JANUARY FEARS

If it's as good as it gets, 2022 is shaping up to be a tough year for investors. For old Wall Street traders, January's performance is often considered the thermometer of the entire year. The US S&P, which sets the pace for all other indices, closed the month with a 6% contraction. And the Nasdaq, where the stocks that hold the greatest hopes for growth are listed, fell by 10%. Europe, too, did not shine, even if, in some ways, it marked its first revenge in relation to its noble competitors on the other side of the Atlantic. The Eurostoxx50 lost 2.9%, while the UK's Ftse 100 even closed in positive territory. The conservative Swiss SMI was not spared, correcting 5%, while the SMIM, with its mid-cap companies, lost 8.6%. Simple profit-taking after the 2021 Christmas rally? In part, certainly yes. But not only that. Geopolitical tensions and the related repercussions on energy costs, caused by the challenge between Russia and Ukraine, certainly complicate the scenario. But the real cause for concern relates to the macroeconomy and central bank policy, with the US Federal Reserve at the centre.

Growth expectations for the global economy, according to the International Monetary Fund (IMF), have been reduced from 5.9% in 2021 to 4.4% in 2022 (half a percentage point lower than in its October Outlook), particularly considering the slowdown in the world's two main economic areas. In the US, the uncertainty and downsizing of the *Build Back Better* tax package highlights the Biden administration's difficulties in asserting its vision for growth in the country, which is also facing supply shortages. In China, pandemic-induced disruptions related to the zero-tolerance policy towards COVID19 and prolonged financial stress in the real estate, education and digital sectors lowered expectations by a further 0.8%. But, nevertheless, the growth expectations of the world economies, even if revised downwards, remain considerable.

The real problem is that the Federal Reserve no longer believes in the scenario it had forcefully instilled in the markets that growth would be consistent, thanks in part to generous liquidity, with moderate and transitory inflation. With this view, which

has been consistently confirmed, stock markets reached significant heights last year with little volatility. But in December prices in the US rose by 7%. While core inflation, PCE (which excludes food and energy), the issuing institution's main benchmark, rose by 4.9% for the year, the largest increase since 1983. This data has caught the Federal Reserve off guard, as it now plans to end Quantitative Easing (QE) in March (it will no longer buy bonds in the market), when it will begin raising rates. Inflation has frightened the Fed; the Fed has frightened the markets. But are we sure - they ask - that the issuing institution really has its finger on the pulse of the American economy? In fact Jerome Powell, its chairman, has had to admit a fundamental error: inflation is much higher than expected and probably not even transitory. Discontent is growing and so is pressure. It is a dangerous picture, where stress can easily lead to mistakes. The markets know this and are beginning to anticipate four rate hikes this year, some as many as seven. And in order to have a more coherent curve, one must also expect to decrease the FED's balance sheet; then sell bonds (withdrawing liquidity) and increase longer-term rates. The risk of the scenario becoming one of moderate growth and high inflation has shocked the markets. From 1.5% at the start of the year, the 10-year Treasury rate peaked at 1.88% for the month before falling back somewhat. Against this backdrop, stocks with high multiples (price-to-earnings ratio), which were expecting future earnings at very low rates, had to face up to the new reality. The S&P's growth sub-index lost 14.5% over the month, but the value stock sub-index performed well, albeit modestly. The 77% of companies that reported results for the final quarter of 2021 often exceeded expectations (Refinitiv data), but stocks did not always rise. This is a sign that the market is now demanding much more, knowing that liquidity will tend to shrink and rates will rise.

So what to do now? Markets tend to anticipate and exaggerate movements. Tactically, it may be time for selective buying: the Fed will continue to inject liquidity until March. In addition, two important market indicators such as Microsoft's and Apple's excellent earnings bode well. The assumption, however, is that COVID19 has indeed reached a major peak and Russia and the US find a modus vivendi on Ukraine. With the start of the

Winter Olympics in Beijing, it is possible to hope for a truce, also in geopolitical and oil price terms.

But, strategically, 2022 will remain a volatile year, although not necessarily negative: the important thing is that real rates remain negative. Inflation news will be crucial in trying to anticipate the Fed's moves. However, the context is one of tightening liquidity and rising nominal rates. So any news on inflation and growth, as well as corporate earnings, has to be particularly significant to stimulate markets. Otherwise markets will simply adjust the prices of risky assets. What the markets know by now is that liquidity will fall, and they assume that inflation will fall too, but it is unlikely to return to pre-pandemic levels: the new economy costs money and geopolitics act on commodity prices as well as supply and transport bottlenecks. It is also known, at least in the US, that wages have risen (over 4% in the year) and that the workforce is struggling to get back to work as it used to. What is not yet clear is how much productivity has increased, thanks in part to the pandemic, which has forced people to do more with less. The markets will remain nervous in this first part of the year, as they gradually try to digest new balances. In the run-up to the Midterm Elections in the United States, President Joe Biden may be trying to concentrate his difficulties in the first half of the year, hoping to arrive in November with a recovering macroeconomic and financial environment. The strong dollar, which the FED provokes, is positive for Washington at this stage because it reduces imported inflation. While in the second half of the year a weakening of the greenback would help exports in a world that has hopefully managed to tame the pandemic at least to some extent, and would give emerging countries breathing space.

Europe is helped by the low euro against the dollar. It is working on fiscal stimulus and will exit QE after the US. In relative terms, European stock markets are well positioned, thanks in part to banking and energy and, more generally, the strong presence of value stocks. The main macroeconomic risk is gas and oil prices, which a war in Ukraine would increase: the resulting inflation would undermine social stability. China will probably be forced to increase liquidity this year in order to boost the economy. The Chinese stock market will rise in the second half of the year, as

will its bond prices. The yuan will remain a strong currency, as the Chinese will do all they can to make it the world's reserve currency.

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