

FINANCIAL MARKETS AND THE ECONOMY IN 2021

Good news, bad news and real news

In 2021, bouncing back from the depths of the pandemic, we got a lot of good news. But not good enough for the stimulative policies to be pulled back. We also got an indisputable reminder of what really drives financial market returns.

At the outset of 2021, financial markets had shaken off the shock from the outbreak of the pandemic in the winter/spring of 2020. Governments in numerous countries had launched comprehensive countermeasures, with swift interest rate cuts, bond purchases, expansionary fiscal policies and direct support to vulnerable companies and consumers. This had helped calm nerves and build confidence, which in turn had lifted financial markets to new all-time highs.

Not until 2021, however, did these countermeasures begin to take full effect. Meanwhile, a lot of demand had been put on hold due to uncertainty and direct restrictions on the supply side, not least travel, restaurant visits and other services with physical customer contact. With the easing of restrictions, households had significant amounts of cash ready to be spent.

We thus entered 2021 with strong potential demand in the world economy.

And we were yet to worry about Russia and Ukraine.

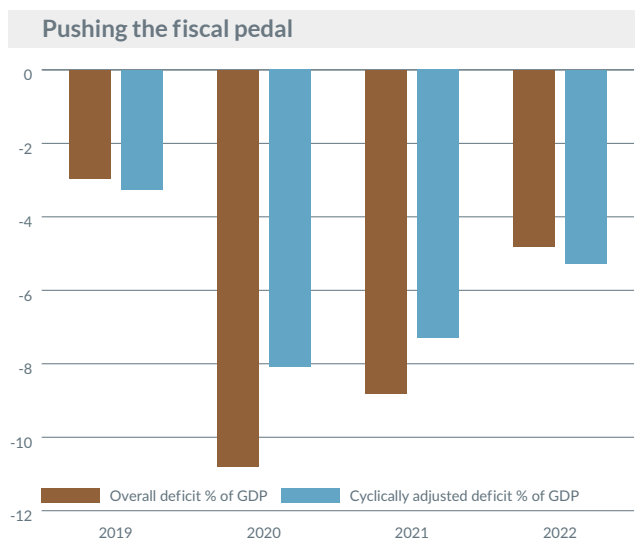
WAITING FOR TIGHTER POLICIES

Bull markets are said to climb a wall of worry. In 2021,

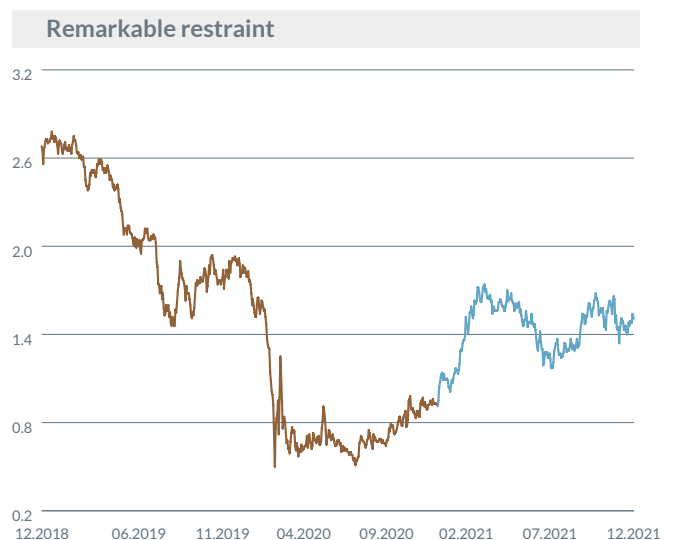
inflation was a recurring concern. From the beginning of the year, it was clear that record-low interest rates and rapidly increasing money supply could breathe life into inflation. In turn, this would have to be met with higher interest rates, an obvious menace to both the stock and bond markets.

Furthermore, the combination of lockdowns in many countries and significant backlogs also led to bottlenecks in a number of supply chains in many industries. This, too, was obviously driving inflation. Headline inflation rose, while underlying inflation remained relatively calm for a long time. Interest rates nevertheless rose in the first few months of the year. Their rise was not enough to arrest the bull market, but clearly enough for fixed-rate bonds to fall and value stocks to outpace growth stocks – after having delivered better returns than value stocks since 2006.

