Economic Background – July 2020

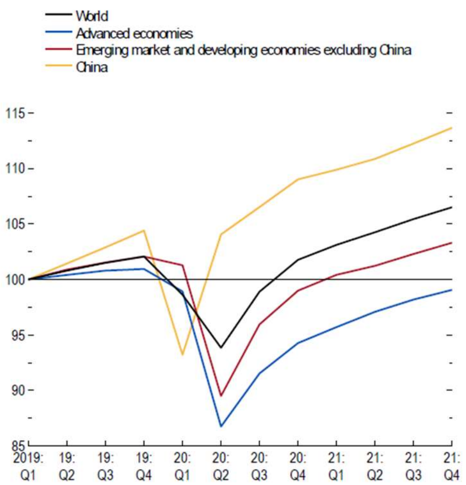
The Only Way is Up[1]

It has been a tumultuous 6 months for economies and markets. There is a high probability that the second half of the year will be similar. Coronavirus continues to affect everyone's life, the global economy and financial markets. Far East and Europe appear to have the virus in retreat, however case numbers are growing rapidly in the US, Latin America and India. Anthony Fauci, the director of the America National Institute of Allergy and Infectious Diseases, warned the US Senate this month that the country was "going in the wrong direction" on the pandemic. "We're now having 40-plus thousand new cases a day. I would not be surprised if we go up to 100,000 a day if this does not turn around … I am very concerned because it could get very bad".

Is the worst over?

For now, though the lockdowns are more localised rather than nationwide as governments try to move forward with a return to 'normality'. The new 'normal' is unlikely to be the same as the old one anytime soon. It is possible but unlikely that we will see the broad global lockdown that we experienced in the Spring return. There is a consensus that the worst of the economic damage has occurred, now we just need to count the cost.

Quarterly World GDP

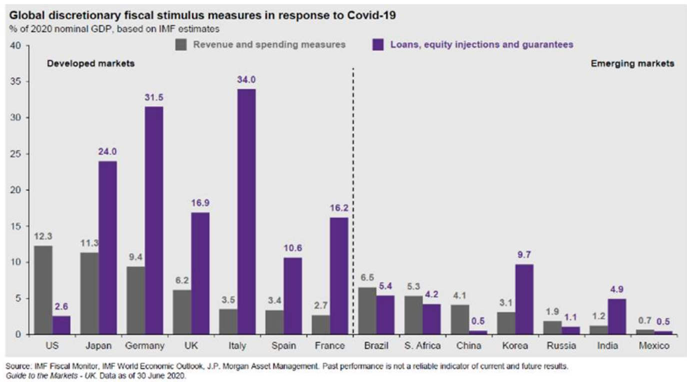


Source: IMF staff estimates.

In the second quarter of 2020, many economies will likely post the biggest percentage economic declines in their history. Oxford Economics believe it will the deepest contraction of the global economy since the end of WWII. In June the International Monetary Fund (IMF) released their greatly revised economic outlook showing a deterioration from its March data. For the first time, all regions across the world are projected to experience negative growth in 2020. The IMF predict the US will contract by 8% over 2020, the Euro area and UK by 10.2% each and Asia by -0.8%. Recovery to pre Covid-19 levels is not expected globally until 2022 at the earliest. No one knows if the worst of the crisis is over or not and much will depend upon the understanding of Covid-19 as we head into the autumn and winter months. There are welcome reports from the pharmaceutical community of developments that might prevent the worst effects of the virus and even lead to immunity. However, whether the economic data is accurate or not will depend upon how quickly we recover from the scarring nature of the economic decline. There is increased uncertainty surrounding the potential path of unemployment data, particularly in the US and the UK. California's Governor has reimposed lockdown measures, alongside Texas and Arizona on wide parts of its economy. Furthermore, social and political stability, protectionism and de-globalization have the potential to knock economies further off course. These trends have all intensified during this recent period.

