Market Synopsis – January 2022

<u>Omicron vs the global economy</u>

January has been a distinctively negative month for the global equity market, falling more than 10% from its high at the end of 2021. The S&P 500 has fallen below its 200-day moving average, and is currently underperforming ex-US equities in USD terms – see Figure 1.

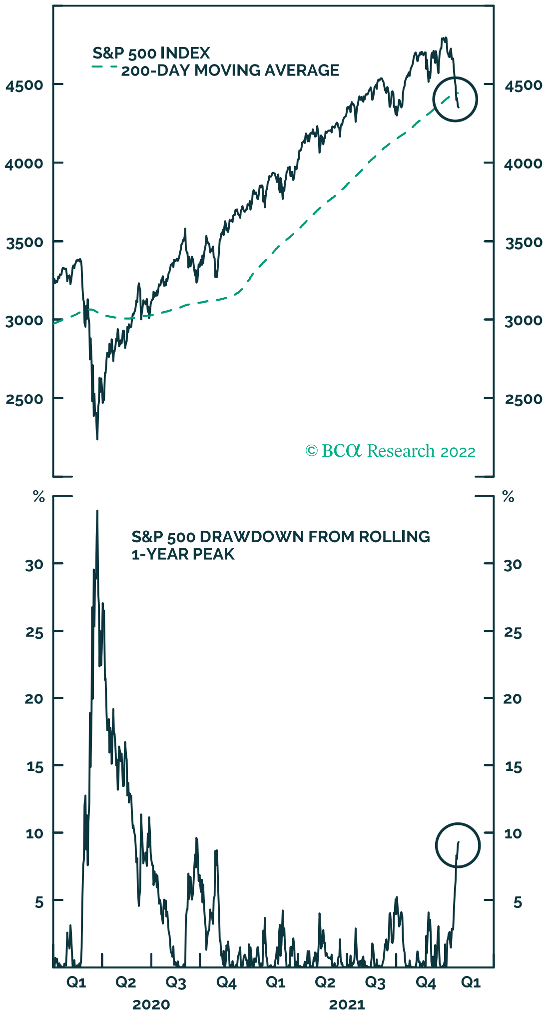

Figure 1 – S&P 500 performance

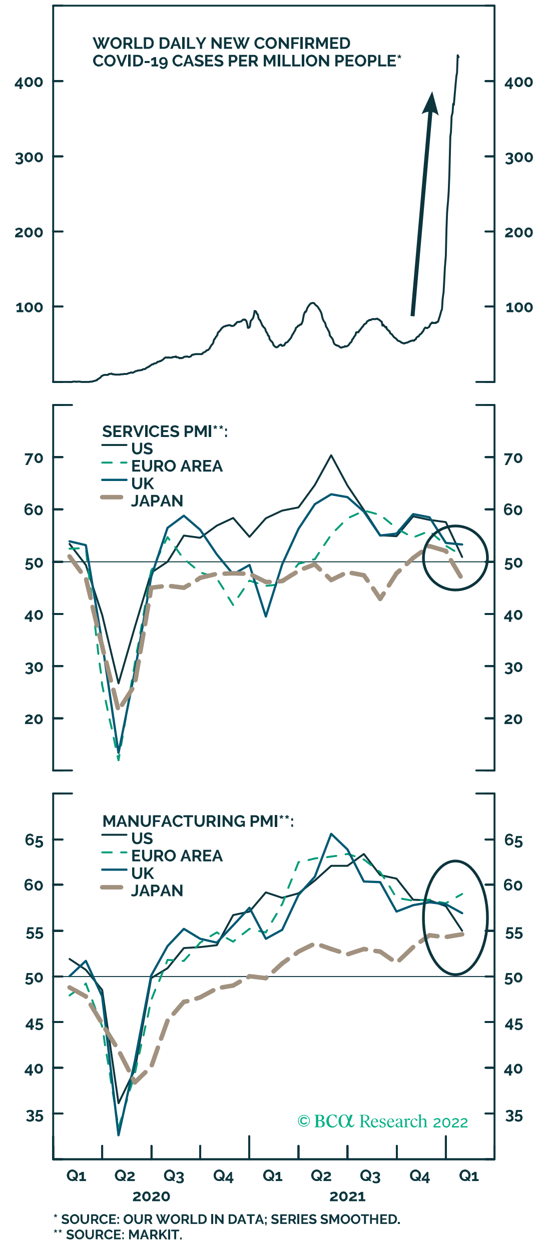

Figure 2 – The Omicron surge and its impact on PMI

Unfortunately, the pandemic has not slowed down as many had hoped. The number of positive COVID-19 cases spiked in December and January, and may even be understated as the testing capacity across the world has been pushed to their limits – see Figure 2.

Service PMI fell dramatically in January due to Omicron. This is indicative of both renewals in pandemic control measures and precautionary adjustments to consumer behaviour. Manufacturing PMI fared far better than services, even while natural gas prices are at record highs.

On a more positive note, promising signs have emerged from hospitalisation data in developed countries, which indicates we are approaching the peak in the number of people with COVID-19 in hospitals, and more specifically in intensive care units. While the emergence of a new variant remains a distinct risk, the rapid increase in vaccine