RECOVERY WATCH

fathom
Independent Thinking

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Subscribe to Fathom's regular *Recovery Watch* newsletters for the latest insights into the impacts of COVID-19.

Headlines

- Covid cases appear to have peaked in several European countries, including the UK
- In a replay of the first wave, US new cases continue to climb as they lag Europe by one or two months
- Caseloads in Emerging Markets are just beginning to increase
- Bullish sentiment in markets as Dow Jones index hits the psychologically important 30,000 level
- A continued bull market is increasingly likely in the short-term if policy stays accommodative
- Important short-term and long-term risks need to be recognised too, including challenges in delivering the vaccine and the need to deal with deficits fuelled by unprecedented policy measures

Despite the upbeat sentiment generated by encouraging news on vaccines, the hard truth remains that the COVID-19 emergency is not over yet. Large parts of Europe remain in lockdown. This has helped tame the number of new cases and control the number of deaths, which is a positive in no uncertain terms. However, governments have blemished their records by continuing to rely on blunt and expensive instruments to meet these objectives, such as widespread mobility restrictions. Many of the lessons from the first wave have been unheeded and policies have largely remained reactive rather than proactive.

This is all too clear when we look at trends in deaths and new cases. There is a lot of emphasis on these numbers, and rightly so. But there should also be more public scrutiny of the dynamics of the virus, and the effects of the policy measures that have already been introduced. In the UK, for example, there is a healthy debate about how far the peak and drop in cases can be explained by the new lockdown measures. Internationally, the dynamics of the virus remain similar to those observed in the first wave: new cases and deaths rise first in Europe, then the US follows suit and then selected EMs become a hotbed of contagion.

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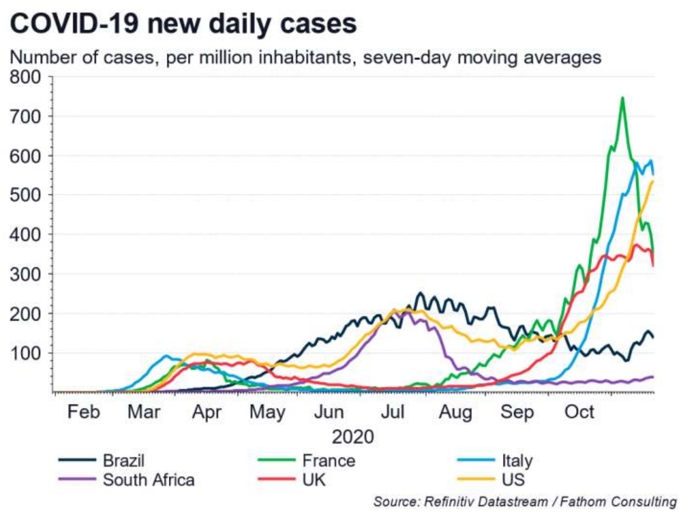
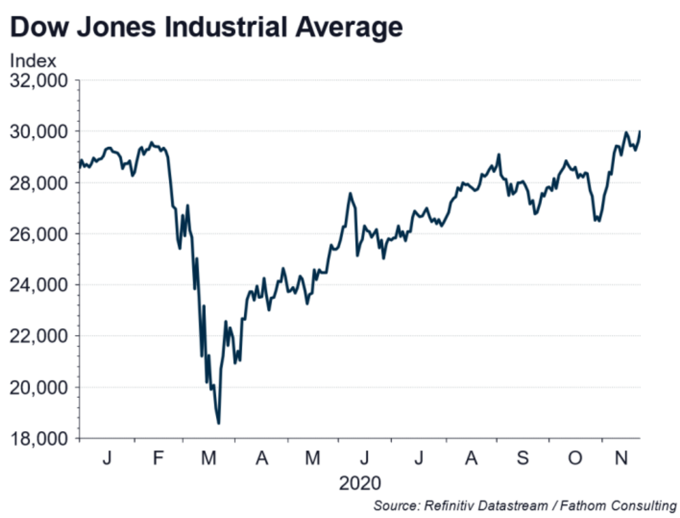