Immediate support with long term cost

The deep contraction of the global economy has occurred despite central banks and governments providing swift and unprecedented amounts of support. The consequence of which is that we must now adapt to a new world where we will have massive fiscal deficits, low (negative) interest rates, increased quantitative easing and weak economic growth.



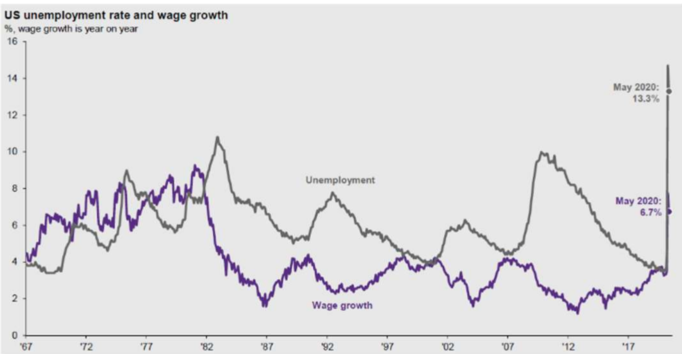
This is not a 'normal' recession and recovery, and governments face tough choices and policy dilemmas between public health and getting the economy moving. Fiscal and monetary policymakers around the globe have responded to the crisis with a shock and awe approach to prevent the initial shock from transitioning into a protracted decline. Policy is

[1] Yazz and the Plastic Population, 1988.

to remain extremely loose, with the emphasis now shifting to the fiscal stimulus. The US government debt's extreme increase is just one example of markets' response, rising by more than 12 percentage points in the past three months. Showing some of the cause behind the effect, the US Federal Reserve's (Fed's) balance sheet has doubled over the past few months.

The US Fed announced that it was to start buying individual corporate bonds with remaining maturities of 5 years or less alongside the credit ETF purchases it had already made. Jerome Powell (Chair of the Fed) has dismissed employing negative interest rates but yield curve control is a policy they are still exploring. Recognising that monetary policy can only do so much, Jerome Powell told Congress that there are 25 million people who are out of employment and it would be a

"concern if Congress were to pull back from the support that it's providing too quickly".



Source: BLS, Refinitiv Datastream, J.P. Morgan Asset Management. Wage growth is average hourly earnings of total private production and non-supervisory employees. Past performance is not a reliable indicator of current and future results. *Guide to the Markets - UK.* Data as of 30 June 2020.

Despite some improvement since these comments, the latest data on continuing unemployment claims are still persistently high at 20.5 million. Many economists believe the numbers do not capture the full scale of job losses as many are being still classified as employed but are absent from work. In addition, several states are scaling back or pausing reopening efforts to respond to the second wave of coronavirus infections and more people may lose their jobs. Press reports suggest that President Trump will soon announce a $1tn infrastructure bill to try and drive job growth. Central banks will remain instrumental in allowing the huge fiscal loosening to continue, but people's behaviour will determine how long the recovery will take.

Britain's economy shrank by 2.2% in the first quarter of 2020, the largest drop in UK GDP since the third quarter of 1979. As expected, The Bank of England (BoE) expanded its Asset Programme by £100bn (Voted 8 to 1 in favour) and kept rates at 0.1%. No discussion was had about lowering yields into negative territory with the issue remaining under review by the Bank. The extension of the Asset Programme or Quantitative Easing (QE) was dovish however the BoE decided to slow the pace of purchases by 2/3 from £13.5bn weekly average to £4.5bn. The lone dissenter in raising QE was Andy Haldene, the BoE Chief Economist. He believes the UK economy is recovering much faster than the central bank had originally thought, and

"If spending levels were maintained from current levels on the path the bank forecast in May, the economy would be 3 per cent larger than expected over the next few years, implying inflation would be one percentage point higher than forecast".

The UK Chancellor is not resting on the current rate of recovery. In his statement this month, Rishi Sunak presented a £30bn package to save jobs, to transition those on furlough back into the workforce and kick start the economy. The next few months will provide guidance as to whether he will need to up the ante in the Autumn.

