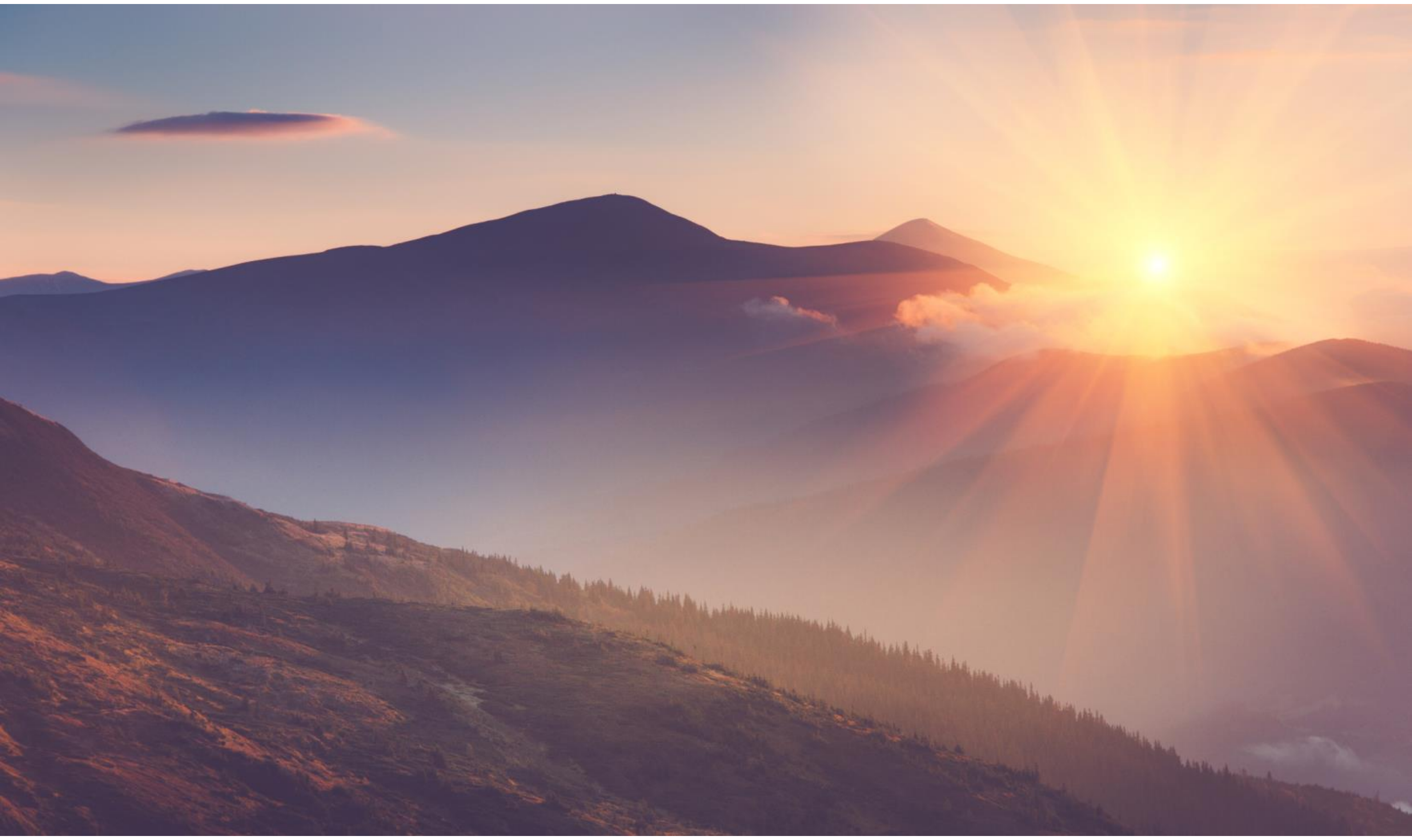
LAZARD
FRÈRES GESTION

ECONOMIC AND FINANCIAL OUTLOOK

January 2022



Source: Shutterstock

Document written 28 January 2022

As the year begins, all eyes are on inflation. The last few months have shown this to be more enduring than was envisaged a year ago. Will it slow as much as the central banks hope in 2022? If this is not the case, they will need to accelerate their monetary tightening and potentially push the economy into recession. Given the time lag with which central bank policies take effect and their current extremely accommodative level, this negative impact could take time to materialise. In this context, what strategy should be adopted in terms of asset allocation?

