Global Markets Daily: Early December Headwinds Not Just From Omicron (Wilson)

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- Cyclical assets dropped dramatically on Friday amid fears of the impact of the "omicron" variant. The impact on the economic outlook from omicron is still unclear, given incomplete information. Market moves so far already imply a significant downgrade to growth views. Potential downside scenarios do not appear to be fully reflected but there are also clearly scenarios that prove better than anticipated by the sharp shift in pricing last week.
- The challenge to a sustained recovery comes not just from further potential worries about the new variant, but from the broader news flow between now and the December FOMC. Cyclical tailwinds from the acceleration in US and global demand growth in the last couple of months have been a key support for markets. But the scope for positive surprises is diminishing as expectations catch up; COVID case rates are likely to rise further in the near term; and Fed officials have signaled that continued economic strength will reinforce the case for the accelerated taper that we now expect at their December meeting.
- The market is now pricing clearly below our 3-hike Fed forecast for 2022. Our commodities team also sees the repricing in oil markets as likely to prove excessive relative to the demand outlook. But we think a broad risk recovery may be impeded in the near term by the need to digest the prospect of a more hawkish Fed and a less consistent cyclical tailwind. Ironically, the omicron scare itself may now create the best possibilities for relief in the coming weeks, either because incoming news is better than feared or because it prompts monetary policymakers to take a more cautious stance toward tightening.

Early December Headwinds Not Just From Omicron

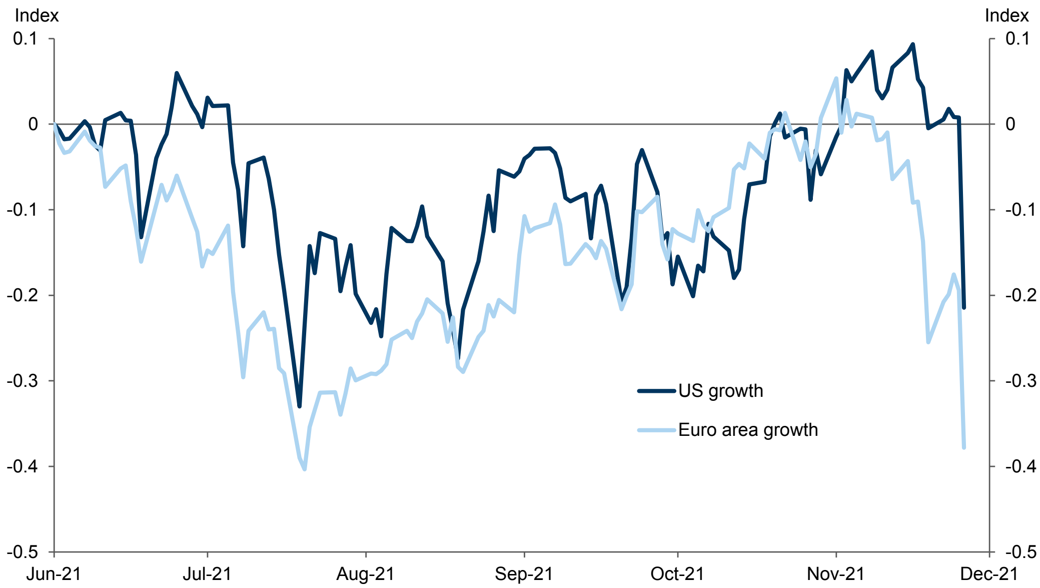
Markets reacted dramatically on Friday to worries about the new COVID "omicron" variant, with equities and commodities dropping sharply as investors worried anew about fresh travel restrictions and larger potential risks beyond. Cyclical assets performed particularly poorly. The Russell 2000 saw its largest one-day drop since February. Front-month oil prices, which are more sensitive to near-term demand risks than more forward-looking assets and have proven highly sensitive to potential shifts in the outlook for travel, fell by 13%. And US rates market shifted from pricing nearly three Fed hikes in 2022 to pricing a little more than two hikes by the close of the day, with a large rally across global government bond curves.

We argued in our recent 2022 markets outlook that, in the context of a flatter overall trajectory for equity markets, the best opportunities were likely to come when the market worried about risks that we thought would ultimately not eventuate. The near-term challenge is that even before the omicron news, the risk picture was already turning more difficult simply on the basis of the run-up to an accelerated taper, the prospect of diminishing help from the data and a likely seasonal pick-up in COVID case rates. With fewer positive catalysts on the horizon in the period between here and the December FOMC, we suspect that worries may have to build further before sustained relief is possible. Ironically, it may be the omicron scare itself that now creates the best possibility of some relief over the period, either because incoming news about the variant is better than feared or because monetary policymakers take a somewhat more cautious stance in response to the news.

