Economic Background – June 2020

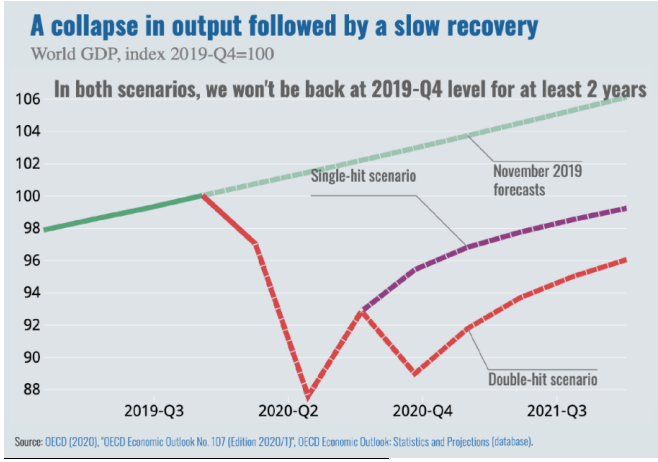
Bouncin' Back[1]

Whilst much of the western world has seen a reduction in Covid-19 infections over recent weeks there are still countries grappling with the virus and its economic consequences. We don't know when or if we may get a vaccine, but the data suggests that in the UK and Europe the measures taken have reduced the replication rate enough for the lockdown to be lifted. In the US however four states (Texas, Arizona, Florida and North Carolina) appear to be experiencing a sharp rise in Covid-19 cases after lockdown measures were lifted. The pandemic has caused a huge human and economic cost already and a re-emergence would be devastating.

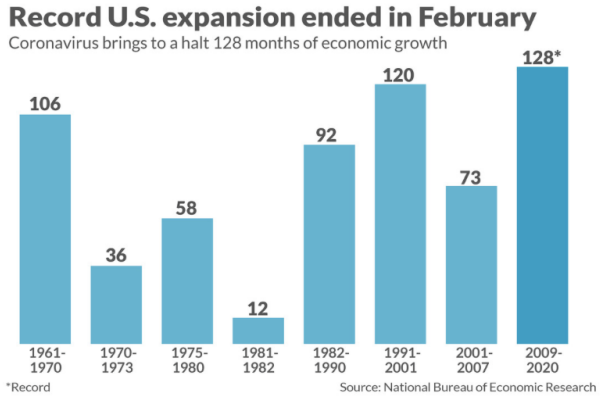
Fast or Slow recovery?

The global economy is suffering from the impact of the Covid-19 virus and an oil price collapse in part caused by the former and a supply control issue between Russia and Saudi Arabia. The combination of the two have caused yet untold economic harm and a liquidity crisis within capital markets. The UK (and EU) also face the uncertainty of Brexit.

In its June outlook the OECD (The Organisation for Economic Co-operation and Development) described the world economy 'on a tightrope' with the future 'highly uncertain'. If another outbreak of the virus is avoided it projects the contraction in global gross domestic product (GDP) to be -6% for 2020 in a synchronised global downturn. This is a marked deterioration from the International Monetary Fund's prediction last month of -3.8%. If there is to be a second wave of the virus in the autumn or winter, the OECD predict GDP will likely contract further to -7.6%. In both scenarios it predicts the global economy will not be back to the levels seen in 2019 for at least another 2 years. The OECD highlights that unemployment is rising sharply and without a second wave will be 10%+ in the third quarter of this year in most developed nations.



The National Bureau of Economic Research declared that the US had entered a recession in February this year, signalling the end of the longest periods of economic expansion in the country. US GDP declined at a rate of 5% in the first 3 months of the year. Given that the majority of the lockdown has occurred during the second quarter of the year the next GDP figure is expected to be much worse. Expectations are for it to decline at a rate of c20% in the second quarter with the US Federal Reserve (Fed) expecting the 2020 decline to be -6.5%. The latest data release on the US job market surprised many with a report that 2.5 million jobs had been added in May beating expectations that 7.5 million jobs would be lost. Whilst this was a surprise it leaves the unemployment rate at 16.3% (having been 3.1% 12 months ago). Inflation remains subdued with the Fed believing it will be sub 1% for the rest of the year.