boosters administered and the speed at which the Omicron variant has been spreading points to a peak in the impact that the current variant has on the demand side of the global economy – at least in developed economies.

However, there have been no clear signs of a waning impact on the supply side of the economy. The Omicron variant poses a significant risk of more frequent and longer lockdowns in China, as the country has a zero tolerance COVID-19 policy, as well as the inability of the Sinovac vaccine to provide protection against contracting Omicron. Shipping costs have already begun to tick higher, suggesting that the ongoing lockdowns and mandatory quarantines in key Chinese locations are already having an impact – see Figure 3.

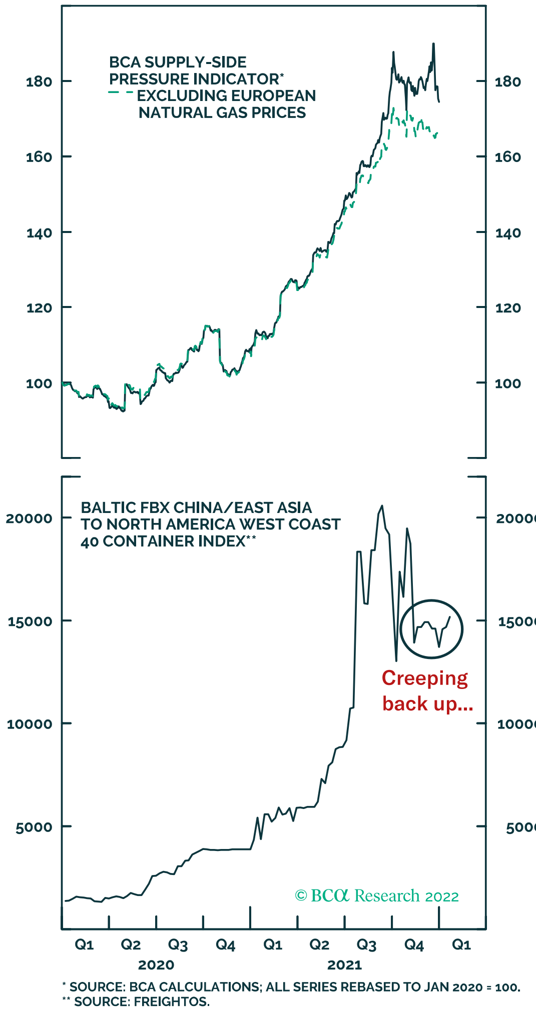

Figure 3 – The Omicron surge and its impact on supply

A newly hawkish Fed

The combination of temporary negative US demand and labour shortage, as well as the impact of the global supply chain, has increased the Fed's urgency to raise interest rates. The Fed's ability to achieve one of its core functions – keeping inflation under control – has been challenged over the past year. While the probability of extreme US inflation (>4%) has fallen, inflation rates higher than average is expected. Based on this, it is still likely that the Fed will proceed with a rate hike in March.

