# RATIONAL EXUBERANCE AND IRRATIONAL PESSIMISM?

December marked the end of an extraordinary year for the world's major stock exchanges, with a final toast as New Year's Eve approached. The long-awaited Christmas rally did not fail to materialise: the S&P gained 4.4%, the Nasdaq100 rose 1.1% and Europe outperformed its American big brother by 5.4% (Eurostoxx50). Two indices from non-European Union (EU) countries also managed to rise by 5.47% (Switzerland, SMI) and 4.6% (England, FTSE 100). This exceptional result reinforces the figures for the entire - splendid, as far as stock market performance is concerned - 2021. During the year, the S&P recorded +26.9%, the Nasdaq100 +26.6%, the Eurotoxx50 +20.56% and the world index (MSCI World) +20%. Yet the year that is drawing to a close has not been spared bad news on the pandemic front. COVID-19 proved persistent, with the Delta variant and then Omicron. The markets have learned to live with the virus whose biological objective is to survive, i.e. not to kill the people it infects. This is what the latest variant, which spreads very easily but seems to be less dangerous, indicates. But the optimism that made it possible to overcome pandemic fears is a direct consequence of vaccines. It is they who made it possible to anticipate the recovery while states and central banks were trying at all costs to avoid a deep and long recession. The world found itself flooded with liquidity and fiscal incentives, just as the signs of recovery were multiplying: the growth of Gross Domestic Product in 2021 was, at least for the major economies, dazzling, with a synchronised recovery worldwide (over 5.5%). In such an environment, corporate profits exploded, driven by demand that had been suppressed during the first part of the pandemic, when citizens had been forced to save by lockdowns. The declared aim, in the US and Europe, was to continue the expansive monetary policies tested after the Great Financial Crisis of 2008 while simultaneously acting on the real economy, piloting investment programmes that would expand employment opportunities. The key to success lies in low or negative nominal rates and, above all, in negative real rates capable of stimulating growth. The bond market has been effectively nationalised through Quantitative Easing (QE). Joe Biden, in the United States, has prolonged direct aid programmes to Americans to help them out of the pandemic, promising to go further: his Build Back Better agenda is a legislative design to stimulate social services, welfare and infrastructure, as well as making funds available to contain the effects of climate change, encouraging the transition to a digital and sustainable economy. On this side of the Atlantic, Europe, too, has chosen the path of financial support in its own way: the European Central Bank (ECB), in addition to an already functioning Quantitative Easing programme, has added another special, pandemic one. The EU states have introduced the 'Next Generation EU', which involves issuing common debt instruments on the global markets. This is a temporary instrument, but it nevertheless opens the door to EU debt, a fundamental step towards more sophisticated forms of integration.

If the stock markets celebrated 2021 to the hilt, it is precisely because investors had no alternative. While the bond market was practically dead, with negative real rates, growth and expectations of growth in the real economy fuelled the economic expansion. Vaccines and easy liquidity doped risky financial assets. All this was possible because the scenario of the last decade had accustomed us to disregarding the inflation problem, which had affected the economy so much in the 1970s. Globalisation, digitalisation and an ageing population in the industrialised countries have helped to keep prices down. Energy costs, despite a few flare-ups, have always fallen: new energy sources were seen as a looming threat that would have wiped out oil production in the long term and therefore helped to curb producers' appetites. This context also allowed the accreditation of Modern Monetary Theory, which postulates the possibility for states to create money almost without limits. Indeed, with only one limit: inflation. But since inflation in the advanced countries had no way of animating it, the limits were really about to become infinite. In reality, inflation could not contaminate the real economy, even though it has exploded, accelerating in the last decade, in the financial economy.

But inflation has started to raise its head with the initiatives to combat the pandemic; last November in the United States it reached 6.8%, in the Eurozone 4.9%, in England 5.1%. Numbers that put in difficulty the central banks that until a few weeks ago insisted on saying that this was only transitory, due to bottlenecks in production, suppressed demand and the accumulation of savings. The basic problem is that energy prices have started to rise and these affect everyone else. Investment in new fields has declined in recent years. Oil companies have focused on the energy transition by betting on alternative sources and paying dividends to support their stocks. The pandemic has contributed to the realisation that the world is not yet ready to support an electrified and de-carbonised economy. Especially in Europe, where Germany and other states have decided to give up nuclear power. Russia has realised this. Its aim is to push Europe in particular to use gas as a tool to produce electricity, which is less polluting than coal, and perhaps also to produce hydrogen. By curbing the production of gas destined for the EU, Putin has made it clear that Europe's energy destiny passes through him and insists on making Nord Stream 2 operational, strengthening his hold on the Old Continent. The old reflexes of energy geopolitics have come back into focus. Oil producers have realised that their era is not yet over: they have more time to take advantage of the hunger for gas and oil (the consumption of which is constantly increasing) and to inflate their incomes. In addition, other raw materials, such as lithium and rare earths, are fuelling power appetites.

