J.P.Morgan

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Macro and Market Views: Can the Rally Continue?

Positive advances for vaccines outweigh the rising second wave with US election uncertainty to fade

Please click here for the conference call replay of the J.P. Morgan Global Research cross-asset macro and market conference call on November 18th, outlining our views on the current state of markets and the outlook for the global economy. This link to the PowerPoint deck contains key charts highlighting core views across asset classes.

Attention on the US election outcomes and President-elect Biden's policy priorities has been subsumed in part by the trajectory of COVID-19, with the market weighing the current rise in a second wave of infections against the longer-term outlook given the positive advances for vaccines. Our strategists are comfortable staying long risk as challenges to the US presidential election outcome are likely to be resolved by the December 14th Electoral College deadline to certify votes. The most likely outcome for the Senate remains Republican-controlled which means a smaller fiscal stimulus, but which also reduces the possibility that populist policies and tax increases will be enacted. The melt-up for credit markets and Value rotation for the S&P 500 should continue into 2021, even after the strong rally of the past few weeks.

Top 10 takeaways from J.P. Morgan Global Research virtual meeting on Nov 18

1) **Challenges to the Presidential election unlikely to linger past the December 14th deadline for the Electoral College to certify the vote, while Republicans appear likely to retain control of the Senate from the two January 5th Georgia Senate run-off races**. The first cabinet announcements could be made right after Thanksgiving, while the extension of spending authorization to avoid a government shutdown by December 11th is likely to pass in the lame duck Congressional session.

2) **The second wave of COVID-19 is close to peaking in Europe, but the drop in mobility due to lockdown measures since mid-September to ease the spread of the virus has resulted in a 9% annualized contraction in GDP for 4Q20.** Europe's experience suggests that greater downside lies ahead for US growth as the second wave of infections continues to rise, with the downside effects on GDP growth likely to materialize in 1Q21, which could see a modest contraction in growth, although of a much lower order of magnitude than 1H20.

3) **Successful vaccine development is the circuit breaker between rising COVID-19 infections and increasing restrictions on activity.** On the heels of positive developments from BioNTech/Pfizer and Moderna, we see a higher probability of success across the board for other vaccines to scale up production, with the timing for mass global vaccination programs likely by next summer.

4) **The next fiscal stimulus will likely be smaller and take longer to materialize, and our US economics team anticipates a ~$1trn stimulus to be approved in late 1Q21.**

5) **The Fed will likely look to extend the weighted average maturity of their Treasury purchases at the December FOMC meeting given the downside risks to growth**, but the extension of the Federal Reserve 13 (3) Facilities[1], which are due to expire at year-end, remains uncertain.

[1] For a full listing of the Federal Reserve 13 (3) Facilities, please see "Alphabet Soup 4.0: A Fed intervention cheat sheet", Alex Roever and Teresa Ho, 05 June 2020.

6) **Our US rates team sees that fair value for 10-year UST yields at year-end could dip to around 75bp, while the steepness of the curve staying fairly close to where it is now.** The extension of the Fed purchase programs and the rotation from shorter duration purchases to longer duration could continue to weigh down the Treasury yield curve keeping it flat but will help take care of extra supply issues.

7) **Credit spreads could continue to move tighter and overshoot our year-end targets further, with our global credit team eyeing the prospects of both High Grade and High Yield transitioning back to pre-pandemic levels.** The classic low-beta, high-beta convergence trade or, in the common vernacular, a "dash for trash," has room to run further, and it is conceivable that US High Yield could tighten back to the low 400bp level.

8) **High Yield default rates will edge lower in 2021 to 3.5%.** Fears of zombie companies may be misplaced, and the key issue remains whether some companies in COVID-impaired sectors will be able to grow themselves into their capital structures. This depends on the path of the economy, behavior in a post-COVID world, and whether there is recovery in demand that approaches pre-pandemic levels.

9) **Our US equity strategy team sees S&P 500 reaching 4,000 by early next year, with a good potential for the market to move even higher (~4,500) by the end of next year.** The team has revised 2021 EPS estimate by $8 to $178 and introduced 2022 EPS of $200.

10) **There remains ample runway for the Momentum/Value rotation to continue.** The most attractive sectors within Value are consumer cyclicals tied to leisure and entertainment, banks and energy.

