Policy Note

"The stock market is a lot of things, but last I checked, it doesn't have a medical degree. And yet, for the second consecutive session [Friday & Monday], the market traded as if it knew the future of the pandemic."

- Alex Eule, Barron's Review (Nov 29)

Introduction:

The SARS CoV-2 variant B.1.1.529 (the "Omicron" variant) was first reported to the WHO by government officials in South Africa on November 24th, although the first confirmed infection occurred on November 9. In naming the "Omicron" strain, the WHO chose the 15th letter of the Greek alphabet, skipping over two letters ("Nu" because of potential confusion with "new", and "Xi" because it is a common name in China, i.e., Xi Jinping).

More importantly, the strain is believed to be the most "divergent" variant detected in large numbers to date ("many more" than Delta). Information on the mutation is nonetheless limited and will likely take weeks to assess (with estimates varying between 2-8 weeks for more definitive information).

The range of public health, economic, and market outcomes at this time is wide. Until more is known, companies should therefore contingency plan for multiple potential scenarios. Concern - yes. Panic - no. Throughout the crisis, companies have made impressive adjustments to business strategy to drive record earnings and margins in the face of delta, inflation and supply chain dislocations.

What to Watch in Public Health?

In South Africa, Omicron has accounted for around 70% of total COVID cases over the past four weeks (over 90% in Johannesburg). This suggests that **the mutation could soon usurp Delta as the most dominant COVID virus strain globally within days or weeks.** As of this morning, over 20 countries have *reported* cases of Omicron, though the actual number is likely substantially higher.

The large vaccine producers have indicated optimism about quickly adapting existing vaccines, if necessary, to address the Omicron variant. According to big pharma executives, a new vaccine could be approved and available in large quantities by early 2022 (possibly as soon as 3 months), if needed. In research notes published yesterday, some healthcare analysts preliminarily concluded that a modified booster vaccine is "more likely needed than not."

The genetic sequence of the new strain has revealed approximately 50 mutations, 30 of which impact its primary spike protein including several associated with reduced vaccine efficacy. **However, there is no definitive evidence yet on whether Omicron is more transmissible, causes more sickness, is more deadly, less responsive to treatment or more evasive to immune responses**. Reports of milder symptoms associated with Omicron are largely anecdotal, and may be based on limited sample sets of healthier and younger populations.

Going into the long Thanksgiving holiday weekend, the 7 day average for new US COVID cases was approaching 100,000 per day, up 25% in just two weeks. To date, 8 billion vaccines have been administered globally across 184 countries, including over 450 million in the US.

59% of the entire US population is now fully vaccinated, below the 85% threshold recommended by epidemiologists and public officials given highly transmissible variants. **71% of Americans over age 18, and 86% over age 65, are now fully vaccinated.** 20% of the total US population has had a booster dose (which includes 42% of those > age 65).

With only 36% of adults in South Africa vaccinated, the Omicron mutation (and its potentially evasive properties to immune responses) does shed light on the importance of globally coordinated and equitable "virus prevention" strategies (i.e., higher vaccination rates globally).

What to Watch in the Economy?

More time and information will be needed to assess the economic implications of the Omicron variant. A look-back to Delta's impact in Q3, however, suggests decelerating growth and rising inflation.

Mild to Moderate Omicron scenarios: Unlike March 2020, individuals have become more adept at "co-existing" with the virus, while businesses have become more effective in making strategic adjustments, thereby creating a "higher floor" on economic contraction in downside scenarios. If Omicron symptoms and risks prove mild, the near-term negative effects on the economy can be quickly reversed. **In moderate impact scenarios, economic damage would most likely be confined to Q1 2022 with moderate catch-up likely to follow in Spring and Summer.** Supply side disruptions will likely outweigh demand dynamics medium term.

More severe Omicron scenarios: In more severe downside scenarios, demand shocks will likely outweigh supply disruptions in terms of their impact. Should such tail risks arise, Oxford Economics forecasts that **US and global GDP growth in 2022 could slow to below 2% and 2.3%, respectively, well below the existing baseline forecast for both at around 4.5%.** Primary channels of contagion in this scenario would be driven by global travel restrictions, supply chain delays, service sector spending declines, labor market shortages and the knock-on effect to consumer and business confidence.

Potential downward pressures on inflation: Lower oil prices on reduced demand for travel; consumer pullback on services spending (restaurants, travel, leisure and entertainment).

Potential upward pressures on inflation: Consumer purchases shifting back toward durable goods over services; supply chain delays and disruption (especially as China and East Asia embrace a "zero-COVID tolerance" policy).

What to Watch in Markets?

Omicron's potential market impact will primarily be a function of its impact on the global economy and Fed policy tightening, as well as other variables noted below.

US Rates: The UST curve has steepened and dropped lower as markets moved rapidly to reprice growth and Fed tightening. As of this morning, 10 year yields have dropped to 1.43%, the probability of a June Fed hike has declined to 42%, and the total number of rate hikes expected in 2022 has dropped from 3 to just under 2. Decelerating growth expectations and lower energy prices should continue to exert downward pressure on yields until Omicron's impact is better understood.

Expectations for the next Fed (Dec 15), ECB (Dec 16) and BOE (Dec 16) meetings should be revised accordingly. In particular, adjustments to the Fed taper schedule in December have become more complicated as growth dampens and inflation rises.

