

# THE BIG PICTURE OF GLOBAL ECONOMICS

GLOBAL CIO WEEKLY BY GARY DUGAN



December 07, 2021

## Its No Longer Transitory

---

- **Omicron has shown that COVID is simply not transitory**
- **The Fed no longer considers inflation to be transitory, yet the policymakers' response to the COVID crisis is increasingly coming into question**
- **The 10-year yield hovers under 1.40%, but it neither discounts the underlying growth in the US nor the risk of inflation sticking longer than thought**
- **Meanwhile, US equity index hovers near the 50-day moving average, a level that, if breached, could see the market drop a further 5%**

---

You might also like our [The Omicron Edition](#) and [The US Gives Thanks While Europe Worries](#).  
Click [here](#) to read them for free.

**It's no longer transitory.** The financial markets are in a muddled state. We watch as the consequences of the ultra-loose monetary and fiscal policies prove counterproductive and continue to push inflation to new peaks. And yet, the markets worry that the new coronavirus variant will hollow out global growth. Policymakers now realise that neither COVID nor inflation is just transitory.

**Policymakers remain at sea.** Last week, US Fed Chairman Jerome Powell retired the phrase “transitory” from the Fed’s narrative about the current inflation surge. Perhaps, Powell read the writing on the wall, for the consensus view is that later this week US headline inflation will rise to 6.9% from 6.2%.

**Policymakers’ reaction to COVID is inconsistent and nervy.** The reaction to the Omicron variant has at times been stronger than the threat posed, thereby debilitating household and industrialists’ confidence. Nassim Nicholas Taleb calls out this policymaker reaction as the real black swan and not COVID itself.

**It is the consequence of that unpredictable response on part of the policymakers that has pushed the yields on 10-year government bonds down to 1.35%.** Markets now fret that further restrictions on the mobility of individuals will have negative consequence for growth. In our view, long-dated Treasuries should be yielding higher. Nevertheless, a 10-year bond yield below 1.40% comes nowhere close to discounting the current growth in the US economy—and the threat of inflation. Somewhat surprisingly, the US yield curve has been flattening since the middle of October. The differential between what the US 10-year yields and three-month rates dropped to 130 bps last week from 165 bps. Ordinarily, curves tend to flatten when the market discounts slower economic growth ahead.

For sure, some economists have cut back their US GDP forecasts for next year, but most still sound upbeat. Goldman Sachs, for example, cut its GDP forecast for 2022 to 3.8% from 4.2%. In our view, the only way that one could justify such a low 10-year yield at present would be to believe that the Fed will make a policy mistake by tightening monetary policy too aggressively.

**We believe that the Fed may eventually taper bond purchases far quicker than anticipated, leaving the prospect of a first-rate cut by the middle of next year.** However, we would not characterize such a move as overly aggressive. What if the Fed moved the monetary policy in line with its current playbook? In that case, we suspect it will taper its bond-buying programme and then ideally leave it for several months before raising interest rates. This way, the reasoning goes that the market would not see QE and interest rates as synonymous. However, with inflation no longer transitory, it may have to move things along faster.

**Tactically speaking, many major equity markets remain in a tight spot.** US equities, for example, sit on the support line of the 50-day moving average, a level that, if breached, could see the market drop a further 5%. During any episode of market volatility, the discussion often switches to how overvalued the markets are, and people throw in several technical factors out there to suggest that the market is about to witness a precipitous fall. Valuation, of course, matters, but it remains a poor tool for market timing. Knowing the PE of the market does not provide a reliable insight into the future market returns either.

**Chart 1: S&P500 sits on critical support level**



Source: Bloomberg

Asia equity markets should fret less about the Fed and have the potential to perform given the acceleration of vaccination programmes in the region and pent-up demand in countries such as Japan. Omicron is disrupting the pace of re-opening to a little extent, but Asian economies have shown promising evidence of consolidation of reasonable activity levels. Industrial confidence surveys in Korea, Taiwan and Vietnam last week showed fading supply disruption issues, and surveys in China showed stronger industrial output. Korean exports rose to an all-time high in November.

**The outperformance of the emerging equity markets last week is worth noting.** While the greater focus on US asset price valuations and future monetary policy is understandable, emerging market equity valuations remain low. In many of these markets, monetary policy has already moved to mitigate inflation risks (except for Turkey!). EM equities rose 0.5% on the week against the 2% drop in developed markets. We are highly selective in our emerging market buying, where we have remained largely out of China because of the troubles it has faced of late. However, Russia (particularly after the recent sell-off) and Vietnam appear attractive to us.

**Credit spreads are flashing risk-off.** The drop in underlying government yields shields investors from outright severe losses in the credit markets. Credit spreads have been widening significantly since the news of the new variant broke. There has been a rise of 55 bps in the spread between high yield debt and US treasuries. Some of the moves can be attributed to the traditional whipping boy, the energy sector, when things get tricky in high yield, especially now as crude oil prices are down with Brent off more than \$10 per barrel at \$69. The other sectors have also seen a greater or lesser spread widening. Investors are quick on the trigger to exit the asset class at signs of stress, transitory or otherwise.

---

The reaction in the high yield market is more likely to be one of the broad risk concerns expressed by investors. High yield spreads were pushing towards all-time lows before the new.

**Gary Dugan**

**Johan Jooste**

**Bill O'Neill (Consultant)**

Disclaimer & Important Notice

FOR THE INTENDED RECIPIENT'S USE ONLY

The Global CIO Office operates under Purple Asset Management. This document has been prepared by Purple Asset Management Limited ("PAM" or the "Company").

The document has been prepared on the basis of accounting and non-accounting grade information extracted from within the Company and its affiliates; and of publicly available economic and market data sources. This information has not been verified by an independent third party and should be treated accordingly. It is furnished to you solely for your information, should not be treated as giving investment advice and is to be kept confidential and may not be copied, reproduced, distributed, published, in whole or in part, or otherwise made available to any other person by any recipient.

The facts and information contained herein are as up to date as is reasonably possible and are subject to revision in the future. Neither PAM nor any of its directors, officers, employees or advisors nor any other person makes any representation or warranty, express or implied, as to the accuracy or completeness of the information contained in this document or undertakes any obligation to provide recipients with any additional information. Neither PAM nor any of its directors, officers, employees and advisors nor any other person shall have any liability whatsoever for losses howsoever arising, directly or indirectly, from any use of this document.

Whilst all reasonable care has been taken to ensure that the facts stated herein are accurate and that the opinions contained herein are fair and reasonable, this document is selective in nature and is intended to provide an introduction to, and overview of, the business of PAM. Any opinions expressed in this document are subject to change without notice and neither PAM nor any other person is under any obligation to update or keep current the information contained herein.

Such information contains "forward-looking statements" which are not historical facts and include expressions about management's confidence and strategies and management's expectations about future revenues, new and existing clients, business opportunities, economic and market conditions. These statements are made on the basis of current knowledge and assumptions. Various factors could cause actual future results, performance or events to differ materially from those described in these statements. These statements may not be regarded as a representation that anticipated events will occur or that expected objectives will be achieved. The forward-looking statements in this document are only valid until the date of this document and ISI does not undertake to update any forward-looking statement to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events. This document is not an offer to sell securities or the solicitation of an offer to buy securities, nor shall there be any offer or sale of securities in any jurisdiction in which such offer or sale would be unlawful prior to registration or qualification under the securities laws of such jurisdiction