Rathbones
Look forward

Review of the week

10 January 2022

A strange and profitable year

Another COVID-blighted year has passed. Yet, for all the turmoil, 2021 was a great one for markets.

Last year was a spectacular one for investors. Not exactly smooth sailing, but over the course of the year it delivered strong returns driven by the sharpest economic recovery in modern history. Put simply, 2021 was a stellar year for profit growth. Despite rekindled inflation pushing input costs higher, global corporate profits jumped about 50% over the year. At the outset, analysts had expected growth of just 26%.

Looming over the market - indeed, looming over everything - was COVID-19. The virus that just won't go away was the reason for the wholesale shutdown of economies that created such a large economic crater to set off 2021's recovery. It was the reason governments and central banks poured on more stimulus than anyone could ever imagine. It was the reason the spending habits of households and businesses changed in ways that upended supply chains and swung demand from services - tourism, restaurants, cafes and theme parks - to goods and construction.

It has been a weird couple of years. And 2022 will likely be just as strange as these unusual dynamics start to unwind. COVID, the troublemaker, is no doubt here to stay. However, there is burgeoning hope that the Omicron variant marks the beginning of a less harmful, more endemic form of the disease. If this does bear out, we are left with the great unravelling: emergency-level monetary policy cannot remain in place when inflation is hitting new multi-decade highs each month, the unemployment rate is in the basement, households are hoarding stacks of cash and corporations are minting money. So investors have already started to map out how they think this will go.

Every week economists seem to add another rate rise to their forecasts of the US Federal Reserve's (Fed) interest rate path. Goldman Sachs and Deutsch Bank are now suggesting four 25-basis-point hikes this year. We believe three is more likely. The probability of a March move is nearly 90%, according to interest rate futures. Last week, the 10-year US Treasury bond jumped 25bps, all but pricing in the Fed's anticipated tightening. Meanwhile, the US yield curve has steepened - that is, the yield of longer-term bonds has increased by more than the yield of shorter-term ones. This is a good sign because it implies that investors believe that rate increases won't cause an economic slowdown that will lead to lower GDP growth in the future.

Looking at the Fed itself, the monetary policy committee's latest minutes show it is getting more concerned about inflation. Not only that, but it has cottoned on to the 'great retirement'. The COVID years have convinced many older workers that life is too short and that they should pull the rip cord on work much earlier. This decision was no doubt helped by big gains in markets that made defined contribution pensions and market-based savings much bigger than expected. As these skilled workers drop out of the workforce, it becomes harder for businesses to find the right people for jobs across all types of industries. This could put upward pressure on wages and reduce productivity.

The Fed has a tough job ahead of it - as do other central banks. We have come through a period of unprecedented change. Governments and central banks have used an abundance of extraordinary monetary and fiscal policy tools to get us through, yet they now must learn how to reverse them without tripping up the economies they are trying to sustain.

Rising prices

One of the big numbers to watch this week is US inflation for December, which is released Wednesday. This time last year it was flat at 1.4%; this week it's expected to rise 20bps to 7.0%.

The rising cost of energy is a big driver of the ramp-up in inflation over the fourth quarter and this energy squeeze is likely to continue into 2022. Brent oil has risen above $80 a barrel once again and worldwide gas prices have been marching higher for some time. This rise in energy prices should abate as the year progresses, with supply chains untangling and economies returning to a greater degree of normality. However, any conflict in Ukraine would upend energy markets again. The Russian army is massed on the border of its southwestern neighbour, if it invades the US and EU have made it clear that they would enforce sanctions. That would curtail the gas and oil exports of one of the world's largest suppliers.

After an unexpectedly strong year for businesses and households, 2022 is looking like one where income will be squeezed by higher costs. Yet looking at a whole range of measures suggests a recession isn't on the cards in the near future. That is most important for investors.

You can listen to our co-chief investment officer Edward Smith give a short rundown of 2021 and an outlook for 2022 here.

If you have any questions or comments, or if there's anything you would like to see covered, please get in touch by emailing review@rathbones.com. We'd love to hear from you.

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