Jason Rosenberg, Head of U.S. Government Relations

Challenges to the Presidential election outcome should be resolved at the latest by December 14th when the electors of the Electoral College meet to cast ballots for the President and Vice President, but the bigger political focus is on the January 5th Georgia Senate seats runoffs which likely will be held by the Republicans, confirming a Democratic President and split Congress scenario. The unresolved control of the Senate will be decided in the two January 5th Georgia Senate runoff races, but is currently driving much of the political dynamics in Washington. The delay in ascertainment by the Government Services Administration (GSA) is more important than just for logistics, as it delays processes such as comprehensive background checks for incoming appointees.

Stimulus will unlikely be sooner or bigger than Democrats were hoping for if a blue wave would have materialized. The package is likely to slip into late-1Q of next year (around $1trn), and election outcome will reinforce the overall trend towards executive action; expect cabinet names post-Thanksgiving. There are two must-do's in the lame duck session, extension of spending authorization to avoid a government shutdown by December 11, and the annual defense authorization process, but we should not expect much more. Biden has already started announcing senior White House Advisors who do not require Senate confirmation, we may get a few names for confirmed Cabinet-level positions in the next week or so, but should get much more post-Thanksgiving including key positions such as Defense, Treasury, and the Attorney General. The trend towards greater policy delivered through executive action has been in play since George W. Bush, and we should expect more of that under a Biden-split government. Expect executive action towards rejoining WHO, the Paris Climate accord, and reversal of energy sector and immigration actions under Trump in the first few days of Biden's presidency. With Judy Shelton unlikely to get confirmed, Trump will likely leave one Fed board appointment for Biden to make, assuming Christopher Waller does get confirmed.

Cory Kasimov, Senior Biotechnology Analyst

Early vaccines likely to get emergency authorization before year-end, before others follow, with global mass vaccination programs likely next summer if not slightly earlier. Both early mRNA vaccines from BioNTech/Pfizer and Moderna have released very encouraging preliminary results and are requesting emergency authorization globally. In the US, the FDA has indicated it may convene an advisory committee for around December 8-10, and we expect emergency authorization will come shortly after, possibly before the end of the year. The path towards mass global vaccination programs depends on how many additional effective vaccines will be available and how quickly they can scale up production. The outlook is encouraging as there are a number of additional vaccine candidates not far behind that should release data in December/1H21, and many are already ramping up. We understand the US has secured half of the initial planned production (around 25 million of the 50 million does) from one of the first two RNA vaccines. Companies have been tight lipped about distribution plans, but indications are that vaccine nationalism shouldn't be an issue. Low temperature storage also should not be an issue especially in the initial mass roll-out since vaccines will be used immediately upon delivery rather than stored.

Initial results look encouraging for vaccine effectiveness against severity and tolerability, although there will be a lot more to learn, especially around duration; the best assumption is that this is an annual vaccine. There will be a lot more data coming, and this will bolster vaccine acceptance. In the initial results of the two early RNA vaccines reporting, there were 11 severe cases in the placebo group, and only 1 of the 10 severe cases was in the vaccine group for the other trial vaccine across a total of approximately 75k people who received the vaccine in these trials. In terms of tolerability, there was some indications of flu-like symptoms around the second dose, but more severe symptoms were in the low-mid single digit % of test subjects.

COVID equity plays seem to have been overdone, although 2020 underscores the long-term potential for the sector more generally. There are too many vaccines under development, and the sustainability of cash flow is under question. But 2020 is a reminder of the potential for the sector that makes long-term prospects encouraging.