For months on end, investors kept looking for signs of imminent tightening. All releases from the US Federal Reserve were scrutinised, as were communiques from the European Central Bank and the Bank of England. A change in phrasing might induce temporary market declines, but nothing much was actually done. And stock markets kept rising.



Advanced economies, actual and estimated. Source: IMF



Yield, per cent, 10-year US government bonds. Source: FactSet

Towards the end of the year, many central banks nevertheless initiated a cautious process of tightening. In Norway, we got two interest rate increases, each of a quarter of a percentage point, before the year was through. In the US, the Federal Reserve had clearly communicated that they were ready to begin tapering, which they did in November. All in all, however, modest tightening measures were implemented in 2021.

COVID-19 AS A MONETARY PARAMETER

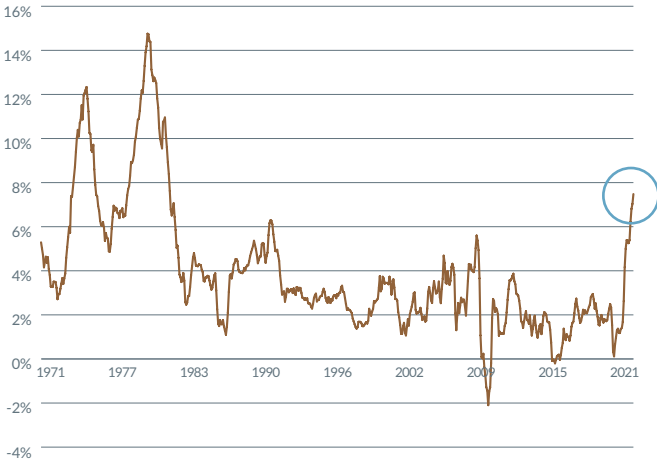
What kept the tightening at bay? Most likely the pandemic. The fight against the pandemic was to have several setbacks, in the form of new virus mutations and new restrictions. Towards the end of the year came the omicron variant, which proved to be much more contagious than previous mutations. Thus, the year ended with new restrictions and partial lockdowns in several countries.

However, these setbacks were not only negative for the financial markets. They may have contributed to prolonging the expansionary economic policies, as they made the recovery somewhat more subdued in the short term and the need for tightening less acute.

After all, it might have looked like a grave mistake if central banks stepped on the brake just as the global economy was thrown into another bout of pandemic distress. And central banks certainly behaved as if this was a central consideration. Bad news on the pandemic thus became good news for investors, at least in the short run. In 2021, this peculiar tug of war balanced in a quite pleasant way.

On the other hand, there was an obvious risk of being “behind the curve” – tightening too little, too late. As 2021 drew to a close, current inflation rates reached levels not seen for decades in several countries – with the important US headline inflation ending the year at 7.0 per cent.

The ghost of price pressures past?

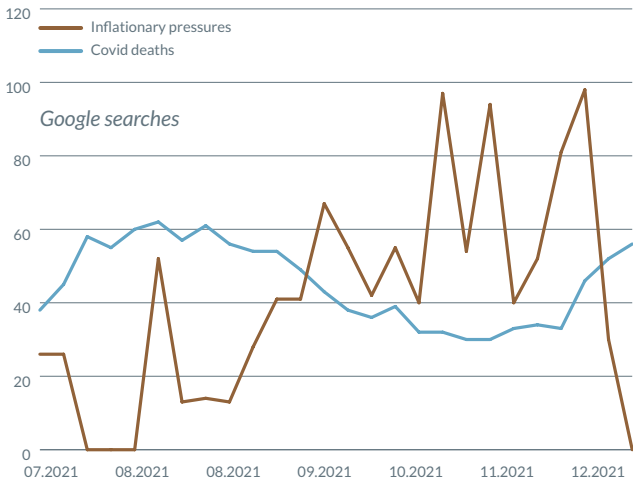


12-month change in the US All Urban Consumers CPI. Source: bls.gov

The yield on US 10-year government bonds, while recording a very modest increase in December (when the Omicron mutation proliferated), rose by 60 basis points during the year, ending just above 1.5%. This hurt global high-yield bonds, vulnerable to such increases because of fixed coupons and long duration. Barclays Global Aggregate, an index of global investment grade bonds, fell by more than 4.7 per cent. Given the sheer size of this market, almost \$5 trillion in the United States alone, 2021 was a dismal year for many investors.