Investors will need to be cognisant of the Fed's recent hawkish shift, and how this will impact economic activity and the financial markets. Not only do investors need to worry about the speed and size of the potential hikes, but also the impact of quantitative tightening as the Fed slows its pace of asset purchases. We believe that investors should be more concerned about the former. The level of the S&P 500 was almost perfectly correlated with the Fed's total security holdings between 2008 and 2015. This broke down completely between 2016 and early 2020, and only returned to its near perfect correlation as the Fed's holdings of securities surged during the pandemic – see Figure 4.

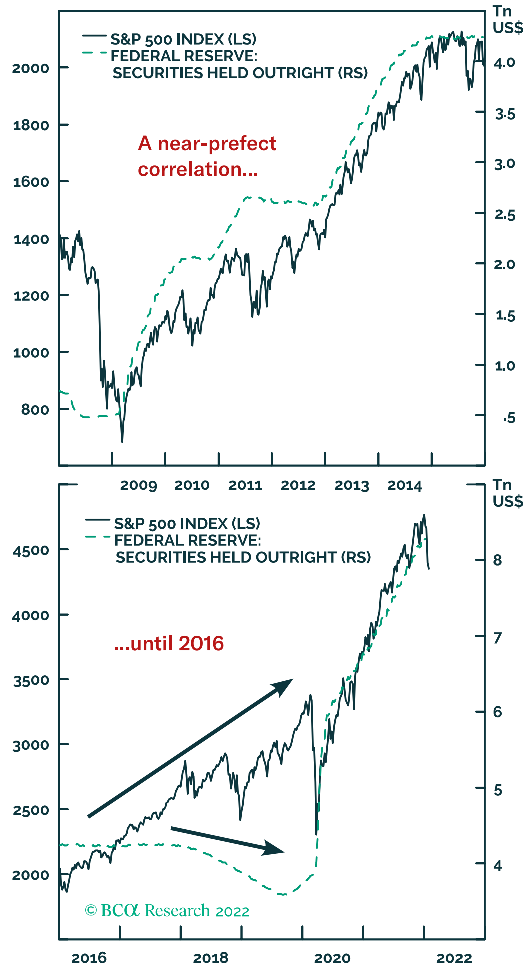

Figure 4 – Correlation between Fed's security holding and S&P 500

This changing relationship indicates that the correlation between the two is most likely spurious – meaning they are indirectly related. The periods in which the Fed's security holdings increased was due to monetary easing, which is beneficial for risky asset prices.

The 10-year US government bond yields are currently 40 basis points below what is implied by the Fed's interest rate projections. Therefore it is possible that the rapid reduction in asset purchases by the Fed will cause yields to quickly converge with their fair values. This means the US 10-year bond yield could rise to 2.35% as early as Q2 2022, rather than in Q4 as was previously anticipated.

Value vs growth

The fact that the selloff in global equites was concentrated in the US, before the increase in tensions over Ukraine, indicates the cause of the decline: The NASDAQ has fallen dramatically more than the S&P, and US growth equities have underperformed value – see Figure 5.

