Investec

OUT OF THE ORDINARY

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The Omic(h)ronicals

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As those of us who were not taught it at school continue to learn the letters of the Greek alphabet, it's unsurprising that there is only one topic in town at the moment, which is the Omicron COVID variant. The equity market's reaction to news of its presence was swift and selectively brutal on Friday 26 November, as well as intuitive. "Opening up" stocks and sectors were pummelled, while "stay at home" investments benefitted. Within the FTSE 100, for example, there was almost twenty percentage points of relative performance difference between on-line grocery firm Ocado at the top and IAG (parent company of British Airways) at the bottom.

Almost exactly the same gap prevailed in the FTSE 250 between retailer Games Workshop and cruise operator Carnival, as it did again in the EuroStoxx 600 between online pharmacy company Zur Rose and airline Deutsche Lufthansa. You can't say that investors were inconsistent in their conclusions.

However, it's worth making the point that there might be something of an asymmetry of potential outcomes here, which was recognised in the paucity of gains for the winners relative to the dramatic falls of the losers. It's hard to see a second secular shift in favour of the beneficiaries of COVID, and certainly not to the extent that was experienced in 2020 and early 2021. It could be the sort of addition to earnings that deserves a Price/Earnings multiple of not much more than one. And while the COVID losers are not going to suffer the same sort of shock as they did on the last couple of occasions that activity was more severely curtailed, any extended loss of revenue when capacity and costs have just been ramped up again could lead to financial pressure and the need for further injections of capital which tend to be dilutive to existing shareholders.

The effect of new waves

Indeed, the experience so far during this pandemic has been that every new wave has been less severe in its economic effects that the last, and, for now, we are working on that premise. History also shows that investors are never as shocked by repeated events as they were by the initial one. We have observed a similar response, for example, to terrorist attacks.

Government bonds were the main market beneficiaries, with the US 10-year yield dropping 16 basis points on the day. Gold managed to win back some favour by rising a few dollars, but Gold's putative successor as a safe-haven risk diversifier, namely Bitcoin, proved to be positively correlated with risk assets, losing 9% of its value. But to be fair, it has recouped most of its losses over the weekend. No official opinion here – just an observation.

In any event, we are faced with a period of uncertainty as scientists attempt to evaluate (at least) four key factors about the Omicron variant – namely: 1) how much more transmissible it is; 2) any increased severity of infection; 3) can it evade current vaccine protection; and 4) what is the outlook for new vaccine development? We are unlikely to have firm answers for another couple of weeks, but initial commentary from the medical community in South Africa suggests that symptoms are not too bad. However, that comes with the caveat that those infected have tended to be younger. Moderna is reported to be confident in having an updated vaccine available by early in the New Year.

Unsurprisingly, implied volatility shot up, with the VIX index putting on ten points on Friday to 28.62, which was pretty much the day's peak. That was its highest close since February of this year when we were in the midst of "meme stock" madness. And rising implied volatility implies a reduction of gross trading positions by certain types of funds, which in itself can reinforce the rising volatility. Unhelpfully, this all occurred on a half-day of trading in the US owing to the Thanksgiving holiday, when volumes tend to be

thin. Add in the fact that investment banks tend to reduce liquidity to flatter their balance sheets towards the year-end, and you had a recipe for an air pocket. In some ways we might have got off lightly on Friday. Some equilibrium has been restored at the beginning of the new week now that investors have had a couple of days to consider the latest facts.

Government reactions

As for the authoritarian response of governments around the world, one detects a bit of a bullwhip effect at work (the same effect that has exacerbated supply chain disruption, as we have observed previously). Having been accused of being too complacent first time around, governments are generally reacting immediately to the new threat rather than employing the former tactic of waiting to see if things get worse before doing something. One lesson learned is that if there are a few cases officially diagnosed and reported in the system, then there are inevitably a lot more already in incubation. The new variant certainly gives excellent cover to any leader who might have been shy of previously executing a perceived policy U-turn on matters such as mask-wearing or COVID passports for social events. But it also looks as though policy will not be "one size fits all" around the world, with Japan, for example, appearing to take a much more extreme stance on incoming travellers.

