still seems

to be in play, but sell the rally is also working". Callum also noted that the sources of US equity market return are narrowing. Just five stocks – Apple, Microsoft, Google, NVIDIA, and Tesla – contributed 35% of the S&P500's year-to-date return. We note that the tech sector has underperformed the S&P500 of late. Indeed, without the five heavyweights' contribution, the Nasdaq 100 would have been down for the year. Investor concern about rising long-term interest rates has undermined sentiment towards tech stocks. High PE multiple stocks tend to underperform in a rising rate environment and also when they don't meet market expectations. Last week, Adobe gave guidance to the market of slower revenue growth. The stock, which was at an all-time high just a month ago, is down 17% month-to-date. The sell-off in tech stocks has been broad; the WisdomTree Cloud Computing exchange-traded fund, a basket of cloud software names, has tumbled 22% in the past month.

Bears in the equity market are starting to line up. In fact, Morgan Stanley notes that the US equity market could fall 20% at any time. And there is evidence of significant profit-taking amongst institutional investors and company insiders. Goldman has seen the largest net-selling by institutional investors since April 2020. November saw record insider selling in the main market by the management of companies listed on exchanges. Private equity deals and exits are at the highest level in 20 years.

With the negative sentiment around, it would be easy to lose sight of the positives in the global economy. While there are signs of a slowdown, it will be from a high base. Fourth-quarter global GDP growth looks likely to surge past 5% on a quarterly annualised basis. Asia, in particular, has run hot through the fourth quarter, helped by an easing of supply bottlenecks. Korean exports data showed a 20% rise year-on-year. Vietnam's export data for November showed a 7% month-on-month increase, leading to a 9.3% month-on-month increase in industrial production. Indonesia reported last week that exports were up approximately 50% year-on-year in November.

To be sure, there are signs of a material slowdown in activity as policymakers fret over how to handle the impact of the omicron variant. The pace of the spread has clearly concerned governments, although there is an emerging view that omicron is much less deadly than the previous variants. What we or the doctors say about omicron is almost irrelevant. What matters is the actions of the policymakers that will set the tone for the general population. At the moment, there is a sense of panic among governments, particularly in Europe, to lock down their respective countries, to stop or slow the pace of spread. Such government action will inevitably slow global growth down through the first quarter of 2022.

In conclusion, equity markets should be able to enjoy a generally upbeat tone set by the likely good fourth-quarter corporate results. However, forward-looking statements by company management are likely to be cautious in tone. It leaves the markets open to greater volatility and sideways movement through the coming months.

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