Macro update

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Vaccines versus variants: investing for lockdown easing

The prospect of a vaccine trade war promoted by the EU is a worry in the context of markets that have come a long way in the last 12 months.

New cases are tumbling in the UK but heading in the opposite direction in Europe. And they're falling in the US despite lockdown restrictions that have always been looser than in Europe and that are being steadily relaxed: 18 US states have no requirements to wear masks, for example.

Now I do expect new cases to rise in the next few weeks in the US following Spring Break and the lockdown easing. But what matters for governments is hospitalisations, and they might be ok because it's the young that are doing the social interacting and the older cohorts have been vaccinated. We'll see.

Balancing lockdown easing with vaccine roll-outs: some are doing better than others

The trick is to balance lockdown easing with a vaccine roll-out. And amazingly I think the UK has judged it spot on. Looking at new Covid hospital admissions, they peak at over 4,000 per day on 9 January, that's a huge number and it stemmed directly from the lockdown easing and revelry over Christmas and New Year. It was made worse by the UK variant, which is up to twice as infectious as the original strain. The total number of people in hospital with Covid peaked 10 days later at almost 40,000. The NHS was close to breaking point. The improvement since then has been fantastic, and indexing the fall with different age groups shows that much of the improvement reflects vaccination, which of course started with the over 85s.

Key risk

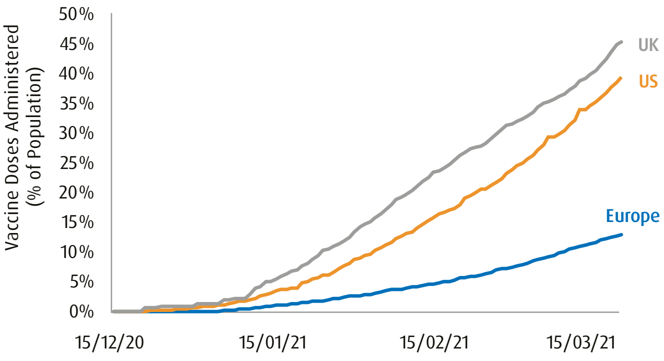
The value of investments and any income derived from them can go down as well as up as a result of market or currency movements and investors may not get back the original amount invested.

"I expect growth in Q2 and Q3 to be strong in the US, but even stronger in the UK."

The combination of rising new cases with a slow vaccine roll-out is bad news for Europe. And there's more bad news for Europe: the South African variant may be taking hold there. This strain is believed to be more resistant to vaccines. The UK has a handful of cases of the South African variant and sends in a SWAT team of contract tracers to contain each outbreak. They can only do that because the numbers are so low. France may be seeing 1,500 to 2000 cases of this variant every day: too many for a SWAT team approach.

Every day things get worse in Europe relative to the UK and the US. And the EU have responded by threatening to ban exports to the UK, not just of vaccines but the ingredients too. This could get nasty. The UK makes one of the key components of Europe's production of the Pfizer and Moderna vaccines. The likely result is some disruption of total supply and some diversion of supplies destined for the UK to the EU. Without this disruption the UK would probably have met its target early of offering a vaccine to every adult in the UK by the end of July, possibly by early May. So, in the absence of more severe disruption, the lockdown easing schedule is still on track.

Chart 1: Vaccine doses administered as a % of population



Source: Bloomberg, BMO Global Asset Management, as at 22-Mar-21

The EU will get enough doses eventually. They have certainly ordered enough, but even then, they've created more vaccine sceptics so they could be left with an un-vaccinated pool of people allowing the virus to circulate and mutate.

The UK has a very difficult decision to make: arguably France should be put into the 'red zone' but that would worsen the vaccine trade row and could massively disrupt trade. If you're planning on booking a holiday to Europe this summer, make sure you can get a refund. Boris Johnson's remark about European virus cases washing up on our shores was no accident.

What are the effects on global economies?

All this has real economic effects. Purchasing Managers' Indices (PMI) data is a reasonably good guide to overall economic activity. The rise in the UK PMI is sustainable, and will go further in my opinion. The US is probably ok despite the likely rise in new cases expected next month, but the EU's position is not good. They are tightening lockdowns and the huge rise in new cases is frightening people.