David Mackie, Senior Advisor for European and Global Thematic Research

Europe's mobility decline is likely sufficient for new infections to peak soon, with lockdowns to be eased in early December, which will allow a rebound in economic and social activity during the holiday season. The broadening of restrictions that took hold in September are accelerating a slide in our Google activity index of mobility (GAI), and we now forecast a 9% annualized contraction for the European economy in 4Q and 6% for the UK economy. Recent declines in the GAI match the degrees of restriction across countries. The steepest drop is in France, where restrictions are tightest, and we forecast a 15% annualized GDP fall this quarter. In the US, the continued sharp upswing in cases and hospitalizations points to more stringent containment measures in the coming weeks. Our analysis suggests that the US will need to lower its GAI by at least 14% cumulatively to break the current wave. This cumulative move of 14%-pts would be around 29% of the decline seen in the spring. By comparison, the falls in mobility already seen as a proportion of the first wave move are 43% in Germany, 27% in Spain and 25% in the UK. While the restriction in mobility needed in the US to push the reproduction number below one is far less than what we have already seen in Western Europe, it would represent a much larger drag than is currently embedded in our forecast for US GDP growth to slow to a 1.5% annualized rate in 4Q.

Michael Feroli, Chief U.S. Economist

Downside risks to growth in Europe have not yet materialized in the US as we have not seen much in terms of decline in mobility and activity data so far but do not rule out risks to growth in 1Q21. Chase credit card spending data through November has rebounded, and we still see positive 4Q growth in the US. There would need to be a large collapse in December for that view to change, but we do not rule out the risks especially in 1Q21 where risks are building to the downside. The Thanksgiving holiday could prove to be a super spreader event which could potentially affect activity data in December and January and, in turn, move growth in 1Q to a small negative, but the magnitude would be less severe than the hit to 2Q growth of this year. Another area of concern is in consumer services with restaurants being hit particularly hard into the holiday season. Claims data have become unreliable since the pandemic and relate to issues at the state labor offices dealing with a backlog of past claims. The link between claims data and actual layoff activities has become tenuous. In the September JOLTS report, the layoff rate was at an all-time low even though claims were still running at around 700k-800k. On fiscal, we see a potential $1trn package sometime in late 1Q of next year, which would support growth in the second and third quarter of the year. However, the composition of the package is still uncertain but could be similar to the CARES Act cut down by half in terms of what to expect with PPP, unemployment benefits, etc. For the Fed, we are now looking for the committee to extend the weighted average maturity of their Treasury purchases at the December meeting given both Fed Chair Powell and Vice Chair Clarida have acknowledged that the near-term outlook is deteriorating, which calls for more monetary policy action. Extending the weighted average maturity is likely the easiest method and more effective than just increasing notional amounts. It remains to be seen whether the Federal Reserve will extend the 13 (3) facilities, however.

Alex Roever, Head of U.S. Interest Rates Strategy

US elections, surge in infection rates, and headlines of recent vaccine developments have contributed to volatility and sharp movements in US Treasury markets over the past month. 10-year UST yields have round-tripped 10bp in the last week but have averaged ~86bp over the past month. Steepness of the treasury curves have also been choppy with the 5s30s curve, which is currently around 120bp, averaging 225bp (plus or minus 5bp) over the past month. Markets have been super attuned to headlines and have been trying to pick out signals from the noise but have become more resigned that fiscal stimulus will likely come later rather than sooner. It is possible that fair value for 10-year UST yields at year-end could dip to around 75bp while the steepness of the curve stays fairly close to where it is now. Our US economists' recent call that the Fed will extend the average maturity of its purchases at the December FOMC meeting should put downward pressure on the curve into year-end, before retracing higher in 1Q21.

The extension of the Fed purchase programs and the rotation from shorter duration purchases to longer duration could continue to weigh down the Treasury yield curve keeping it flat, but will help take care of extra supply issues. This will likely offset Treasury's size of bill issuance done earlier this year in their efforts to normalize the average maturity of what they were issuing in the marketplace but which would involve issuing more coupons. In addition, the expansion of the Fed's balance sheet, and the recent rally in bank stocks could have an influence on GSIB scores being larger at the end of this year. Year-end volatility around repo markets will also likely be reduced this year due to the Fed's asset purchases and because the Fed's backstop in regards to the provision of cross currency dollars being provided to foreign central banks is helping to keep the cross currency basis markets and FX markets more in line which will also help keep GSIB scores higher. We continue to find corporates more attractive versus opportunities in mortgages on average.

