TORELL & PARTNERS

Economic Background – October 2020

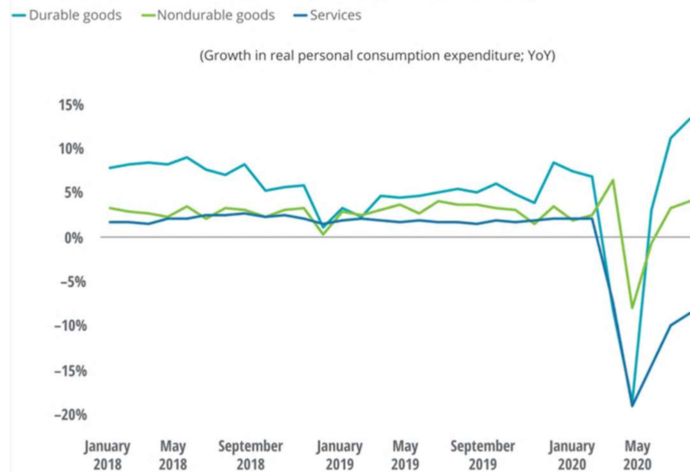
Tug of war[1]

The global economy has maintained its recovery from the depths of the worst recession since WWII; however, we have not recovered to pre-crisis levels, and the outlook remains uncertain.

The global daily Covid-19 case count rose steadily over the past month, with Western Europe seeing a notable increase. This has led to fears of a second wave and governments responding by implementing further restrictions. In the short-term these will have a negative impact on GDP.

Recovery

The global economic recovery has been supported by the consumer. Consumers have reduced spending on nonessential items and with social gatherings restricted and many working from home, consumers are not spending as much as they used to on services such as transportation, leisure and travel, clothes and eating out. In contrast, sales at food and beverage stores have risen sharply in March (26.9%) due to some panic buying, as people not only stocked up on groceries but also substituted eating at restaurants with more meals cooked at home and have also increased spending on durable goods.



[1] Tug of War, Paul McCartney, 1982

A surprise has been how well residential homes sales and prices have been during this period, across both in the US and Europe. Mortgage approvals in the UK are at their highest levels since before the financial crisis. The Nationwide House Price Index in the UK increased by 5% year-on-year in September 2020. The latest reading pointed to the steepest growth in house prices since September 2016, with all UK regions experiencing a rise in prices from a year ago. According to Nationwide:

Source: Nationwide

"The rebound reflects a number of factors. Pent-up demand is coming through, with decisions taken to move before lockdown now progressing. The stamp duty holiday is adding to momentum by bringing purchases forward. Behavioural shifts may also be boosting activity as people reassess their housing needs and preferences as a result of life in lockdown"

A key driver of the recovery has been the speed and size of stimulus from central banks and governments, totalling $10 trillion and counting. In general, the announced stimulus measures have three primary objectives:

1. Maintain financial stability;
2. Maintain household welfare and;
3. Assist companies to survive the crisis.

In most countries the focus of the fiscal stimulus has been on supporting the flow of income to households, through wage support to firms, to allow them to maintain employment through the downturn, or as direct payments to households.

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The US for example provided an $600 extra weekly unemployment benefit on top of the standard amount provided by each state. These extra benefits expired at the end of July and over the past two months. Congress have been unable to reach agreement on another round of fiscal stimulus, including an extension of enhanced unemployment benefits. These enhanced benefits have been crucial in allowing households to sustain consumption through the downturn. Without these benefits, the outlook for consumption becomes opaque, especially through the next 6 months.

Obviously, a major risk to the recovery is a global resurgence of the coronavirus through the autumn and winter. Whether governments / countries have preventive measures in place to be sufficient to avoid this outcome, remains to be seen. Furthermore, a related concern is that the vaccine may take longer to arrive or be less effective than anticipated.

Another risk that economists highlight is the lingering effects of the virus. Unemployed workers, for example, may see their skills depreciate as they struggle to find new jobs. Some firms who didn't have enough cash reserves to survive the downturn have gone out of business. Corporate defaults are at 10 year highs. Their exit implies a net loss of productive capacity for the economy. The virus will also leave scars on the balance sheets of households, firms, and the public sector. Any deleveraging that results is likely to be another restraint on spending and growth.

The trajectory of recovery has varied significantly across geographies. The reported rebound in industrial production in China has been particularly impressive, with output now slightly above its pre-Covid level. Rising exports, particularly of PPE and electronics, have been a key contributor to this bounce, and the authorities' macro stimulus has supported the industrial sector.

China – New export Orders Index

"The economic recovery has picked up its pace after the epidemic. In the near future, great uncertainties remain about the overseas pandemic and the US presidential election,"

Wang Zhe, senior economist at Caixin Insight Group.

In the emerging markets excluding China, industrial production fell more sharply than retail sales, with both indicators 5% below their pre-virus levels.

Changes at the top

In Japan, there has been a smooth transition from Shinzo Abe, the longest serving Prime Minister in the country's history, to Yoshihide Suga. Prime Minister Suga is expected to continue the policies pursued by the Abe government.

With the US election a few weeks away, it remains to be seen whether there will be a smooth transition if Joe Biden should win the Presidency.