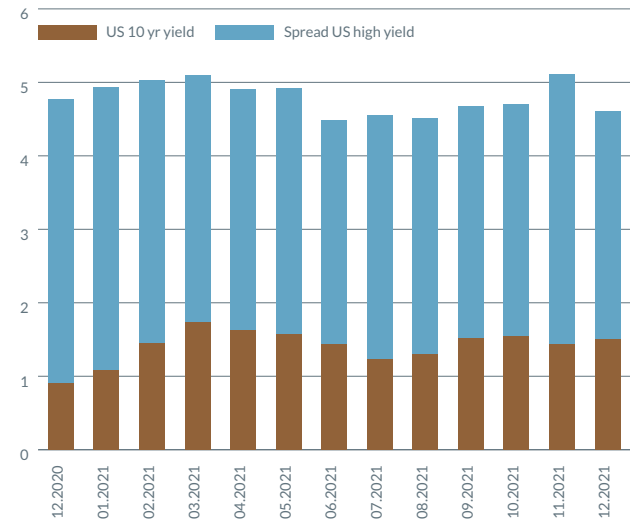
The stock market, however, was exuberant. And, arguably, quite rationally so.

Inflation and Covid taking turns



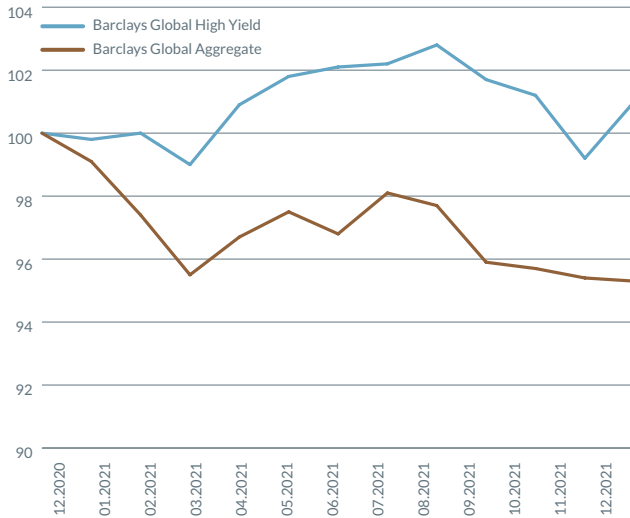
Relative frequency, search terms in Google Trends.

Spreads and rates balancing



Per cent. Source: FRED, FactSet

IG bonds falling, HY barely in black



Rebased. Source: FactSet

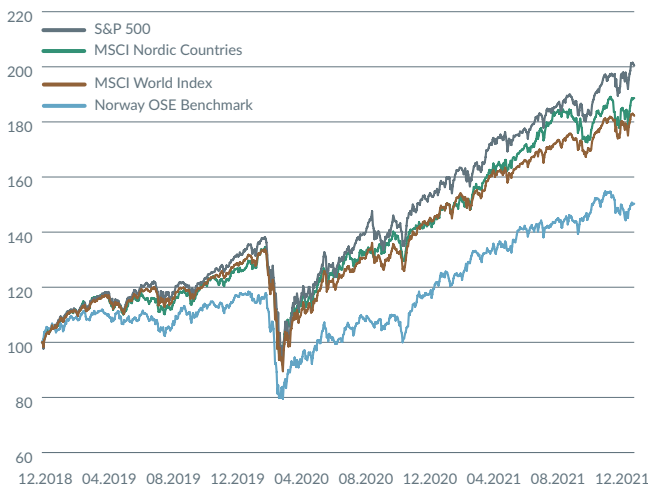
EARNINGS ON A ROLL

Just look at these figures: The MSCI Nordic countries index rose by 30 per cent in local currency. The S&P 500 was not far behind, at 28.7 per cent. And the Norwegian benchmark index, while reaching a somewhat more modest 23.4 per cent, was certainly on the satisfactory side.

