Opening Bell

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Where will vaccines take the markets?

We have a deal on Brexit and a new US President. Both huge changes. And vaccines promise salvation but how will it play out? We'll take a look at the prospects for the global economy and the implications for corporate earnings; all with a view to judging where financial markets are headed.

Huge amounts of vaccines have been ordered around the world but there are worries about those refusing the jab. Uptake in the UK has been high, with France the most vaccine-sceptical country in the world; and acceptance has plummeted in the last few months. I'm also surprised that the US has a high acceptance rate and has risen in recent months. Mayor Cuomo has said that care home residents in New York State have had a 90% acceptance rate. For care home workers, it's 85%.

These are very high numbers, but the risk-reward is an easy calculation if you're over 80. It's not the same if you're much younger. But I wonder what will happen if and when one of the 10% elderly refuseniks dies from Covid. Acceptance rates will presumably go up. But we need to remember that no medicine, including vaccines, is 100% safe. We've already had cases of anaphylactic shock. When someone dies after getting the jab, acceptance rates go down. We'll just have to see how it all plays out.

There are other issues: will companies meet their ambitious production targets, a shortage of vials, and the logistics of testing and distributing batches. But so far so good in terms of the vaccine roll out, at least in the UK and US. Israel is currently way ahead in its vaccination programme but Europe is struggling, and it's a major political issue.

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.

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Continued

There is a lot of good news...

As people get vaccinated, the number of hospitalisations will start to fall. Remember that the various vaccines have high efficacy rates for stopping you getting Covid symptoms. Efficacy rates for keeping you out of hospital were 100%.

Against all the odds, it does seem that the UK government can meet its target of 2 million doses a week. As pressures on the NHS ease, once the most vulnerable have been protected, restrictions can be eased. From Easter onwards the government hopes.

So, there is lots of good news. AstraZeneca will publish peer-reviewed results in the next day or two, updating their trial. And we expect more good news – we understand that they are quietly confident that their vaccine will be just as effective against the Kent variant that's on the rampage here in the UK.

...but don't get carried away

Let's not forget that the pressures are set to hit breaking point. The Kent variant has shot the UK to the top of the global list for the virus. Up from a mid-table position before the Kent variant took hold. There are serious concerns that the South African variant will reduce vaccine efficacy. And of course, the trials had very few elderly recruits and none looked at a single dose strategy. I do think it's the best approach, but it adds to the uncertainty.

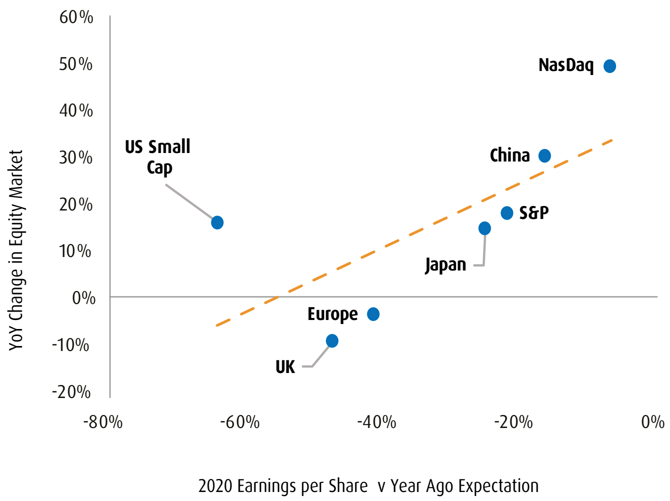
And once we start relaxing restrictions, the fall in new cases, hospitalisations and fatalities will flatten. And there will be mutations yet to come. The experts are confident that they can tweak the vaccines but it will take time.

So, my optimism that we'll regain pre-Covid levels of economic activity by the end of this year remains. But that doesn't mean life returning to normal. We'll be living with Covid and its variants for years, just like the flu except that it's a much nastier disease.

What does this mean for markets?