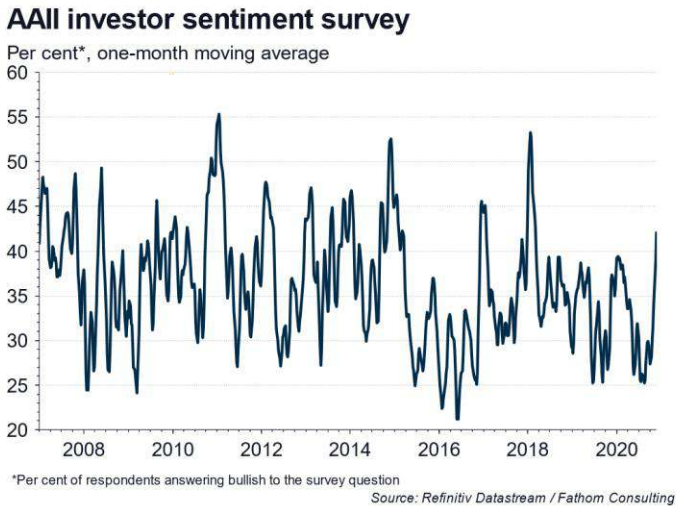
Seen through this lens, we are just approaching the second phase of the second wave, with conditions likely to get worse in the US and outside Europe before they get better.

The point is a deeper one than merely using hindsight to criticise the actions taken by governments. Hope needs to be rooted in reality. In a working democracy, it is vital for the public to hold the government to account and to expect high standards of the policies it formulates, firmly rooted in evidence. The public also needs to take an interest in how well policies are delivered. For example, sentiment may be running high on news about the vaccine. Yet, implementing an effective, swift, mass-scale vaccination programme requires a standard of competence in the delivery of public policy that is somewhat above the level that we have been accustomed to recently. For the moment, it is hard to completely dispel the notion that the vaccine is becoming another short-term miracle solution, a *deus-ex-machina* which is helping to deflect public attention from the immediate shortcomings in the bureaucratic apparatus. The rollout of the vaccine programme may not be as seamless as current market sentiment appears to suggest.

Positive sentiment has swept through the financial markets with particular force. Yesterday, the Dow Jones index broke through the psychologically important 30,000 level for the first time ever. Outgoing US president Donald Trump even picked the occasion for a short press conference which had all the hallmarks of a swan song.



According to the American Association of Individual Investors' survey, a widely used indicator of market bullishness, sentiment among investors has hit the highest since 2018 and is at levels approaching over-confidence.



Other dynamics are also in play. The pandemic has disproportionately benefited a narrow segment of the market, with the top 5 stocks in the S&P500 — Apple, Microsoft, Facebook, Amazon and Google — making up over 20% of the total market capitalisation of the index. News of a vaccine has moderated some of the enthusiasm for tech stocks. The question in investors' minds now is increasingly less about whether a normalisation in this trend is likely to continue, but how. Is a generalised surge to loftier valuations in prospect across a broader section of the index, or is a tech meltdown towards more sober price levels more likely?

Monetary policy will be important in determining whether we get a meltdown or a melt-up. Should policymakers be too eager to declare 'mission accomplished' and withdraw measures designed at providing liquidity to markets, investors may be caught flat-footed. This is a potential trigger point for a meltdown scenario.

Our proprietary market liquidity measure, FLiq, highlights this risk well, as overall liquidity conditions have not fully recovered and large segments of the market have become reliant on liquidity support measures.

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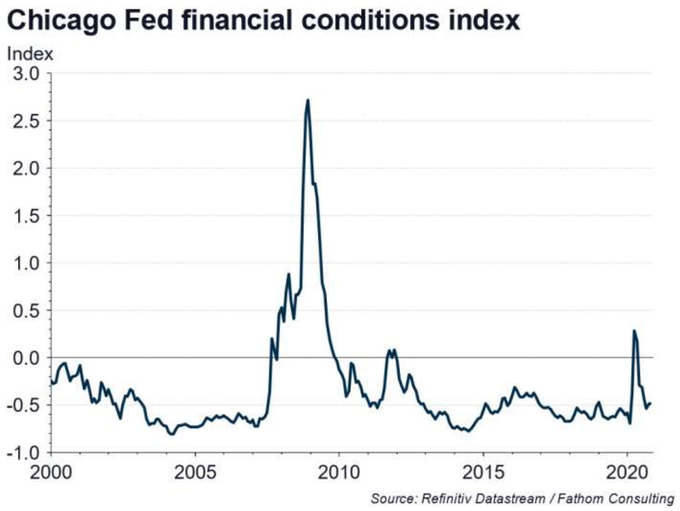
Throughout this pandemic, policy makers have been very aware of financial risks and have been effective at quashing any source of potential stress in financial markets. Large government programmes and abundant liquidity have led to a compression of risk premia, possibly even capping them. Financial conditions are well within normal levels and they never spiked significantly out of control during 2020, unlike 2008 in the period after the Lehman bankruptcy.



