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Edward Markus

+31 (0)30 232 8000
ecr@ecrresearch.com

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2022: a year that will break the trend

Wednesday, 5 January 2022 | Contents

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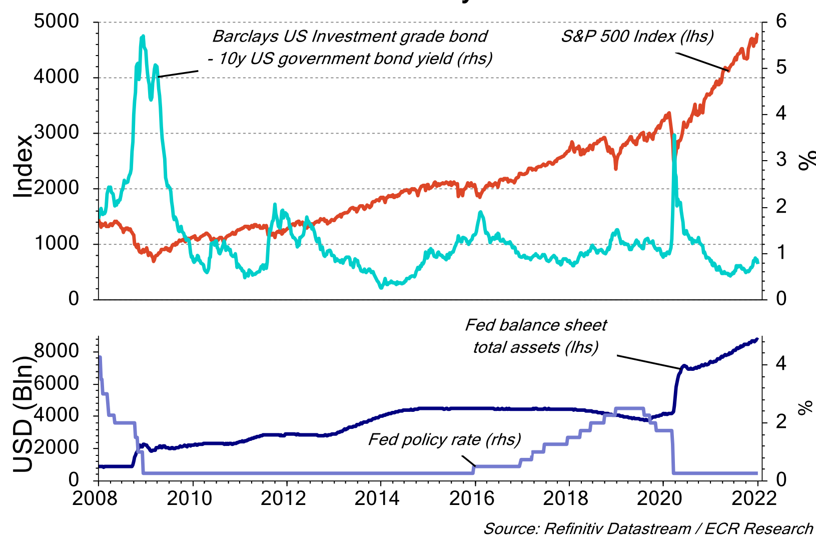
A different monetary policy setting

To start with, we would like to wish our readers a very happy and above all healthy new year.

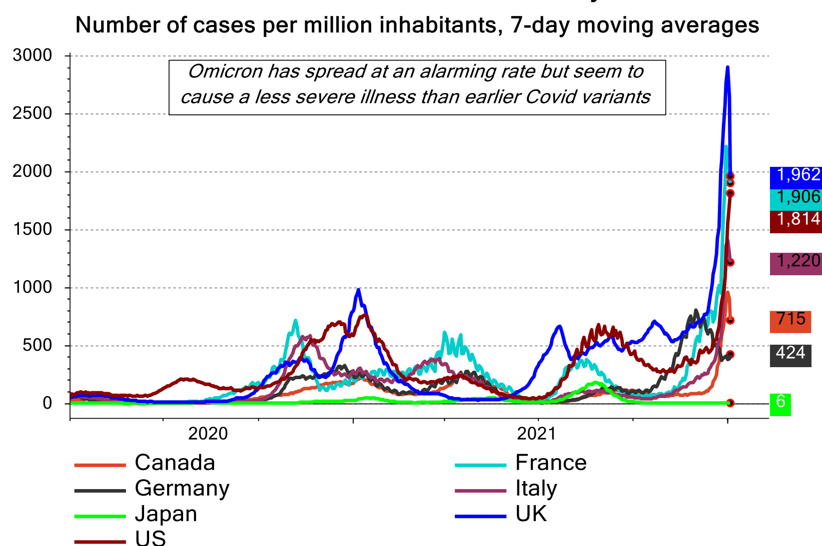
Below, we will briefly outline how we view the outlook for the economies and financial markets at this point. Next week, we will resume our normal schedule and publish an extensive GFM report.

As we look at it now, the year ahead will see a trend break with the past 13 years, and this will create considerable turmoil in the financial markets. The past 13 years have been characterised by limited fiscal stimulus, coupled with ultra-loose monetary policies. The latter manifested itself in ever lower interest rates – and risk premiums – combined with more money creation than the real economy was able to absorb. The resulting surplus money subsequently drove up prices of shares, bonds, property and commodities, and so on, to ever higher levels. As this policy was implemented in most countries, it also led to minor fluctuations in currencies.

Already in 2019, it gradually became apparent that this ultra-loose monetary policy could not be pursued for much longer. However, corona turned everything upside down. The pandemic triggered a very rapid decline in the economy, as a result of which deflation threatened again. This is why the authorities responded with massive fiscal stimulus and renewed monetary stimulus. It did not take long before a new wave of surplus money reversed the economic slowdown and started to boost asset prices.



Last summer and autumn, however, it looked as though the spread of corona began to be curbed far more effectively, prompting the markets to price in that the exceedingly loose fiscal and monetary policies would come to an end.
In the ensuing period, Omicron started to circulate. As this mutation spreads very rapidly, there were great concerns about public health, hospital admission rates, the economy and so on. However, it increasingly looks as though the situation is not too bad, and that the vast majority of people only develop mild symptoms. If this scenario continues, things will even turn out favourable in the coming quarters, as many people will become infected and will consequently build up resistance to all sorts of other mutations. Combined with vaccines, this could fairly soon result in a reduction in the number of patients. In this case, many measures against the spread of corona could be relaxed if not terminated.

