Rosa & Roubini
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R&R Weekly Column
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Markets Are Off To A Bumpy Start In 2022, Due To Inflation, Central Banks, And Geopolitics

The first week of trading in 2022 delivered a very bumpy start to markets. Major equity indices recorded heavy losses during the week (especially the US NASDAQ), and only some European indices managed to close the week in slightly positive territory. There are multiple reasons behind this bumpy start.

First, it is still unknown what the impact of Omicron on economic activity will be. Data suggest that the variant seems less deadly than Delta, but much more transmissible. As a result, the *absolute number* of hospitalisations is expected to increase significantly (even if the *rate* of hospitalisation – of mortality – is lower than that caused by Delta). This is forcing many countries to adopt restrictive measures that may have an impact on economic activity in Q1. PMI numbers seem to have peaked in most advanced economies, and are beginning to signal a slowdown in growth. Investors remain puzzled and on the fence regarding the ultimate impact of Omicron and the reimposition of restrictions it is causing.

Second, inflation continues to bite. In the Eurozone, inflation has now reached 5%, and may increase further. In the US, CPI is expected to reach 7% this week and core CPI 5.4%, the highest readings in decades. We have made a distinction between short-term and long-term inflation, which to us is much more significant than that between “transitory” and “permanent” inflation. We think that short-term inflation has yet to peak in many countries, after which it may finally start falling towards the central banks’ target levels during the second half of this year (since China’s PPI seems to have peaked at the end of last year). But long-term inflation, which includes energy and tech transitions, will be the theme to watch for in coming years.

Third, central banks continue to be hawkish. Last week, the minutes of the Fed’s meeting in December showed that the US central bank may be prepared to start increasing rates in March, and could start reducing the size of its balance sheet soon after its initial rate increases. This would be a much more aggressive stance than is currently expected. Jay Powell’s and Lael Brainard’s confirmation hearing in the US Senate this week will shed more light on the current FOMC thinking. Equally, ECB President Christine Lagarde’s remarks at the Bundesbank’s change of office this week may provide more insights as to the ECB’s views on inflation.

Fourth, oil prices continue to rise. Even in the first week of the year Brent prices rose by 3.6%, to $81.8pb. As President Lagarde said in December, two-thirds of the recent rise in inflation was due to increases in energy prices. So as long as energy prices continue to increase, headline inflation will continue to rise. The upcoming meeting of OPEC+ may reduce some tensions in oil markets, if the group agrees on an increase in production, but there may be geopolitical obstacles that prevent such an agreement.

Finally, geopolitical tensions persist in countries that have a large impact on commodity prices, including Russia, Ukraine and Kazakhstan. The situation at the eastern border of Ukraine remains extremely tense, with Russian troops possibly ready for an invasion. Upcoming US-Russia talks in Geneva (where the EU would like to be involved) may provide some short-term relief, but the situation will remain problematic for years to come. Meanwhile, Kazakhstan seems on the verge of a regime change, perhaps through a coup. Clearly the former Soviet republic has now entered the Russian radar screen. Kazakhstan is a major oil producer, but also a major centre of crypto-mining, hence the recent collapse in Bitcoin, Ethereum and other crypto-asset prices.

All these factors, and in particular the rise in inflation and oil prices, and the hawkish reaction by central banks, have caused a sizeable increase in short- and long-term interest rates in the US and the Eurozone. In the US, the 10y Treasury yield has reached 1.75%, and in the Eurozone, the 10y bund yield is now almost back into positive territory.

Clearly a combination of higher inflation and market yields is severely detrimental for most asset valuations, including bonds, equities, real estate, and risky assets such as tech stocks (which have suffered their worst week in more than a year). Unfortunately, those factors most likely will remain in place for most of 2022. And for this reason, 2022 is likely to be a much more volatile year in markets than 2021 was, as was recently discussed by Nouriel Roubini.

Our Recent Publications

- Macro Picture: ASEAN Countries Divided On AUKUS Agreement, *by Mirko Giordani, 7 January 2021*
- Travel Notes: Italy: All Eyes on The Upcoming Presidential Election, *by Brunello Rosa, 5 January 2022*

Looking Ahead

The Week Ahead: Inflation To Rise In The US And To Fall In China; Unemployment Rate To Drop In the EZ

In the US, December's inflation rate and core inflation are likely to rise to 7% y-o-y (*p:* 6.8%) and to 5.4% y-o-y (*p:* 4.9%) respectively.