From day to day, markets may record considerable movements on news of new COVID-19 mutations, lockdowns, bottlenecks, inflation rates, or interest rates. For such large returns through the year, on top of what were new all-time highs in many markets at the end of the year before, there must be a more fundamental driver.

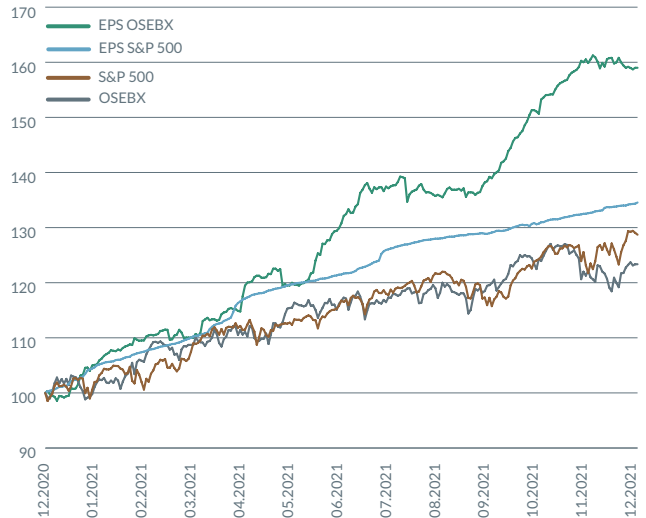
In 2021, as so many times before, this major driver was corporate earnings. Many companies used the low interest rates and their recognition of the crisis to deleverage. They therefore met the recovery in good shape and earnings picked up significantly in 2021. This not only became a significant driver behind the bull market; it contributed to earnings multiples being lower at the end of 2021 than one year before.

Straight pandemic rebound



Rebased, December 2018 = 100. Source: FactSet

Stock prices playing EPS catch-up



Total return stock indices in local currency and estimated next 12 months' earnings per share, rebased December 31, 2020 = 100. Source: FactSet

To put it differently: Earnings estimates outpaced stock prices in a number of markets.

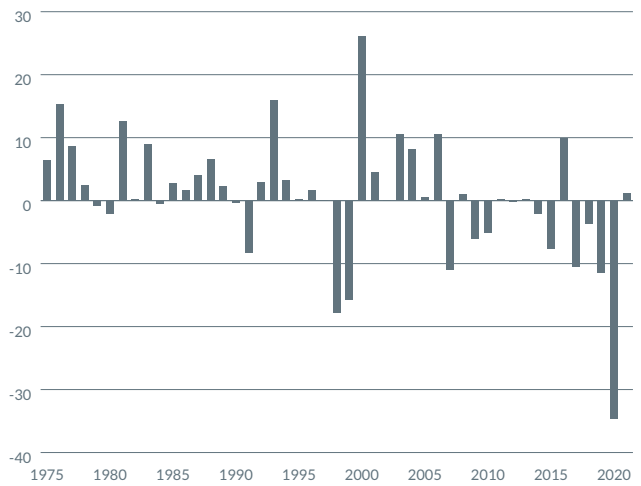
I know, analysts are notoriously optimistic. But this year, they missed the mark from below. Earnings surprises were unusually positive and analysts had to keep adjusting their estimates upwards rather than cutting them.

Actual (coincident) earnings rose even more sharply. For the full year 2021, S&P 500 profits rose by an impressive 68 per cent, according to SP Indices. Most of this figure (95 per cent) is now actuals, not estimates.

Yes, that's operating earnings. If you wonder what it looks like with reported earnings, I can assure you it is not weaker. On the contrary: Reported S&P 500 earnings apparently more than doubled in 2021.