Stephen Dulake, Global Head of Credit Research

We have been looking for a 'melt-up' in credit markets for a little while, which it feels like we've gotten and which we think can extend further. European credit spreads should tighten about 10% from current levels for both High Grade and High Yield. For US High Grade, spreads are currently around 140bp and we think there's potential to initially tighten to 125bp, which is where they entered 2020. US High Yield spreads could get back to the low 400bp level, which is where they entered 2020. We see High Yield default rates edging lower next year to around 3.5% and could go even lower in 2022, possibly to 2-2.5%. We expect US High Grade gross issuance to decline next year to around $1.2trn vs the $1.75trn forecasted for this year. With COVID-related drags hopefully fading, it would be good from a creditor perspective to see some of the cash on company balance sheets find its way to paying down debt and reducing leverage at the margin. One of the key medium term questions in High Yield is whether there is enough growth for companies to grow into their capital structures; the extent of demand recovery in the hardest hit sectors remains to be seen. If companies can't grow into their capital structures then we will likely see more liability management and restructurings. However, capital markets have provided a lot of companies with a liquidity runway well into 2022. Financials remain attractive as unemployment levels are currently running below the worst case scenario outlined in CCAR stress tests. Energy offers residual value, and there is scope for COVID-impaired risk to tighten further.

The term "zombie company" seems to be fast-becoming one of those frequently used, yet not quite well-defined. In the aftermath of the Global Financial Crisis and the days of "amend and pretend," the term "zombie company" meant a company that continued to receive financing long after it should have absent a restructuring, and suggests that zombie companies were equally the product of weak lenders. We're not sure there are too many zombie companies that meet past definitions, but we think a key issue remains whether some companies in certain sectors are able to grow themselves into their capital structures. As we know and commented on previously, capital markets, particularly in the COVID-impaired sectors, have provided meaningful liquidity runways, in some cases well into 2022. This relates more to the path of the economy, peoples' behavior in a post-COVID world, and whether or not we see the sort of recovery in demand that approaches pre-pandemic levels. If not, there could be a proverbial Judgement Day. It could get messy, more restructurings, more defaults, and low unsecured recoveries, but it doesn't feel like we have some of the key ingredients we saw in Europe just over a decade ago.

Dubravko Lakos, Chief US Equity Strategist

The equity market has one of the best setups for sustained gains in years. We highlight expectations of many key risks subsiding (e.g. US elections, pandemic and vaccine news, etc.) clearing the path to a more positive forward outlook with an S&P 500 target of 4,000 for early 2021 and 4,500 by year-end. While has been some upward pressure on rates, central bank policy continues to be accommodative and a major pillar of support for equity multiples. We expect some incremental fiscal stimulus but scope and size should be narrower given the gridlock. Further, there should be less incremental negative headlines on issues of trade though the issue will sustain for longer. Positioning has been light and below average levels for systematic quant but also discretionary investors given stubbornly high market volatility. We expect continued volatility compression in the coming months to drive a mechanical re-leveraging process further supporting equity multiples. With record cash build-ups in 2020 along with expectations of normalizing economy (i.e. positive vaccine news), corporates will likely deploy incremental capital towards M&A and buybacks (net buybacks well below ~$650B run-rate YTD). Earnings recovery remains intact based on 3Q results with positive discussion around the state of the US consumer. Earnings expectations still have room for upside surprise with 2022 growth likely pulled forward to 2H21. There are still risks around the confirmation of political gridlock (i.e. GA Senate run-offs) especially given the potential for anti-growth policies under a Blue sweep scenario. Interest rates are also an area of complacency in the market that could pressure equity multiples and mega cap stocks (i.e. bond proxies) depending on the speed of increases and level. However, the 10-year yield would need to move up substantially to 1.50% to make us less comfortable with holding US equities.

There remains ample runway for the Momentum/Value rotation to continue. Pre-COVID, there was already a large dislocation between Momentum/Value. However, COVID and the subsequent measures in response to it further accelerated the dislocation as many Momentum stocks were key beneficiaries of WFH/e-commerce while Value was more negatively impacted by the weaker economy. Last week was one of the largest factor moves (momentum crash) since 1980 given the sharpness of the move over a short time frame. We expect Value to continue to perform well into 1H21 but to normalize at a more gradual pace. Within Value, consumer cyclicals/leisure/entertainment with stronger balance sheets are likely to benefit the most given their higher exposure to economic normalization. Bank and Energy stock also remain attractive.

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