The US has another advantage over Europe: the massive fiscal stimulus. US consumers have, according to my estimates, almost a year's worth of extra income unspent. That's a huge number. Some of it has been used to pay down debt, some has gone into the stock market, but most is sitting in the bank.

UK consumers also have a 'Covid piggy bank' waiting to be spent. Around half a year's worth, but because our lockdown has been so strict, in contrast to those in the US, the spending surge will be more concentrated. So, I expect growth in Q2 and Q3 to be strong in the US but even stronger in the UK.

The big question is: will all this lead to inflation?

There are certainly prices pressures, and I expect these to build. The US Federal Reserve expect them to build too but they also expect them to be temporary. And I agree, but markets will definitely get nervous. It's like walking up a hill in the fog; you never know you've reached a peak until you go down the other side.

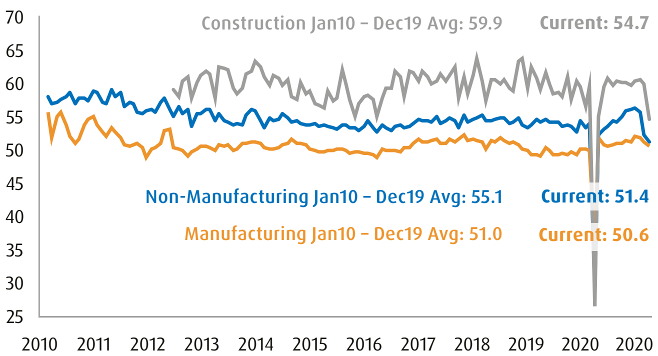
Commodity prices have certainly been going up. But recently there's been a change – could supply be catching up? Oil prices have gone up a lot, but oil futures prices actually fell at longer dates. That's anticipating extra supply, which is already getting going in US shale. And in the last few days, the whole curve has shifted down following the extension of lockdown restrictions in Europe.

The combination of rising inflation expectations and central bank asset purchase programmes, which suppress bond yield increases, means that real yields, as measured by US TIPs or UK indexed linked gilts, have hit record lows. Yes, they have risen a bit since then, but at -1.2%, this is a massive support for risk assets.

Around the globe

China – has staged an impressive recovery from the virus. All their PMI numbers have been above historical averages, until recently. The big dip in the construction and non-manufacturing PMIs reflected President Xi Jinping's 'stay put' order over Lunar New Year, but as I suggested last month, China is tightening policy and is set for a gentle slowdown.

Chart 2: China's construction and manufacturing PMIs dip after rising above pre-Covid levels



Source: Bloomberg, BMO Global Asset Management, as at 22-Mar-21

> Inflation fears are set to rise, and I believe this will be temporary, but markets will get jittery. If and when they do, I'd see that as a buying opportunity.

Emerging markets – There is tightening in other emerging markets too. The interest rate cycle has turned up and it's not just Turkey, Brazil and Russia, India may be next. Rates are still very low by historical standards, but financial conditions are just not as favourable. Emerging market equities will benefit from the boom in the US though.

The UK – the budget was much as expected. More money pumped into the economy this year with promises that fiscal parity will be restored in the future. But I don't think there's enough attention given to the extremely ambitious green agenda. Massive expenditure is planned in a public-private partnership that – if it is successful – could well form a template for other countries.

The green infrastructure drive is seeing a global effort, the like of which we haven't seen in peace time. This isn't billions or even hundreds of billions, it's tens of trillions.

What does this all mean for financial markets?

All of this is good for global growth, and good for corporate earnings. I anticipate that earnings estimates will rise this year. In the last week or so, rebalancing flows have been a big feature of the market. All those balanced portfolios with fixed targets for percentages in bonds and equities have been buying bonds and selling equities to offset the huge movements in market prices. Those pressures should end in the next few days and I expect renewed selling of bonds and buying of equities.

Yes, inflation fears are set to rise, and I believe this will be temporary, but markets will get jittery. If and when they do, I'd see that as a buying opportunity.

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