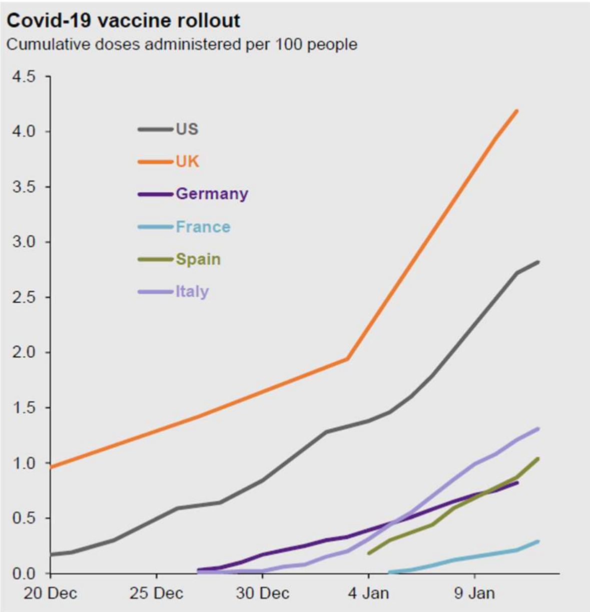
TORVELL &PARTNERS

Economic Background – January 2021

There's been some speculation[1]

At the start of 2020 the economy was set up for a year of synchronised growth. Thoughts of any growth were put aside as the Covid-19 pandemic caused the worst recession since the Great Depression. The speed and scale of the of the monetary and fiscal stimulus has ensured that the financial markets have continued to operate, and the announcement of multiple vaccines towards the end of the year have provided hope. More recently renewed waves of infections and variants of the virus have caused concern. Nevertheless, countries who have the vaccines are operating at pace. In the US the injection rate is at 1 million plus a day accelerating to 2 million as new vaccines are made available.



Covid-19 vaccine rollout
Cumulative doses administered per 100 people

Source: JPMorgan

The International Monetary Fund (IMF) has increased its forecast for the global economy to grow at 5.5% in 2021 and 4.2% in 2022. The 2021 forecast is 0.3% higher than its last forecast. The strength of the recovery is unlikely to be synchronised and will vary across countries. China has reportedly contained the pandemic and re-opened its economy remarkably quickly. The world's second-largest economy is expected to grow in by 8.1% in 2020 and 5.6% 2021. In the US, which enjoyed a record 33.1% annualised GDP growth in the third quarter of 2020, the IMF anticipates the economy will expand by 5.1% in 2021 following an expected decline of 3.4% for 2020 overall.

Global trade in goods and industrial production returned to pre-pandemic levels for the first time late last year according to Netherlands Bureau for Economic Analysis. China has been the main beneficiary with a 5.6% month on month growth in exports. The US Manufacturing PMI in January was 59.1, a record high level.

(real GDP, annual percent change)	ESTIMATE 2020	PROJECTIONS 2021	2022
World Output	-3.5	5.5	4.2
Advanced Economies	-4.9	4.3	3.1
United States	-3.4	5.1	2.5
Euro Area	-7.2	4.2	3.6
Germany	-5.4	3.5	3.1
France	-9.0	5.5	4.1
Italy	-9.2	3.0	3.6
Spain	-11.1	5.9	4.7
Japan	-5.1	3.1	2.4
United Kingdom	-10.0	4.5	5.0
Canada	-5.5	3.6	4.1
Other Advanced Economies	-2.5	3.6	3.1
Emerging Markets and Developing Economies	-2.4	6.3	5.0
Emerging and Developing Asia	-1.1	8.3	5.9
China	2.3	8.1	5.6
India	-8.0	11.5	6.8
ASEAN-5	-3.7	5.2	6.0
Emerging and Developing Europe	-2.8	4.0	3.9
Russia	-3.6	3.0	3.9
Latin America and the Caribbean	-7.4	4.1	2.9
Brazil	-4.5	3.6	2.6
Mexico	-8.5	4.3	2.5
Middle East and Central Asia	-3.2	3.0	4.2
Saudi Arabia	-3.9	2.6	4.0
Sub-Saharan Africa	-2.6	3.2	3.9
Nigeria	-3.2	1.5	2.5

Source: IMF

The Eurozone is expected to grow stronger than Japan and Canada but slower than the US, Asia or the UK. Europe's exporters are well placed to benefit from the recovery provided that the EU recovery fund solves its issues and governments resolve the current delays with their vaccination rollout.

Markets expect the UK to bounce back strongly from an expected -10% decline in 2020 to grow by 4.5% in the forthcoming year and 5% in 2021, the fastest growing across all the Advanced Economies. The securing of a trade deal with the European Union (EU) will support this growth.

[1] Some Speculation, Pet Shop Boys, 1993

Economic Background – January 2021

Deal

After four and a half years, the UK-EU have agreed a basic trading arrangement. Pragmatism prevailed (eventually) as many hoped it would. The deal, which provides for zero tariffs and quotas, goes further than other standard FTA's and provides a basis for more positive future cooperation. The main gripe for the naysayers is that there is a limited agreement on services and particularly financial services. Whilst this was expected and signalled well ahead of the deal, it may lead to further frictions with the EU. Whether you agree with the deal or not the Free Trade Agreement (FTA) removes a significant amount of uncertainty for UK investors and some stability for the Sterling exchange rate which makes it more attractive for international investors.

