Blog November 20, 2020

Elections and lockdowns and vaccines: Are we there yet?

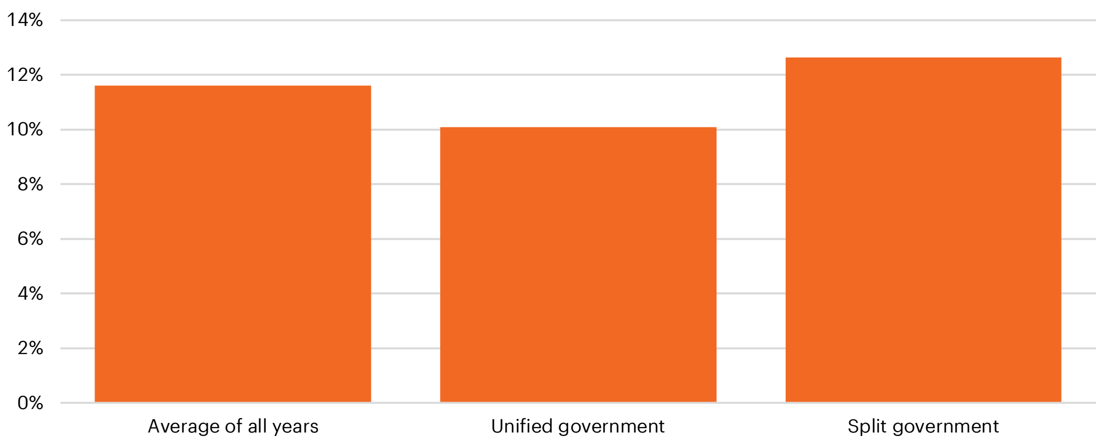
Over the past two weeks, elections, vaccines and lockdowns have been thrown into the mosh pit we call 2020, and equities have once again come through at fresh highs. While most indicators of volatility remain subdued, it is hard to imagine 2020 finishing without a final curveball, and it could come from where investors least expect.

The election: Are we there yet?

Yes and no. The election outcome has been described—and we agree—as a Goldilocks scenario for markets. President-elect Biden looks likely to preside over a divided government where Republicans maintain control of the Senate. As far as markets are concerned, a divided government means more gridlock, more compromise and less significant reform. Equities have historically outperformed in just this scenario.

Equities outperform when government is split

Average S&P 500 total return since 1960



Source: Bloomberg Finance, L.P., FS Investments, as of November 5, 2020.

The election may yet spark volatility, however. The transition of power has in its earliest days been rocky. Several key states (starting with Georgia and Pennsylvania) will certify their elections over the next week. This could put the transition further on the market's radar. Moreover, due to a runoff election in Georgia, the Senate is still in play. On January 5, Georgia will vote for two senate seats, a race that will likely occupy national attention. Currently, the Democrats have 48 seats in the Senate versus 50 for Republicans. The Democrats would have to win both senatorial seats in Georgia to attain a 50-seat tie, which could then be theoretically broken by Vice President-elect Harris.

The election implication on policy is important, particularly because the "blue wave" has not materialized. The expectation of a $3 trillion fiscal stimulus package included in Mr. Biden's economic platform will likely be slimmer. For the economy, the difference between spending $1 trillion and $3 trillion is enormous—it is the difference between 5% and 15% of GDP. That is a gross oversimplification which ignores the timing and manner of stimulus which can vary immensely. This is more a point about the magnitude of the numbers being discussed and, needless to say, the evolution of stimulus will be closely watched for those of us adding up a GDP forecast.

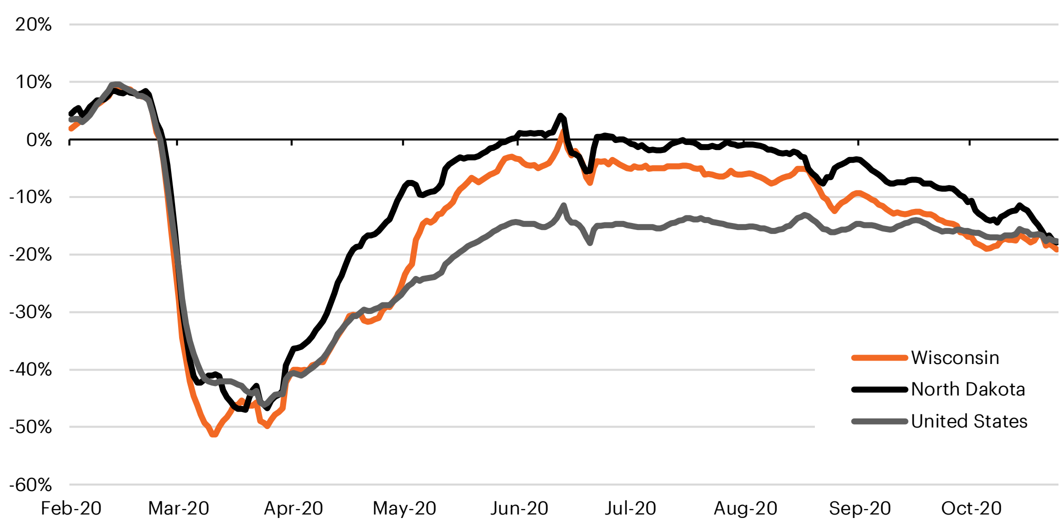
For equity markets, the divided-government bonus stems from the diminishing likelihood that the corporate tax cuts from the 2017 Tax Cuts and Jobs Act will be reversed. In other words, moderation seems to have prevailed. For fixed income, the expectation that significantly higher deficit spending, with potentially higher growth, could send yields higher has eased somewhat (more on this later). We saw this play out in the week following the election, as the S&P 500 rose 4.2% and closed the week at the high of the week, yet the 10-year Treasury yield fell 8 bps.