Official Chinese economic figures suggest that activity continues to recover, with industrial capacity utilization back to 90% of the pre-Covid-19 level. The May Services Purchasing Managers Indices (PMI) increased to 55 from 44.4 in April, indicating a pick up in activity, albeit it from very low levels. The Chinese politburo has provided targets for local authorities to create 9 million new urban jobs this year. Though the 6% GDP growth target has been dropped in this year's National Party Congress, urban unemployment is targeted at the 5.5%-6% range. China's inflation rate fell to 2.4% in May from 5.4% in January. However, food inflation remains high at 10.6% (actually a 9 month low) with pork prices rising for a 15 month in a row.

[1] Rubber Ball, Bobby Vee 1960.

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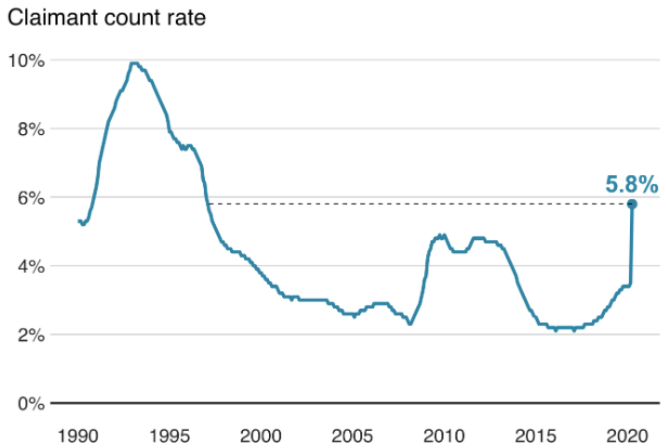
In the UK GDP contracted 2% in the first quarter, which was better than the 2.5%-3% expected. Inflation slowed to 0.8% in April from 1.8% in January and consumer confidence slumped to the lowest level since January 2009. The latest unemployment data we have is from February when the rate was 3.9%. In April alone more than 856,500 people claimed for unemployment benefits, bringing the total to over 2 million, a 5.8% unemployment rate. This is much less than the 10.6% rate in the spring of 1986 and the 9.9% in the early 1990s, but 2020 numbers don't include the number of people who have been placed on the governments furlough scheme. As of 7 June. 8.9 million people are currently on the scheme. Combining the benefit claimant count and the number of people on furlough suggests the rate of which the number eligible people who are not working at over 30%! How the UK transitions from the current status quo to the new reality will be crucial over the coming months.

Percentage of people claiming benefits



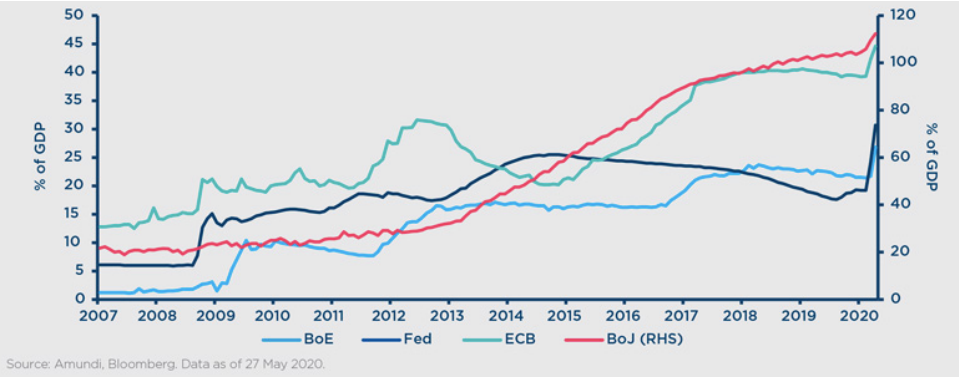
Office of National Statistics, BBC

The Eurozone economy shrank by 3.6% in the first three months of 2020, which is the steepest contraction on record. Among Europe's largest economies, Germany's GDP contraction was the sharpest since 2009, while France, Spain and Italy economies shrank the most on record. The major economies of the world are grappling with a deflationary environment and contracting growth, increased unemployment, social unrest and global trade tensions. Businesses are changing how they work and interact with staff and their customers. This inevitably requires increased expenditure on lower revenues and consequently lower profits. We expect the upcoming months to be quite challenging for the consumer and the businesses that rely upon them. Despite the gloom, history suggests that we will recover, eventually.