The transition to normality will become more complicated in 2022: production problems in the supply side, the energy crisis in the EU, uncertainty about inflation in the medium term limit the ability of central banks to act and amplify the risk of mistakes. But also the uncertainty about the costs of the green economy - central to the new path - are considerable and have structural features.

Central banks are having more difficulty positioning themselves between inflation and growth. It was already clear before the pandemic that they would emphasise growth by tolerating inflation levels above 2%, then they considered inflation to be transitory, and now they are really worried. They know that there are now priorities in the hands of states, hence policy, that could be inherently inflationary: fiscal spending, taxes and labour, climate change, social inequality, protection of strategic productive assets, regulation. The great pandemic stimulus artificially kept structurally weak companies on their feet: the cycle restarted without wiping out unsustainable debts and marginal activities. Sociologically, too, the face of work in many advanced countries has changed: the children of the baby boomers of the 1960s have brought forward their pensions; women have decided not to return to work after the first lockdowns; the search for a new balance between work and quality of life. Moreover, the situation of public finances does not allow for the absorption of other shocks, but increases vulnerability to the possible reaction of long-term rates.

So a difficult 2022 lies ahead for the financial world? There is no shortage of pessimists, who may have experienced the financial bubbles of the beginning of the millennium, when Alan Greenspan (then chairman of the Federal Reserve) spoke of "irrational exuberance". Or that of the Great Financial Crisis of 2008, which turned central banks into liquidity hoses to keep a paralysed system alive. Their arguments are often extremely rational and convincing: they use indicators that, had they been taken seriously and in time, would have prevented major collapses. At the basis of these analyses is often the unsustainability of the debt that has grown out of all proportion, first to save the system and then to prevent the pandemic from sweeping through the economy. In this context, speculators, reflexively complacent, fuel the creation of further debt (Minsky Moment).

While not underestimating their arguments, it is the underlying motivations for borrowing that need to be considered. Quantitative easing (the forced injection of liquidity) has not only played the role of 'bailouts of last resort'. They have in fact become the instrument to finance a new digital and de-carbonised economy and, as Jeremy Rifking argues, at zero marginal cost. It is not only a historical coincidence that during the hardest periods of the pandemic the economy continued to produce, remotely, thanks to Microsoft, Zoom, Alphabet, etc., but that it was also able to do so in the future. On the contrary, COVID-19 even forced the increase in productivity that was already underway. Thanks to digital, fewer people are producing more and cheaper. Those who drove up the stocks of Apple, Alphabet, Microsoft, Amazon, Meta, etc. did not act out of 'irrational exuberance'. Rather, they were motivated by the rational observation that their technology is powerful and immediately taken up by the social and productive network. Nothing like what happened in 2000, when the Nasdaq collapsed because investors irrationally exaggerated man's ability to integrate software and hardware into everyday life. In this sense, the only real bubble we can see today concerns cryptocurrencies. Because, perhaps, it will take more time and regulation before we truly make them part of our daily lives.

Central banks have effectively forced investors to finance the new economy, even by borrowing. They are forced to do so because nominal and real rates are negative, making the bond market unviable. For this path to continue, inflation has to come down to prevent rates from rising too much. In 2021 real rates were strongly negative, so there was no real alternative to equities. Especially as economic growth was powerful and corporate results stellar. In 2022, growth is expected to be more subdued, but will remain at high levels. 10-year inflation expectations are 2.4% for the US, while the 10-year Treasury yield is 1.8%. So we are still in negative territory. The situation in Europe is even more pronounced: the 10-year Bund yields zero, but 10-year inflation expectations are 2.2%. This environment remains favourable for equities in 2022, provided that growth prospects are confirmed and inflation is close to its peak.

But this will not happen unidirectionally, due to the pandemic and the central banks' narrative that they still want to avoid market exasperations. New economy stocks are discounted at 2021 average rates, which have now risen by 0.3-0.5%. So, it is natural that their valuations will have to correct, although they will still be supported by the results. In 2022, attention will have to be paid to the macroeconomy: growth and inflation are the keystones that will move the central banks. However, they cannot afford exaggerated corrections. They will try to keep real rates in negative territory, even if nominal rates rise. Given the importance of the new technology on the US stock market, it is perhaps worth, in relative terms, looking more at Europe, where multiples are lower. In addition, the ECB will be more cautious and the collaboration between France and Germany, but also with the support of Italy and Spain, will help to foster growth rather than fiscal discipline. For similar reasons, Japan could also offer interesting insights.

The central banks' taps are still open. There will still be liquidity provision for the first and perhaps also the second quarter, but at much lower levels. The year will be volatile and difficult, but in the end, given the growth assumptions, it could reveal a positive balance and make pessimism less rational and exuberance more selectively rational. China, which has remained on the sidelines of the major growth in the world's major stock markets, could be the surprise of 2022. In 2021 it began to rebalance its economy aided by the mighty liquidity of the Federal Reserve, the European Central Bank and the Japanese Central Bank. It could take over in 2022, injecting the liquidity that will be lacking and averting what happened in 2018 when the world ran out of cash.

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