The next stage of negotiations involves decisions on data and financial services and the equivalence (or not) of regulations. The volume of euro-dominated shares being traded in London has fallen sharply. The FT estimates the United Kingdom has given up EUR6 billion of daily volume since the end of last year. As per the terms of the FTA either side have the right to challenge the other on state aid and other "*level playing field*" issues. Fishing will continue to be a point of discontentment and will take centre stage in 2026 when the first annual UK-EU negotiations on fish quotas will take place.

The deal removes a potential headwind for the UK economy in 2021. The prime minister Boris Johnson urged business leaders to get behind plans for regulatory and legislative reform. As the UK adopts its new, more distant trading relationship with the EU, these new arrangements will likely change the way many businesses operate, creating both challenges and opportunities. It provides some clarity for business and for investors and is a better outcome for the economy than if tariffs and quotas had been introduced. Investor sentiment has improved with flows into UK based funds at five-year highs in the last quarter, having spoken to several fund houses, international interest in UK funds is on the increase after the trade deal was announced. In the last few months, the market has seen 19 bids for UK listed companies, the most since before the Great Financial Crisis. In the fourth quarter US companies Mastercard, Cisco and Electronic Arts have bid for UK companies. The board of RSA, the insurance company have accepted a bid for the company and more recently Entain, the owner of Ladbrokes was bid for by US company MGM. Last year Caesers Entertainment purchased William Hill. This wave of UK mergers and acquisitions is due in part to the undervalued position of the UK. In general UK corporates are trading at a significant valuation discount to their international peers as can be seen in the chart opposite. Sterling, whilst having strengthened over the last quarter, is still weak and Private Equity has raised billions of cash in recent years, much of which is waiting to be deployed.

Overseas peers – price-to-earnings differential

UK-listed companies	P/E 2020E	Overseas-listed companies	P/E 2020E	Overseas-listed companies	P/E 2020E
GlaxoSmithKline	11x	Novartis	16x	Novo Nordisk	23x
BT	6x	Deutsche Telekom	14x	KPN	21x
Imperial Brands	6x	Philip Morris International	16x	Swedish Match	20x
RSA Insurance	16x	Intact	21x	Tryg	23x
ITV	11x	ProSieben	14x	Mediaset	23x
Rentokil	39x	Rollins	74x	Servicemaster	59x
Johnson Matthey	16x	Sherwin-Williams	30x	Umicore	32x
Unilever	20x	Nestle	25x	Procter & Gamble	25x

Source: Threadneedle AM

The Bank of England are concerned with the immediate health of the UK economy and have raised the amount of quantitative easing from £745 billion to £895 billion over the course of 2021. A Coronavirus resurgence and

> *"signs that consumer spending has softened across a range of high frequency indicators, while investment intentions have remained weak".*

With the reinstatement of the furlough scheme, the MPC expect unemployment to remain significantly lower than its September forecast, but predict it will still rise from the current rate of 4.5% to 7.75% by next summer. The bank warned that the UK economy was likely to suffer permanent scars from the coronavirus crisis that

> *"would be greater the longer that the current conditions of infection, restriction and uncertainty persisted".*

Economic Background – January 2021

The BoE revised down its growth forecasts over the next three years following the resurgence of Covid-19, and it now estimates that activity in the economy will only regain pre-coronavirus levels in the first half of 2022.

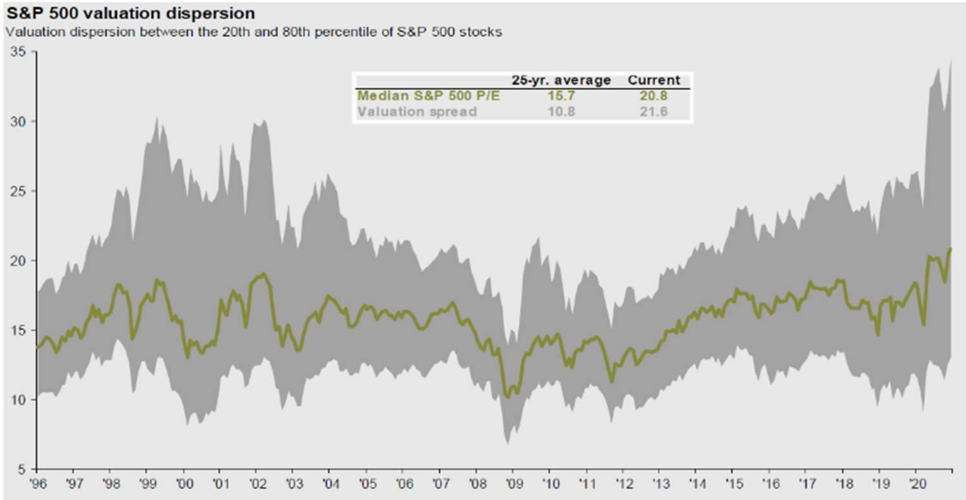
What will Biden/Harris do?