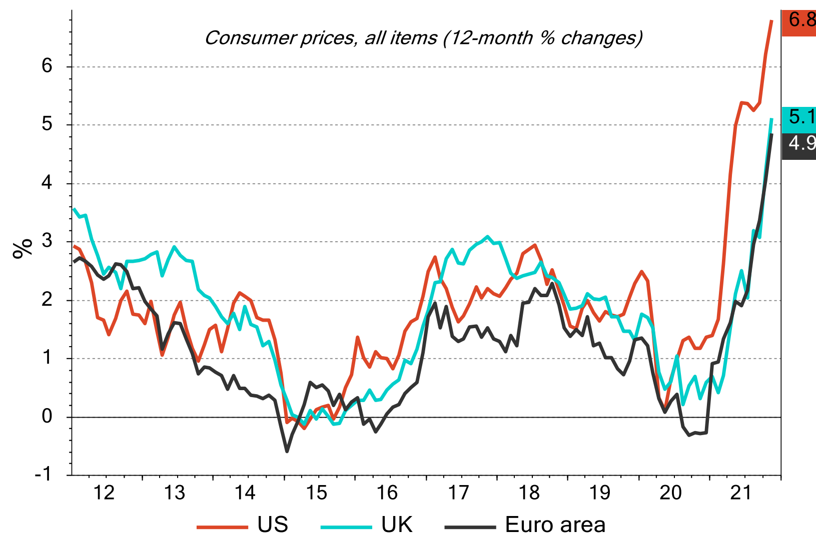


It is generally argued that, in the US in particular, inflation has far exceeded the level of wage increases, and that this is affecting consumer purchasing power. There are also concerns that fiscal stimulus will be scaled back considerably, as Congress has so far rejected President Biden's Build Back Better plans and many fiscal stimulus measures to absorb the economic impact of the corona crisis have been terminated. This is why US economic growth is expected to fall back.

It remains to be seen whether lower economic growth will lead to a decline in inflation. The financial markets assumed this to be the case, as they priced in a considerable decline in inflation following three Fed rate hikes of 0.25%. More recently, however, this picture has begun to shift due to the following reasons:

- Americans still have considerable savings that they could spend now.
- It is quite likely that Congress will still adopt a substantial proportion of Biden's fiscal package.

- Many measures that restrict the economy could quite possibly be lifted fairly soon, as Omicron turns out to be less severe than feared. At the same time, supply side restrictions could persist for a while.
- If Omicron is indeed only a mild hiccup – with economic growth speeding up as a result – the US labour market will tighten considerably, which is likely to result in additional wage increases.
- One third of the CPI consists of items related to house prices. These prices will almost certainly continue to rise sharply in 2022. Price increases of other items should be very limited in order to achieve a considerable decline in inflation. Given the above, however, this seems unlikely. All the more so because little is invested in the production of commodities due to the fight against climate change. As a result, commodity prices are more likely to rise.



In conclusion, the US economy will continue to grow at a rapid pace this year, and inflation will probably remain stubbornly high. The Fed would basically have to hit the monetary brakes fairly hard. On balance, however, the central bank is likely to stay behind the curve. That is to say, the central bank will tighten, but not to the extent where inflation is depressed in earnest. In order to really rein in inflation, the Fed would have to tighten monetary policy to the extent where asset prices could plummet. This could trigger another credit crunch. The Fed is unlikely to take this risk.

The situation is slightly different in Europe, as unemployment is higher there and inflation has not risen as high as in the US. This also means that the ECB will have to tighten, but at a far slower pace than the Fed. This picture might change in the slightly longer term, as the US is leaning towards fiscal tightening, while Europe is increasingly heading towards fiscal easing. In the long run, this could mean that the ECB will have to hit the monetary brakes harder compared to current market expectations.

