Monthly Review

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January 2022: "as goes January, so goes the year"...?

Financial markets went through a volatile start to 2022. All, or virtually all, asset classes yielded negative returns, with US (tech-) stocks delivering the biggest losses. For global stock markets, a partial recovery in the last week of January prevented even worse performances.

After a very good December 2021, January 2022 came as an unpleasant surprise to investors, especially to investors in American equities. The realisation that the US central bank, the Fed, may hike interest rates in 2022 by (much) more than anticipated earlier, sent US equities lower, the main reason being that 'net present values' of companies are lower when discounted at higher interest rates. This is especially true for companies with high expected profits in the future but little or no profits now, which explains why the most 'innovative' (but profit-less) technology companies were hit the hardest. After the first three weeks of January, the technology-heavy Nasdaq-index had lost almost 15% of its value. A partial rebound near the end of January kept losses on the MSCI North America equities-index (in euros) 'limited' to -3.8% for the month, but that still meant the worst start to a year since 2009. European and Asian equities fared slightly better, with monthly returns of -3.2% for the MSCI Europe equities-index and -2.6% for the MSCI Asia Pacific equities-index. Somewhat surprisingly, the worst performing equity-index of 2021, the MSCI Emerging Markets equities-index, was the 'winner' of January 2022, with a monthly return of just -0.1%.

Whereas equity markets experienced a sudden turnaround from a stellar 2021 (note that even including the negative January 2022 returns, the MSCI World Developed Markets equity-index has still returned almost +25% on a 12-month basis), bond markets remained on the same track as during most of 2021, i.e. of higher yields and therefore negative returns. European sovereign bonds returned -1.1% in January, with the German 10-year bond yield exceeding 0.0% for the first time in almost three years. 'Investment grade' corporate bonds lagged somewhat behind sovereigns with a monthly return of -1.3% and the more risky 'high yield' corporate bonds performed worse still, with a return of -1.5% in January.

Finally, European listed real estate weathered the January storm with a negative return of just -0.1%, which is quite remarkable considering the combination of higher interest rates and much more negative returns on other European equity markets.

The monthly returns on various asset classes are as follows:

Rendementen (total return, in euro's)	januari	1e kwartaal	2022	12 maanden
Bloomberg Barclays Eurozone Staatsobligaties	-1,1%	-1,1%	-1,1%	-3,9%
Bloomberg Barclays Euro Bedrijfsobligaties	-1,3%	-1,3%	-1,3%	-2,2%
Bloomberg Barclays Euro High Yield Bedrijfsobligaties	-1,5%	-1,5%	-1,5%	1,5%
MSCI Europe Onroerend Goed	-0,1%	-0,1%	-0,1%	10,1%
MSCI Europe Aandelen	-3,2%	-3,2%	-3,2%	22,0%
MSCI North America Aandelen	-3,8%	-3,8%	-3,8%	31,1%
MSCI Asia Pacific Aandelen	-2,6%	-2,6%	-2,6%	0,4%
MSCI World Developed Markets Aandelen	-3,6%	-3,6%	-3,6%	24,9%
MSCI Emerging Markets Aandelen	-0,1%	-0,1%	-0,1%	0,8%
EUR/USD	-1,8%	-1,8%	-1,8%	-8,0%

Bron: Bloomberg

'A sudden change of scenery': from monetary policy loosening to monetary policy tightening

There appears to be one overriding reason for the turmoil on financial markets in January 2022: the so-called 'Powell pivot', i.e. the expected turnaround in the US Fed policy stance from monetary loosening to tightening. Still just a few weeks ago, financial markets were expecting the Fed to start increasing interest rates in 2022, but only at a leisurely pace of two, or maybe three rate hikes of 0.25% each. After the freshly re-appointed Fed Chairman Jerome Powell had stated by late November 2021 that the Fed no longer considered inflation to be 'transitory', he upped the ante in January 2022 by indicating that the Fed could start raising interest rates as early as March 2022, while at the same time halting the 'quantitative easing'-programme of asset purchases. Financial markets have since started pricing in at least five rate hikes by the Fed for this year, which would take the Fed funds rate from 0-0.25% today to around 1.25-1.5% by the end of 2022, with more to follow in 2023.

Even at this much increased pace of expected monetary tightening, the Fed could still be argued to be 'behind the curve'. Inflation in the US has now reached 7%, the highest level of inflation since the 'stagflationary' early 1980's. Core inflation (excluding volatile food and energy prices) has gone up to 5.5%, also the highest level in almost 40 years. Meanwhile the US labour market, the other target of the Fed's dual monetary policy mandate, appears to be on the verge of reaching 'full employment', although various indicators do offer somewhat contradictory signals as to exactly how tight the labour market is. At any rate, with inflation at 7% and unemployment below 4%, a base interest rate of 0% combined with still on-going 'quantitative easing' seems like an almost bizarrely inappropriate monetary policy stance.

