Market Watch: The 5P's to Keep an Eye On in 2022

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If the month of January was any indication of how markets would behave for the rest of 2022, it's probably going to be volatile. Here are the key watchwords beginning with the letter **'P'** that investors may be hearing a lot of this year.

The 5Ps

- **Pandemic** – Re-opening challenges with new variants
- **Profits** – Growth is slowing but still above trend
- **Policy** – Shifting towards modest tightening
- **Positioning** – Record inflows
- **Politics** – Status quo in US-China relations

Pandemic

Omicron is a reminder to markets that COVID remains a clear and present risk. Investors got a sense of déjà vu all over again as the more infectious strain triggers renewed lockdowns in parts of the world. However, the reopening theme should continue to sustain because of higher vaccination and low mortality rates.

A stronger medical arsenal in dealing with the pandemic will also help bolster efforts towards reopening. This includes Pfizer's new antiviral pills that has shown promising signs in preventing deaths and hospitalisation. Recently, the oral pills was granted approval by the US Food and Drug Administration (FDA) for home use last year.

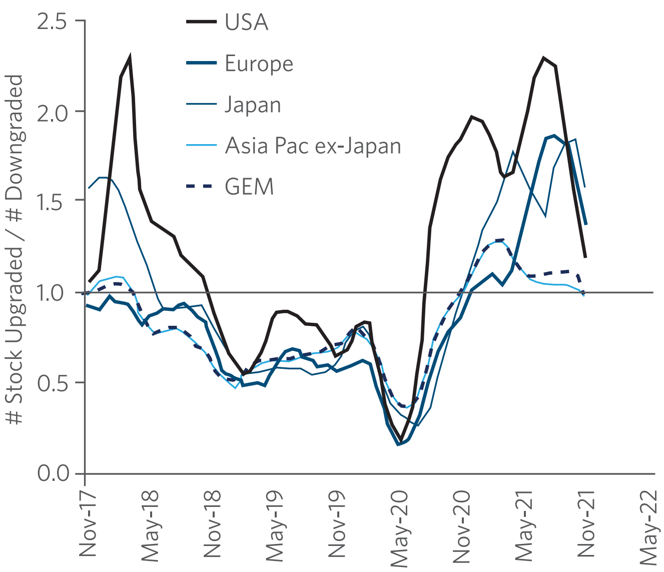
A subsequent full approval and a wider manufacturing rollout would aid global efforts towards stemming future infection waves and hospitalisations. Canada became the latest country to approve Pfizer's COVID pills for mild to moderate cases in adults. This could set the tone for a firm transition to an endemic phase where the world learns to live with the virus globally.

Profits

After an exceptionally strong year of economic growth and earnings upgrades in 2021 where businesses clambered to meet renewed demand, this pace is expected to normalise in 2022. However, growth rates are still expected to remain above trend which would support valuations.

Recovery could also be uneven across different regions with developed markets (DMs) expected to outperform emerging markets (EMs), as DMs adopted a more aggressive stimulative stance to combat downward pressure arising from the pandemic in the form of rate cuts and handouts.

Chart 1: Trends in Earnings Expectations by Region



Source: BofA Merrill Lynch, as of 25 November 2021.

Policy

2022 will also see major policy shifts taking place. Firstly, the US Federal Reserve is embarking on an aggressive tightening path to tamp down inflation which has surged to new highs. At a congressional hearing, Fed Chair Jerome Powell said that the Fed was determined to ensure high inflation did not become "entrenched."

Fed funds futures are pricing-in a 90.0% chance of a rate hike in March 2022 with another 3 more rate hikes expected for the rest of 2022. The Fed is also seeking to accelerate its tapering of bond purchases to shrink its balance sheet which ballooned at the onset of the pandemic when the Fed injected massive stimulus to keep the economy afloat. With inflation rising and signs of recovery in the labour market, the Fed is now thinking of withdrawing stimulus which could unnerve markets.

A key inflection point for markets to turnaround is when inflation starts to recede and the Fed becomes less hawkish in its monetary policy direction. While inflation has remained persistent, upward price pressures should start to recede on the back of easing supply bottlenecks and lower commodity prices.

Meanwhile in China, the policy focus of the government has shifted from that of regulatory tightening to now supporting growth as its economy wanes. In the past year, Beijing had cast a wide regulatory dragnet that impacted a range of sectors including technology, education and e-commerce. A slump in the property sector which is a key component of China's GDP also dragged down economic growth.

However, Beijing is now looking to turn on the fiscal taps to prop-up growth with stimulus expected to be frontloaded in the 1H'2022. Top officials in Beijing have consistently emphasised the need for economic stability at several policy meetings last year. With a major congress taking place in 2022, there is also incentive for the Chinese Communist Party (CCP) to prevent any further slippage in growth to shore up its political legitimacy after celebrating its 100th anniversary.

Chart 2: BofA Bull & Bear Indicator

Source: BofA Merrill Lynch, as of 20 January 2022.

Positioning

The past 2 years saw robust inflows into various asset classes including bonds and equities as investors ploughed into risk assets to ride the recovery in markets. This extended bull-run was tested several times by inflationary fears as well as supply bottlenecks, but still continued to defy expectations. The S&P 500 pierced new highs last year as investors shrug off these concerns to notch higher gains.

However sentiment indicators aren't flashing irrational exuberance yet which typically portends to an imminent market pullback. In fact gauges such as Bank of America's (BofA) Bull & Bear Indicator has fallen over the year and is sitting at neutral territory from bullish levels before.

With more favourable technicals and markets not reaching its bullish peak yet, we could see more upside for risk assets. Though, that doesn't mean the ascent will necessarily be a smooth one with headwinds arising from higher interest rates and tighter liquidity conditions.

Politics

It will be 'election years' in both US and China this year. The US will hold its midterm elections sometime in November, while China will convene its 20th National Congress in October. With a razor-thin majority, the Democrats are widely expected to cede control of the Senate as the Republicans gain ground. Meanwhile political observers widely expect Xi Jinping to claim an unprecedented third term as president at China's 20th National Congress. In 2018, China had scrapped the two-term limit on the presidency, effectively allowing Xi to remain in power for life. Irrespective of how both events pan out, the US is expected to continue to take an assertive stance in its relations with China.

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