Illumination: Equity strategy and market outlook

October 2020

Published by Edison Investment Research

EDISON

Global perspectives: Lockdown 2.0

Analyst

Alastair George
+44 (0)20 3077 5700
institutional@edisongroup.com

- **A second wave of lockdowns has arrived in Europe.** In response to rising COVID-19 infections, further lockdowns have been announced across France, Germany, Italy and Spain in recent days – and markets have responded negatively. However, the measures are not as severe as earlier in the year even if they will undoubtedly have a depressing effect on Q4 GDP.
- **'Hands, face, space' has proved inadequate protection.** The necessity of these circuit-breaker lockdowns represents a meaningful bump in the road to recovery. However, they are likely to have only a relatively modest impact on the outlook for 2021, provided an effective vaccine becomes available early next year.
- **The risks for markets in respect of the US presidential election appear to centre on the possibility of a contested result, which we believe would be poorly received by markets.** Over the medium term, a Biden administration would be likely to result in a less confrontational approach to foreign policy but also higher domestic US corporate taxes. This may facilitate a reversal in the very large underperformance of European equities versus the US seen in recent years.

Lockdown 2.0 is here

In response to rising COVID-19 infections, social restrictions have now been reintroduced across Europe. Markets have responded negatively as some of the more optimistic scenarios for a smooth recovery out of the original period of disruption have been effectively ruled out. While the lockdown measures are not in general as severe as earlier in the year, they will undoubtedly have a depressing effect on Q4 GDP in Europe.

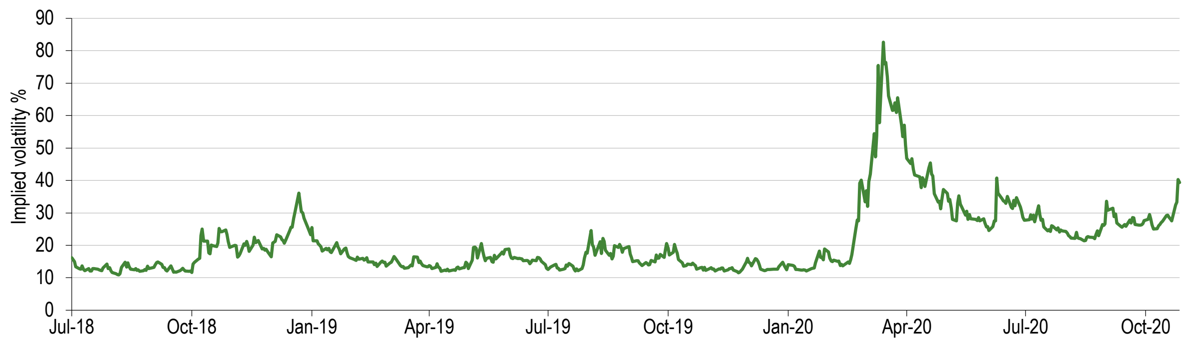
These new lockdown measure have tested investors' resolve and drawn attention back to the very short-term outlook. Equity markets have suffered meaningful volatility in response to these lockdown announcements. New social restrictions certainly represent a bump in the road relative to our earlier views but were always a risk. With vaccines expected to start becoming available in only a few months, and lockdowns targeting a relatively narrow section of the economy compared to earlier in the year, we believe the overall economic impact and market reaction will be measured. National economies are also better adapted to the restrictions, with 29% of UK adults now working from home.

France and Germany have implemented a one-month period of enhanced social restrictions during which restaurants and bars must remain closed and personal travel is highly discouraged or banned. Spain has announced a national curfew on restaurants and bars. Importantly, there has been recognition of the need to keep the economy moving as much as possible and to this end schools are expected to remain open. Outside the leisure, travel and hospitality sectors it remains business as COVID-usual for now.

While the UK has not announced any national measures in recent days, there are variety of similar regional restrictions already in place. The effect of these measures, prior to any additional government spending to offset the impact, is likely to be in the region of 1–2% of GDP given the targeted nature of the measures on social sectors and the relatively short announced duration of one month, at least compared to the lockdowns earlier in the year.

The question for investors in recent days is whether the acceleration of infections represents a structural turn for the worse in the pandemic or a bump in the road. We view it as an unwelcome, but not entirely unanticipated, bump in the road. It is unwelcome because it demonstrates that 'hands, face, space' combined with contact tracing has proven ineffective in keeping the effective reproduction rate below or close to 1.0. There have been shortcomings with contact tracing systems in the UK for example, but the commonality of a rising trajectory of infections across Europe suggests that it is an approach which is struggling to deliver on its earlier promise.

Exhibit 1: Implied volatility has risen in recent weeks but remains a fraction of March levels



Source: Refinitiv, VIX index

Nevertheless, this reset to social distancing plus circuit-breaker lockdowns will have been at least in part anticipated by investors. This scenario has previously been modelled by epidemiologists to spread the burden of infections through time to reduce pressure on intensive care facilities and to manage through the period prior to the availability of a vaccine. We note the growth rate of infections and mortality both initially appear to be lower than in the first round of the pandemic, although comparisons are difficult due to the rapid expansion of testing.