Economic outlook

Easing concerns about the Omicron variant

The extremely contagious nature of the Omicron variant and its greater resistance to vaccines have led to an unprecedented increase in infections in major western countries. However, the epidemic seems to have peaked in the UK and the US (Chart 1).

The experience of countries that appear to be out of the woods bodes well for the rest of the world. The pattern observed is that of a sharp rise in infection for 4 to 6 weeks, with a moderate strain on intensive care units and a relatively limited rise in deaths. This is in line with the results of studies indicating that the Omicron variant is less dangerous than the Delta variant and that vaccine-induced immunity and infection are effective against serious forms.

If this pattern is repeated in most countries around the world, we could see the global pandemic situation stabilise in the second quarter of 2022. Public health restrictions are measured (Chart 2) and even if they are strengthened, experience has shown that a drop in activity is quickly recovered.

The public health situation is unlikely to interrupt the economic recovery, and will at most slow it down.

Activity well set

Globally, the Omicron wave does not seem to be having such a strong impact on activity as previous variants. Confidence surveys remained strong, and household consumption remains on a much higher trend than that prevailing before the crisis (Chart 3).

Supply problems have created latent demand, and the rebound in auto production in several countries suggests that these may be fading away. This could lead to a further upturn in industrial activity in the coming quarters. This issue should continue to be monitored.

On the fiscal front, the expected tightening for 2022 is unlikely to weigh heavily on growth. It is of the same magnitude as last year and concentrated in the US, where normalisation has already taken place (Chart 4). In Europe, the clause suspending Stability and Growth Pact rules will still apply in 2022. The pact is expected to be restored in 2023, but a revision process is being considered to ensure fiscal tightening is not excessively brutal.

The presidential elections in Italy and France should be monitored.

Chart 1

COVID-19: incidence rate per 100,000 inhabitants over 7 days

Source: Johns Hopkins as of January 26, 2022.

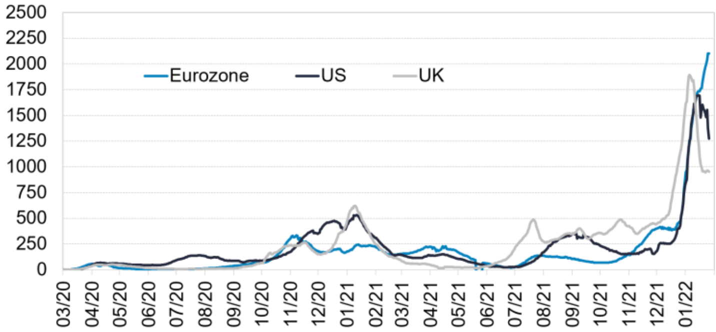


Chart 2

Restriction severity indices on a scale from 0 to 10

Source: UBS as of January 21, 2022.

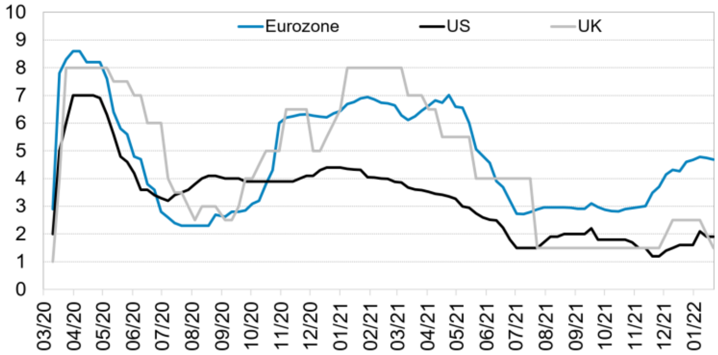


Chart 3

Global retail sales in volume, base 100 in 2019

Source: Bloomberg as of November 30, 2021.

