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Q&A: Managing through a new COVID-19 variant

Key takeaways

- Cases of the Omicron variant of COVID-19 are showing up in Europe, Africa, Asia, and Canada. New lockdowns in Europe triggered selling in equity and commodity markets last Friday.
- The emergence of a new variant is another source of uncertainty but has always been a possible risk in our overall outlook.

What it may mean for investors

- We continue to expect that the economy will grow in 2022, but earlier this month we recommended a greater focus on quality and a balance in equity portfolios between growth and cyclical exposure, in large part because of the risk of additional coronavirus outbreaks in 2022. We now reiterate that guidance.

Cases of the Omicron variant of COVID-19 are showing up in Europe, Africa, Asia, and Canada. New lockdowns in Europe triggered selling in equity and commodity markets last Friday, while investors moved into fixed income. COVID-19 cases in the U.S. Northeast and Midwest were already increasing with the cold weather, and some U.S. Omicron cases almost inevitably will emerge in the coming days or weeks.

There is much that scientists do not know yet about this new variant and will be learning in the coming weeks. One fact remains important to remember, in our view – namely, that the world has better tools to combat a new COVID-19 variant than it did in March 2020. We continue to expect that the economy will grow in 2022 but earlier this month we recommended a greater focus on quality and a balance in equity portfolios between growth and cyclical exposure, in large part because of the risk of additional COVID-19 outbreaks in 2022. We now reiterate that advice.

What should investors be watching for with this new Omicron variant?

The critical questions are (i) how easily the new variant spreads, (ii) to what degree it can evade current vaccines, and (iii) whether it has the potential to be more deadly than previous variants. There is little data on whether the Omicron variant can evade the vaccines completely or partially, and even less on its mortality. In South Africa, Omicron has spread quickly in just two weeks. The more easily transmissible, evasive, and deadly the new variant, the more likely that there may be new lockdowns, probably most widespread in the Northeast and in California. This is the scenario that equity markets reacted to on Friday.

What is the likely economic impact from the new variant?

Global populations seem well accustomed to masks and distancing. Many stores already have plexiglass shields at cash registers. Booster shots are now available to U.S. adults, and the new variant may overcome at least some vaccine hesitancy, which has been a problem in various parts of the world. Most of all, scientists already are adapting new vaccines to the genetic code of the Omicron variant. Those vaccines could be available before the spring of 2022.[1] In addition, anti-viral COVID-19 pills have shown significant success in reducing the severity of illness in high-risk patients and are awaiting Food and Drug Administration approval.[2] These factors may limit restrictions and any slowdown in economic activity.

Inflation pressures have increased during 2021, and it is not clear yet whether the new variant will help or worsen that problem. Last Friday, European Brent crude oil futures prices fell from $80.92/barrel to $71.59/barrel, an 11.6% decline and the lowest level since September 10, 2021. Prices on Monday rebounded to $75.17/barrel, perhaps suggesting more of a wait-and-see approach. Nevertheless, if economic activity slows, inflation could peak sooner than our first-half of 2022 expectation. Much will depend upon how scientists will answer the three key questions regarding this new COVID variant.

We also saw a rebound in equity prices on Monday, following the Friday rout. Asian and European markets were down but by less than 1%, and U.S. S&P 500 futures prices were higher in the pre-open. These signs suggest to us that markets are willing to wait for additional information.

What should investors do now?

We stand by our expectation that global economic growth and inflation will slow but remain above average in 2022. The emergence of a new COVID-19 variant is another source of uncertainty but has always been a possible risk in our overall outlook. If the Omicron variant proves more deadly, more transmissible, and completely evades the currently available vaccines, then slower economic growth may develop, and equity growth sectors may take a stronger leadership role. This worst-case combination is far from inevitable, but even if Omicron has low mortality but spreads easily, it still may pose an additional economic obstacle.

In part for this risk, we adjusted our guidance earlier in November, specifically to increase quality in portfolios and to rebalance between U.S. cyclicals and growth-oriented equities. An environment of slowing but above-average economic growth can benefit both cyclical and growth-oriented equity sectors. We favor a combination of Information Technology and Communication Services sectors for growth, and Financials and Industrials for exposure to the economic cycle's upswing.

Quality is a key component of our guidance. First, because we believe that the U.S. will lead in vaccine development and in economic growth, we prefer the U.S. over international equity markets. Second, our preference for Information Technology reflects its leadership among the S&P 500 Index sectors in quality metrics such as return on equity and (low) leverage. While valuations are above historic averages, we believe investors likely will continue to pay a premium for companies that are posting consistent growth and that show some resilience to cyclical slowdowns.

[1] "The Omicron Variant Panic", *The Wall Street Journal*, November 26, 2021.
[2] "When will Americans be able to get a COVID-19 antiviral pill?", CBS News, November 16, 2021.

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