ALPHA SOURCES

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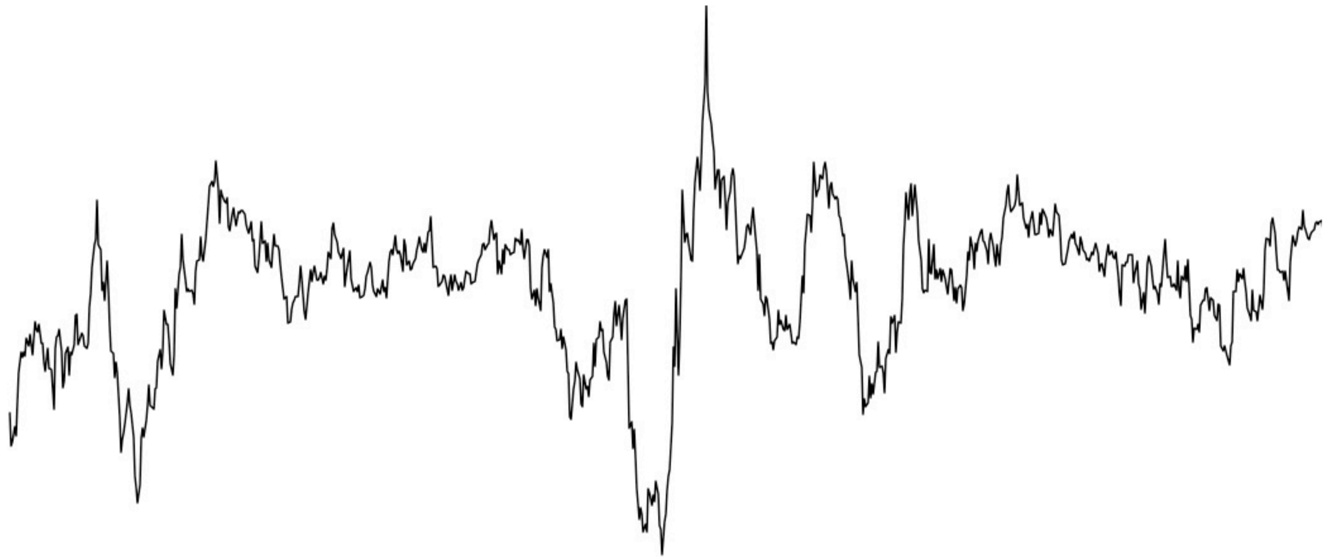

BLOWING IN THE WIND

It's been a week on the wild side in markets, though amid all the confusion and commotion the main story is simple. The uplifting vaccine news from Pfizer has invited markets to consider how a world without the virus looks like. Taking the initial reaction at face-value, this is a world basking in the glory of reflation—and accelerating nominal GDP growth—higher long-term interest rates and a sustained rotation from growth to cyclical and value stocks. Let's start with the obvious point. **There is now a chasm between those basing their world view on an effective vaccine, and the end of Covid-19, and those staring down the barrel of a still-uncontrollable spread of the virus, and associated lockdowns to contain it.** As far as the economy goes, forecasters now have to pass Fitzgerald's test for a first-rate intelligence. The near-term outlook for developed economies is not pretty, and as restrictions encroach on December, the Q4 GDP forecasts are sinking without a trace. We're currently living in a start-stop economy. The question economists have to answer is whether this situation has to be assumed for 2021? It's certainly possible in Q1 and Q2, but Pfizer's news has thankfully made such an outcome less likely. The problem is timing and whether we have to be on lockdown-lite through parts of H1, as we wait for the 'shot'. The best case scenario is that the population at large gets the shot in the first half of the 2021, but that's a Hail Mary. Take it from me, a professional economist whose day job it is to put numbers on the state of economy over the next six-to-12 months, we don't know.

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CLAUSVISTESEN.COM, CLAUSVISTESEN@GMAIL.COM

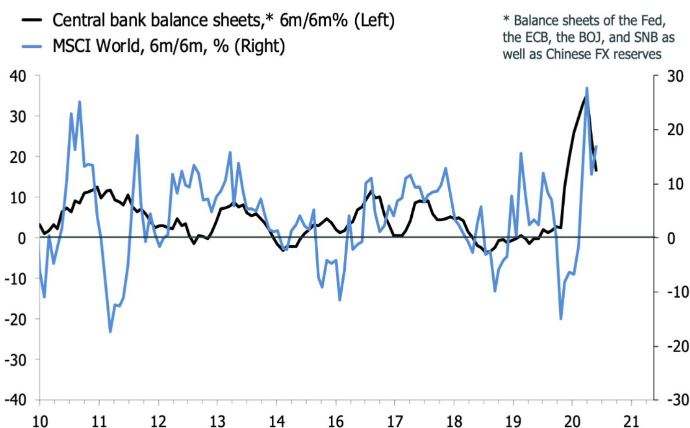
In the Eurozone, we're currently working with ranges for 2021 GDP growth between 4% and 7%, and that interval will probably get wider over the next few months as the reality of the near-term slide in output through Q4 becomes clear.