We should also note that COVID-related restrictions were already being increased across much of Europe last week thanks to the increasing prevalence of the Delta variant, which might well now be superseded by Omicron. I recall the advice given by Michael Osterholm of the University of Minnesota, since elevated to President Biden's COVID Advisory Board. Early in the pandemic he likened COVID to a forest fire that will keep on seeking out material to burn until everything is reduced to ashes. And like a forest fire it can appear to have burnt out, only to be spreading underground and then pop up somewhere unexpected and unsupervised. This seems pretty prescient advice, especially as even now less than half of the world's population has received its first dose of vaccine and will probably not have much immunity.

Other economic developments

It's something of a shame that Omicron stole all the headlines, because there were some other interesting developments last week. On the central bank front, we had the renomination of Jerome Powell as Federal Reserve Chair, with Lael Brainard as Vice-Chair. This news, combined with the latest Federal Open Market Committee meeting minutes, led investors to start anticipating an acceleration of monetary policy tightening, with a faster tapering of asset purchases and an earlier lift-off date for the Fed Funds rate. This had helped shorter-duration equities before Thanksgiving, although there was then a massive reversal on Friday, with Value having its worst day relative to Growth since June 2020.

Further comments from all central bankers will be especially important this week. They will no doubt be cursing the latest COVID news and hurriedly rewriting their scripts. It will be instructive to see if there is any hint of a policy U-turn in light of the news. The main event will be Jerome Powell (and US Treasury Secretary Janet

Yellen) testifying before various Congressional committees.

Another salient event was the release of oil stocks from Strategic Petroleum Reserves (SPR) around the world, notably those of the United States. The total release was around seventy to eighty million barrels, well below the expected one hundred million. To put this in context, the world's daily consumption of oil is just short of a hundred million barrels. The market response was to be underwhelmed, with the oil price initially rising, but Friday's news saw sharp falls. OPEC+ meets again this week to decide on whether it will proceed with previously announced supply increases.

The point I would like to emphasise about this, though, is the "political theatre" involved. The initiative was led by President Biden, who is not faring well in the polls at the moment, and whose grip on Congress is currently forecast to be lost in next year's Mid-Term elections. Therefore, visible action on the rising cost of fuel and its impact on inflation was expected. Previous releases from the SPR have been in response to specific supply shocks as a result of either a specific event (think accident or hurricane) or a war (in either the Middle East or North Africa, for example).

It suggests the risk of other "populist" policy moves ahead. What if the response to sticky inflation is to hand out even more money to those who are most affected by it? That might raise the risk of stoking yet more inflation. No wonder "policy error" remains high on the list of investors' potential worries for the months ahead. Such errors could be from central banks as well as from governments.

Extreme weather events

And then there is the cold snap that has settled over much of Europe. If you thought it was cold here, spare a thought for the citizens of Sweden, where the mercury dipped to -37 degrees centigrade over the weekend, the lowest November reading since 1980. When you then also consider the severity of the first named storm of the season in the UK, it would appear to add to the evidence of extreme weather events as a result of global warming and the consequent climate change.

Finally, with a nod back to last week's Weekly Digest, I failed to recall that 1974 was the year in which Investec was incorporated in South Africa. Apologies for that!

Economic Commentary

FTSE 100 weekly winners

BHP Group Plc	4.1%
Intertek Group plc	3.9%
United Utilities Group PLC	3.7%
Severn Trent Plc	3.2%
Unilever PLC	2.7%
London Stock Exchange Group plc	2.2%
Rio Tinto plc	2.0%

FTSE 100 weekly losers

International Consolidated Airlines Group SA	-11.5%
Flutter Entertainment Plc	-10.8%
Rolls-Royce Holdings plc	-10.6%
Prudential plc	-10.2%
Entain PLC	-10.1%
ITV PLC	-10.0%
Melrose Industries PLC	-9.5%

FTSE 100 index, past 12 months

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