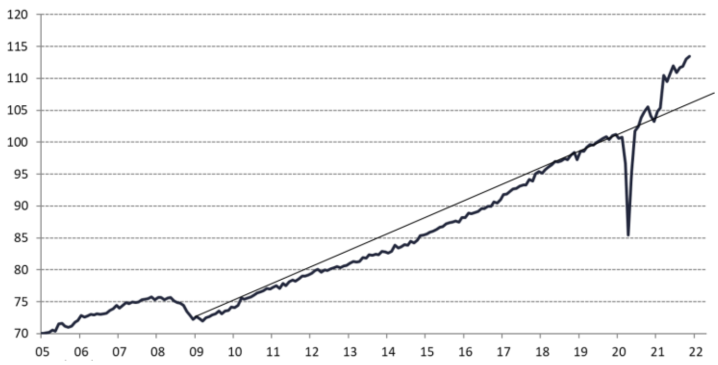
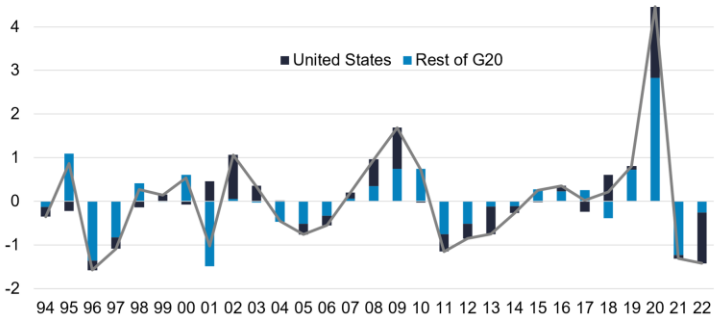


Chart 4

G20: fiscal impulse (change in the cyclically adjusted primary balance)

Source: IMF as of January 3, 2022.



In the US, companies' investment intentions remain very strong and households have not begun to tap into the stock of additional savings built up during the crisis, which constitutes a consumption reserve (Chart 5). Given the historically low debt burden, the private sector should be able to absorb rate hikes.

In China, stability is the watchword for this year of the 20th Communist Party Congress, which should reappoint Xi Jinping as head of the country. Economic policy will be more favorable to growth and the slowdown in the housing sector will undoubtedly be supported by the authorities. The continuation of the "zero-Covid" policy, however, could slow the recovery in consumption.

Energy prices (Chart 6) remain a variable to be monitored for activity in the short term. In China, rising coal costs led to power shortages and plant closures in the third quarter, but the situation appears to have returned to normal. In Europe, the thaw and LNG deliveries have eased the pressure, but a cold snap could trigger new record prices. As well as its effect on household purchasing power, rising energy prices could have a direct impact on activity in certain sectors.

Focus on inflationary pressures

Price rises are reaching levels not seen in several decades in the US and the eurozone (Charts 7 and 8). US inflation measured year-on-year could slow in the coming months, with the spring 2021 comparison base being very high, but this does not mean tensions have been resolved.

The increase in the cost of housing will continue to spread in official statistics and the upturn in wage costs will impact the price of labor-intensive services such as health.

The breakdown of producer prices in the US, which measures the prices charged by producers, shows that this is not simply a problem linked to a significant portion of goods consumption being postponed as a result of the pandemic. We are also seeing a sharp increase in prices in services and construction.

Higher transport costs are also likely to push prices higher. China's zero-Covid strategy has contributed to a sharp rise in freight costs, and the authorities appear to be continuing along this path to curb the spread of the Omicron variant. This could continue to disrupt production chains and thus delay the resolution of supply problems.

