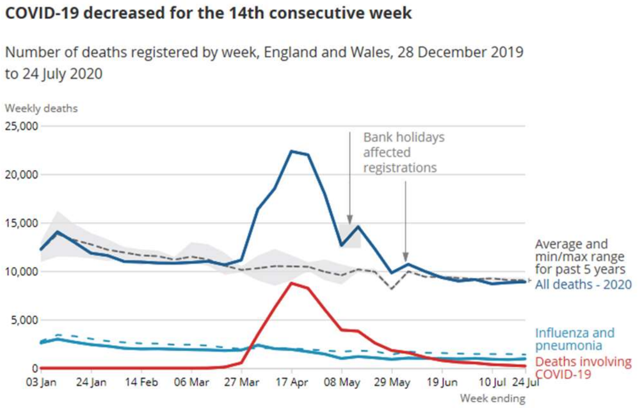
## Economic Background – July 2020

### It's lonely out in space[1]

After the enforced inactivity of the spring there are signs of an economic recovery as lockdown measures are lifted and social distancing relaxed. These measures have also allowed the Coronavirus to re-emerge. The number of confirmed virus cases globally is now above 19 million, with the number of deaths over 700,000.



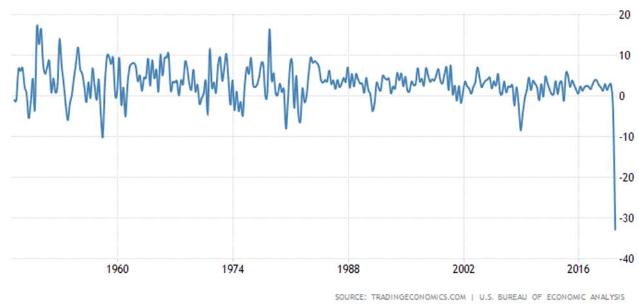

In the UK it appears that the actions appear to be working, with the number of daily new cases continuing to fall despite localised 'flare ups'. The Office of National Statistics data shows that Covid-19 deaths have decreased for the 14th week in a row. This is not the case in the rest of the world. Towards the end of the month an increasing number of Covid-19 cases in many European countries has led to fears that we may be entering a 'second wave' of the pandemic. While it is right that governments continue to act with heightened vigilance, they are in a far better place to deal with any future spikes than was the case earlier in the year. Improved test and trace capabilities, a better understanding of how to manage the disease therapeutically, and the shielding of those at highest risk should all help mitigate any flare-up of the disease.

Over the last month infections appear to back on the rise in most areas with Latin America the current epicentre, contributing to almost half of all deaths each day. Brazil are reporting over 50,000 cases a day. India is another area of concern with more than 62,500 cases being recorded each day. The number of recorded cases in the US grew by 77% in July increasing to 4.64 million from 2.64 million at the end of June. While US case levels remain elevated, there does appear to be some flattening of new cases in some of the most severely affected states. Progress in developing a vaccine continues, with positive news released from several clinical studies during the month.

### Mixed signals

Recent economic data has been mixed. Whilst July data provided some evidence that activity is improving since lockdowns were lifted, more high frequency data and recent spikes in Covid-19 cases suggests it is not going to be a straight-line recovery.

*US GDP growth rate (annualised)*




As expected, the second quarter GDP figures for all major economies were extraordinarily weak. US GDP fell by an annualised 32.9% over the last quarter, the greatest drop in output since records began in 1947 (according to Deutsche Bank the fourth worst since 1900. Beaten only by two quarters during the Great Depression; the first quarter of 1946 as the US was demobilizing after World War Two and a quarter in 1921). Growth in the eurozone slumped 12.1% compared with the prior quarter or an annualised 40.1%. Spain was the hardest hit member state, experiencing a contraction of 18.5% quarter over quarter.