Fathom's own measure of sovereign risk, the Sovereign Financial Vulnerability Index, points to how the positive influence of these policies from developed markets has spilled over into emerging markets, although less markedly into frontier ones.

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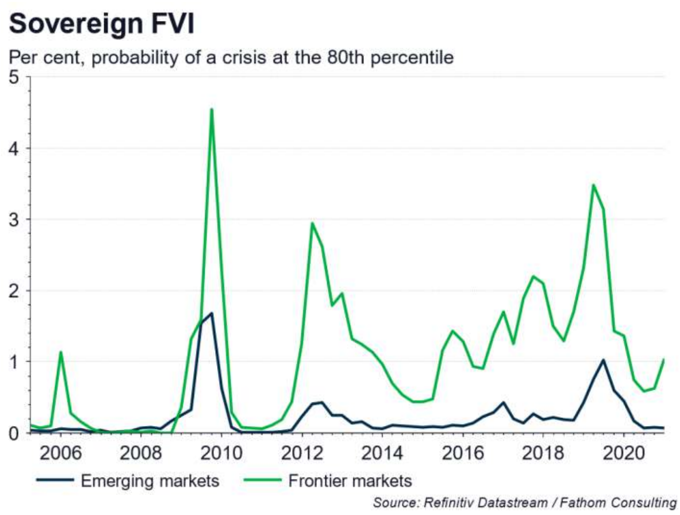

Early evidence seems to suggest that conditions will remain very accommodative in the short term. In Europe, the ECB has already telegraphed that more stimulus is on the way in December. In the US, the change of guard at the White House also comes with lofty ambitions for further spending. If the appointment of Yellen to Treasury Secretary is a statement of intent, fiscal policy will be explicitly set by a former central banker.

Overall, given accommodative policies and some potentially easy ground to be made up, it is understandable why markets feel confident. As we noted this week in our weekly markets update, *Fathom the Markets*, we see the greatest upside potential in the short term coming from stocks strongly connected to economic fundamentals. However, it is important not to lose sight of the immediate risks in terms of the virus, the challenges associated with delivering a vaccination programme and the barriers to the presumed quick return to normal. At some point it will be also worth discussing the long-term consequences of the unprecedented generosity of current policies. In the meanwhile, feel free to reach out, and keep reading for more.

Interesting reading

- Qantas Becomes First Airline To Require Passengers To Get Covid-19 Vaccine Before Flying Internationally: https://www.forbes.com/sites/roberthart/2020/11/24/qantas-becomes-first-airline-to-require-passengers-to-get-covid-19-vaccine-before-flying-internationally/
- CDC Director goes on record to announce US vaccine roll-out as early as mid-December: https://www.foxnews.com/health/redfield-projects-covid-19-vaccine-to-be-rolled-out-by-end-of-the-second-week-in-december
- A neat dashboard exploiting mobile tracking to measure impact on different sectors: https://www.cuebiq.com/visitation-insights-visit-index/
- Corporate credit measures unveiled by the Fed during the pandemic capped risk premia in credit markets at 100 percentage points: https://www.nber.org/papers/w28097
- The UK's notorious 'Excel' glitch in contract tracing is associated with more than 125,000 additional infections and over 1,500 additional COVID-19 related deaths, new research finds: https://warwick.ac.uk/fac/soc/economics/research/centres/cage/manage/publications/wp521.2020.pdf
- A novel database has been used to estimate that each job saved in this pandemic has cost the US treasury $37700: The Economic Impacts of COVID-19: Evidence from a New Public Database Built Using Private Sector Data | Opportunity Insight

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