VACCINES, LOCKDOWNS AND EQUITIES

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COVID-19 cases are rising at an alarming rate in the U.S. and Europe. So, why are equities reaching new highs?

With the COVID-19 case count rising rapidly across the United States and Europe, the immediate economic outlook associated with renewed lockdowns is turning darker. But announcements from Pfizer and Moderna around the efficacy of their vaccines have cheered financial markets considerably. How should investors think about the possible short-term deterioration in economic data in tandem with the greater certainty of a longer term path to normalization?

Better-than-expected vaccine results drive markets higher

Our expectation, and the expectation of many forecasters, had been for vaccine candidates to report decent efficacies and for vaccines to begin deployment toward the end of 2020. So, the news on vaccine efficacy (which has exceeded expectations) has been a positive surprise compared with the base case. The tail-risk of no immediately successful vaccine has been summarily dismissed in the past week, and the associated market implications have been profound. Companies that were unfavorable without the prospect of a successful vaccine have again become subject to analytical scrutiny.

The significant advance and rotation in equity markets makes sense:

- Companies most profoundly impacted by COVID, such as travel and leisure firms, have recently jumped enormously in value over recent days as they have become investable again.
- Companies that we would anticipate performing well under a reflationary environment have also risen impressively, although not to the same extent.
- Good quality companies that will prosper under most scenarios (except one without a successful vaccine) have also performed well because the left tail scenario has been cut.

Considering the longer-term impacts of COVID-19

The COVID-19 crisis has left a profound impact on the economy and financial markets, and there are other long-term variables to consider alongside the vaccine news. Without the novel coronavirus, we wouldn't have had the deep and sudden weakening of the real economy that's given large public companies the opportunity to accelerate their "old economy" sector disruption. Time will tell the degree to which anti-trust or regulatory responses will slow or reverse this latest land-grab. Without the crisis, we wouldn't have seen long-dated bond yields plummet (along with discount rates used to value risky assets) pushing up the present value of future cash flows. The degree of economic scarring is still unknown, but most analysts, investors and policymakers are betting that there will be no rapid rise in long-dated yields for the next couple of years because of the disinflationary impact that COVID-19 has ushered in. Without COVID, we wouldn't have had household, corporate and government debt levels spike. A higher level of debt doesn't necessarily imply higher levels of debt service (given the collapse in bond yields), but it does place some limits on how much rates can rise; equilibrium interest rates are, all else equal, likely to be lower.

Conclusion

It may seem paradoxical that equity markets are rallying into a new economic slowdown, but it's worth remembering that large public companies are only a subset of the economy, and equities are long-duration assets. The most important news we've received recently is that it's unlikely we'll see a future without a successful vaccine. And that's something that financial markets and humans alike can find common ground in celebrating.

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