US retail sales have rebounded 27% since the lows in April and are nearly at the levels of January providing hope of fast recovery. Consumer incomes have so far been protected (increased) by fiscal support packages provided by the US government. The US Congress has already provided $3tn in economic relief, with the $600 a week in jobless benefit introduced in March finishing in July. The second round of stimulus and benefits have yet to be agreed and is expected to be less generous than before. Having cut its interest rate to 0-0.25% in March, the US Federal Reserve (Fed) have stated the rate will remain near zero until the economy is on track to achieve maximum employment and price stability controls.

[1] Rocket Man. Elton John, 1972

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The Fed has also pledged to maintain its bond purchases and selection of lending and liquidity programs at least at its current pace.

In the Eurozone GDP declined -12.1% over the quarter, the largest contraction on record. Germany (-10.1%), France (-13.8%), and Italy (-12.4%) all recorded double digit declines in GDP growth however Spain (-18.5%) was much worse than expected. The Spanish economy has lost more than 51,000 businesses between February and June this year and more than 1 million workers have lost jobs during the second quarter. The quarterly drop in employment is the worst on record, resulting in an unemployment rate of 15.3%. This during a period where Spain normally adds to employment as the tourist season begins. With travel bans and quarantine restrictions in place, this is unlikely to reverse course any time soon. The Spanish government has indicated that its furlough scheme will be extended to the end of the year, with expectations that unemployment will rise to at least 22% in this period. Spain alongside other Mediterranean countries will likely be willing recipients of grants and loans from the newly agreed €750 billion recovery fund. The fund will be backed by common bond issuance by the European Commission and is part of the new seven-year budget worth €1.074 trillion.

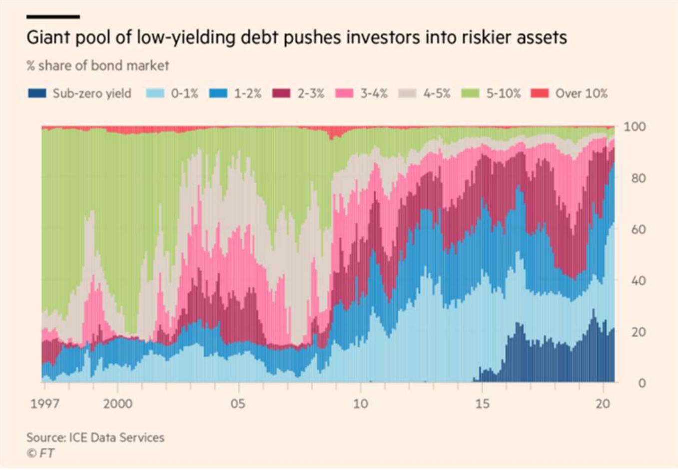
The Bank of England's (BoE) August report highlighted that Covid-19 is reducing jobs and incomes, but as restrictions have eased, production and spending have recovered. Despite this employment and incomes will be lower than they were prior to Covid-19 for some time. With unemployment at 4.1% in quarter 2, the BoE predicts that employment will not return to c4% until 2023. The BoE believe unemployment will peak at 7.5% towards the end of the year but could rise as high as 10%. Interest rates will be kept low (maximum 0.10%) for some time to come and they will maintain the level of quantitative easing, keeping government bond yields low even as government borrowing increases to cover the costs of Coronavirus. The UK 10-year bond yield is at 0.1%, with the 5 year bond yield falling to -0.15% during July.


*Source: Bank of England, August 2020*

Meanwhile, China continued its recovery with reported improvement int the health of the manufacturing sector. Official Chinese GDP figures report an increase of 3.2% in the second quarter and despite localised coronavirus outbreaks manufacturing output and new orders both rise at the fastest rate for nine and a half years. It is worth noting however that export orders contracted for the seventh consecutive month reflecting the sluggish global economy.