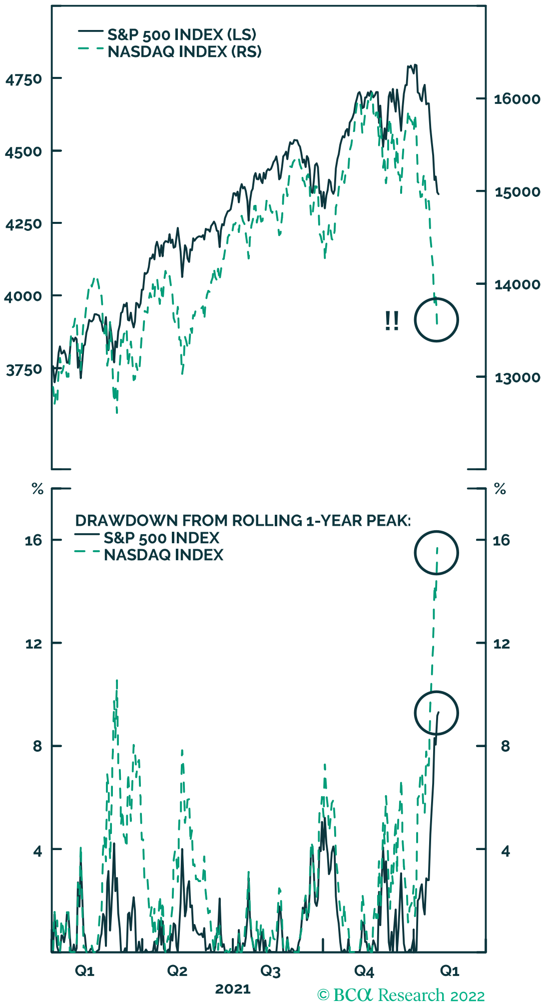

Figure 5 – NASDAQ vs S&P 500

This value outperformance over the past month is indicative of the fact that the relative performance of growth over value since the pandemic began was largely driven by changes in valuation that would reverse if bond yields increased. This also explains the underperformance of US equities in general, given how heavily they lean towards technology companies – see Figure 6.

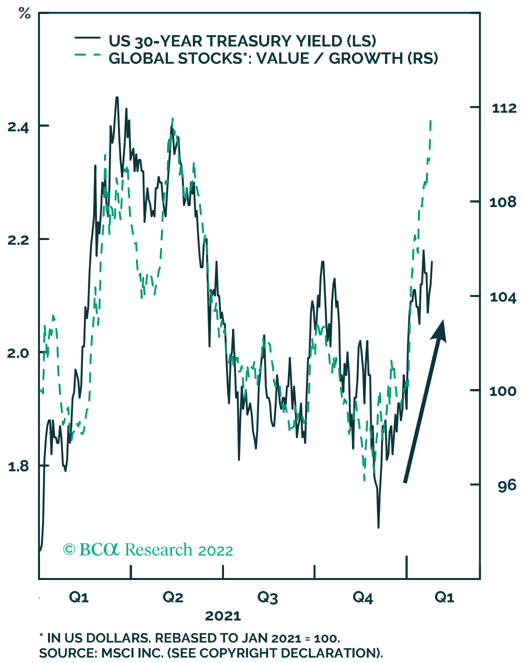

Figure 6 – Value benefits over growth when Treasury yield rises

However, investors have punished both growth and value shares as bond yields have risen. This general sell off of equity reflects the overall level of investor discomfort regarding further interest rate hikes.

The Dollar

Despite the recent increase in US interest rate expectations the USD has behaved strangely since November, even as the Omicron variant rapidly spread around the world. The USD was trading opposite to both the intensity of the pandemic and relative interest rate differentials, both of which had appeared to explain the USD's movements for most of 2021 – see Figure 7 on the following page.

Prior weaknesses in the USD may be explained by easing foreign purchases of US equity, as global investors rushing into the technology weighted US market during the height of the pandemic began to wane. However, we expect that another variable may contribute to future USD weakness – the correlation between the total number of cases and USD strength will reverse, from positive to negative. For the majority of the pandemic, new waves and variants were perceived by investors as an indication of slowing global growth, thereby increasing flows into the US market. However the pace at which Omicron has spread, coupled with the fact that it appears to cause less severe infections has led many to believe that Omicron may actually decrease the time it takes for to shift from a pandemic to an endemic. COVID-19 gaining

