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CIO Viewpoint

Vaccinating the equity market

Investment Solutions

16 November 2020

Will a vaccine for Covid-19 prove an antidote for businesses hurt by the pandemic? The prospect of an effective coronavirus vaccine drove equity markets last week, increasing expectations that an end to the pandemic is in sight. Economically sensitive stocks gained on the news. Should investors rotate their equity allocations into these sectors as they recover ?

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Key takeaways

- The prospect of a Covid-19 vaccine opens a path to a full economic recovery
- In equity markets, business-cycle sensitive "value" stocks gained on the news
- Expectations for an end to the pandemic should support value stocks in the coming quarters
- We added some exposure to value names mid-2020 while keeping an allocation to growth sectors, which should continue to outperform in the long run in this low-rate, low-growth environment.

We have consistently argued that a fuller economic recovery depends on an effective vaccine. On 9 November, Pfizer Inc. announced success in its Phase 3 trial of a vaccine with collaborator BioNTech. The claim that the vaccine is "more than 90% effective" in preventing the virus, and the timing, surprised markets as this exceeds expectations. In common with other vaccines still undergoing trials, two doses taken a week apart offer protection 28-days after the initial shot. The economic recovery will still depend on the logistical challenges to broadly distributing the vaccine, probably starting in the second quarter of 2021. It also depends whether a vaccine can prevent asymptomatic carriers from passing on the virus. As we write, US biotech company Moderna announced on 16 November that its own vaccine was 94.5% effective.

In the past decade's persistently low-growth, low interest rate environment, investors looked for returns in businesses growing faster than the rest of the market.

Concentrating on tech

As a result, "growth" stocks, such as US-based technology names, have been trading at an increasing valuation premium since the Global Financial Crisis, a reflection of their significant out-performance over "value" companies. As measured by the ratio between market value and the value of a company's assets, or price-to-book (P/B), that premium now exceeds levels seen during the dot-com bubble (see chart 1). Through the pandemic, technology stocks in particular have further outperformed; the MSCI World IT index returned 31% as of 12 November, compared with 8% for the MSCI World, as consumers and businesses turned to online shopping and broader connectivity.

This demand for secure growth has affected the makeup of markets. In the US-based S&P500 for example, the share of technology stocks by market capitalisation has now reached 27%, more than 10 percentage points higher compared with four years ago. Online marketing and interactive media sectors take that share to nearly two-fifths of the market. The largest five companies – Facebook, Amazon, Apple,

Microsoft and Alphabet (Google) – account for much of this concentration with more than 22% of the value of the S&P index, and as much as half of the NASDAQ.

This has concentrated market performance into these few key stocks in the US and in two listed names in China: Alibaba and Tencent.

The technology sector is vulnerable to regulatory headwinds. The Biden administration in the US may pursue the Justice Department's antitrust case against Alphabet, the parent company of Google, on monopoly charges. That case could be combined with a series of state-level investigations.

Last week, signs that China may tackle internet monopolies cut the value of Chinese tech firms, such as Alibaba, Tencent and JD.com. The country's regulator said in draft guidelines that it is looking for feedback on how to protect competition, just weeks after rejecting the initial public offering (IPO) of Alibaba's Ant Group subsidiary.

Time for a "value" rotation?

The prospect of a vaccine and promise of a more profound economic recovery is now acting as a performance catalyst in equity markets. A recovery from the deepest recession in more than a century favours industrial, construction and material stocks, while offering some relief to more structurally challenged industries such as energy or financials. All of these sectors, collectively considered "value" stocks, suffered under the pandemic slowdown and tend to perform early in an economic upswing.

Such a return to improved performance is often described as "mean reversion", which simply refers to a swing back to a relative historic average valuation. The question is whether under a new business cycle, a mean reversion episode will prove long lasting.

Investors are recognising the prospects for other industries too. A full economic recovery will benefit sectors such as tourism and hospitality that came to a near halt under working-from-home and lockdown routines this year. These industries also gained last week. However, their business models may have to adjust before they return to pre-pandemic activity levels, taking account of increased debt levels and changes in working habits that may, for example, alter demand for commercial real estate.