The impact of the omicron variant on the economic outlook is obviously still quite unclear. The impact is likely to be significant only if the variant proves substantially more likely to evade vaccines or generates more severe outcomes. The early signs have pointed to elevated risk with respect to vaccine evasion, but information is still incomplete and may change in the coming days and weeks. At the same time, the response from policy authorities has been relatively swift, new vaccine boosters may be relatively easy to design if needed and the impending antiviral pills should remain effective. As a result, our global team has laid out a range of potential scenarios, some of which involve intensified worry and some of which involve relief.

The market has also already made a significant downgrade to growth views simply on the basis of the price action late last week. Using our growth factors as a proxy (Exhibit 1), at Friday's close markets had reversed nearly all of the upgrade to US cyclical views since mid-August. And in Europe, where cyclical views were already under pressure given the surge in COVID case rates in Germany and elsewhere, the hit to cyclical pricing from the recent peaks has been even more dramatic. We think the downside (and severe downside) scenario that our global team presented is not fully reflected at hits point, so it is easy to envisage downside scenarios that lead to further downward pressure. But is also clearly possible that the news around omicron could ultimately turn out to be better than anticipated by the sharp shift in pricing at the end of the last week.

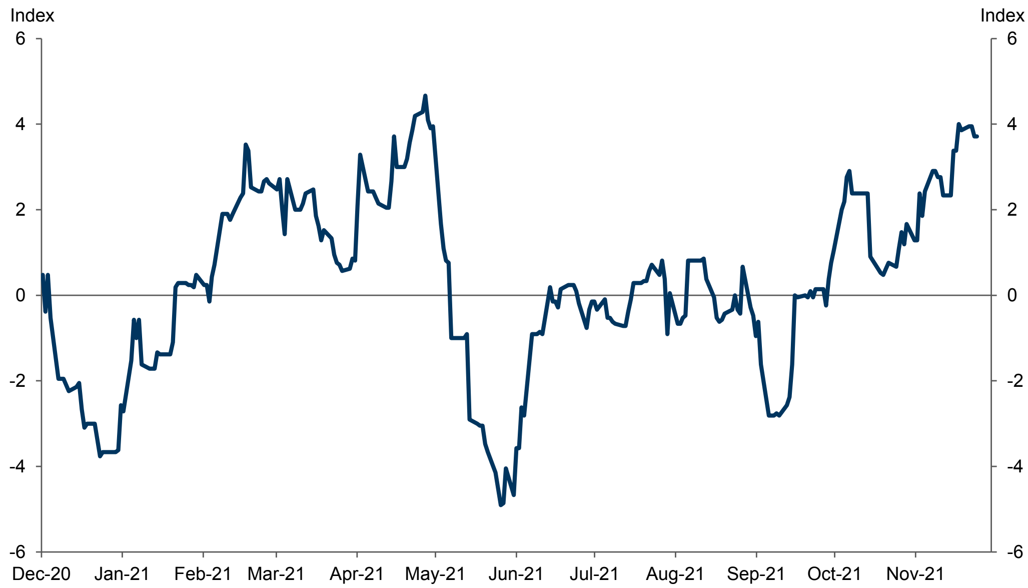
Exhibit 1: Cyclical views reverse most of the rebound since late summer
Change in US and China growth factors from June 1 to November 26



Source: Goldman Sachs, Goldman Sachs Global Investment Research

Beyond renewed downside risks from omicron, the main near-term challenge is that the strongest reason for recent cyclical optimism—consistent positive data surprises, especially from the US —is a less obvious tailwind in the weeks ahead. Over recent months, we have generally taken a more positive stance on cyclical assets—including equities—despite fears of inflation and central bank tightening that have been the major focus over that period. That more positive view has in large part been predicated on the view that the market was underestimating the acceleration in US (and global) demand since the late summer. Our US Current Activity picked up from around 3% in August to nearly 7% in October. Along that track, the US data has delivered consistent strong positive surprises for more than two months (Exhibit 2), with the last month of data recording almost as positive an outcome as the year-to-date peak for rolling monthly surprises back in April.

Exhibit 2: Strong US data surprises have continued, but are more of a mixed blessing now
US MAP surprise index, 21-day rolling average



Source: Goldman Sachs, Goldman Sachs Global Investment Research

Although constrained supply and upward pressure on inflation were the dominant narratives in the market, this underlying cyclical strength meant that the market was forced to upgrade its cyclical view in response. This helps to explain why we have seen fresh highs in *both* equities and front-end yields in recent weeks. The big shift in central bank pricing has not so far dented this cyclical narrative. Despite a significant pull-forward in the market's expectations of rate hikes from the Fed and other central banks, markets have largely moved their views simply to reflect with higher inflation expectations that left real rates steady even at the front end of the curve and lower at longer maturities. Data, not the Fed's reaction function, drove that shift and the market has essentially priced that most central banks would be dragged reluctantly to acknowledge the more inflationary reality.