Investors have already repositioned portfolios to account for COVID-19 risks and while implied volatility has risen notably compared to the summer, Exhibit 1, it remains some way below the peak of early March. We would therefore be surprised to see another liquidity driven sell-off such as that in evidence earlier in the year, especially as expectations for the introduction of the first vaccines remain in place for Q121.

US election – Trump OK, Biden OK, but neither not OK

A very unusual US presidential election is currently underway. A significant proportion of voters will not go to polls, but instead due to coronavirus restrictions will send their ballots in by mail. Polls currently indicate that Biden's lead remains in place in the closing stages of the race and a Biden victory is the most likely outcome, in our view. However, there is also a significant chance of a contested election and weeks, if not months, of legal uncertainty. Time is running short for any waning of Biden's lead into polling day and a clear Trump win at this point appears the least likely outcome.

Investors may be rightfully focused on other risks at present, with developed market GDP still so far below potential due to the fight against COVID-19. The timing of a vaccine and the interplay of monetary and fiscal support over the coming 12 months is still the dominant factor for global markets in our view. Nevertheless, the outcome of the US election will set the tone for US economic and foreign policy at a critical juncture, given the rising strategic challenge from China.

In the short term and in policy respects there is relatively little to choose between the candidates. We believe markets would take a second term for Trump in their stride, having become habituated to volatile and confrontational foreign policy, combined with a US business-friendly domestic agenda.

Furthermore, both Biden and Trump will need to tackle the outstanding issue of a fiscal stimulus package to address ongoing COVID-19 effects for 2021. Further out, should Biden become president we would expect modestly higher US corporate tax rates, which may weigh on sentiment for US equities which to date have had an exceptionally good crisis. The strong performance of the S&P 500 stands in contrast to the relatively weak performance of other developed and emerging markets.

A Democratic president may also look favourably on reducing the alleged monopoly power of the largest US technology franchises. Given the large weighting of these stocks within US indices, this would be a further negative for US markets. On the other hand, the green agenda would receive a boost as Trump's foot-dragging climate change policies would cease to be relevant.

Biden would also in our view step back from the highly confrontational and unpredictable policies of his predecessor in respect of foreign policy. Trump's attempts to appeal to his domestic supporters through the threat and use of trade tariffs on foreign goods – targeting not just China but also allies such as European nations and Canada – is likely to be seen as a policy failure in hindsight, delivering neither economic benefit nor polling advantages.

For these reasons, a Biden administration may have relatively little initial impact at the global market level. However, with a less business-friendly US administration investors may look towards other less highly valued markets over the medium term. For example, we believe the long era of Europe's consistent equity underperformance of the US could finally come to a close.

While Biden may choose to run a more conciliatory policy towards historic allies, the tensions between the US and China are likely to remain in place. The strategic questions in respect of a resurgent and clearly more assertive Chinese state span the US political divide. For example, we do not think a Biden administration would stop the splintering of technology supply chains as firms seek to diversify suppliers to include those outside China. A political test of the resolve of the new administration from China would also be a possibility during 2021.

However, we believe a Biden administration would also aim for a lower profile package of China policies. A more carefully assessed long-term strategic objective of promoting an enduring era of US influence, stability and power on the international stage may result. Investors should welcome the absence of unnecessary uncertainty in this regard.

Unfortunately, the probability of a contested result cannot be excluded given the multiplicity of ways that a close result could be challenged in the US courts. There are for example procedural challenges that can be launched in each US state, if it was believed that due process was not followed during the election. The battle lines in respect of mailed-in votes, which will account for a many times larger share of the total than in previous years, have already been drawn by Trump's campaign with teams of lawyers standing by.

We believe Biden's campaign is no less well legally armed, which means that a close contest will inevitably be challenged by either side which could lead to months of delay and more importantly the risk of policy paralysis at a critical time for the US economy. It is this result which we believe investors should be prepared for, even if they may be atypically indifferent to the success of either of the candidates.

Conclusion

The introduction of new social restrictions in Europe has brought into sharp relief the conflict between the short- and long-term outlook for global equity markets. The necessity of circuit-breaker lockdowns is clearly a negative for the short-term outlook but in our view should not distract equity investors from peering only a little further into 2021 when the likely availability of vaccines may change the calculus in terms of infection rates and the need for severe social restrictions.

Furthermore, following earlier disagreements governments in Europe have resolved that fiscal support will be forthcoming for economies, in addition to central banks' monetary support for markets. We therefore view the recent market volatility as a bump in the road, rather than a precursor to a significantly deeper sell-off at this stage.

The risks for markets in respect of the US presidential election appear to centre on the possibility of a contested result, which we believe would be poorly received by markets. Over the medium term, a Biden administration would be likely to result in a less confrontational approach to foreign policy but also higher domestic US corporate taxes. This may facilitate a reversal in the very large underperformance of European equities versus the US seen in recent years.

Frankfurt +49 (0)69 78 8076960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
1,185 Avenue of the Americas,
3rd Floor, New York, NY 10036
United States of America

Sydney +61 (0)2 8249 8342
Level 4, Office 1205, 95 Pitt St,
Sydney NSW 2000
Australia