For the moment, household inflation expectations have risen for the short term but remain moderate for the medium term. Conversely, companies' long-term cost expectations are picking up more markedly.

Chart 5
United States: accumulated household savings since 2016 (USD bn)
Source: Bloomberg as of December 31, 2021.

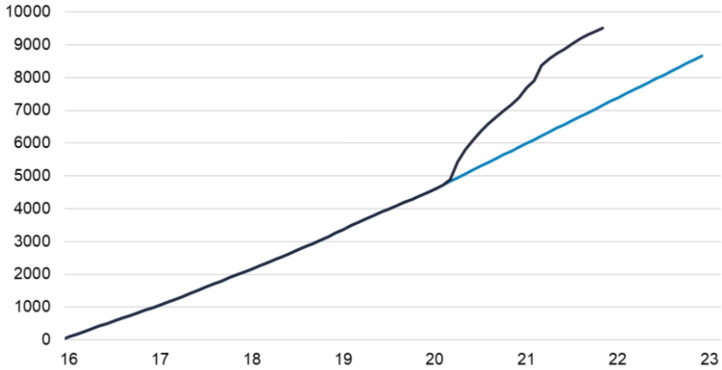


Chart 6
France: electricity prices (EUR/MWh, base load)
Source: Bloomberg as of January 3, 2022.

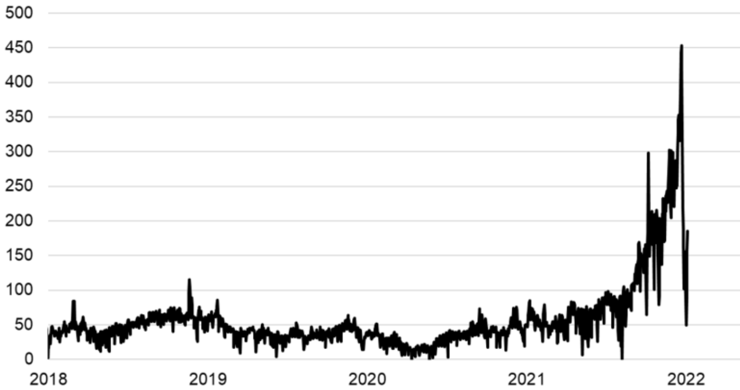


Chart 7
United States: 12-month rolling consumer price index
Source: Bloomberg as of December 31, 2021.

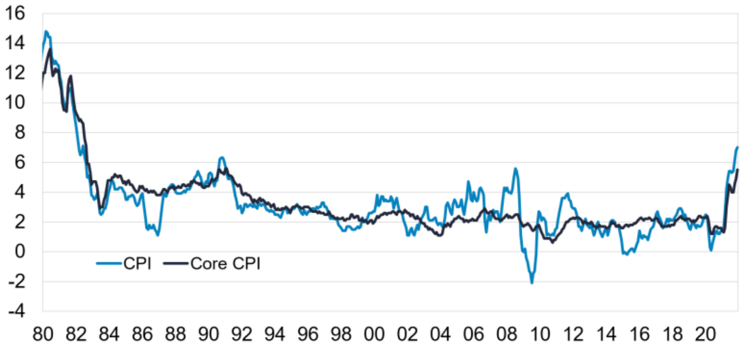
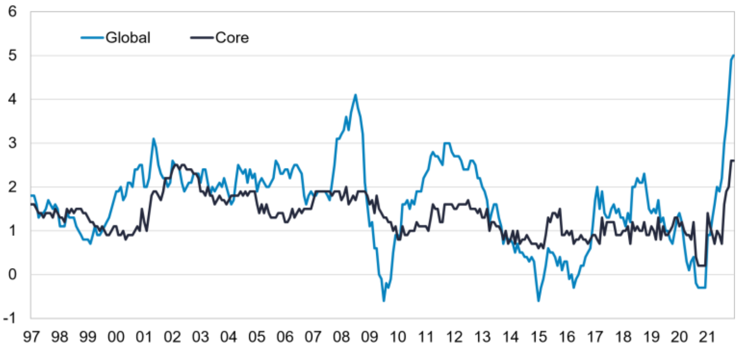


Chart 8
Eurozone: 12-month rolling inflation
Source: Bloomberg as of December 31, 2021.



