FE Investments

The world's big week: cheer the optimism, ignore the exuberance

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We mostly try and avoid commenting on global events, as the long-term effects of any single action are almost impossible to predict. The results of the US election and the announcement of a viable coronavirus vaccine are of such magnitude, however, that we must at least consider that the world might have changed in ways we'll need to react to.

Two of the main agents of uncertainty impacting markets and indeed the global economy, and by extension the lives of billions of people, took a step to being resolved with the results of the US election and the announcement of a viable vaccine for Covid-19. The markets have reacted incredibly positively, but probably to the wrong things. The impact of these two events is almost certainly overestimated in the short term and will probably be under-estimated in the long term.

US Election

Before the election we took the stance that who wins was less important than getting it out of the way. We stand by that. Analysis of policy positions and cabinet picks is secondary to what the election means for a US stimulus package. A Biden victory means there won't be one until at least 2021, and with a likely divided government it will take time to thrash out an agreement. This will take the wind out of the sails of all the investors betting on less erratic presidential Twitter output or lower taxes as the positive outcomes.

That being said, an administration that at least wants to tackle the immediate problem of Covid and the medium-term problems of a weakened economy, inequality and climate change are definitely positive.

Any material changes from a new presidency will be incremental and hard fought. And while a stimulus package is still likely, it's not guaranteed if the Republican party decides to pursue a maximum damage policy to the incoming administration.

Coronavirus Vaccine

The end of the coronavirus pandemic is now in sight. While it was always likely to come to an end eventually, we can now say with certainty that it will be done in a few years and say with confidence that the tide will begin to turn in a few months. This is definitely a big deal.

For markets and investors what happens is slightly less important than what people expect to happen. Right now the markets are signalling that people expect things to go right back to normal as soon as the vaccine becomes available. This is unlikely.

Although an end to the pandemic may be near, the scale of the economic damage means it will take a long time to recover. The financial crisis, for example, has never fully been recovered from, with interest rates and QE still in place a decade later. Many of the businesses that have struggled most will not bounce back. The high street will continue to lose out to online and working patterns may be forever changed. Travel and hospitality sectors have the most to gain but will have far fewer customers with unemployment high.

Even in the very short term, a modest return to normal isn't imminent. While there may be a vaccine shortly, there won't be enough for everyone. The best-case scenario is that after a relatively normal summer we will be able to get through next winter with the most vulnerable immunised and fewer restrictions, but the virus will likely still be with us.

The equity markets appear to be forecasting a complete return to pre-Covid conditions within a matter of months and we expect them to calm down soon enough once everything sinks in. The bond markets are telling a more complex story.

Longer-term rate expectations have increased along with inflation expectations, although they remain very modest overall. Short-term expectations are still gloomy. There is much uncertainty around what this might mean for fiscal stimulus. The economy might not need life support for much longer, but it still requires a lot of rehab.

The timeframe for recovery and the amount of support it's given are now the driving factors in uncertainty. One interesting thing to look out for is how attitudes to government spending change. Just as the legacy of the financial crisis has been permanently lower rates, so too could coronavirus bring about a permanent change in fiscal policy. It will be hard to argue that it's ok to let kids go hungry again over the holidays just because there's a vaccine.

The debt markets are currently very supportive of a big increase in spending. How long that lasts will be critical.

FE Investments Response

While there has undoubtedly been a change in sentiment, the fundamentals remain mostly the same. The rally in airline stocks, banks and other expected winners are already present in the portfolios through value funds such as JO Hambro UK Dynamic or Dodge & Cox US Stock and are also well represented in the index funds. While we don't hold very much in these positions, it's enough that we're not being caught out by the news.

The change in yields has brought gilts down a little, but not by an amount that would make us consider the position. The change in yields and rate expectations over the longer term will need careful thought. These will be factored into the modelling conducted by our actuarial partners and we're waiting to see what impact they have on asset allocation.