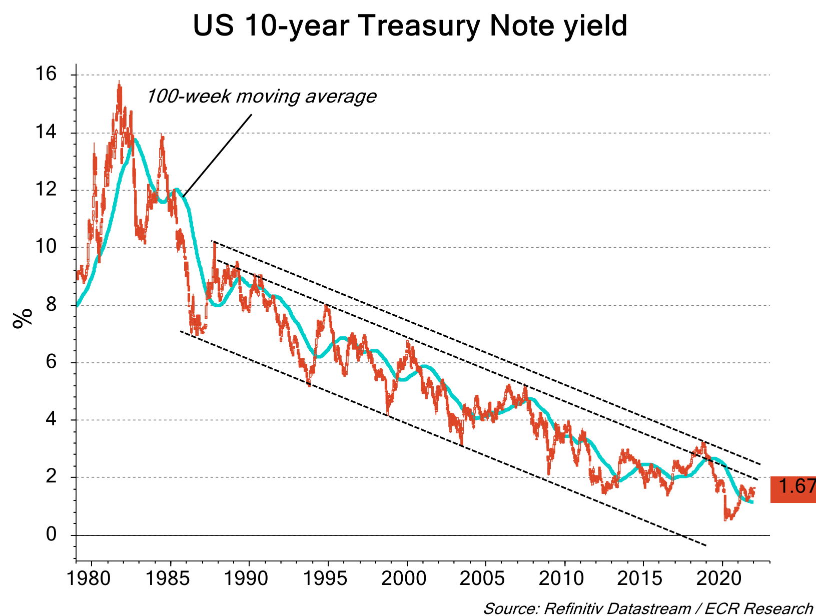
Consequences for the financial markets

Against this backdrop, we anticipate the following for the markets.

Interest rates

As of May this year – once the spread of corona has been curbed more effectively – the Fed is likely to raise its short-term interest rates three times by 0.25%. As we believe that the central bank will stay behind the curve in terms of inflation, this is likely to be accompanied by persistent high if not rising inflation expectations. As a result, the yield curve will steepen and interest rates on 10-year TIPS are likely to become more negative – they are unlikely to rise.

As for interest rates on 10-year US government bonds – now around 1.66% – the 1.75% limit should be closely monitored. A breakout above this level would probably point to a rapid further rise to 2%-2.2% (this a matter of time).



The ECB is likely to start raising its short-term interest rates by the end of this year/early next year. Interest rates on 10-year German government bonds – now around -0.125% – will probably be pulled up by the movements of US long-term interest rates. Once 10-year German interest rates exceed -0.1%, we anticipate a further increase to around 0.2%

Shares

Good economic prospects and central banks refraining from significant monetary deceleration are favourable factors for shares. However, the rise in (long-term) interest rates and additional wage increases are unfavourable elements. Hence, we believe that the S&P 500 index will continue to fluctuate between roughly 4,200 and 4,900 for the time being. Most stock markets in the rest of the world are likely to follow this pattern.

EUR/USD

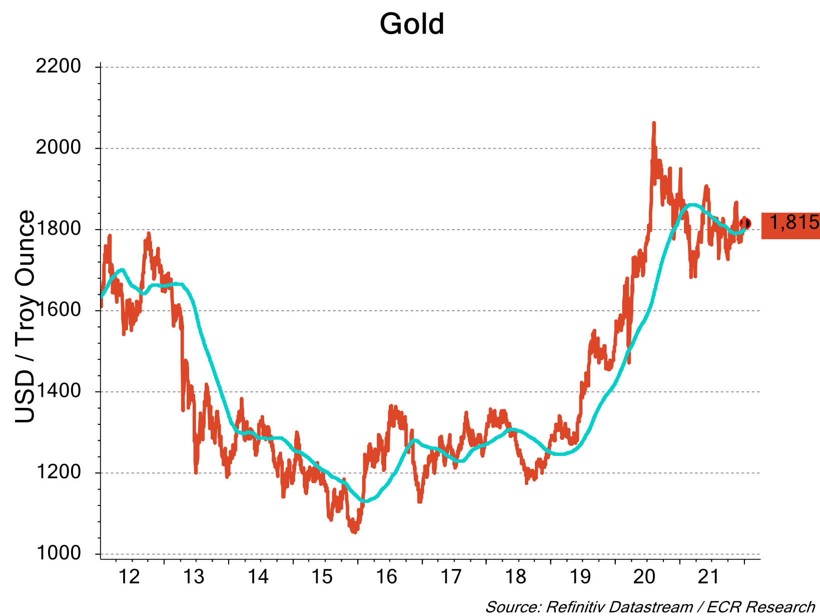
The markets have largely priced in that the Fed will tighten and that the ECB will continue to pursue a very loose monetary policy for the time being. Nevertheless, we expect foreign exchange markets to be jolted by persistent high inflation. Said markets will consequently price in an even tighter monetary policy by the Fed. Hence, EUR/USD is likely to hover in a range between roughly 1.12-1.16 for the time being, after which the pair will decline further to 1.05-1.10. In the longer term, EUR/USD is set to rise considerably as a result of the exceedingly high US twin deficits. Other factors include the Fed staying behind the curve and Europe leaning more towards fiscal stimulus (i.e. a less loose monetary policy).

Gold

Lately, the gold price has been supported by high inflation rates in the US and Europe, but it has been hampered by the expectation that central banks will tighten as a result of this. The latter could persist

for a while, but the gold market will increasingly price in that the Fed in particular does not want to crack down on inflation.

This is why the gold price is basically unlikely to decline far below $1,775. In an extreme scenario, it would decline further to roughly $1,675, but this is unlikely. On the contrary, the gold price will increasingly enter into an uptrend. First of all, the resistance at roughly $1,865 should be overcome, and subsequently that at $1,925 and $1,975. Above the latter level, there would be scope for a further rise towards $2,500-3,000.



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