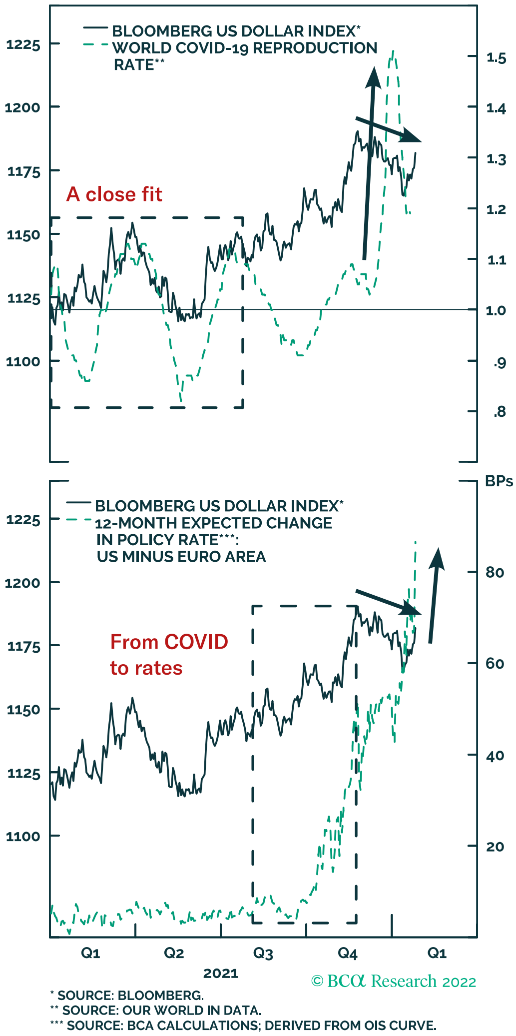

Figure 7 – The trend of USD strength

an endemic status would mean life would mostly return to pre-pandemic normality, resulting in a large increase in service spending as well as international travel. Both would be positive for global growth, and therefore negative for the USD.

Investment implications

The Omicron variant is hopefully the blessing in disguise that brings an end to this drawn out pandemic. A return to normality will result in an increase in the service sector and international travel, both of which will benefit ex-US equities. Until then, the inability for the Sinovac vaccine to protect Chinese citizens from the effects of Omicron, as well as the government's stringent control measures, will likely lead to increased lockdown measure in the region. This chokehold on global supply will put further pressure on inflation and increase the likelihood of global increases in interest rates. Increasing interest rates should reverse much of the outperformance growth has enjoyed over value the past few years. While increased flows into ex-US economies should devalue the USD over the coming months, possible conflict with Russia over Ukraine makes any accurate predictions far more unlikely. Full blown confrontation remains unlikely, but small skirmishes and increases in sanctions may reverse some of the weakness the USD has recently experienced.

Over the short term, too many factors are in flux to make firm predictions. However, over the long term the answers to all of these issues will emerge. We believe that over the following 12-18 months value will maintain its edge over growth shares, and the USD will have lost some of the strength it gained in 2021. This will benefit ex-US value shares, and particularly the service sector if pandemic control measures ease.

For more information on this Market Synopsis or to discuss solutions provided by Integrity Asset Management, please contact us at:

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Indicator	Spot	MTD	YTD	Y-o-Y
Gold	1 797.17	-1.8%	-1.8%	-2.7%
Brent Crude	91.21	17.3%	17.3%	63.2%
USDZAR	15.3866	-3.5%	-3.5%	1.5%
EURZAR	17.2825	-4.7%	-4.7%	-6.2%
GBPZAR	20.6873	-4.1%	-4.1%	-0.4%
JSE All Share TRI	12 078.30	0.9%	0.9%	23.9%
JSE Resources TRI	5 620.93	3.9%	3.9%	31.2%
JSE Industrials TRI	19 220.70	-1.9%	-1.9%	12.6%
JSE Financials TRI	9 948.15	3.4%	3.4%	36.0%
JSE Listed Property TRI	1 635.67	-2.9%	-2.9%	37.4%
S&P 500	4 515.55	-5.3%	-5.3%	21.6%
Euro STOXX 50	9 227.42	-2.8%	-2.8%	22.2%
FTSE 100	7 395.62	1.1%	1.1%	20.7%
Nikkei 225	45 371.48	-6.2%	-6.2%	-0.8%
Hang Seng	73 031.19	1.7%	1.7%	-13.6%

Source: Bloomberg, as at 31 January 2022