LASTING TENSIONS ON THE LABOR MARKET

Unlike previous recessions, unemployment fell very quickly in the major western economies (Chart 9). In the US, excluding data for 2020, we must go back to 1950 to see such a rapid drop in unemployment over six months.

Business demand for labour is strong, but labour supply is lower than before the crisis and the potential for a rebound seems limited by demographic trends. This imbalance between supply and demand is reflected in an exceptional increase in the number of job offers in the US and Europe (Charts 10 and 11). At the same time, there has been a sharp increase in resignations, as employees are more confident in their ability to find another job.

In order to attract and retain staff, US companies have significantly increased their salaries. Salary intention surveys are at all-time highs (Chart 12), suggesting that this trend is likely to continue. In the eurozone, labor shortages are also a major issue for companies, which report that this factor is limiting their production. However, this is not yet reflected in wages.

A sharp slowdown in growth from current levels is needed to deflate labor markets. Historically, growth needs to fall below 0.9% in the eurozone and below 1.6% in the US. Given the current extremely accommodative nature of monetary policy, the road ahead for central banks is potentially very long.

Chart 9
Developed countries: unemployment rate
Source: Bloomberg as of December 31, 2021.

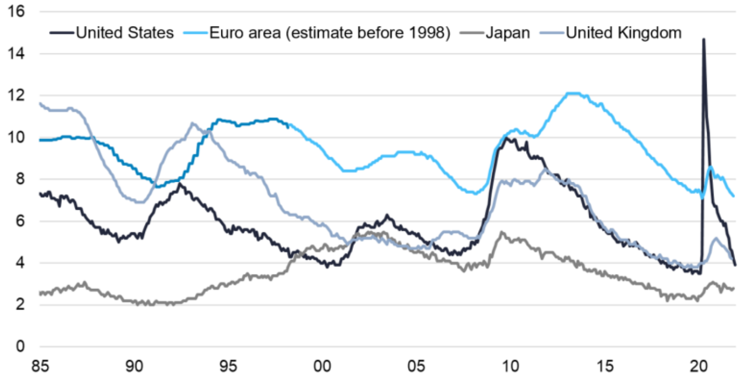


Chart 10
United States: job offers / active population
Source: R. Barnichon, San Francisco Fed, Bloomberg as of December 31, 2021.

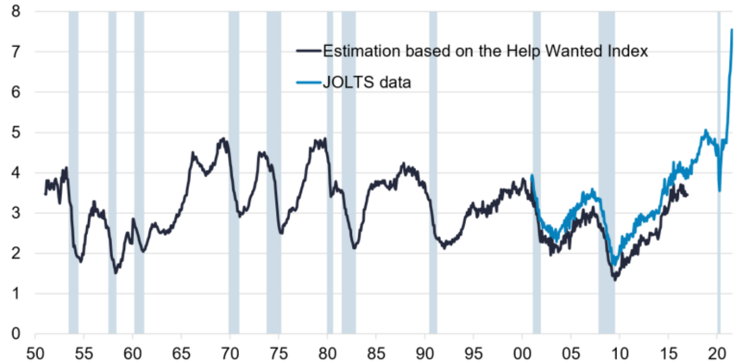


Chart 11
Eurozone: job offers/workforce
Source: DARES, Eurostat, Bloomberg as of December 31, 2021.