China's reported economic data continues to improve. The Caixin China General Services PMI jumped to 58.4 in June, pointing to the strongest growth in services activity since April 2010. New orders grew the most in nearly a decade as companies reported that greater customer numbers were resuming more normal business operations. In addition, export sales rose for the first time since January, amid improving global demand.

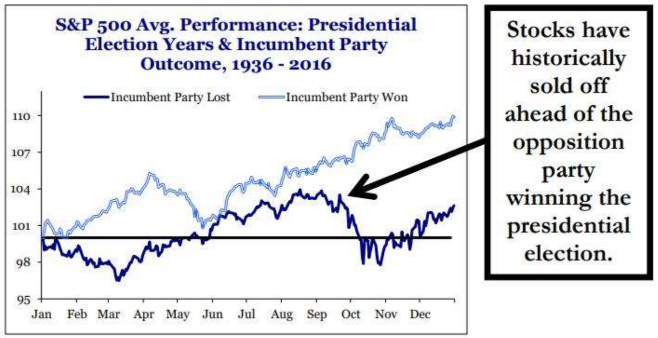
More controversially China passed a national security law for Hong Kong and immediately started to arrest protestors who had "committed secession or subversion-related crimes". The new law allows China to select judges for particular trials and "serious" or "complex cases" can be transferred to mainland China. The move has been widely condemned by the Western democracies. The US have taken some economic counter measures by rolling back special trading privileges it afforded Hong Kong post the handover from Britain. The UK has offered Hong Kong citizens the right to live and work in the UK, whilst Europe, Japan, Australia and New Zealand have all publicly expressed their concern.

Despite the phase-1 trade agreement between the US and China the latest developments and tit for tat sanctions on prominent politicians from both sides are a further move away from global trade. The Covid -19 crisis and resultant policies have accelerated a trend of de-globalisation that started post the global financial crisis. This is not just a US/China phenomenon. Governments in Europe too are significantly behind in the technology race are increasing their fight against the US and Chinese technology companies and the tax regimes they work within.

Running mates

Covid-19 has made the outcome of the US presidential election increasingly uncertain. One would expect the background of a global pandemic, rising inequality and the black lives matter movement would be a positive for Biden, as President Trump's handling of the pandemic and protests after the death of George Floyd have led to President Trump losing ground in the national polls.

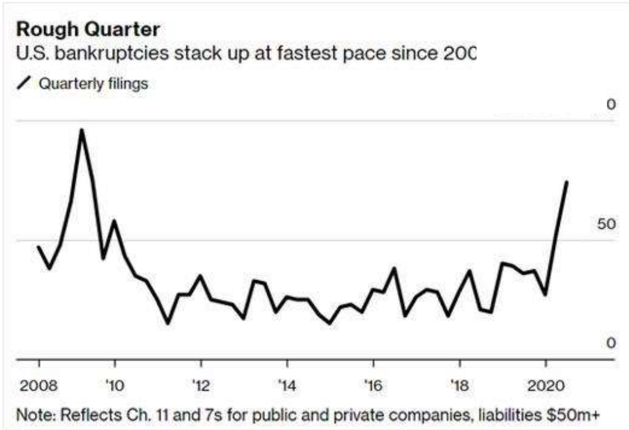
Whoever occupies the White House in January 2021 will have to deal with the problem of high government debt, building consumer and business confidence and the growing competitive China.



Markets don't like change and the US market has typically sold off ahead of the opposition party winning the presidential election. A prospective Biden victory is expected to bring a few market-related policy changes. America's Chinese foreign policy would largely remain unchanged but could become less volatile. Tech and healthcare regulation would increase and policy direction to be more social, greener and socially redistributive. If the Democrats manage to also control the Senate then this would imply higher corporate taxes and more fiscal spending. The market's reaction will likely be negative.

The froth on top

The election focus comes at a time when markets are in an interesting place. Government and credit bond yields have never been lower. The Barclays Bloomberg US IG corporate bond index yield is now at an all-time low of 2.2% with US 10 year government bond yield below 0.70%. In the UK the 10 year government bond yield has fallen as low as 0.13% in June and much of the yield curve below this duration is providing a negative yield.