In a surprising and sometimes shocking series of events over the past month, Democrats won the remaining two Senate seats. With Vice President Kamal Harris' vote, Democrats have the majority in Congress/Senate. Speculation now turns to what they will do now. Top priorities will be pandemic control and further economic stimulus. The election campaign also focussed on climate change, trade, and inequality, so we should expect movement in these areas.

President Biden has made it clear that he sees a need for more stimulus and has outlined a US$1.9 trillion proposal. The new President's negotiating skills will be tested as he works to move the proposal forward, and the details and dollar amounts will surely evolve. Biden also promised another stimulus proposal in coming months, which will include spending on infrastructure, manufacturing, and innovation. In general, there is more bipartisan support for this. Increased taxation proposals are not expected to be tabled until after the midterm elections. Given the stance of his predecessor, there will be a lot of focus on President Bidens' trade policy. There is an expectation of greater predictability of process to reduce policy uncertainty. Greater fiscal spending supports the rotational theme that began to emerge in 2020. If further crises are avoided the yield curve should steepen and increase the number of possible directions the stock market can move in. If the Fed should become sanguine of the future US economy, the market will start to price in moves ahead.

The rationale for more stimulus is that the current economic situation is worsening and is likely to deteriorate. In December, the number of payroll jobs fell by 140,000 from November; the first decline since April. Retail sales declined in December, for the third consecutive month. The sales fall coincided with the Coronavirus infection rate soaring and when states were imposing restrictions on economic activity. In January the number of infections initially increased and now seem to be levelling off. This has prompted some to question whether the Government still needs $1.9tn in aid pumped into the economy. Given the near-term uncertainty in the pandemic it is perhaps surprising to see markets at or near new highs. In theory, though, equity prices reflect expectations about the future not the current.

In broad terms US equities appear expensive compared to other developed country equities. However, there is a wide valuation dispersion within the market. The valuation multiples of the 20th percentile (the boundary between the first and second quintile) is higher now that it was during the technology bubble, whereas multiples for the 80th percentile have hardly moved (The widest dispersion between the second and fourth quintile since the data was collated.). Within the top quintile are the high growth and momentum companies.



Sources: FactSet, Standard & Poor's, J.P. Morgan Asset Management.
Guide to the Markets – U.S. Data are as of December 31, 2020.

Goldman Sachs have created a Non-Profitable Technology Index, consisting of a basket of non-profitable companies in innovative industries. The index grew over 300% in 2020 (400% since March) as profitability and earnings has been trumped by speculation. This index has traded modestly since 2014, when it was launched, so what has caused the rapid rise? As mentioned in previous Economic Commentaries, trading in individual stock options has had its own boom. Data shows that it is the retail investor that is driving the prices, with purchases of 10 contracts or lower leading the chase for the next unicorn. History suggests that holding non-profitable companies will fail in the long run. Until it does, investors will continue to push the prices up until it stops. Then all bets are off.

Cryptic Assets

Adding to the speculation boom is Bitcoin, the decentralised unregulated digital token. When the price fell spectacularly in 2018, many believed that the volatility of the token would be too much to be viewed a serious asset, besides the other flaws of it having no intrinsic value (there is no income or utility). However, 2020 has seen a resurgence of interest. The price of a Bitcoin was $8,000 at the start of the year, before falling to $5,000 in March and then rallying to over $40,000 through the year end. It has since fallen over 20% to $30,000 in January.

Prices have been driven by the narrative that Bitcoin has a finite supply and that it cannot be printed like fiat currencies makes it a 'safe asset'. Proponents argue that the market value of Bitcoin is 'only' $0.6 trillion, whereas the total stock of Gold is $17tn and so there is more room for it to grow. With Governments and Central Banks effecting Quantitative Easing and increasing fiscal stimulus due to the effects of Covid-19, investors in Bitcoin believe that it is 'safer' to hold than fiat currencies controlled by central banks. The proponents of Bitcoin are less keen to discuss it popularity amongst the criminal fraternity or the environmental damage caused by mining a coin.

Central Banks and Governments have yet to have their say. Gavyn Davies writes in the FT

> *"The Fed is collaborating with foreign counterparts in investigating the development of central bank digital currencies. It is almost certain that CBDCs will eventually be issued in the major jurisdictions, following China's lead. However, they will be denominated in national currencies, not crypto.*
>
> *Private competitors denominated in genuinely new currencies, such as bitcoin, will be heavily regulated or actively discouraged. Hybrid stablecoins, such as Facebook's libra, that are pegged to a single currency or other real assets may be more welcomed by central banks, if they were directly transferable into traditional currencies. Furthermore, they may not be powered by blockchain. Each of the major central banks may develop its own distributed ledger technology."*

The Financial Conduct Authority have started to act by banning the sale of crypto currency derivative products to retail investors. It also warned in January that anyone investing in crypto assets…

"should be prepared to lose all their money"

Chris Davis
Chief Investment Officer