For the Norwegian benchmark index, estimated future earnings per share rose by 59 per cent during the year. Trailing earnings rose by almost twice as much.

Value neutral



Difference in annual total return, MSCI Value less MSCI Growth, percentage points. Source: MSCI

THE COMMODITY BOOM

For Norway, the earnings increase was partly due to a commodity boom that started to accelerate after the pandemic shock in 2020, sending Brent Blend crude oil up from \$23 per barrel at the end of March 2020 to \$78 per barrel at the end of 2021. This sizable increase can probably be ascribed to a combination of fear subsiding and growth picking up.

For other commodities, bottlenecks due to partial lockdowns and supply lags were more important in driving what was to be a commodity boom unparalleled since the temporary spike in the prelude to the global financial crisis. In 2021 alone, the Dow Jones Commodity Index rose a further 29 per cent.

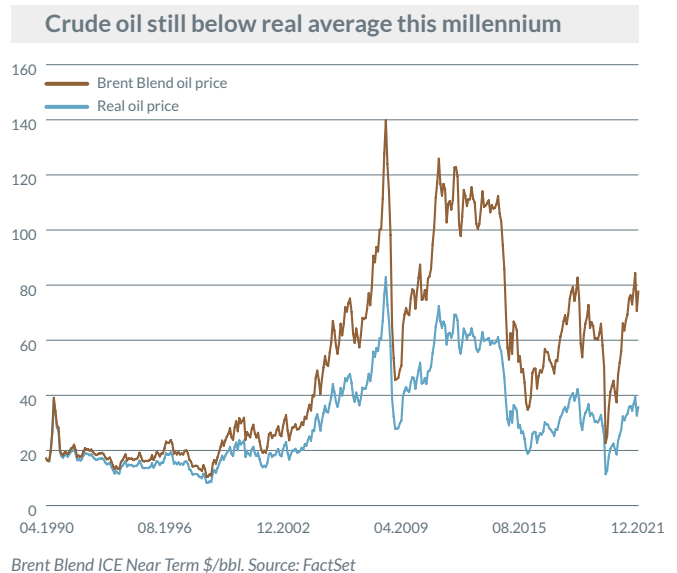
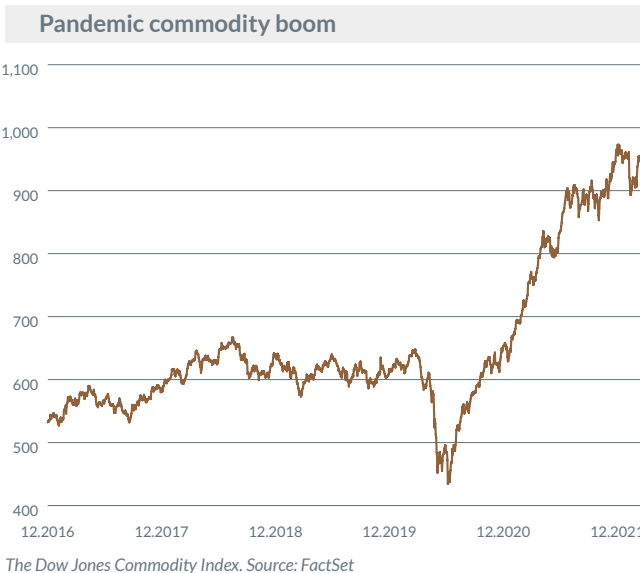
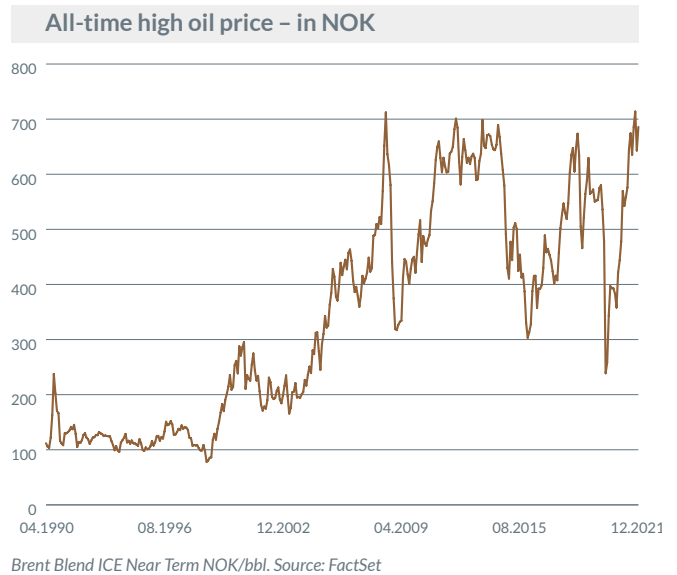
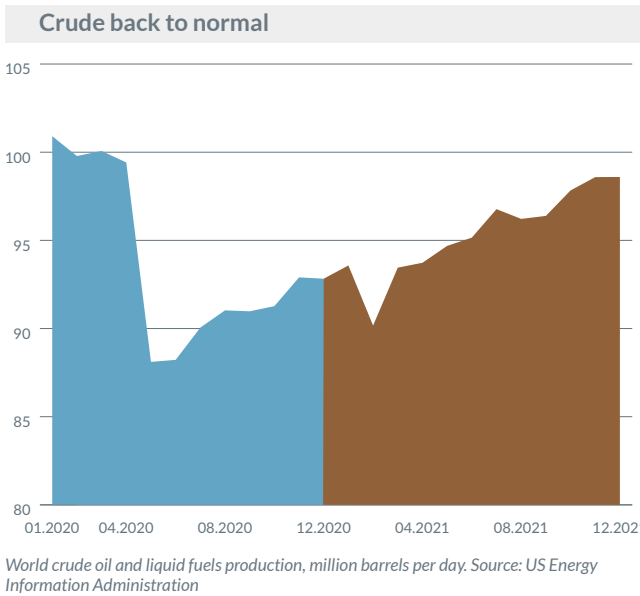
One commodity really stood out: European natural gas. Starting the year at \$17.40 per oil barrel equivalent, it shot above \$155 just before Christmas, before more than halving in the last week of the year. The American market saw no such price movements, a testament to the cost of transporting natural gas across the Atlantic.