Of course, the picture is expected to change somewhat during the course of 2022, as inflation may soon peak out if only due to 'base effects': it is now about a year ago that inflation (and economic growth) bottomed, and from here on the 'reference level' for year-on-year comparisons will move higher. In that scenario, the pace of monetary tightening as now foreseen by financial markets appears to be quite reasonable. However, in a less benign scenario the combination of higher consumer prices and an increasingly tight labour market may trigger a 'wage-price spiral', which the Fed may then find difficult to control without resorting to a much faster pace of interest rate increases, and thereby increasing the risk of triggering a recession.

Where the Fed goes, the ECB will follow..?

Whereas in the US the Fed may appear to be 'behind the curve', in the eurozone the ECB is facing a very similar, if not greater risk. So far, the ECB has been indicating that just like the Fed it will wind down its 'quantitative easing'-programmes in 2022, albeit at a much more gradual pace than the Fed. The ECB is expecting to stop its asset purchases only by the end of the year, and then to start hiking interest rates no sooner than early 2023. Financial markets are questioning whether this is a realistic scenario, and are now pricing in a first rate hike by the ECB in September 2022.

It remains to be seen whether the ECB will stand by its earlier statements, or at some point will be forced to adopt a more 'hawkish' stance. Much will depend on incoming inflation data in the next few months. According to the ECB's latest macro-economic forecasts from December 2021, eurozone inflation is expected to average 3.2% over 2022. With a starting point of 5% inflation as per December 2021, that would imply that inflation will have to start coming down soon. Unfortunately, so far there has been very little data to confirm that this is actually about to happen. The current high level of inflation in the eurozone is predominantly caused by higher energy prices, and despite the relatively favourable weather conditions these have not come down in January. On the contrary, both oil and gas prices have remained at well-above average levels, which is at least partly due to increasing tensions between Russia and Europe (and the US) over Ukraine. Although a large-scale military invasion of Ukraine by

Russia may not be the most likely scenario, so far there has also been no sign of de-escalation. Whatever the final outcome, it seems unlikely that the situation with regard to Ukraine will resolve itself soon.
In the eurozone higher energy prices are now the main source of inflation, but wage inflation may follow

One more or less comforting (at least to the ECB) difference between US inflation and eurozone inflation is that so far higher consumer prices in the eurozone have not translated into much higher wage pressure. This may be partly due to structural differences between US and eurozone labour markets. Wages in the eurozone are more dependent on negotiated contracts between employers and labour unions than in the US, where workers in a tight labour market are much more likely (and quicker) to transfer to better-paying jobs. Of course, eventually wages in the eurozone are just as likely to adjust to higher prices as in the US, if labour markets were equally tight. At least at first sight, the US labour market appears tighter than that in the eurozone, with unemployment in the US currently at 4% and in the eurozone at 7%. However, the eurozone has never before (i.e. for at least 25 years) experienced an unemployment rate as low as 7%, so labour markets here are probably tighter than they may appear to be. It could therefore well be just a matter of time before higher prices in the eurozone are to feed through in higher wages, which would make the ECB's job of containing inflation all the more difficult.

Inflation may be contained by higher interest rates, but what about economic growth?

It is clear that for both the Fed and the ECB, as well as for many other central banks around the world, inflation is now the biggest issue. This is of course a major change from just a year ago, when fighting deflation was still the main challenge for central banks. At the same time, central banks will also want (or need) to consider the implications of monetary policy on economic growth. The good news is that, at least for now, the growth environment should not be a major worry. In the last quarter of 2021, the US economy grew at a 5.5% year-on-year rate, the eurozone at 4.6% and China at 4.0%. For all three major economies, this was well above expectations, as the negative impact of the Covid-pandemic on growth was less than feared.

Of course, it remains to be seen what the impact of the 'omicron'-variant on the world economy will be, since that variant only to started to spread at a very fast rate in early 2022. From that perspective, the Chinese economy appears to be most at risk, since the 'zero tolerance'-policy Chinese authorities have so far applied to the Covid-threat, may be difficult to sustain against the highly contagious 'omicron'-variant, or only at considerable economic cost. It is partly for this reason that the IMF has recently downgraded its forecast for global economic growth in 2022 to a still-respectable 4.4%, with China expected to be the worst-performing of the large economies in relative terms.

'As goes January, so goes the year': usually a useless prediction, but maybe not so in 2022

For financial markets, uncertainty over the inflation outlook and the prospect of higher interest rates were the main sources of turbulence in January 2022. Unfortunately, it is not very likely that these factors are going to go away any time soon. It therefore appears reasonable to expect that the assets and asset classes which are most negatively correlated to higher interest rates and which suffered the most in January, will remain the most at risk also in the coming months. In our view, this may not bode well for sovereign bonds, both in the US and the eurozone, as well as for those stocks and stock markets that have benefited most from low interest rates over the past few years. From that perspective, US stocks appear more vulnerable than eurozone stocks, and so-called 'growth' (e.g. technology) stocks more than 'value' (e.g. financials and energy) stocks. However, we do believe that in an environment of reasonable economic growth, high inflation and tighter monetary policy, equities as an asset class can be expected to perform better than bonds, at least in relative terms.

In summary, although the old stock market adage 'as goes January, so goes the year' finds little support in actual historic market data, it may very well turn out to be of ominously predictive value for financial markets in 2022.

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