In China, December's inflation rate is expected to decrease to 1.8% y-o-y (*p:* 2.3%).

In EZ, unemployment is seen to drop to 7.2% (*p:* 7.3%).

The Quarter Ahead: Biden's Difficult Year; Reduced Covid Restrictions in the UK; Presidential Elections In Italy.

In the US, President Biden is facing multiple crises in the most crucial year for presidency as coronavirus infections are surging, the economic agenda is stalling, and tensions are aggravating with Russia. The Biden administration is on the defensive, trying to hold to the promises he made one year ago ahead of the November 2022 mid-term elections.

In the UK, the Prime Minister opts for removing Covid restrictions. Despite the raising number of Covid-19 infection cases, Boris Johnson believes there is no need for further restrictions and a lockdown. In order to monitor critical workers' health, the government will give daily Covid swap tests without a general shutdown of economic activities. Political tensions could spur from the PM's stance, as a number of Tory MPs are opposing the cut in restrictions.

In China, Covid policy will likely affect growth. At present, China is keeping its zero-Covid with strict lockdowns and closed borders, curbing consumption and economic stabilization. Domestic consumption has been harshly hit as well as property investment. If Beijing will hold these stringent controls until the end of 2022, the growth in economic activity is likely to be very slow.

The EU has demanded a seat in next week's negotiations between Russia, US and NATO. Brussels has insisted on its significant role in determining the future of Europe, underlying that it "*cannot be a neutral spectator in the negotiations*". The sidelining has underscored the EU's lack of foreign policy clout between divergent views on how to handle tensions at the border between Ukraine and Russia, while EU's security policy is at stake. Brussels is now hosting discussion on how to achieve more "strategic autonomy."

Nomination of the next Italian president might fuel a government crisis. On January 24, the Italian Parliament will convene to start the presidential electoral process, perhaps hampering the national unity government. Mario Draghi, the current Prime Minister, is a potential candidate, but his resignation as premier would fuel the risk of delaying structural reforms and investments linked to agreements with the EU.

Last Week's Review

Real Economy: Unemployment Dropped In The US; PMIs Fell in the US and Euro Zone; Higher Inflation Rates In EZ

In the US, non-farm payrolls fell to 199K (*p:* 210K), well below the market forecast of 400K in December. Unemployment dropped more than excepted to 3.9% (*p:* 4.2%), pointing to a sustained recovery in the job market fueled by a fast-recovering economy and strong demand for labor. In December, manufacturing PMI fell slightly lower than expected to 57.7 (*p:* 58.3) and services PMI stood at 57.6 (*p:* 58.0).

In the Eurozone, December's inflation accelerated to a record high of 5% from 4.9% in November. November monthly retail sales increased by 1% (*p:* 0.2%), while annual retail sales increased to 7.8% (*p:* 1.4%). Consumer confidence in December was confirmed at -8.3 (*p:* -6.8). December's manufacturing PMI decelerated to 58.0 (*p:* 58.4), due to the slower improvement in manufacturing condition; services PMI fell to 53.1 (*p:* 55.9) , marking the weakest pace of expansion in the service sector since April.

Financial Markets: Global Equities Decrease And Induce a Fall in US 10y Yield; Oil Prices Fell While Gold Prices Rose

Market drivers: Last week's main market movers were: *i)* release of minutes from the Fed's mid-December policy meeting; *ii)* expectations for higher interest rates; *iii)* disruptions due to the Omicron variant, such as local lockdowns and raising case numbers.

Global equities decreased w-o-w (MSCI ACWI, -0.11%, to 743). In the *US*, the S&P 500 ended lower (-0.41% w-o-w to 4,677). In the *EZ*, shares fell (Eurostoxx 50, -0.44% w-o-w, to 4,306). In *EMs*, equities rose (MSCI EMs, +0.74%, to 1,226), while the Chinese stocks dropped (Shanghai Comp., -0.18%, to 3,580). *Volatility* increased (VIX S&P 500, +1.85 pts to 18.76, *52w range.:* 14.1-37.51).

