

## The Covid-19 end game?

*Here is a thought: What if Omicron brings about a quick end to the pandemic? What would that mean for the financial markets?*

So far, the Omicron variant has been at the same time far more transmissible and less dangerous than the earlier variants. The jury is still out regarding the immunity that the Omicron leaves behind, but if an infection leads to some immunity, we could be heading for “herd immunity” and an end to the pandemic far sooner than expected.

That would be good news for the economy and for the markets – or would it?

### Inflation worries

Currently, there is no shortage of worry about inflation. On the demand side, the massive support packages have kept the economies afloat. Many families have saved quite substantial sums during the lockdowns and are spending on larger items.

On the supply side, labour is in short supply in several countries as many have used a period of unemployment to rethink their direction. On the manufacturing side we have seen supply chain disruptions and shortage of central products such as chips built into cars. Add that energy prices have increased markedly.

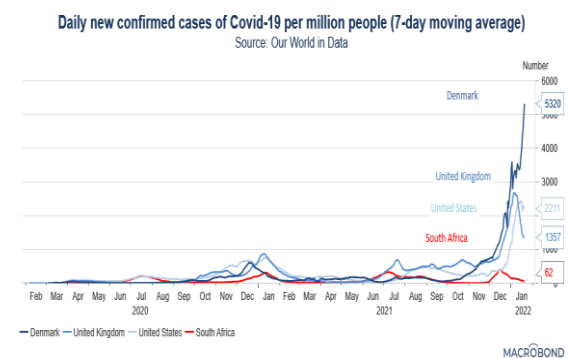
It has meant that inflation is creeping up in several countries, including the USA, where the most recent data for “core CPI” showed an inflation rate of 7%. Market participants have made a brave attempt at convincing themselves that the current uptick in inflation will quickly recede and then all will be back to normal.

Such speculations prompted US Fed chief Jay Powell to suggest cancelling the word “transitory” when discussing inflation. It is too easy to confound “transitory” with “short-term”. Powell clearly believes that inflation will be here for a while but that there are no significant signs of a longer-term inflation

trend. For good order Powell used the opportunity to indicate that a return of US monetary policy to normal would be faster than hitherto assumed.

What if the Omicron variant accelerates the “return to normal”?

On the demand side, the effect is likely to be a resurgence of consumer optimism, leading to a further demand boost. That would in turn lead to faster reversal monetary policies of check the inflationary effects of increasing demand while supply lines remain clogged.



That would almost certainly extend the “transitory” bout of inflation and lead to higher interest rates faster than markets are currently expecting

## Inflation expectations count

And here lies the rub: an important factor in determining inflation are expectations of higher inflation. Explaining the transmission mechanism is the object of a different blog post, but the conclusion is that the longer the bout of inflation, the more ingrained become the inflation expectations.

We have in an earlier post explained how expectations of higher inflation adds a whole new layer to the calculus used to evaluate the present value of cash flows. The effects of inflationary expectations will affect any asset price depending on the valuation of an underlying cash flow.

Coming back to the opening question, if Omicron brings about a quick end to the pandemic, it is likely to extend the current period of inflation, it would lead to accelerated central bank action to increase interest rates and reducing the central bank balance sheets, and the longer the current inflationary bout is, the more resilient the inflationary expectations.

Investors need to begin to consider what higher inflation would do to their portfolios. We are not yet at a point where inflation will stabilise at, say, 4-5%. But it would certainly be a good idea to review the portfolio in the light of 10-year bond yields at 4% or so. Doing so would be the most rational way to handle the increasing risk of inflation. For now, at least.

We will return with a longer-term view of inflation and a more granular piece about winners and losers in a new scenario where inflation shifts to a higher gear.

We will follow up on this in detail separately.

Coverage of the process can be found in blog's [Cry Wolf \(Feb 2021\)](#), [Jackson Hole \(Aug 2021\)](#).

Stay tuned

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