Turning on the taps

Against this backdrop equity and corporate credit markets bounced back through April, May and early June supported by central bank and government stimulus. In the depths of the crisis in March, liquidity was the issue in capital markets. To counter this central banks around the world have taken extraordinary measures to counteract the illiquidity. Where they can central banks have dropped interest rates to zero and then focussed on expanding their balance sheets with asset purchases.

Central bank balance sheets, as a share of GDP



Within the Eurozone the European Central Bank (ECB) has launched a €750 billion Pandemic Emergency Purchase Programme (PEPP). In Japan the government is working on another $1 trillion package of measure to supplement the $1.09 trillion package already in place. The Bank of England (BoE) increased the amount it purchases corporate credit by £200 billion to a total of £645 billion and bought gilts 'at the fastest rate operationally possible' according to Deputy Chairman of the BoE Jonathan Cunliffe. This has resulted in the UK Gilt yield curve trading with negative yields between 2 and 5 year duration over the last month. The US Fed initially provided $500 billion in Treasuries, then removed the constraint, indicating that it was an 'open-ended purchase programme'. The US has injected $3 trillion of liquidity into markets and another $3 trillion through the CARES Act.

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At the latest Federal Open Market Committee (FOMC) meeting Jerome Powell (Fed Chair) kept interest rates at 0% saying;

> "We're not thinking about raising rates. We're not even thinking about thinking about raising rates"

All members of the FOMC expect interest rates to be 0% through the end of 2021 and 2 members expect the policy to be there through 2022. Mr Powell also outlined the minimum amount of purchases per month the Fed will buy of Treasuries ($80 billion per month) and Mortgage Backed Securities ($40 billion per month). The Fed's policy is to ensure that the credit market continues to function so that liquidity can flow around the financial system, make progress on full employment and get inflation back to 2%. Prior to the meeting there was noise as to what else the FOMC will do. Mr Powell has already indicated that a negative interest rate policy is not one they will consider for now, yield curve control 'remains an open question'. Yield curve control is where the central bank target a longer term rate (10 years) and guarantee it would buy enough longer term bonds to ensure that the rate would not rise above its target. Interestingly it was at this point in the presentation, when it was clear that yield curve control was not immediately forthcoming, that the dollar rebounded and equities fell. Perhaps the market is indicating its expectation that the Fed needs to do more if it is to continue its remarkable climb higher.

When History Rhymes

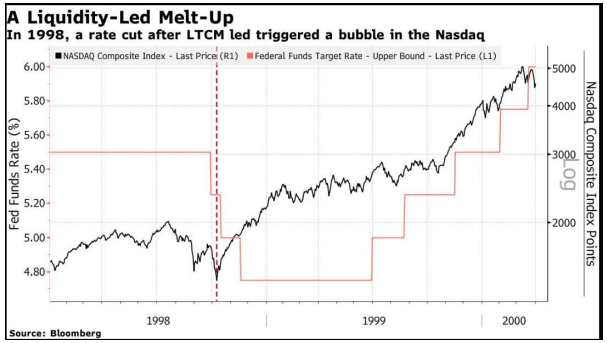
'When History Rhymes' is a title of a article written by Christine Lagarde (now President of the European Central Bank) in 2018 referencing a quote attributed to Mark Twain, namely that;

> "History never repeats itself, but it does often rhyme"

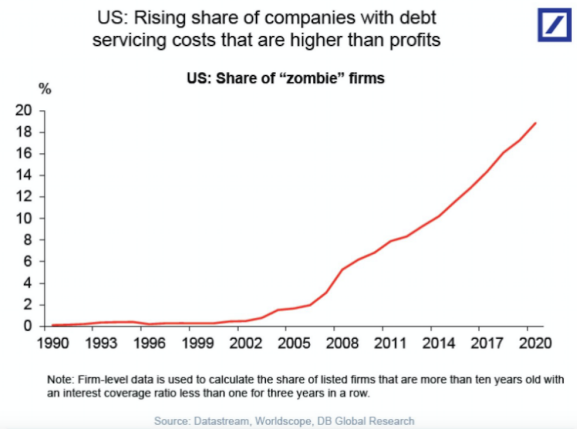
In the 2018 article Ms Lagarde remarks that;

> "As heads of state gather in Paris this week to mark 100 years since the end of World War I, they should listen closely to the echoes of history and avoid replaying the discordant notes of the past."