Fixed Income: The US 10-year yield rose substantially during the week from 1.51% to 1.76%, while Germany's 10-year bond yield rose from -0.12% to -0.04%), while remaining in negative territory. The EMTX 7-10 RT decreased by +0.29pts, to 278.

FX: w-o-w, the US Dollar Index fell (DXY -0.4% to 95.73; EUR/USD lost 0.06%, to 1.1361). In *EMs*, currencies strengthened against the USD (MSCI EM Currency Index, +0.14% w-o-w, to 1,732).

Commodities: Oil prices rose (Brent, 3.6% w-o-w to 81.78 USD/b). Gold Futures slightly fell (-0.2% w-o-w, to 1,796.25 USD/Oz).

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The picture in the front page comes from this website

Abbreviations, Acronyms and Definitions

a	*Actual*
AKP	*Justice and Development Party, Turkey*
ann.	*annualized*
ARS	*Argentinian Peso*
avg.	*Average*
bn	*Billion*
BoC	*Bank of Canada*
BoE	*Bank of England*
BoJ	*Bank of Japan*
bpd	*Barrels per day*
bps	*Basis points*
BS	*Balance sheet*
c	*Consensus*
C/A	*Current account*
CB	*Central bank*
CBB	*Central Bank of Bahrain*
CBK	*Central Bank of Kuwait*
CBT	*Central Bank of Turkey*
CDU	*Christian Democratic Union, Germany*
CNY	*Chinese Yuan*
CPI	*Consumer Price Index*
DJIA	*Dow Jones Industrial Average Index*
DJEM	*Dow Jones Emerging Markets Index*
d-o-d	*Day-on-day*
DXY	*US Dollar Index*
EC	*European Commission*
ECB	*European Central Bank*
ECJ	*European Court of Justice*
EIA	*US Energy Information Agency*
EM	*Emerging Markets*
EP	*European Parliament*
EPS	*Earnings per share*
EU	*European Union*
EUR	*Euro*
EZ	*Eurozone*
Fed	*US Federal Reserve*
FOMC	*US Federal Open Market Committee*
FRB	*US Federal Reserve Board*
FX	*Foreign exchange*
FY	*Fiscal Year*
GCC	*Gulf Cooperation Council*
GBP	*British pound*
GDP	*Gross domestic product*
IMF	*International Monetary Fund*
INR	*Indian Rupee*
IPO	*Initial public offering*
IRR	*Iranian Rial*
JPY	*Japanese yen*
k	thousand
KSA	*Kingdom of Saudi Arabia*
LN	*Northern League, Italy*
M5S	*Five Star Movement, Italy*
m-o-m	*Month-on-month*
mb	*Million barrels*
mb/d	*Million barrels per day*
MENA	*Middle East and North Africa*
MHP	*Nationalist Movement Party, Turkey*
mn	*Million*
MPC	*Monetary Policy Committee*
NAFTA	*North-American Free Trade Agreement*
NATO	*North Atlantic Treaty Organization*
OECD	*Organization for Economic Cooperation and Development*
Opec	*Organization of Petroleum Exporting Countries*
p	*Previous*
P2P	*Peer-to-peer*
PBoC	*People's Bank of China*
PCE	*Personal Consumption Expenditures*
PE	*Price to earnings ratio*
PM	*Prime minister*
PMI	*Purchasing managers' index*
pps	*Percentage points*
pw	*Previous week*
QCB	*Qatar Central Bank*
QAR	*Qatari Riyal*
QE	*Quantitative easing*
q-o-q	*Quarter-on-quarter*
RE	*Real estate*
RBA	*Reserve Bank of Australia*
RRR	*Reserve Requirement Ratio*
RUB	*Russian Rouble*
SWF	*Sovereign Wealth Fund*
tn	*Trillion*
TRY	*Turkish Lira*
UAE	*United Arab Emirates*
UK	*United Kingdom*
US	*United States*
USD	*United States Dollar*
USD/b	*USD per barrel*
UST	*US Treasury bills/bonds*
VAT	*Value added tax*
VIX	*Chicago Board Options Exchange Volatility Index*
WTI	*West Texas Intermediate*
WTO	*World Trade Organisation*
w	*Week*
w-o-w	*Week-on-week*
y	*Year*
y-o-y	*Year-on-year*
y-t-d	*Year-to-date*
ZAR	*South African Rand*
2y; 10y	*2-year; 10-year*