**Risk free assets, or reward free risk**

The consequence of central banks setting expectations that interest rates will remain low for the foreseeable future and massive quantitative easing programs, is that yields within government and corporate bond market have been driven down. Fears of a resurgence of Covid-19 and rising geo-political tensions have added to further demand for 'safe' assets. $24 trillion in stimulus has been provided by central banks and governments to fight the impact of Covid-19. This has driven down the yield on the 10-year Treasury note to 0.52% - a 234 year record low. The equivalent UK Gilt traded with a yield of 0.078% and the equivalent German Bund yielded -0.55% in July. Low borrowing costs have also encouraged companies to issue debt. The data in the chart above shows that nearly over 20% of the bond market is offering negative yields and 90% of the $60 trillion global bond market tracked by ICE Data Services trades with yields no higher than 2%.



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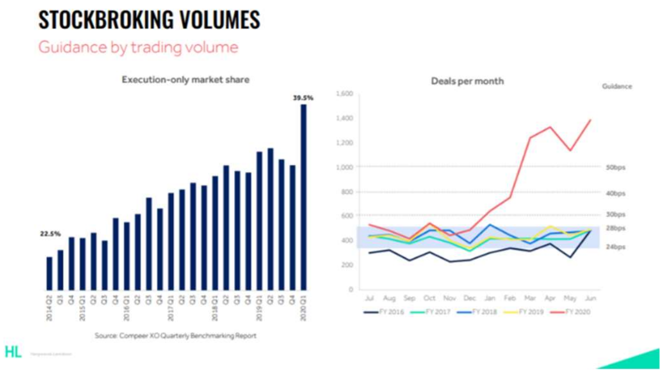
Alphabet (Google's parent company) has just raised $10bn in a corporate bond sale even though it has $120bn in cash and marketable securities on its balance sheet. The AA-plus rated company's $2.25bn 10-year bond sold with a coupon of just 1.1%. That was well below the 1.5% coupon Amazon obtained when it sealed record low interest costs on a 10-year US dollar bond earlier this year. Alphabet's 5-year bond is priced at 0.45% for those tempted. $5.75bn of the debt is earmarked for ESG projects. Therefore, the quest for yield for fixed income investors becomes very narrow and pushes them potentially into riskier areas of the market. This reduction in interest rates has provided the backdrop for the gold price to reach new all-time highs of over $2,000 (per ounce).

**(Ir)rational markets**

The US S&P500 index has risen by more than 40% from its March lows, but some shares have risen far more than this. As investors have poured money into technology stocks, indices have become more concentrated in large technology companies than ever before particularly from those who have been a beneficiary from the Covid-19 crisis. Facebook, Amazon, Apple, Microsoft, and Alphabet account for over 22% of S&P 500 market cap and trade at a 70% P/E premium to the other 495 S&P 500 constituents (31x vs. 18x), which is the largest premium in 20 years. Their rise has strengthened their sway over market cap-weighted indices such as the S&P 500, leaving the whole index vulnerable to swings higher or lower based on the fortunes of a small group of companies.

The decline in government bond yields and therefore the discount rate enhances the valuation case for owning company equity with 'predictable' or 'high growth' cash flows many years into the future.

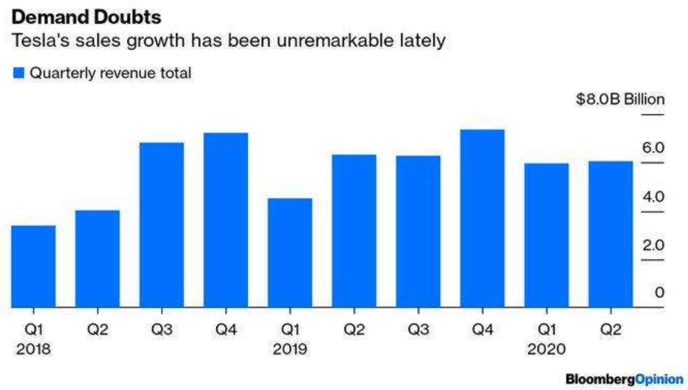



Retail investors (or perhaps those working more from home) are not immune to the temptations of technology and other companies which appear to have limitless growth potential. According to data from Goldman Sachs the top 4 online brokers in the US have seen a significant rise in execution only share trading by individuals. In June these brokers have logged over 8 million daily trades and the July data looks set to exceed this. The June data is a 333% increase from June 2019 and a 210% increase from January this year. These figures exclude Robinhood (a US based zero fee platform) and Fidelity. The recent data provided by Hargreaves Lansdowne confirm that this is not just a US trend.