Let's turn now to the economic outlook, the framework to judge where markets are going. And if you think that in this mad world of pandemics, negative interest rates and Tesla's share price, that fundamentals no longer matter, take a look at Chart 1. It plots equity market performance on the vertical axis, with the earnings versus expectations on the horizontal axis. It's not a perfect fit, but with the exception of US small cap, the hierarchy of performance was exactly in line with the hierarchy of earnings outperformance.

Chart 1: Earnings v. expectations and equity markets



Source: BMO Global Asset Management and Bloomberg as at 08-Dec-20

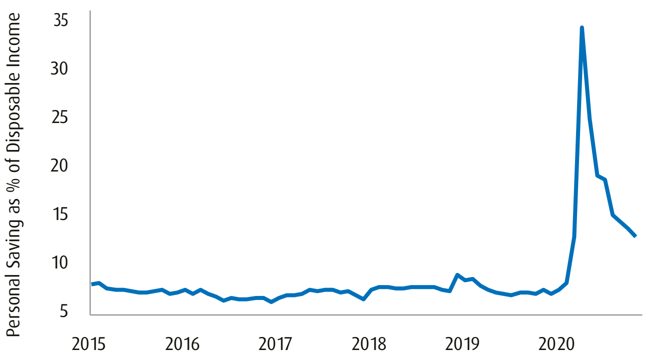
Let's consider the outlook for GDP growth. The outlook for the UK got worse and worse through last year, and forecasters assumed that the UK would bounce back this year. There has been a leap of optimism since the vaccine news hit last November; forecasters increased their numbers for the UK massively. This optimism may well be justified, but it means that there's already a lot priced in.

For the immediate future, the levels of Purchasing Managers' Indices (PMIs) show that the US is stronger than Europe, and, perhaps surprisingly, the UK is stronger than the eurozone. Looking closer at the US, they've fared better than Europe so far in the pandemic. Partly because they've got a more flexible economy, not least due to the massive amount of fiscal stimulus.

Continued

Chart 2 shows that consumers, in aggregate, have saved much of their fiscal handouts, not to mention the reduced opportunity to spend money. A few weeks ago, I thought the US was heading for negative growth in the current quarter because the outgoing Congress failed to pass a budget stimulus. But at the eleventh hour they did agree a new fiscal package, and it's big – nearly 3% of GDP. When the cash arrives later this month and in February, people are going to see another huge boost to their incomes. As the US continues to roll out its vaccine programme and restrictions are eased, we could see really strong growth.

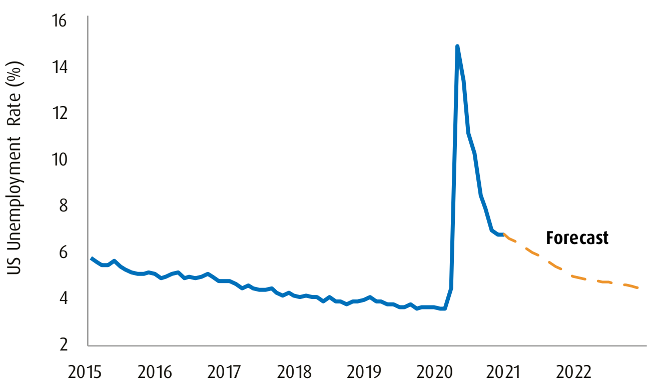
Chart 2: US consumers have huge spending power



Source: BMO Global Asset Management and Bloomberg as at 07-Jan-21

And that will pull down unemployment. It's already fallen from a horrendous 14.7% to around 6%, and it should tumble from the late spring onwards. That's obviously great news. But the big question here is: will such a massive turnaround in the economy lead to inflation?

Chart 3: US unemployment set to fall



Source: BMO Global Asset Management and Bloomberg as at 08-Jan-21

Upward global price pressures to lead to sustained rise of inflation?

We're already seeing global price pressures in commodities, and US survey data is also showing increasing price pressures. The worry is whether this will feed through into a more generalised rise in inflation. My guess is that it won't, because there is still slack in the economy, but I can't be sure; neither can the Fed and neither can markets.