President Trump has not confirmed he would provide a smooth transition. The first 'Presidential' debate was chaotic and characterised by both candidates exchanging petty insults and talking over each other. Former Vice President Biden is generally ahead of President Trump in the polls, but so was Hilary Clinton in 2016 at this point. If Biden does win, the markets will likely welcome his more conventional operating style, and the prospect of renewed fiscal stimulus, but will also worry about the possibility of higher taxes and tighter regulation. A Trump victory, in contrast, is likely to bring another round of trade war against China and, possibly, against the European Union. Another concern for the market is the possibility of a disputed outcome, where the outcome is unresolved for weeks after election day. Such a situation could be deeply divisive and create unwelcome uncertainties for the markets, and for the global economy more broadly.

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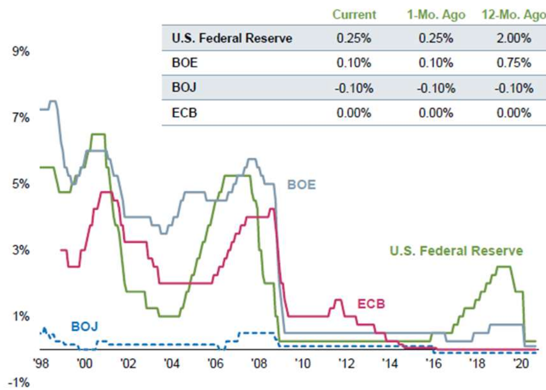
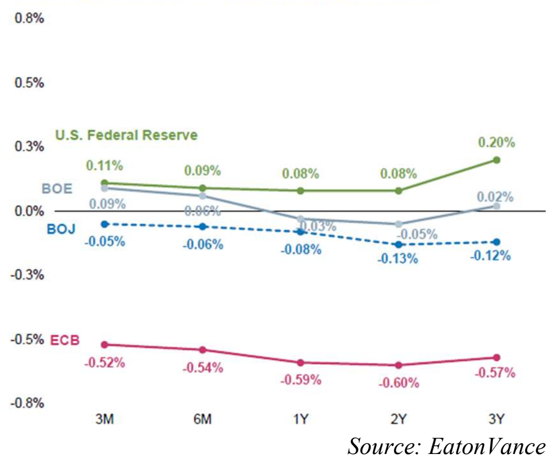
Sterling remains volatile as deadlines for a deal between the EU and UK over Brexit have come and gone. Fishing remains a major obstacle despite representing a small percentage of UK and EU GDP, with the protagonists seemingly unwilling to compromise in the key areas of subsidies and a regulatory framework.

The deflationary / inflationary tug of war





Source: EatonVance

Central banks have convinced financial markets that that rates will stay low for years to come. With rates low the yield on government bonds is at historically lows and are priced to be so for some time to come.

The US Federal Reserves (Fed) is focussing in on inflation and is waiting and hoping for inflation to rise above 2% (currently 1.3%). Jerome Powell (Fed Chair) has said that they would be willing to let inflation rise above 2% and achieving maximum employment before raising rates again. Not content with the levels of monetary stimulus, Mr. Powell is keen to push the fiscal authorities to do their part, warning Congress that the US economic recovery will suffer if they don't pass a new fiscal stimulus package.

The future path of inflation is a hotly debated topic as are the tools required to generate it effectively.

Inflation in general terms is a sustained rise in the price of goods, but there are so many different facets to it that it is hard to predict.

On the inflationary side we have experienced over the last 6 months a colossal expansion of monetary supply at a rate not seen before in financial markets. This monetary inflation first effects the capital markets (fixed income, commodities and growth stocks), with the hope it eventually raises the prices of goods (through rising commodity prices). Furthermore, there are fiscal stimulus packages aimed at cushioning the impact of the coronavirus which are needed short term but are potentially inflationary if left unchecked longer term.

There are other structural trends (e.g. globalisation and technology) that affect inflation. Studies have shown that globalisation has a had a modest decreasing effect on inflation and the likelihood is that over the coming years re-shoring has the potential to increase inflation. Technological advances are deflationary. Advancing technology in general increases productivity and lowers prices with large swathes of sectors being enhanced by rapid technological gains. In just 6 months this crisis has fast tracked several technological advances like online retail, remote working and automation.

One of the effects of the pandemic was a steep rise in unemployment, thus causing a drop off in demand for goods. So even as the money supply in the economy is increasing the demand for goods has fallen away. There is also concern that if jobs do return, the 'emotional scarring' of those back in work will affect consumer behaviour. In addition, and importantly for inflation the 'Velocity of Money' or the number of times $1 is used to buy goods or services per unit of time has slowed markedly. If the velocity of money is

US: Velocity of Money

Source: Federal Reserve Bank of St. Louis

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increasing, then more transactions are occurring. Quantitative Easing has played a major part in dampening the velocity of money, as central banks provided capital to savings institutions in return for their Treasury securities. All the savings institutions could do was buy financial assets as they couldn't buy goods and services, so that money can't affect nominal GDP. Conversely, if the velocity of money increases, through a direct transfer to households, or businesses and consumers begin to spend the money they have borrowed recently at a greater pace then the velocity of money will increase and so will inflation.

Market prices are telling us that investors are trying to hedge the potential inflationary measures by using precious metals (gold, silver, platinum etc) or through inflation linked securities in US Treasury Inflation Protected Securities (TIPS) or UK inflation linked bonds (Linkers).

Chris Davis
Chief Investment Officer

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