Momentum stocks are typically the favoured trades for this breed of trader. Momentum investing is based on price trends and in its simplest form is to invest in stocks that are exhibiting price growth greater than the market in the belief that they will continue to do so. Artemis fund management highlight the case of Shopify, the Canadian e-commerce software provider, as a classic momentum stock. The share price grew 37% in 2017, 187% in 2019 and in the first 6 months of 2020 the share price increased 137%. The company is definitely growing and it recently reported revenue in the second quarter of $714 million, an increase of 97% on last year. The global market for 'e-commerce software is expected to grow 16% annually to around $20 billion in 2027. The disconnect is that Shopify's market cap is already $116 billion or almost 6 times the value of its entire market in five years' time. At these prices the shares are trading at 60 times its current sales and 2,000 times its estimated profits for this year.

**Musky business**

Momentum investing relies upon the following of the crowd and nothing fires up a crowd than a strong difference of opinion, the love/hate of charismatic CEO and their products. This can lead to investors avoiding key questions around the businesses/products/accounts to just focussing on the share price. Tesla Inc. is at the centre of the momentum strategy and is now one of the largest components in momentum funds. To the end of July this year the stock had risen 242%, following a 26% rise in 2019. Elon Musk, the



company's CEO has created a devout following of 'believers' that he will create the first full production self-driving capable automobile. So far, that has not been achieved.

What Musk has created is a vertically integrated, premium electric car company selling 388,146 cars across 4 models over the last 12 months to June 2020. This is an increase of 16.7% on the 12-month sales volume reported to June 2019, which is positive but unremarkable growth. In the UK base models start at c£40,000 rising to over £100,000. In contrast Toyota sold 10.6 million cars in 2019, Volkswagen Group have group sales of 6.3 million vehicles and BMW sold 2.5 million cars in 2019.

Tesla's current share price has resulted in its market capitalisation rising to $277 billion, exceeding that of Toyota or Volkswagen, becoming, by value the largest automobile manufacturer in the world and briefly the 10th largest company in the US (ahead of JP Morgan Chase). The latest push in its share price has coincided with speculation that Tesla stock will be included into the S&P 500 index, and then must be bought by the plethora of passive funds that track the index. The S&P index requires that a company must be profitable for a year, including its most recent quarter for it to be eligible. Tesla has achieved this although some have questioned its accounting methodology. In the last two quarters Tesla has increased its recognition of regulatory credits, earned by producing zero-emission vehicles (ZEV). Fiat Chrysler is the purchaser of the ZEV credits to make up for shortfalls if their own sales of zero-emission vehicles. In the first half of the year Fiat Chrysler has recognised the purchase of $370 million ZEV credits. In contrast Tesla has reported the sale of $782 million ZEV credits suggesting a significant number of other buyers. Tesla's total GAAP earnings are $120 million in 2020 and would be negative if not for the ZEV credits.

Wall street analysts' views of Tesla fair price diverge between c$300 to $2,300 a share, a $2,000 spread that is more than 100% of the current stock price of $1,489. Elon Musk is not too concerned, his compensation package is based upon the share price momentum and is paid entirely in Tesla stock through a generous compensation plan. He already owns 20% stake in Tesla and this will increase once his compensation options vest, which he has plans for …

> *"Essentially. Long-term purpose of my Tesla stock is to help make life multiplanetary to ensure its continuance. The massive capital needs are in 10 to 20 years. By then, if we're fortunate, Tesla's goal of accelerating sustainable energy & autonomy will be mostly accomplished."*

Meanwhile the stock trades on a trailing P/E ratio of 717 a forward P/E of 227 and 11x current revenues. Shareholders will hope that the growth will increase to fit the valuation, otherwise the potential loss is substantial.

Chris Davis
Chief Investment Officer