Other factors were at play as well. Storage levels were low going into 2021 and it may well be that Russia had limited their spot supplies as a means of softening resistance to the Nord Stream 2 pipeline that would bypass both Ukraine and Poland.

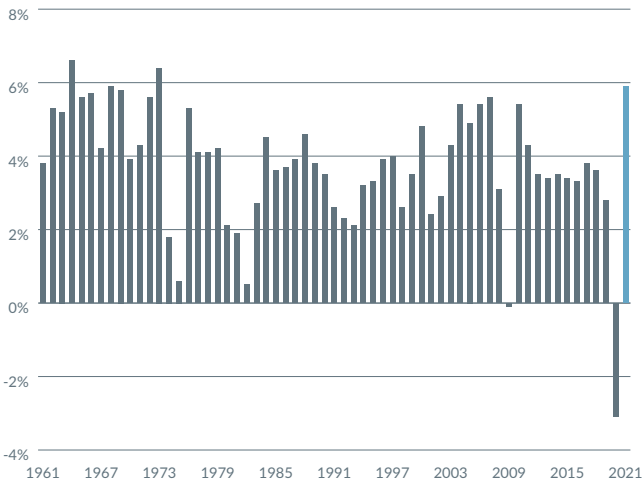
Knowing what was to happen in 2022, one may probably be excused for having harboured such suspicions.

BEST GROWTH SINCE 1973

Driving both profits and commodities, of course, was the strong growth in the global economy. Since the expansionary policies had now worked for a while and consumers had, after all, found more to spend money on, growth picked up significantly. Consequently, the world economy went from a sharp decline in 2020 to an exceptional upswing, probably the highest global growth rate since 1973. The latest IMF estimate puts global GDP growth at 5.9 per cent in 2021. The rebound was even stronger in the advanced economies, which are now estimated to have grown by some 5.0 per cent. Historically, growth has been stronger in the developing economies.



