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Covid-19 vaccines, lockdowns and equities

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Coronavirus cases are rising at an alarming rate in the US 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 around efficacy on new vaccines has cheered financial markets considerably. So how do we approach the possible short-term deterioration in economic data with the greater certainty about the longer-term path to normalisation?

Better-than-expected vaccine results drive markets higher

Our expectation, and the expectation of many forecasters, had been for vaccine candidates to report decent rather than spectacular efficacies, and for vaccines to begin to be deployed towards the end of 2020. As such the recent news has been a positive surprise when compared to the base case. Furthermore, the tail-risk of no immediately successful vaccine has in the past week been summarily dismissed, and the associated implications for markets have been profound. Firms which were uninvestable without the prospect of a successful vaccine have become once more subject to analytical scrutiny. As such the significant advance and rotation in equity markets makes sense:

- The firms most profoundly impacted by Covid-19, such as travel and leisure firms, have jumped enormously in value over recent days as they have become investable again
- Firms that we would anticipate performing well under a reflationary environment have also risen impressively, although not to the same extent
- Good-quality firms that will prosper under most scenarios (except one without a successful vaccine) have also performed well as the left-tail scenario has been cut.

Considering the longer-term impacts of Covid-19

However, the pandemic crisis has left a profound impact on the economy and on financial markets. Without the novel coronavirus we wouldn't have had the deep and sudden weakening of the real economy that has given large public companies the opportunity to accelerate their disruption of “old economy” sectors. 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 (and with them 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 indeed policymakers are betting that there will be no rapid rise in long-dated yields given the disinflationary impact that Covid-19 has ushered-in, most likely for the next couple of years.

And without Covid we wouldn't have had a spike higher in levels of household, corporate and government debt. Higher levels of debt do not necessarily imply higher levels of debt service, given the collapse in bond yields, but they do place some limits on the degree to which rates can rise before monetary tightening is effected – meaning that equilibrium interest rates are, all else being equal, likely to be lower.

Summary

It may seem paradoxical that equity markets are rallying into a new economic slowdown, but it is worth recalling that large public companies are only a subset of the economy and that equities are long-duration assets. As such, the most important news we have received over recent days is that one possible future – that of no successful vaccine – no longer looks likely. And that is something that financial markets and humans alike can find common ground in cheering.