Over the years I have often mused that the real purpose of financial markets is to humble us whenever we might think we have some idea of what is going on. There have been plenty of instances in my career, but perhaps none more so than Friday of last week. My supposedly well reasoned letter was waiting for Thanksgiving to pass and to be sent out, but the new strain of the virus hit the news and in the minds of many turned the outlook for economies and markets totally upside down. I'm thankful for the opportunity to reassess, but it is not my intention to make a U-turn (yet).

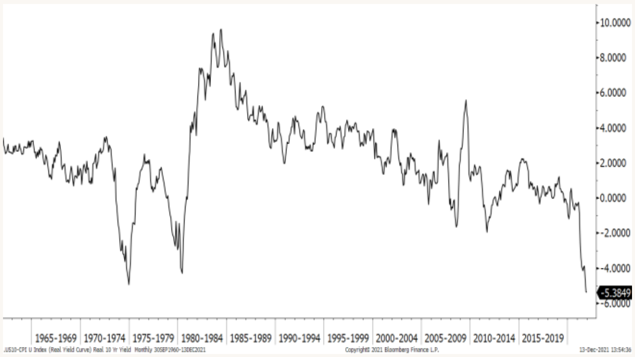
By coincidence the Seinfeld rerun that night was the one where George knocks over kids and old ladies to escape an apartment filling with smoke. I couldn't help seeing the parallel with the reactions of investors and politicians to the latest news. It is better to overreact to the risk involved then to not react at all. I would hold out hope that the market moves of Friday reflect an appreciation of the situation and that with increased global immunity, increased vaccination rates and the ability to quickly provide new boosters the worst outcomes can be avoided. I have read what I can on this new iteration of the virus and can't understand the lion's share of what I read, but what I can take away is that even the experts, while concerned, are hesitant to reach any definitive conclusions. What we know for sure after last week is that COVID has replaced inflation as the driving force in the near-term outlook for the world's economies and by extension for financial markets.

It doesn't require a PHD in economics to realize more shutdowns and travel restrictions will be a negative for global growth. Lab results on what exactly the Omicron variant is all about are expected within the next two weeks and hopefully will answer many questions about its overall impact on our health and welfare. If more restrictions are necessary to control this mutation, then estimates for GDP and earnings growth will need to be lowered. That in turn will change our expectations for stock markets, inflation, the Fed taper timing, and interest rates both of the market and regulated varieties.

If as I pray/hope/expect the Omicron variant will be challenged and controlled, we will return to inflation as the key variable in the market outlook. Therefore, we must remain attentive to disruptively high levels of inflation. Last month I wrote about inflationary concerns centred around wage growth and supply chain problems. Today I'll explore energy costs and the explosion in demand post pandemic as factors in the inflation we are currently experiencing.

Energy costs in Europe can easily be described as in crisis, and anyone filling up their car here in North America knows we are not immune. The causes are myriad; from Russia holding back natural gas supplies to Europe to world-wide restrictions on investment in fossil fuel development and maintenance. The recent climate conference impressed me by the number of leaders of state that showed up, as opposed to 20 years ago where the attendees would have amounted to a bunch of professors with pictures of crumbling glaciers. Policies and actions, though, are still very much a work in progress. It was pointed out to me that the final paper released from the

Figure 1:
US Real 10 Yr Yield (10 Yr – CPI)
Low interest rates and a spike in the inflation data have pushed real rates in the US to record lows.



Source: Bloomberg, Mulvihill Capital

conference subtly changed the wording on the future of coal from “phase out” to “phase down”. It's ironic that not many years ago the U.S. had become energy independent as drilling and production particularly in shale beds, exploded. Today, that business has been outlawed by governments or made uneconomic due in large part to market suppression by OPEC. Now, President Biden has been forced to go hat-in-hand to request Russia and Saudi Arabia increase production and thus lower prices. Kevin Muir who is a great observer of the often strange goings-on in geopolitics, tweeted this amusing message; “Mr. Biden, your neighbour to the north has lots of oil and we haven't beheaded anyone in centuries, and we even let women drive”. At any rate the President released a portion of the U.S. Strategic Petroleum Reserve. It's a small drop in the bucket, but at least indicates to OPEC and the American public that he is serious about energy prices. Then Friday happened and oil prices dropped an unbelievable $10. There's no doubt new lockdowns would impact demand, but something more was happening to cause such a big move. Possibly more George look-alikes were stampeding for the exits. Whatever the case, I imagine a rebound is in the offing.

The supply chain problems we referenced last month have in many ways been caused or at least exacerbated by unexpectedly large increase in demand. Household savings expanded rapidly as consumers were nervous during the pandemic. Fiscal policy and direct payments added to that reserve and the money is being spent as the economy reopens. Someone referred to it as “overstimulated demand”. Companies were also nervous and cut back production, and here we are lots of demand and not enough supply. Et voila; price increases. It all demands close monitoring, but I believe that more normal times are coming.

Where will the Fed go from here? I will assume Powell and Brainard will be approved by Congress and personalities will therefore be less of a factor than if Brainard had become Chair. There were definitely concerns (or hopes) as to what policies a potentially more progressive board under Brainard would have looked like. It had become perceived wisdom that there would be no increase in Fed rates until after the tapering of quantitative easing was complete. However, with recent inflation seeming less “transitory” the futures markets had priced in a quarter point increase by the middle of 2022 instead of the fall. Friday flipped that narrative and estimates are back to later in the year. I'm guessing now but convinced that what happened in markets last Friday will make the Fed much more measured before it makes any policy or rate changes.

The mid-term U.S. elections are less than a year away and will begin to impact markets early next year. I believe there is a strong likelihood of a shift in power in Congress. Given Biden's poor approval ratings, COVID exhaustion, price shocks, falling consumer confidence, and the general desire to “throw the bums out”, the Republican party will have every opportunity to regain legislative control of the country. That would likely lead to a reversion to Trump era policies like lower taxes and less regulation. Both have proven to be positives for stock markets, but the potential for those people with horns on their head who attacked the Capitol Building having renewed influence in Washington makes my blood run cold. It would also give more credence to a Trump return in 2024.

So what does it all mean for financial markets? If the Omicron variant proves to be more debilitating than I currently expect, all bets are off and markets will be vulnerable. That's a warning, not a prediction, and as I stated at the outset, I think we will beat this and subsequent mutations. Nevertheless, until there is some certainty about the future impact of the virus, I expect lots of volatility, but eventually a return to a path to normalcy and better markets.

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