Highest growth in almost half a century



World GDP growth in constant international dollars (chained).
Source: IMF, World Bank

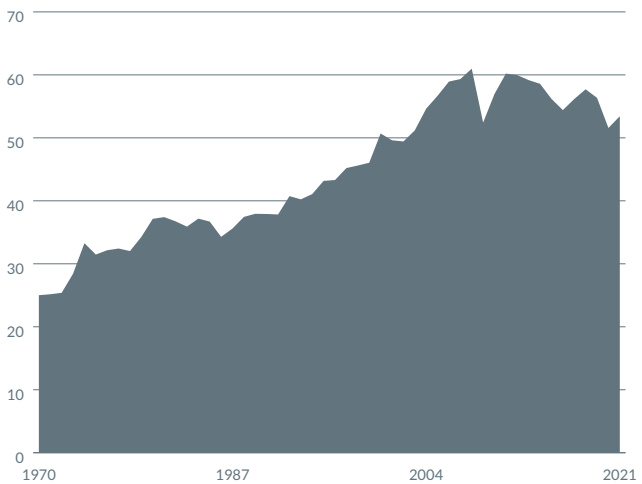
Furthermore, the upswing was well synchronised – or correlated, if you will, reinforcing the original impetus. Trade picked up, despite bottlenecks. As a percentage of global GDP, trade increased for the first time since 2018, although unassumingly so.

Part of the rebound was probably discounted in 2020 – remember, you should not equate growth with contemporaneous stock price appreciation – but there was obviously more to be had in the stock market.

WHAT ABOUT THE OUTPUT GAP?

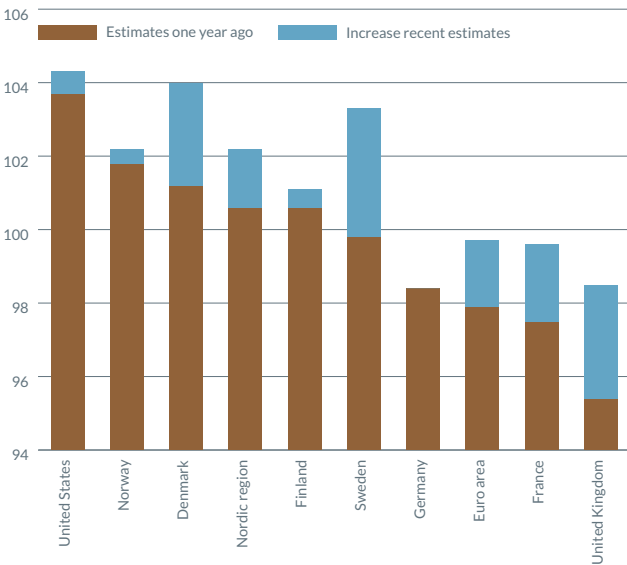
Was, or is, there more to be had in the real economy? Economists often attempt to calculate potential GDP, a theoretical concept showing the maximum sustainable GDP level given present resources (factors of production). I will not attempt such calculations now, but I have a fair guess that many economies are a bit below their potential GDP.

World trade still struggling



World trade to GDP ratio in per cent. Source: World Bank, IMF, own estimates (2021)

Somewhat overblown fears



Estimated 2021 GDP in per cent of 2018 GDP.
Source: IMF, SSB, SCB, Pareto Asset Management

Last year, both the eurozone and the United Kingdom were still below their 2018 GDP levels, despite upward revisions of growth in the interim years.

In the United States, GDP probably exceeded its 2018 level by a wide margin. And many people have not returned to the job market after the pandemic, resulting in an unemployment rate that has once again crept below 4 per cent despite a low labour force participation rate.

Judging from appropriations passed in Congress and the ways in which they are to be implemented, there are still vast amounts of public dollars waiting to be spent. The crucial question, then, is whether this increased demand will be met by sufficiently high supply, or by inflation.