We've already seen a rise in breakeven inflation in the US. But the Fed have so far kept the lid on bond yields, despite all the fuss about 10-year yields pushing above 1% at the start of this year. The result has been that yields on TIPS – inflation protected Treasuries – have hit record lows. That's good news for risk assets, but, if inflation worries increase, yield curves will become even steeper, and we could see real yields rise as the market starts to get nervous about the Fed needing to act. I do not think there will be a sustained increase in inflation, but if investors get too nervous about a potential increase, this will affect markets.

New POTUS: all change, please

Biden would like to pursue a tax-and-spend agenda, but he can only move at the pace of the most moderate Democrats in the Senate and the House; and remember that the Democrats have the slimmest of majorities in the Senate, and their majority in the House has been cut to only 5. We think that the corporate tax rate will rise but only modestly to 25%, cutting earnings per share (EPS) by only 5%. His spending plans will probably offset that in aggregate, but it won't be an easy ride and the changes won't be radical. There will be a big change on the ESG front and that's something we at BMO welcome; most US electricity is generated by coal and natural gas, and Biden will try to change that.

On foreign policy we can breathe a sigh of relief that the maverick policies of Trump are gone. But Biden does care more about human rights so don't expect a soft approach to China. And we don't expect him to go for an outright free trade agenda either.

> So, my optimism that we'll regain pre-Covid levels of economic activity by the end of this year remains. But that doesn't mean life returning to normal.

Around the world

China

China, where the pandemic began, looks in great shape. Their PMI indices are all above historical averages. The economy has fully recovered. Indeed, we need to watch for a shift in policy towards tightening. The National People's Congress on 4 March will see lots of bold policy announcements as part of the fourteenth Five Year Plan. Let's see if tightening follows.

India

Generally speaking, emerging market economies have fared well through the pandemic. Partly because low inflation means they've been able to slash interest rates. But the monetary easing cycle is over. The next move in Indian interest rates is probably up. The fundamentals are still good in emerging markets, but the easy gains are behind us.

EU

So we finally have a Brexit deal. Talking to the experts in the area, including lawyers who negotiated this agreement in Europe and in the UK, there is hope that this will be productive and cooperative. However, I think it's a recipe for conflict and retaliation – let's hope I'm wrong. In general, there's lots in the agreement on trade in goods where the EU enjoys a wide and growing surplus. Much less on services where the opposite is true.

Scotland

If the Scottish elections go ahead as planned in May, and the SNP win a substantial majority, as many predict, then the issue of a second independence referendum will pose another headache for Boris Johnson.

UK

The UK is focused on divergence to reap the benefits of Brexit as the government sees it. They'll pay more attention to financial services and manufacturing – especially electric vehicles and battery production. And there's a broader agenda. Expect to hear more on alternative energy, battery production, the whole 'levelling up' agenda. 28 out of the 34 major car production sites are in Conservative held seats. One of the biggest decisions relates to when taxes are raised and spending is cut to restore the public finances. My guess is this will have to wait until next year, until we've had a good recovery.

Where does all this leave us?

The vaccines should lead us out of this virus nightmare. That means equites should outperform bonds and cash. I haven't mentioned currencies, but we are reducing our sterling hedge after the Brexit deal was signed, and we could see a stronger dollar in 2021.

Inflationary pressures are on the rise in the US – not in Europe or Japan where inflation looks set to remain below target for the foreseeable future – but it's the US that matters. And while I don't think we'll see a sustained rise in inflation, if nervousness about a potential inflation rise takes hold of the markets, then the Fed may need to act to calm those nerves.

I've been very bullish at various times in the last 10 months or so, but there's a lot priced in now and I just don't think it is the time to make any bold moves. We think there is a place for government bonds in a diversified and balanced portfolio, but a limited position. Enjoy the equity rally but be prepared for a bumpy ride.

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