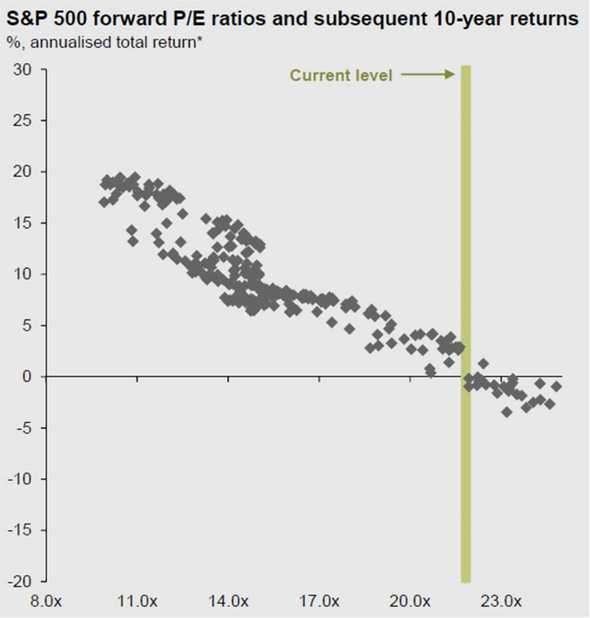


Source: Bloomberg

Targeted central bank buying has helped to drive a market recovery in credit spreads and allowed record issuance of corporate bonds. At the same time the last 3 months have seen record number of bankruptcies since the global financial crisis. The likes of Hertz, Cirque de Soleil, Chesapeake, Brooks Brothers, J Crew and Neiman Marcus have filed for bankruptcy. Whilst high quality investment grade corporate debt is in demand, there are certain parts of the high yield and junk market that are to be avoided.

Stock markets too have risen sharply. China and particularly in US technology companies have risen in the expectation (hope) of a swift return to normal. This is despite expectations that the operating profit in the second quarter for the S&P500 is expected to be down 45% on last year. Chinese stock markets have been given further impetus by the government actively encouraging retail investors aided by the nations state media. According to Bloomberg "A front page editorial in the China Securities Journal on Monday said that fostering a "healthy" bull market after the pandemic is now more important to the economy than ever. Chinese social media exploded with searches for the term "open a stock account"". The last time the government did this was in 2014. The Shanghai composite rose 100% in 12 months, before halving in the following 6 months and remains significantly below its 2014/15 highs.

Worryingly there are signs that certain parts of the market appear 'frothy'. In June a peer to peer property and casualty insurance company called Lemonade Inc had its initial public offering (IPO) on the New York Stock Exchange, promising to disrupt the insurance business (I am sure Berkshire Hathaway and Warren Buffet will be surprised). This has all the hallmarks of a Pets.com in 1999, Lemonade Inc, however, has been well backed and can boast an enterprise value (EV) of $4.8bn, which appears high given last year it had total revenue of $64mn and net income of ($108.50mn).



It is not just the IPO market which has attracted attention recently with Tesla, the electric car makers share price, rising parabolically. In mid-July Tesla's share price was up over 300% year to date. This would value the company at an EV of $285bn. In comparison Volkswagen's EV is $214bn.

As we know Jerome Powell revealed in a recent Congressional survey how he now interprets his task: as long as inflation does not rise, the clear mandate is to support the labour market, and not prevent any asset price bubbles that may arise.

The performance and size of the technology sector in the US market has elevated the forward P/E ratio of the S&P 500 to high levels. Whilst for some it may seem tempting to follow the crowd for fear on missing out, for the long term investor valuations must always be considered. As the chart to the left shows there is a clear correlation between the subsequent 10 year return and the valuation at which you pay. Whilst in aggregate the US market appears expensive, it is not a homogenous group and there are opportunities within. There are more in the rest of the world.

Chris Davis
Chief Investment Officer