USD credit spreads: Historically, high yield spreads are more sensitive to volatility and uncertainty than IG. On Friday, the IG index widened 5 bps while HY widened 30bps. While markets improved on Monday, spreads have already reset closer to the wides of the year, after over 6 months of trading near multi-decade tights. Overall, look for extraordinary global liquidity and technical demand to keep USD credit more resilient than most other risk assets (i.e., equities, EM, commodities) in more adverse Omicron scenarios.

Equities: Reopening sectors (travel, leisure, financials, energy) will be more sensitive to slower growth scenarios. Equity markets in jurisdictions with "zero COVID policy tolerance" (China, East Asia) are also more vulnerable, as are domestic equity markets in regions higher beta to global trade (i.e., Europe) and commodity prices (South Africa, Brazil). **December also poses increased risk as investors seek to lock in strong YTD gains and liquidity declines**.

DMFX: COVID fears have returned as the prevailing driver of currency markets with G10 FX volatility at the highest levels in a year. Developed market "safe-haven" currencies (USD, Yen, Swiss) are likely to strengthen until volatility and uncertainty dissipate. The Euro has continued its decline as EU virus related restrictions increase. Currencies where rate hikes were more fully priced in are also at risk of larger declines (NZD, CAD, AUD, GBP).

EMFX: Emerging market countries in Africa and South East Asia with larger tourism sectors, lower vaccination rates and/or tighter virus policy restrictions are more vulnerable. In downside shock scenarios, EMs with large external financing needs (i.e., Turkey) will come under incrementally more stress. Overall, a strong dollar, lower oil prices and significant virus restrictions are a difficult combination for EM.

Commodities and Related Currencies: Demand reasserting itself over supply as the primary driver of markets until the severity and impact of the Omicron variant is better understood. More growth sensitive, commodity-driven currencies more exposed (NOK, RUB, CAD, AUS, NZD).

What to Watch in Public Policy?

One of the lessons of Delta is that it is very difficult to stop the spread of virus variants across borders. On Monday, the **US State Department implemented a travel ban** for seven countries in Southern Africa (including South Africa), as have dozens of other countries globally. **Other countries have moved further to close their borders** to foreign visitors altogether (i.e., Israel, Japan). Additional countries are likely to follow suit in the days ahead. **This, in turn, may exacerbate economic shocks while having limited impact on virus contagion**.

Yesterday, the **CDC expanded its recommendation for booster shots** to include *all* adults over age 18 (over age 50 previously). This past weekend, the **New York Governor declared a "state of emergency"** through Jan 15 in order to delay elective surgeries and expand hospital bed capacity, if needed.

In more severe downside scenarios, **central banks and governments would likely provide monetary and fiscal stimulus** to address demand shocks and market functionality as needed. Given elevated crisis era debt levels, more targeted measures are likely than used previously.

Last Friday, **the WTO's biennial trade minister meeting scheduled in Geneva, Switzerland was officially cancelled** given the host country's more restrictive border entry measures. In addition, **EU leaders are considering an "emergency summit"** for this coming Friday to coordinate their policy response.

In China, a recent study published last week by the **Chinese Center for Disease Control and Prevention** estimated the disproportionately higher costs if China had adopted lighter "Western" pandemic control measures versus its own "zero COVID tolerance" policy at approximately 200 mm additional cases and 3mm deaths (given lower vaccination rates and less effective treatments). As such, in downside scenarios, a continuation of China's currently more restrictive policy measures appears more likely (with the knock-on effects to global growth and supply chains).

OPEC will meet as planned on Wednesday-Thursday this week and may decide to delay planned production increases given higher virus uncertainty. Two of the more technical OPEC group meetings scheduled for this week, however, have been delayed to give their committees more time to evaluate the new COVID strain.

Longer term, it is certainly possible that the peak indoor cold and flu season in the Northern Hemisphere from November to January could become a seasonally higher risk period for markets for several years to come.

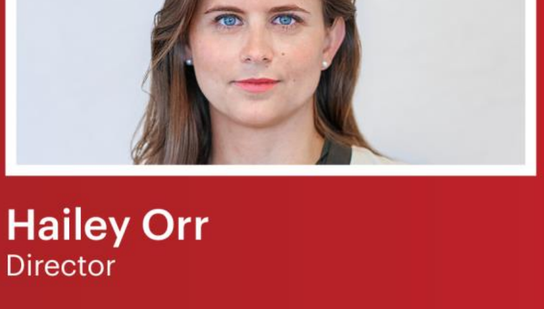
Sources: MUFG Research, MUFG Syndicate & Capital Markets, WHO, CDC, Oxford Economics, Capital Economics, Wall Street Research, WSJ, FT, Bloomberg.

Where Has Omicron Been Detected?

Source: (1-2) Bloomberg. Data as of November 30, 2021. Daily new covid cases is 7-day moving average. News reports.

Global Corporate & Investment Banking Capital Markets Strategy Team

Tom Joyce
Managing Director
Tom.Joyce@mufgsecurities.com
(212) 405-7472



Hailey Orr
Director
Hailey.Orr@mufgsecurities.com
(212) 405-7429

Stephanie Kendal
Associate
Stephanie.Kendal@mufgsecurities.com
(212) 405-7443