Logically, global supply-side delays should sooner or later give way to actual supply. And the IMF did forecast global growth of 4.4 per cent in 2022 in their latest (January 2022) update. Such high growth presupposes at least some flexibility on the supply side, as did pretty much all fiscal and monetary policies in the advanced economies through most of 2021. Higher inflation was believed to be a primarily temporary phenomenon.

An increasing number of countries reported conspicuously high current inflation rates, however. And while modest tightening measures were actually implemented in 2021, more was in the pipeline. There was an easily observable spectre: If temporarily higher inflation were to persist long enough for inflationary pressures to spiral, we would be entering a different financial paradigm.

Such was the overriding question concerning financial markets at the end of 2021. As yet there seemed to be no definitive answer, no consensus.

AND THEN ...

The primary purpose of this annual review, of course, is analysing the financial developments of the past year in such a way that we may extract some useful, more general lessons. This is no venue for forecasts or estimates. Consequently, I devote little space to events occurring after New Year's Eve.

However ...

On February 24, 2022, Russia invaded Ukraine. With that, the country crossed a border – literally – that no one thought any European country would cross in modern times. Russia's invasion, a flagrant breach of international law, has created a humanitarian crisis for the civilian population in Ukraine and triggered unusually massive sanctions against Russia from a large number of countries.

Geopolitical unrest always rattles financial markets in the short term. In due time, however, the markets have always been able to shake it off. The question is whether the current situation is so dramatically different that it becomes pointlessly perfunctory to brush it off with a reference to historical figures. The picture is certainly so hazy that a detailed review may soon be outdated.

A SMALL COUNTRY WITH VITAL COMMODITIES

Some more general reflections are nonetheless warranted. We can start by noting that Russia accounts for about 3 per cent of the world economy, measured in purchasing power-adjusted GDP. This figure is inflated by the relatively low Russian price level. Measured by GDP in current market prices, which better reflects the volume of international trade, the share falls to 1.7 per cent.

Plummeting trade will hurt both exporters and importers. Sanctions will be met with reverse sanctions, and it will not be easier to sell Norwegian salmon there than it has been for the past eight years. For the global economy, however, cutting off parts of Russia's exports may be more important – whether by Western sanctions or Russian attempts to ration critical goods. In addition, there may be indirect effects whereby obstacles in Russian-related supply chains affect price growth in the West and contribute to stronger inflationary pressures.

While potentially critical for the global supply of wheat, due to both Russia and Ukraine being large producers, the war may have a larger impact on the energy market. It has already led to very high oil and gas prices. With the mothballing of the new gas pipeline from Russia, Nord Stream 2, we will have an even tighter energy balance, and with further uncertainty about supply in existing agreements, oil and gas prices may be propped up for years to come.

Whereas, in isolation, this is to Norway's advantage, it is negative for the world economy. However, the contractionary effect is weaker than during previous oil crises, simply because oil accounts for a much smaller share of global GDP.

In conclusion, the political and economic consequences of the invasion and sanctions adopted are obviously uncertain. It still seems fair to say that it will probably hamper growth and fuel inflation, although the perhaps surprisingly subdued market reactions in the West (the Moscow stock exchange plummeted and then closed) might indicate a softer impact.

But let's not get tangled up in financial perspectives. For once, that's really not the most important aspect. Our sympathy goes out to all concerned.

2021 in a nutshell	
OSEBX	23.4%
S&P 500 return	28.7%
MSCI World net (USD)	21.8%
3-month NIBOR	from 0.49% to 0.95%
10-year Norwegian Treasury	from 0.96% to 1.70%
10-year Swedish Treasury	from 0.03% to 0.23%
10-year US Treasury	from 0.92% to 1.51%
Brent Blend	from USD 51.80 to USD 77.78
USD/NOK	from 8.53 to 8.82
EUR/NOK	from 10.47 to 9.99
USD/SEK	from 8.19 to 9.04
GDP growth, global	5.9%
GDP growth, Norway	3.9%
GDP growth, Sweden	5.2%
GDP growth, Mainland Norway	4.2%

Sources: Oslo Børs, S&P Dow Jones Indices, MSCI, Norges Bank, FactSet, IMF, SSB, SCB, Riksbanken, Pareto.