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EQUILIBRIUM

The great rotation

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The COVID-19 pandemic has had a fundamental impact on most of our lives – but it has also had a fundamental impact on markets.

We have discussed in past newsletters and briefings how certain stocks have actually done very well as a result of the pandemic. Those companies that benefit from the working-from-home trend, largely technology companies, have seen their profits and share prices soar.

Meanwhile, companies like cinemas, airlines, and many other "leisure stocks" have seen their profits decimated and their shares plummet.

Last week we had some very welcome news from Pfizer and BioNTech that their COVID-19 vaccine appears to work well.

When this was announced, we saw markets jump. The FTSE 100 Index, which had closed at 5,910 on Friday 6 November, jumped 4.7% to close at 6,186 on Monday 9 November, the day of the announcement.

Certain stocks did particularly well. For example, Cineworld went up 40% on 6 November. Rolls Royce (the aircraft engine maker rather than the car manufacturer) gained 43%.

However, not everything went up. Video conferencing specialist Zoom fell 17% on

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the day, whilst Netflix was down 9%. The Nasdaq Index, which is largely made up of technology stocks, dropped 1.5% on the day followed by a 1.4% loss the next day.

This was a quite dramatic rotation where all the things which had been doing well did poorly, whilst those companies hit hardest by the pandemic rallied hard.

What next?

The vaccine news is extremely positive, but we should be cautious about it until more information is known. The data so far indicates the vaccine is more than 90% effective which is a fantastic result.

However, to date this is based on only 94 confirmed cases of the virus contracted by participants in the study. The vast majority of those cases are in the control group who were given a placebo rather than the real vaccine. This means the vaccine is working, but to fully assess the effectiveness Pfizer themselves say they need to wait for 164 participants to have had the disease.

There are also potential problems distributing this vaccine given the need to store it at -70 degrees Celsius. This makes it harder to roll out quickly and widely. It would pose particular challenges for developing nations.

However, there are other vaccines in stage three trials. Some of these share similarities with the Pfizer/BioNTech vaccine whilst some are designed to work in a completely different way and won't have the same distribution challenges. The Pfizer/BioNTech results raise hopes that more of the potential vaccines will also be effective.

From a stock market point of view, this short, sharp rotation could just be a starting point. If further good vaccine news emerges then there is potentially a lot further for this trend to run. However, if further results are disappointing then it could at least partially reverse.

Rate of recovery

There are also other market dynamics at play here. A speedy roll out of an effective vaccine could lead to a much faster economic recovery than many had expected.

This could lead to higher levels of inflation (at least in the short term) and, down the road, higher interest rates than is currently expected by investors. As a result, we saw the yields on a number of government bonds rise as their prices fell.

Again, if this becomes a longer-term trend this will have profound implications, not just for bonds which may perform poorly, but also certain types of equities.

Many equity analysts use interest rates or bond yields in their pricing models. This is particularly the case for what we call "growth" stocks, where the market expects high levels of earnings growth over the next few years. Analysts use what we call a "discounted cash flow" calculation to work out the present value of future earnings. The "discount rate" they use is often a government bond yield. The higher the discount rate, the less those future earnings are worth in today's terms.

This means that rising bond yields make those high growth companies (many of which are those same tech stocks which benefited most from the working from home trend), worth less.

Meanwhile, some companies benefit from rising interest rates. Notably, banks make much of their profits from the difference between long-term and short-term interest rates. They take in short term deposits on which they pay low levels of interest and lend this out long term at higher rates. A steeper "yield curve" – where longer term bond yields are much higher than short-term rates – benefits banks.

In our view, there is a significant chance that this rotation could continue. However, we also can't discount the possibility that the vaccine is not as effective or takes longer to roll out than we'd hope.

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Balancing act

Over the past few months, we've talked a lot about the difficult balancing act of managing portfolios in this environment.

It is always dangerous to make big binary bets and never more so than right now. Many investors have loaded up on growth and tech stocks which will have served them very well over the past few months but may have hurt them this week.

Whilst we increased tech exposure in the pandemic, we've also balanced this out with more "value" stocks too. This means the gains from many of our funds since the announcement has far outweighed the losses in some of our tech holdings.

We've since made a further tweak to portfolios, slightly reducing tech and growth stocks and adding in a global "recovery" fund. Again, this is not a big bet but just slightly tilting the portfolio back towards more of a hoped-for recovery.

A week is a long time in politics

Last months' newsletter was entitled "pandemics and politics" and in it I made the comment that a week is a long time in politics, and even longer in the investment world.

Never does that feel truer than at the moment. We've just had a US presidential election which felt extremely significant at the time but given what's happened since feels a long time ago!

Whilst Trump is refusing to concede, it is clear to everyone else that Joe Biden is the next president of the USA.

However, the Democrats appear to have failed in their bid to take the Senate. We have a "run off" in Georgia which could lead to a 50/50 split were the Democrats to take both seats. The pollsters' current expectation is they will take one but not the other, leaving the Republicans still in charge.

Markets seem to quite like this outcome. We will have removed some unpredictability with Trump going, but there's less chance of the Democrats putting up taxes or launching anti-trust attacks on the big tech companies.

However, if the Senate is a bit closer, we might see more cross-party initiatives, such as a stimulus package to help America (and thereby the global economy) recover from the pandemic.

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General economic view

Further lockdowns in many countries mean some economies may well see a double dip recession or at least a slowdown. This is particularly the case in the UK and much of Europe but also in the US which is seeing an increase in virus cases. Meanwhile, many Asian economies are continuing to recover well.

However, the vaccine news raises hopes for a quicker return to normality during 2021 and therefore potentially strong economic growth next year. It is possible this may lead to a short-term increase in inflation but we'd expect this to be temporary, and central banks will keep rates extremely low for the next couple of years.

Equity markets

The vaccine and potential for economic growth in 2021 makes certain stocks more attractive but some parts of the stock market look quite expensive. We continue to favour UK smaller companies and Asia, and have increased exposure to global "recovery" stocks.

Fixed interest

Should an economic recovery take hold then we'd expect the yields on governments to rise, meaning prices would fall. However, this would support many corporate bonds and keep default rates low.

Commercial property

Property markets are in flux as the pandemic has hit the retail sector hard, whilst the move to home working increases the uncertainty for offices. The FCA are consulting on whether to require notice periods on property funds. This means property is a risky asset class at present.

Cash

With interest rates remaining at record lows, returns on cash will remain close to zero. We retain higher cash balances than usual as protection against further market falls and have diversified this into different currencies.

Balanced asset allocation

For a typical balanced portfolio, we are roughly neutral on fixed interest and have very little property. We are underweight traditional equity but are instead holding more defined returns. The overall risk/return profile of our portfolios is slightly above long-term averages given our positive long-term equity outlook.

These represent Equilibrium's collective views and in no way constitutes a solicitation of investment advice. The value of your investments can fall as well as rise and are not guaranteed. Investors may not get back the amount originally invested. We usually recommend holding at least some funds in all asset classes at all times and adjusting weightings to reflect the above views. These are not personal recommendations, so please do not take action without speaking to your adviser.

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