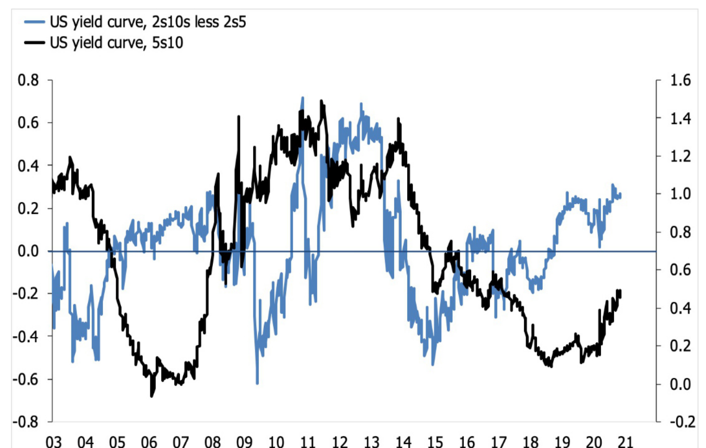
As far as markets go, the initial reaction to the idea of a quick vaccine with a 90% efficiency was textbook. As Bloomberg presenter Jonathan Ferro put it: "markets currently are living in the back-end of 2021, with no virus." With this as a starting point, the set-up over the next few weeks is clear. Markets will now be at the mercy of news on the vaccine's parameters, and good truck trying to predict any future announcements on the safety, timing of the rollout, distribution, storage, competition over deliveries, uptake and the duration of immunity. Instead of trying to predict any of these, the best way for investors to think about last week's jolt is that it challenges two trends, which have been instrumental in defining the regime up until now.

The first is whether the prospect of an economy without the virus will prompt policymakers to roll back the unprecedented degree of stimulus that have defined the Covid-19 economy up until now. A complete u-turn on policy stimulus is unthinkable, but for markets, the key is what happens at the *margin*. The first chart below shows that growth in central banks' asset purchases is now slowing, raising the question of why growth in equity returns shouldn't do the same. I suspect central banks are more likely than not to respond to the recent wave of lockdowns in services by ramping up their purchases, but it will be difficult to match the pace they managed earlier this year. The same is the case for fiscal stimulus. It isn't clear to me that the new political landscape in the U.S. will deliver another blockbuster stimulus package in Q1, and in Europe I reckon next year's fiscal impulse at best will be constant.

The point I am getting at is simple. 2020 will be a year in which developed economies recorded the sharpest drop in economic output on record, with scores of people dying from Covid-19. Baring a disaster between now and the end of the year, however, financial markets will deliver handsome returns for investors. For some, this outcome was a first order objective for policymakers in their response, for others it was either a necessary (evil) or beneficial consequence of saving the economy during lockdown. To the extent that the news of an effective vaccine increases the likelihood that 2021 reverses the economic catastrophe, shouldn't it also reverse the robust performance in financial markets that accompanied it?

fig. 01 / This gap will close, but how? - **fig. 02** / It doesn't look dramatic for DXY, yet

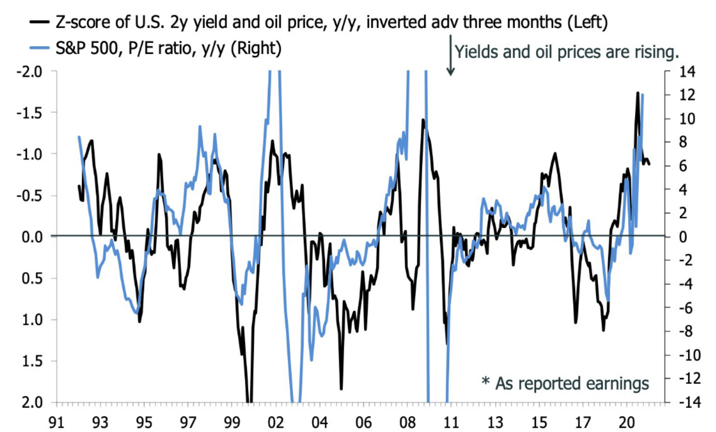




The second trend under scrutiny is a well-known topic for readers on these pages. If the virus disappears quickly next year, allowing the economy to stretch its legs supported by still very accommodative policy, long-term interest rates should be a lot higher. If that's true, a sustained rotation in equities, in favour of value over growth, driving a shift in the outperformance in technology stocks, should occur. We have experienced so many false dawns on this that you would be excused dismissing last week's vaccine-news as exactly that. The price action in bonds seems to challenge this assumption, however, mainly because many strategists and economists have been assuming that the Fed would implement some form of yield curve control around 1% on the 10y. If that's the case, we should expect to be hearing from the Federales soon. I suppose it's possible that the Fed's limit is a bit higher—say 1.5%—or that the near-term risk to growth means that bond yields will now roll over. Sometimes, multiple contraction is the only way forward as the second chart below shows, even if trailing earnings are now rebounding.

More generally, it seems to me that the consensus is now starting to embrace the idea of higher rates, and a sustained bull market in equities driven by an underlying rotation away from growth stocks. If that's the case, it's worthwhile asking why the Fed should step in with a yield cap? After all, a steeper curve, higher nominal GDP growth, and a rebound in inflation expectations should be welcome news for policymakers, shouldn't it? As of last week, the answer to these questions are still blowing in the wind.

fig. 03 / Is a vaccine the catalyst for change? - **fig. 04** / Where can multiples go from here?



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