WESTMINSTER

ASSET MANAGEMENT

Light at the end of the tunnel. **Investment Strategist Peter Lucas see's the recent vaccine news as a significant sign of the expected turnaround in market leadership.**

In late July we said that the low in bond yields was "days or weeks away". Two weeks later (*Buckle up!*) we said that the price action in the bond market was suggestive of a top and warned that we were on "the verge of a major gear change in the markets, which will likely herald a period of volatility as investors figure out what is going on and rejig their portfolios accordingly". The US 10-year yield made its most recent low on August 6th and has been grinding higher ever since. More recently, the rise in yields has been accompanied by a dramatic rotation from growth into value, from large caps to small caps and from COVID havens to COVID victims. Although overall stock market volatility has dropped, the moves at individual stock level have been breath-taking, in both directions. In this note we examine what has behind these developments and explain why we think that the rise in bond yields and the big stock rotation both have legs.

Although US and UK bond yields bottomed in early August, the reality is that they didn't go very far for several weeks. On November 5th the 10-year gilt yield was briefly as low as 0.17%, just 11 basis points above the low posted on August 4th. Although investors have been encouraged by signs of economic recovery, their enthusiasm has been tempered by the spread of COVID, particularly in UK/Europe. That all changed on November 9th when Pfizer said that in tests their COVID vaccine had proved to be 90% effective. This news caused bond yields to spike and investors to dump the shares of businesses that have thrived under COVID and to buy those that have found the going much tougher. That day the share price of Zoom, the online video conference company, dropped 17%, and that of Carnival, the cruise operator, jumped 39%!

The vaccine will take months to be approved, manufactured and distributed. But from a market perspective that doesn't matter. Today's markets are being driven by events that will happen 6-9 months ahead. The market recovery stalled in June despite massive policy intervention because there was virtually no transparency into the future. The Pfizer news changed that, leaving investors much more inclined to view the glass as half full. Indeed, we now think that the markets have now entered the next phase of our story, with much more of what we have seen recently to come. Bond yields will likely rise by 0.5-1.0% to take them back to where they were at the start of the year (as a first target) and money will continue to rotate into more cyclical assets (some of which were highlighted in our July article).

Energy commodities and shares are worth a closer look. The price of oil is relatively low both in real terms as well as relative to other commodities. Energy shares are even cheaper. In the last 30 years the relative performance of the US energy sector (versus the S&P 500) has correlated closely with the real oil price (correlation coefficient of 83%). More recently, whether due to ESG-driven selling or simple investor capitulation, the energy sector has performed considerably worse than the real oil price would have implied. Consider this: at the end of October the real oil price was higher than it was in January 2016, but the energy sector had underperformed the S&P 500 by 126% (-41% vs +85%). Clearly, some of that is down to the unusually strong performance of large cap tech stocks like Microsoft and Apple, but still, that degree of underperformance in just four years is staggering. The likelihood is that clean energy will eventually take over from dirtier fuels like oil, but it is not going to happen overnight, and in the meantime, oil and most particularly, energy shares look like cheap ways to play the recovery/inflation story.

Peter Lucas

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