CIO | VIEW

CIO Flash

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GOLDEN NOVEMBER - SO FAR

The U.S. elections and a Covid-19 vaccine breakthrough have provoked an upheaval in capital markets. Euphoria prevails, with foreseeable pitfalls.

IN A NUTSHELL

_ With regard to the U.S. elections, the market has shown remarkable flexibility, finding positives in a scenario it previously viewed as bad.
_ With markets already buoyant, surprise positive vaccine news added to the euphoria.
_ Overall, two areas of risk appear to have been significantly defused, and euphorically celebrated. From a one-year perspective, we believe there is further potential, as long as interest rates stay tamed.

MARKET REACTIONS

Many investors have enjoyed the start of November a lot, with capital markets suddenly in "risk-on" mode[1]. On Tuesday morning, Europe's stock markets are ahead by an average of around 15% so far in November, compared with less than 10% in the United States. The biggest boost came on Monday, from positive news on a Covid-19 vaccine. Particularly striking on Monday was strong sector and theme rotation. Value stocks rose almost five times as fast as growth ones (whereas growth stocks were in strong demand immediately after the election). And with expected winners and losers from lockdowns, the picture was similar.

The rally since the beginning of this month has more than compensated for the market weakness since mid-October, with the MSCI AC World Index trading at a historic high intraday on Monday. For bonds, reactions were more mixed. While U.S. government-bond yields fell shortly after the election, they soared to just under one percent on Monday, while German Bund yields began the month with little change before also rising significantly. Meanwhile risk premiums on corporate and European periphery bonds narrowed sharply. Since the beginning of the month, the dollar has been weaker against currencies of major trading partners (for example against the Japanese yen and South Korean won) and stronger against the euro.

U.S. ELECTION RESULTS

In our opinion the market reaction to the U.S. election once again showed what an unreliable political barometer the stock markets are. At the beginning of the year a victory by Trump was supposedly investors' preferred scenario but this idea gave way to a feeling in the summer that a clear victory for the Democrats (a Blue Wave, i.e. also the takeover of the Senate) was likely, and would have its pros and cons. In the aftermath of the election, however, investors showed themselves to be flexible again, celebrating a result that they had previously viewed as the worst outcome: a narrow, contested victory, and with power shared between Congress and the White House. At this point, however, we assume that Joe Biden's victory is undeniable, while in the Senate the Republicans will likely retain their majority by a narrow margin. It could, however, take until January 5 (probable Georgia by-elections) to confirm this. In Congress, the election has rather strengthened the political center, which should allow an experienced politician and bridge-builder like Joe Biden to reach cross-party compromises. However, the Democrats' boldest plans, for example, removal of most of President Trump's tax cuts, are likely to be off the table.

COVID-19 VACCINE

For the global pandemic, important news came from a site only about 40 km from DWS's Frankfurt headquarters. A young company together with its partner, a multinational U.S. pharmaceutical company, announced a breakthrough in Covid-19 vaccine development on Monday. The vaccine showed an efficiency of "over 90%," according to a press release.

[1] This means that investments with a higher risk-return profile are preferred to the supposedly less volatile and lower-yielding ones.

Previously, the market had expected much lower levels, with efficiency rates of around 50%. Approval is expected to be granted this month, with up to 50 million units to be distributed to select recipients this year. The aim is to deliver 1.3 billion units in 2021, mostly towards the end of the year. Encouragingly, other companies that share the same technology are also making good progress in developing a vaccine. Of course, there remain difficulties and uncertainties. The vaccine has to be transported and stored at minus 70 degrees Celsius and its effectiveness for specific subgroups and how long it remains effective are still unclear. Reliable data on side effects should be available in the third week of November, and data on efficacy, in line with U.S. regulatory authorities' protocol, in December. Other open questions remain the willingness of the population to be vaccinated with a first-generation preparation (Deutsche Bank Research estimates a range from 34% to 61% for individual countries[2]), and whether the prospect of a vaccine may cause populations to cease to take Covid-19 precautions, with potentially negative consequences.

IMPACT ON ASSET CLASSES

We do not yet know how substantial and lasting the impacts from the U.S. elections will be on asset classes. The political agenda is still too vague. Also unclear is to what extent asset classes may have already priced in future policies. But the news on a new vaccine is certainly positive. We will examine how much this could bolster economic recovery in 2021 and the impact on individual asset classes in more detail later this week as part of our quarterly strategy meeting. From a macroeconomic perspective, we had expected a difficult first half of 2021 and normalization in the second half. The vaccine news, we believe, underpins our assumptions.

From a capital-market perspective, weighty uncertainties certainly seem to have been resolved. There was no immediate unrest around the U.S. elections and the risk that U.S. bond yields will soar seems lower given that the Democrats did not achieve a clean sweep and will not likely have a free rein with their stimulus plans. This is already reflected in a sharp drop in volatility in many asset classes, with the CBOE Volatility Index (Vix) in the U.S., for example, falling from 40 to 25 points at the turn of the month, not far from its lowest point for the year, at 20. However, we believe equity investors should not overlook the complex interaction between the vaccine news, economic recovery, central-bank interventions and interest-rate levels. Especially since mid-2019 the increase in equity valuations has paralleled the course of real interest rates. Now it is possible that the economic outlook is slightly improved. But we believe it is also possible that bond yields move a little higher, which may challenge equity valuations. Previously we had a moderately positive 12-month outlook for equities and corporate bonds, as well as selected emerging-market bonds. We will evaluate in due course if the term "moderately" has to change. For now there seems little to stop markets' new found enthusiasm.

GLOSSARY

Bunds is a commonly used term for bonds issued by the German federal government with a maturity of 10 years.

The CBOE Volatility Index (Vix) is a trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index. It is a popular measure of the volatility of the S&P 500 as implied in the short term option prices on the index.

A central bank manages a state's currency, money supply and interest rates.

The Democratic Party (Democrats) is one of the two political parties in the United States. It is generally to the left of its main rival, the Republican Party.

Emerging markets (EM) are economies not yet fully developed in terms of, amongst others, market efficiency and liquidity.

The euro (EUR) is the common currency of states participating in the Economic and Monetary Union and is the second most held reserve currency in the world after the dollar.

Growth stocks are stocks from companies that are expected to grow significantly above market average for a certain period of time.

The Japanese yen (JPY) is the official currency of Japan.

The MSCI AC World Index captures large- and mid-cap companies across 23 developed- and 24 emerging-market countries.

Periphery bonds are government bonds issued by smaller countries of the Eurozone, e.g. Ireland, Portugal, Greece; sometimes also Spain and Italy are included. Historically, the term ‘Periphery' was based on the stage of economical development and is currently used to refer to the above mentioned countries.

In economics, a real value is adjusted for inflation.

The risk premium is the expected return on an investment minus the return that would be earned on a risk-free investment.

The South Korean won (KRW) is the official currency of South Korea.

Valuation attempts to quantify the attractiveness of an asset, for example through looking at a firm's stock price in relation to its earnings.

Value stocks are stocks from companies that are trading at prices close to their book value and that are therefore cheaper than the market average on that metric.

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

Yield is the income return on an investment referring to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

[2] Deutsche Bank Research, Thematic Research "Everything We Know About a Covid-19 Vaccine II" as of 11/9/20

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