Vaccines vs. lockdowns

Still, this is 2020, and COVID-19 is unwilling to concede top headlines for more than a few days. On Monday, November 9, markets awoke with euphoria as Pfizer reported 90% efficacy of its COVID-19 vaccine, causing the S&P 500 to open up another 3.4%, at an all-time high.[1] Positive vaccine news has continued to roll in—a similar announcement from Moderna followed just days later—keeping equities in record territory.

At the same time, grim headlines of rising rates of community spread and hospitalizations have made clear that the immediate reality of the COVID-19 pandemic has taken a sharp turn for the worse. On November 18, there were 172,400 new COVID-19 cases versus just 47,900 a month prior. Community spread is also much broader. Virtually every state is seeing cases increase, with cities, suburbs and rural communities alike seeing rising contagion. Each state has been navigating its own response, which makes it hard to summarize. Mobility data is showing another gradual decline, but the decline is stronger in several notable states which reopened more quickly and are now seeing some of the worst of the current outbreak.

Google mobility data



Source: Google, Macrobond, as of November 13, 2020.

It is important to take a moment and marvel at how resilient the economy has been to date in the face of the pandemic. Yes, the -31.4% GDP decline in Q2 was a record, but the 33.1% bounce in Q3 GDP was stronger than virtually anyone had expected. A significant disruption in employment has persisted, and yet consumer sentiment has been solid and business sentiment has surged. The CARES Act—the $2.4 trillion fiscal stimulus package passed in March which delivered support to various sectors of the economy throughout the summer and into the fall—was surely an enormous help in cushioning the economic impact of the shutdowns in Q2. We had a second wave of outbreak in June and July, but Americans have gotten better at navigating the pandemic, and consumer sentiment actually improved throughout the summer as the labor market recovered faster than expected.

1 The market sold off from the open, but still ended the day up 1.2% on Monday, November 9.

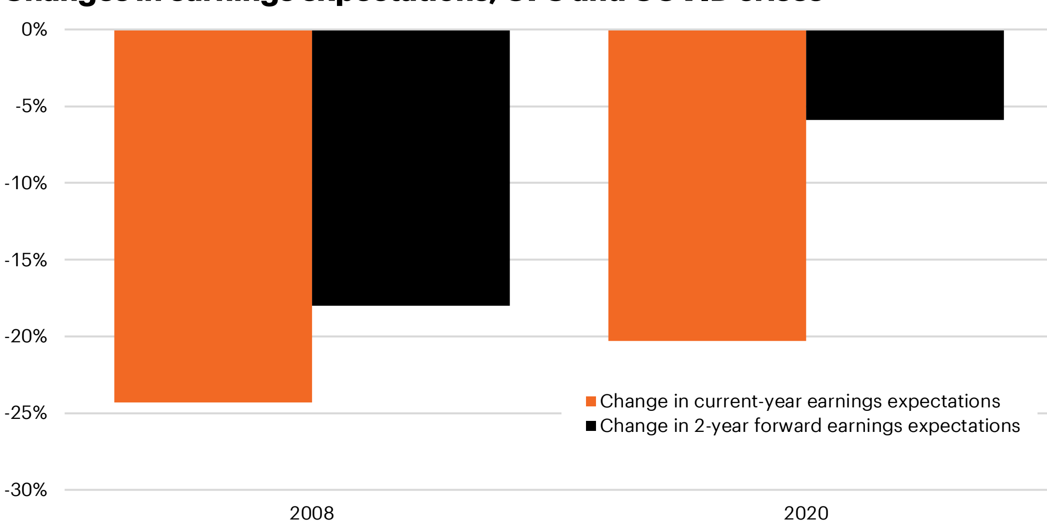
How will this new phase of the pandemic impact economic growth? While the broad-based shelter-in-place orders of the spring are unlikely to be repeated, localized shutdowns have already begun. (Here in Philly, for instance, my kids' sports have been canceled and indoor dining is set to close.) Even a short shutdown can have a significant impact. Early shutdowns in mid-March—just the final two weeks of the quarter—caused Q1 GDP to fall -5%. Currently, the consensus expects Q4 GDP growth of 4.0%.[2] Should the pandemic continue to spread at the current rate, however, that could be too optimistic. Speculation of a "double dip," where growth contracts again instead of steadily expanding, could seep into investor concerns. In fact, this is not abnormal; five out of the last seven recessions (prior to the current one) experienced a double dip. It is unlikely to be nearly as severe as the Q2 decline, but the pandemic remains an undeniable risk to the U.S. economy.