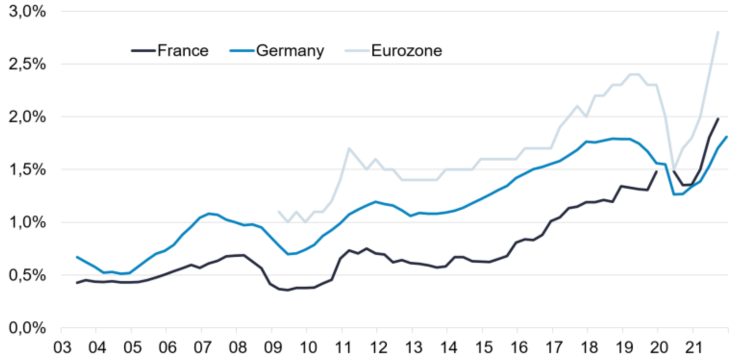


Chart 12
United States: indicator of companies' wage intentions
Source: Bloomberg as of December 31, 2021.

FINANCIAL OUTLOOK

ROOM FOR GROWTH IN LONG-TERM RATES

The Federal Reserve has gradually shifted its stance to prepare the markets for monetary tightening in 2022. The message has been heard and interest rate expectations adjusted. Markets are now pricing in five rate hikes in 2022 (Chart 13).

The first increase could take place in March, when the Fed ends its asset purchase program. However, the market continues to anticipate a very limited tightening cycle, with a terminal rate close to 2% (Chart 14), which seems too low.

While medium-term inflation expectations have picked up, they are still below the level that prevailed before their downturn in 2015, especially in the US. Real rates are still very negative (Chart 15). If the central bank wants to slow down the economy, it will have to bring them into positive territory.

The Fed could start reducing its balance sheet by the middle of the year. From 2018 to 2019, the balance sheet was reduced by USD 40 billion every month, at a time when the Fed did not particularly want to weigh on activity. In the current environment, the pace could be faster.

The minutes of the December meeting showed that a number of participants want to prevent the rise in short-term rates being accompanied by a reduction in long-term rates, which would reduce monetary policy transmission to the economy.

By reducing its balance sheet, the Fed will thus be able to act on the longer end of the curve, which not only reflects short-term rate expectations, but also a risk premium. This is currently close to zero, while it was close to 2% historically. The reduction in the Fed's balance sheet creates the conditions for normalisation, which would be a driver of rate hikes.

On the credit side, corporate issuers' positive fundamentals appear to be reflected in spreads near their lows (Chart 16). The impact on credit of the rise in interest rates will depend on its speed.

With regard to the spreads of peripheral countries, the approaching presidential election in Italy is a source of tension. If Mario Draghi were to be elected, he would have to find a successor as head of government, which may not be easy. This could potentially lead to new elections that could inaugurate a prolonged period of uncertainty, according to the polls.

Chart 13
United States (Fed): number of rate hikes (of 25 bp) expected by the market in 2022
Source: Bloomberg as of January 28, 2022.

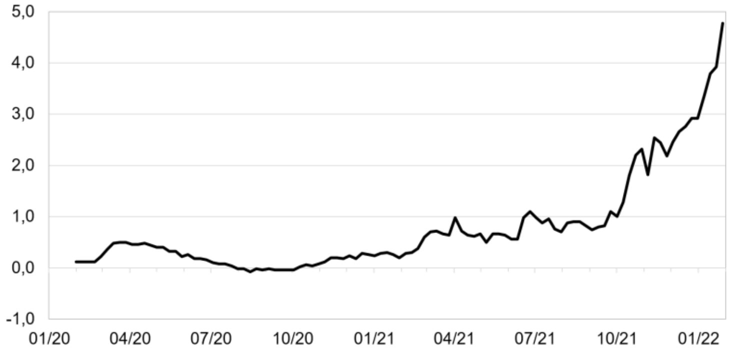


Chart 14
United States: historical (black) and expected Fed rates (blue)
Source: Bloomberg as of January 28, 2022.