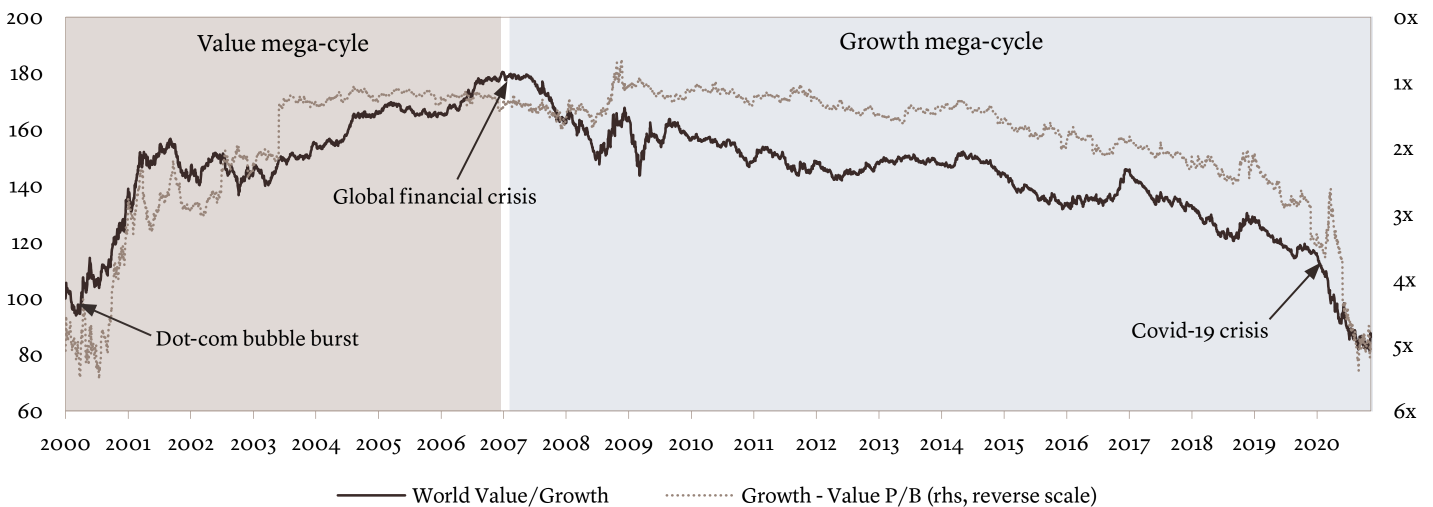
The effects of the vaccine's rollout on financial markets, and its implications for economies worldwide, will be felt throughout 2021. In the shorter term, the promise of a path to fully re-opening economies thanks to vaccines will help markets ride through much of the next six months' volatility. This should support value-sector performance.

Long-term growth

Central banks are committed to keeping interest rates low in order to support the wider economy through its pandemic recovery. The Federal Reserve, for example, may keep interest rates at a lower bound until 2023, or even later.

In the end, companies paying dependable dividends with a sustainable business model, or enjoying structural growth prospects, should continue to offer the best long-term prospects for investors. Some value names, in financials or energy, can

1. Performance of value and growth stocks since 2000



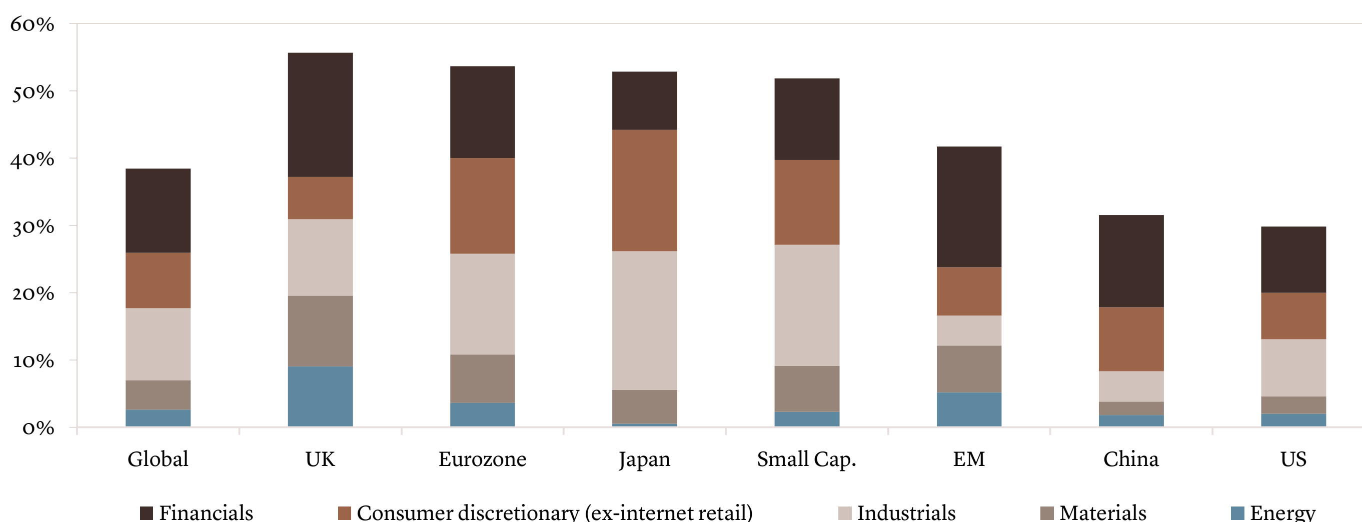
Sources: Bloomberg, Lombard Odier calculations

offer healthy returns in the short term as they catch-up with the wider market, with the greatest potential in markets such as the UK, eurozone, Japan and small caps (see chart 2). However, we do not expect them to outperform growth sectors over a longer period.

Even if the market's current interest in value stocks lasts longer than usual in this economic recovery phase, if only because the lag is so great, we expect the appetite for growth stocks in this low-growth, low-yield world to hold up. Unless de-railed by new regulation, these sectors are based on sound fundamentals supported by extraordinary monetary and fiscal intervention.

We began increasing our exposure to business-cycle sensitive, value names and regions, in the middle of 2020, in anticipation of news on a vaccine. Specifically, we increased exposure to European equities where many value names are concentrated. With the US election behind us, we continue to add exposure, tactically, to the most promising of these value businesses to capture the benefit of the coming cyclical recovery. All the while, we maintain some exposure to quality growth stocks that will continue to offer a balance between risk and reward in the long run.

2. Cyclical sectors as % of MSCI indices



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