The economy is not the markets

This whirlwind of news has starkly different implications for markets and the economy. In normal times, the economy often behaves differently from financial markets. 2020 has stretched that contrast beyond what most could have conceived. The data that we have to measure the economy is the real-time dollars and cents of consumption and production. Therefore, risks of shutdowns, limits to travel, or anything that risks interrupting the almighty U.S. consumer is a clear-cut negative, while household stimulus checks and other fiscal spending is a direct positive.

Markets, however, are inherently forward-looking. Since the beginning of the pandemic, markets have had conviction that the interruption to the economy would be short-lived. Well, let me reframe that: Conviction arrived after a -33.9% sell-off,[3] 175 bps of rate cuts, $3 trillion in quantitative easing, $2.4 trillion in fiscal spending and a host of other emergency facilities created by the Fed to maintain market function. After this hefty dose of "liquid courage," markets and analysts looking ahead have held onto confidence that while the near-term risks to earnings were severe, looking out two years and beyond, we would be close to back to normal. This is in sharp contrast to the Global Financial Crisis (GFC) of 2008, when the economy also weakened and markets fell, and equity markets were more pessimistic about long-run prospects for economic and earnings recovery.

Changes in earnings expectations, GFC and COVID crises



Source: Bloomberg Finance, L.P., FS Investments, as of November 17, 2020.
Note: Chart shows the % change in Bloomberg consensus S&P 500 EPS expectations from January 1 to November 17 of the year shown.

2 Federal Reserve Bank of Philadelphia Survey of Professional Forecasters, November 16, 2020.
3 The S&P 500 fell -33.9% from its pre-COVID high on February 19, 2020, to its bear market low on March 23, 2020.

Where do we go from here?

There are seven weeks left of 2020—what could possibly happen? In a year known for black swan events, it is tempting fate to try to predict how it will end. On the economic front, early indications for Q4 are that the economy is slowing but remains solid, with good momentum from the Q3 bounce. Concerns are creeping in as high frequency mobility data shows a retracement, which is expected given regional reaction to outbreaks. Given the high concentration of community spread in largely Republican states which had been mostly heretofore spared, pressure may soon come to bear on Congress to strike a bargain and push forward some fiscal relief. The broader the problem, the more widespread the call for further stimulus. I had been pessimistic during the summer that we would get another stimulus package, but now the chances of further stimulus may have improved.

For financial markets, 2020 has seen the fastest bear market, and fastest recovery, on record. We look to be closing out of 2020 with equity markets at all-time highs and valuations that mirror the tech bubble. The transition to a new administration looms as a potential source of volatility. And we expect markets to remain hyper-sensitive to news about a COVID-19 vaccine, both positive and negative. Markets are rightly upbeat now as they see a potential vaccine coming in the spring of 2021, but as current vaccine results are still preliminary, there could yet be concerns—even if fleeting—about development, efficacy and distribution.

But still somehow this seems too obvious for 2020—a year that has trained us to expect the unexpected. When I think of how volatility could take investors by surprise, I look to fixed income markets. With the Fed funds target at zero and the Fed buying billions of Treasuries every month, the yield curve has been flattened like a pancake. For the seven months ending in October, the 10-year Treasury yield held to an exceptionally tight range of less than 30 bps, from 0.52% to 0.82%.[4] But suddenly, long-term yields breached the top of that band. Before the election, market expectations of a "blue wave," which (it was reasoned) could cause large deficit spending and potentially higher growth, raised the possibility of higher interest rates.

Now, should a vaccine materialize and return the economy "back to normal," it could mean a significant uptick in yields—and potential headaches for fixed income investors. Currently, with inflation running at 1.5% and 5-year inflation expectations around 1.75%, long-term real interest rates are almost 100 bps in negative territory. Should a healthy economy cause inflation to rise to 2.0%, long-term yields—which naturally track with long-run inflation expectations—would rise as well. While this rise in yield would do little to meaningfully allay investors' income issues, it would be devastating to portfolios that are long duration. Were long-term yields to rise by 100 bps, it would take about three years of 2% income to make up the price decline caused by such an increase in rates.

The current moment is incredible in the sheer number of uncertain variables facing us. An unprecedented election season will be capped by a dual runoff to decide the level to which the incoming administration will be able to implement their policy goals. The Herculean task of distributing vaccines to hundreds of millions of people is complicated by a surge in the very pandemic we all hope they will help cure. Markets have thus far been resilient, and people even more so. For investors navigating these choppy waters, diversification and income have seldom been more important.

4 Bloomberg Finance, L.P. From April 1–October 31, 2020, 90% of market close was within the 0.52–0.82% range.

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Lara is Chief U.S. Economist and Managing Director on the Investment Research team at FS Investments, where she analyzes developments in the global and U.S. economy and financial markets. Her fresh take on macroeconomic issues helps to inform and develop the firm's long-term views on the economy, investment trends and issues facing investors. Lara is committed to the Philadelphia community and serves on the boards of the Economy League of Greater Philadelphia, Hyperion Bank and Starr Garden Park.

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