We wonder if Ms Lagarde is considering this when speaking to other heads of central banks and particularly Jerome Powell. In 1998 after the bailout of Long Term Capital Management (following the Russian default crisis) the US Fed, led by Alan Greenspan cut rates, unannounced and during trading hours. As pointed out by John Authers at Bloomberg this (the red dotted line on the chart) signified the bottom of the market and led onto the last bubble in the Nasdaq. Now as opposed to 1999/2000 the economy is in a much poorer state, yet the forward valuation measures of US indices are only exceeded by those during the Tech bubble. Jerome Powell does recognise that it is an issue but is left with no other option to try to help the job seekers and the economy. In the FOMC press conference he explained that the popping of an asset bubble is not in interests of the Federal Reserves or the US unemployed interests. This tacit support provides an uncomfortable choice for investors: do you ride the liquidity wave hoping to sell before it pops or do you choose a safer path?



As noted by Deutsche Bank there are other side effects of keeping interest rates lower for longer. There is a school of thought that it interferes with the economic process of creative destruction and keeps more unproductive (zombie) firms alive, which ultimately lowers long-run growth rate of the economy. For now though the Fed appears determined to allow many of these companies to survive. US companies issued $65.3 billion in equity in May, the largest



monthly total on record, while over $1 trillion in US corporate debt was issued as of the end of May. At the same time May was also the busiest month for bankruptcies since 2009 in the US and US High yield default rates are to reach 5% in June driven by Energy company defaults. According to Fitch Ratings the trailing 12-month default rate for Energy companies is 11.1% and could reach 17% by year end. S&P Global currently expects the US High Yield default rate to reach 12.5% and the European High Yield default rate to reach 8.5% by March 2021. As these defaults increase it will have an effect on Collateralized Loan Obligations (CLOs) in which the leveraged loans are held. The more speculative CLOs are typically owned by Hedge Funds, Private Equity and insurance companies whilst Banks hold the 'safer' ones. The CLO market certainly has the potential for disruption to the financial world in a similar way that CDO market collapsed in 2008.

Background noise will get louder

In addition to the economic impact of Covid-19 pandemic and the distortion of capital markets by the extraordinary levels of government and central bank support, investors have to grapple with the deteriorating relationship between US and China and who will be the President of the United States in the New Year. The UK-EU risk already hangs over the market depressing valuations of UK companies relative to their global brethren. As the deadline draws closer there will be a need of pragmatism from both sides.

President Trump has accused China of letting Covid-19 run out of control and been critical of their stance on Hong Kong. So far, China has partially complied with the agreed purchases of US goods. There is a lot of catch-up buying to be done in the remainder of the year to remain compliant with the Phase 1 agreements. Both countries (and protagonists) have incentives not to escalate the conflict further.

President Trump's handling of the Covid-19 crisis and the recent race riots has led to a reduction in his popularity and there has been a significant shift in the polls, towards Biden. Polls now suggest that the Democrats have a 56% chance of getting control of the Senate, whereas previously it was a foregone conclusion that it would remain in Republican control. If President Biden took office with majorities in both chambers of Congress, it would be likely that he would be able to reverse Trumps cuts in corporation tax and probably raise other taxes. An increase in corporation tax would reduce earnings per share in US companies. Credit Suisse's estimate is that if the Democrats unwound only half of the tax cut, earnings would drop by 5.4% compared to current consensus for next year. It is doubtful that US equities have this potential turn of events priced in. Of course Donald Trump and the Republicans could bounce back, but the possibility of a Democratic President and Senate could prove a headwind for US and global markets.

Chris Davis,
Chief Investment Officer

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