The market's recent worry has been squarely focused on the omicron variant. But we think the challenge for a full market recovery, at least until the December FOMC meeting, is that the recent cyclical tailwind is likely to be less supportive of the risk picture, even without fresh worry about omicron. We expect the economic news to remain firm, both on the growth front in this coming week but also in the upcoming inflation report. But after a very strong and consistent run of positive surprises, and a meaningful upgrade to market pricing of US growth at least until the omicron news hit, expectations are also catching up. At the same time, the near-term health risks are rising and had been doing so ahead of the omicron news. That has already been visible in Europe, where increased case growth has weighed on local assets since the start of November. US case growth is starting to rise too and may well pick up further following the Thanksgiving holiday. The new variant is obviously a potent reminder that the risks of mutations that lower the efficacy of current preventive measures cannot be ruled out.

With Fed officials—including San Francisco Fed President Daly most recently—also signaling that strength in the economic data similar to recent months would support the case for an accelerated taper, strong data may now be more tightly linked to tightening in the market's mind. Our US team changed their Fed call on Wednesday to forecast an acceleration in the speed of asset purchase tapering at the upcoming meeting that would complete that process in March, and a shift from 2 to 3 forecast hikes for 2022. This shift comes in response to comments from a number of Fed officials that the threshold to speeding up the taper timeline was lower than we had initially expected. This—and related concerns about the potential for a significantly faster hiking profile in the dot plot—have more of the flavor of a hawkish "reaction function" shift, at least relative to market expectations, than the shifts we have seen up until this point. As we move towards the Fed meeting, those concerns are likely to stay in place and if the health news remains concerning, there may be some accompanying worry that the Fed is shifting stance at a point where the economic and health risks are rising.

Our baseline view is that the economic risks from the virus and the Fed will likely prove manageable, and that ongoing vaccinations and health innovations are still moving in a positive direction. But as we saw with the delta outbreaks over the summer, it may take some time for cyclical assets to reflect this if the news flow is deteriorating. And if cyclical concerns are driven by worries about increased health risks, strong spot economic data may not provide much reassurance and may in fact prove counter-productive if it fuels the perception that policymakers will remain more hawkish. Even where central banks have not yet made much of a hawkish turn, markets may still worry that a more dovish response—if needed—is going to be slower to come in the current inflation and policy environment.

The good news is that market has already made a significant shift towards pricing these risks at the tail end of last week. This may create (indeed, already has created) the basis for some near-term relief if the incoming information on omicron is more reassuring. But we think the broad mix of worries about a more hawkish Fed stance and increased concern about the risks to the cyclical picture from the health side may not dissipate clearly, at least until the December FOMC.

Ultimately, we expect this episode to create opportunities to engage more aggressively with equity longs. But given the calendar ahead, we think it is likely too soon to expect a sustained rebound. Reassuring news on omicron itself is perhaps the most obvious potential positive catalyst here. A more dovish tone from the large slate of Fed speakers this week in response to these fresh risks would also help, but we think is unlikely at so early a juncture.

The opportunities opening up in oil are potentially more immediately interesting. This is partly because of our strongly bullish structural view, but also reflects the very large repricing that we have seen here. Our Commodities team thinks that the move so far is already consistent with a severe hit to demand growth assumptions and view the repricing as excessive. The uncertainties over the outlook could still dominate in the near term though.

After Friday's repricing, the opportunities for short rates positions in the US front end, where our new Fed profile is now meaningfully above the forwards for 2022 are opening up more clearly again. We think the current environment should reinforce the flattening bias in the US curve. We still think that longer-dated inflation (5y5y inflation in the US, specifically) is underpriced, but the current backdrop poses some near-term risk to that view.

In Europe, renewed cyclical risks are a headwind to our paid SEK 5y recommendation, although the combination of downside growth risks and potential underdelivery on ECB QE in December points to wider sovereign spreads—we favour short BTPs vs Bonos.

In FX, the combination of heightened COVID risks and a faster Fed taper have reinforced upside risks to our broad Dollar forecasts. Unless the omicron fears settle quickly, G3 currencies are also likely to trade on a firmer footing against cyclical and commodity currencies for a while longer.

We highlighted the disconnect between high levels of macro uncertainty and relatively low levels of implied volatility in our market outlook. We have pointed out that this disconnect makes sense as long as the market continues to exhibit high confidence that the broad recovery remains on track even as it struggles to forecast the month-by-month data flow accurately. But the flip side is that markets are vulnerable to anything that shakes that confidence, particularly more challenging news on the health front or more persistent underlying inflation pressure. So we may see a period of higher volatility until one or other elements fade from the near-term picture.

