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What is the larger investment risk for 2022- A more hawkish Federal Reserve or Omicron / Delta and other COVID – 19 variants materially reducing the efficacy of the current vaccines?

December 2021

Over the last several weeks equity markets have become much more volatile with fears surfacing over the possible negative effect of Omicron on global economic growth and on this new variant further exacerbating supply chain issues and inflationary expectations.

During this heightened risk period, the Chairman of the Federal Reserve Bank has finally decided to become more hawkish with inflationary pressures expected to last for a longer period of time. This involves an increase in tapering the ongoing monthly purchase of long dated US Treasuries. Mohamed Eli-Erian has felt for quite a while that the Federal Reserve has been much too slow in addressing the inflationary pressures and has been advocating an end to the massive Quantitative Easing Program initiated by the Federal Reserve. Chairman Powell has finally decided to begin the process of increasing interest rates once again after many years of doing the reverse.

The immediate effect of all this central bank's activities, is a flattening of the US 10-2-year US Treasury yield curve. While it still remains positive, the spread has shrunk quite a lot from what it was even a few months ago. Historically when the yield curve has turned negative, this has been a clear sign of an impending recession within 6-15 months on average of the yield curve inversion. This does not immediately imply that the current flattening of the yield curve will lead to a recession anytime soon. First of all, the yield curve is still positively sloped. Secondly it is quite normal when the central bank initially becomes more hawkish, that short rates rise faster than longer term maturities. This fact combined with the increased tapering of bond purchases makes the curve naturally flatter. At this time banks are still making money by borrowing short term and lending out into longer term loans, thereby making a profit on their net interest margins. Unless the banks stop lending as a result of a negative yield curve, the current flattening of the curve is not detrimental to economic growth. But inflationary pressures must be closely monitored to ensure that the current above trend numbers do not result in the rapid increase in inflation we had in the late 1970's and early 1980's before the recession of 1982.

In regards to the Omicron variant, there has been quite a bit of confusion and panic regarding exactly what is going on. Personally, I like listening to the CEO of Pfizer who seems to have a good handle on the situation. In a worst-case scenario assuming that the current vaccines materially reduce their efficacy regarding this new variant, both Pfizer and Moderna have indicated that a new revised vaccine could be developed and available for distribution within a three-month period. Secondly it is anticipated that the efficacy of the current vaccines available will probably be reduced materially, but still provide some immunity against this new variant from the two dosages. Pfizer's CEO recently stated that he thinks three dosages of the current vaccine will provide very positive immunity to the Omicron variant, even though the company is still considering a new vaccine if need be. Dr. Fauci stated this week that the severity of patients being infected with this new variant have tended to be milder than other variants but the virus is more easily transmissible. In addition, the current inventory of anti-virals and antibody treatments should provide some defense against an increase in hospitalizations and deaths from this new variant.

In a few weeks more information will be available on the efficacy of the current vaccines against the new variant. But even under a worst-case scenario, new revised vaccines available in about three months will limit any long-term repercussions.

Conclusion

While the jury is still out on the severity of the new Omicron variant, a worst- case scenario of a three month wait for a new vaccine is not as terrible as people originally thought. In addition, the distinct possibility that three dosages of Pfizer's existing vaccine may provide sufficient immunity to the Omicron variant is reason to be optimistic.

The change in direction of the Federal Reserve becoming more hawkish is something far more important for the long-term direction of equity markets. Rising rates not only hurt economic growth, but they also offer more competition to stocks going forward. In addition, PE multiples tend to rise when rates fall but tend to fall when rates rise once again.