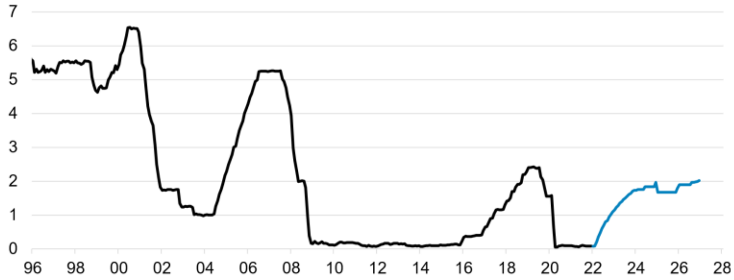


Chart 15
Real yields (10-year bond yields, from which inflation expectations have been deducted)
Source: Bloomberg as of January 7, 2022.

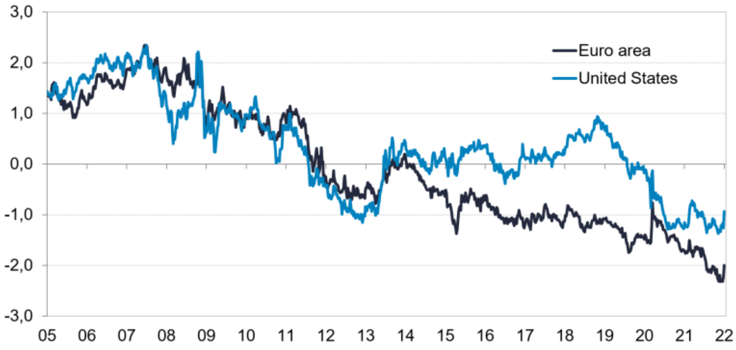
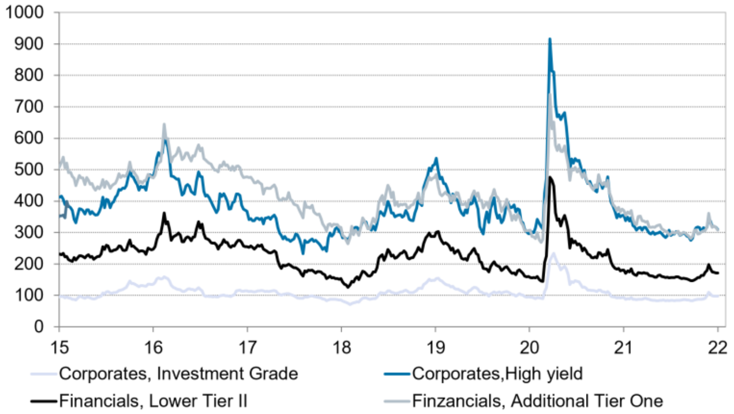


Chart 16
Eurozone: private issuer spread (basis points)
Source: Factset, Bloomberg as of January 7, 2022.



What is the trajectory for equity markets?

Strong growth should continue to support corporate earnings. Expectations for 2022 look reasonable, estimated at around 7% overall.

As the rise in earnings was higher than that on equity markets over the past year, the 12-month Price to Earnings Ratio (PER) fell significantly, except in the US, where it remained broadly stable (Chart 17). While valuations appear *a priori* more reasonable compared to the 2015-2019 average, the US PER is 15% higher despite the recent correction. For eurozone equities, the premium is 4%. Emerging equities returned to the average level of this period and Japanese equities are trading at a discount.

Other indicators such as Price to Sales, for which more history is available than for the PER, show that the S&P 500 has never been more expensive (Chart 18). Cyclically adjusted data, which are long-term averages, also confirm the exceptional nature of the US. The US cyclically adjusted PER was only higher than the current level during the internet bubble (Chart 19). In Europe, this multiple is much lower. It is approaching the peak of the last 20 years, but is not at bubble level.

Equity market valuations remain attractive compared to bond markets. In the US, a rate hike of 100 basis points would, however, put the equity risk premium below the lows of the last ten years. Against a backdrop of upward pressure on interest rates, this indicator is therefore less relevant. Conversely, the correlation of the relative performance of cyclical stocks/growth stocks with real rates is confirmed and is an important element compared to other uncertainties.