TRADE IDEAS

Best Trade Ideas Across Assets

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1. Stay long SGD vs short TWD, opened on October 29, 2020, at 20.95 (indexed at 100), with a revised total return target of 111, and a revised stop of 105, currently trading at 105.95.
2. Stay long 10-year OFZs, USD-unhedged, opened on August 26, 2021 at a yield level of 7.02% and with USD/RUB at 74.02, with total return indexed at 100, a target of 110 and a revised stop of 90, currently trading at 90.65.
3. Position for wider 12-year HGBs bond-swap spreads, opened on September 30, 2021, at -15bp, with a revised target of 50bp, and a stop of -50bp, currently trading at 34bp.
4. Stay short AUD/MXN, opened on October 5, 2021, at 100, with a target of 106, and a stop of 96, currently trading at of 96.96.
5. Stay short 6m10y straddle, opened on 8 October, 2021, at 41bp (running premium), with a target of 25bp and a stop of 50bp, currently trading at 42.3.
6. Stay short AUD/CAD, opened on 3 November, 2021, at 0.9218, with a target of 0.85, and a stop of 0.96, currently trading at 0.911.

7. Close an equal-weighted basket of CZK, PLN and SEK vs EUR, opened on November 9, 2021, at 100, with a target of 105 and a stop of 97.5, for a potential total return loss of 2.50%.
8. Receive KRW 2-year IRS, opened on November 9, 2021, at 1.86%, with a target of 1.6% and a stop of 2.3%, currently trading at 1.85%.
9. Stay long 3-year SA inflation breakeven, opened on November 9, 2021, at 3.87%, with a target of 4.6% and a stop of 3.2%, currently trading at 3.81%.
10. Pay PLN vs receive CZK 5-year IRS, opened on November 9, 2021, at -0.24%, with a target of 0.5% and a stop of -0.6%, currently trading at -0.03%.
11. Stay long the iBoxx leveraged loan index vs. the iBoxx HY bond index at a 1.25 to 1x ratio, opened on November 9, 2021, at 0.0%, with a target of +1.00% and a stop of -1.00%, currently trading at 0.01%.
12. Stay long the BBG US HY Energy Index vs. the BBG USD HY Corporate Index, both rates-hedged, at a 1 to 1.1 notional ratio, opened on November 9, 2021, at 0.0%, with a target of +1.00% and a stop of -1.00%, currently trading at 0.04%.
13. Stay long AAA CLOs hedged vs. CMBX 10 AAA at a 1 to 1x notional ratio, opened on November 9, 2021, at 0.0%, with a target of +0.70% and a stop of -0.70%, currently trading at 0.16%.
14. Receive 2y vs pay 10y EUR OIS (2s10s steepener), opened on November 9, 2021, at 0.39%, with a target of 0.65% and a stop of 0.25%, currently trading at 0.44%.
15. Pay SEK 5y swaps outright, opened on November 9, 2021, at 0.59%, with a target of 1.00% and a stop of 0.40%, currently trading at 0.60%.
16. Stay long 10y Bonos vs BTPs on a 1.25:1 weighting, opened on November 9, 2021, at 37bp, with a target of 50bp and a stop of 30bp, currently trading at 44bp.
17. Add US 2s5s10s belly cheapening butterflies via 3m ATM payers, opened on November 9, 2021, at 0bp, with a target of 18bp, and a stop of -12bp, currently trading at 4bp.
18. Buy 5y5y US breakevens, opened on November 9, 2021, at 2.29%, with a target of 2.55%, and a stop of 2.10%, currently trading at 2.16%.
19. Stay long MSCI EM vs. short EMBIG-Div (duration hedged), opened on November 9, 2021, at 100, with a total return target of 108 and a stop of 96, currently trading at 98.30.
20. Close Mexico and Russian equities (in USD), opened on November 9, 2021, at 100, with a target of 112 and a revised stop of 90, for a potential loss of 10%.
21. Stay long Egyptian equities, opened on November 9, 2021, at 11588, with an EGX30 target of 13500 and a stop of 10800, currently trading at 11278.
22. Close Dec-23 Brent, opened on November 9, 2021, at $72.05/bbl, with a target of $80/bbl and a stop of $66/bbl, closed at stop of $66/bbl.
23. Stay long Dec-23 CME Copper, opened on November 9, 2021, at $9325/mt, with a target of $11,000/mt and a stop of $8,600/mt, currently trading at $9,282/mt.
24. Pair shorts in EDZ3 with longs in BAZ2, opened on November 15, 2021, at 26bp,

with a target of 0bp and a stop of 40bp, currently trading at 21bp.

Disclosure Appendix

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