Conclusion

The environment is particularly uncertain, due to an unresolved pandemic situation, US inflation well above target and a labor market that is already very tight. Regarding risky assets, the situation is complicated by rising inflation and extreme valuations in the US. While it is often counter-productive to over-anticipate the reversal of risky assets in relation to the economic downturn, the rare times where this was relevant were in 2000 (excessive valuations), and in 1970 and 1973 (marked upturn in inflation). In this context, it is difficult to define a hierarchy of asset classes over 12-18 months. However, we believe two positions make sense: low or even negative duration, to be less sensitive to rising interest rates or to take advantage of their rise; an underweight position on the US equity markets in favor of Europe and, more generally, an underweight position on stocks that benefited from the fall in interest rates.

Chart 17
Valuation of equities: 12m forward P/E
Source: Bloomberg as of January 21, 2022.

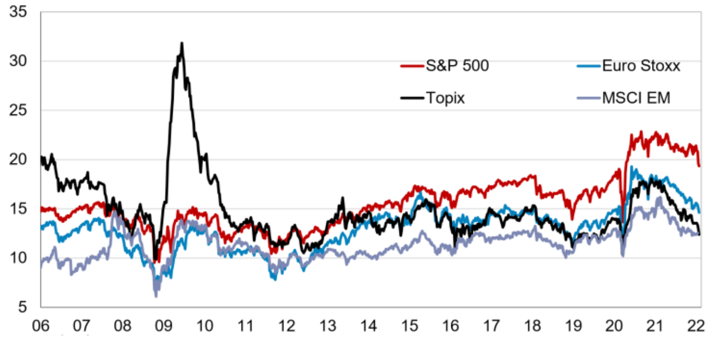


Chart 18
12m forward price to sales
Source: Bloomberg as of January 7, 2022.

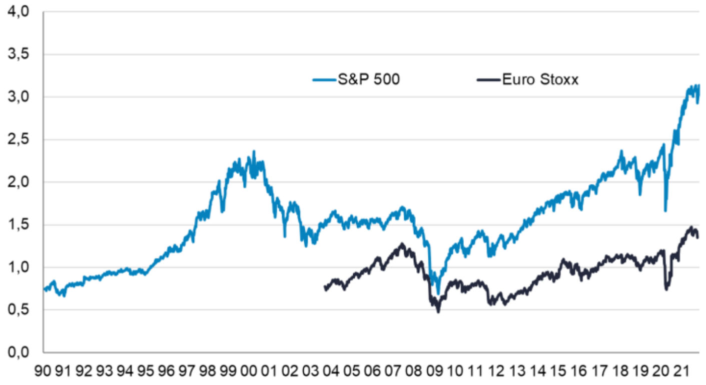
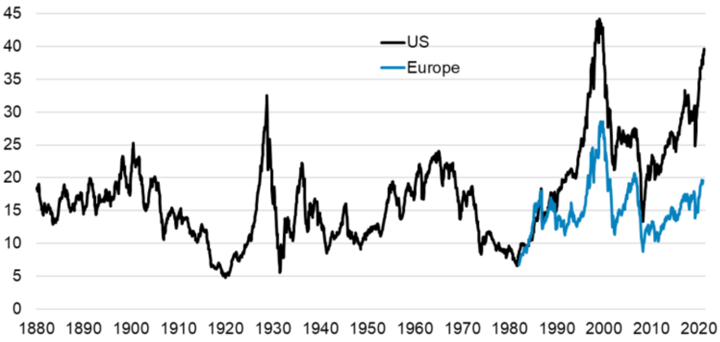


Chart 19
Cyclically adjusted PE
Source: Shiller, Exane, MSCI, OECD as of December 31, 2021.



The opinion expressed above is dated January 28, 2022 and is liable to change. Most recent data as of the date of publication.