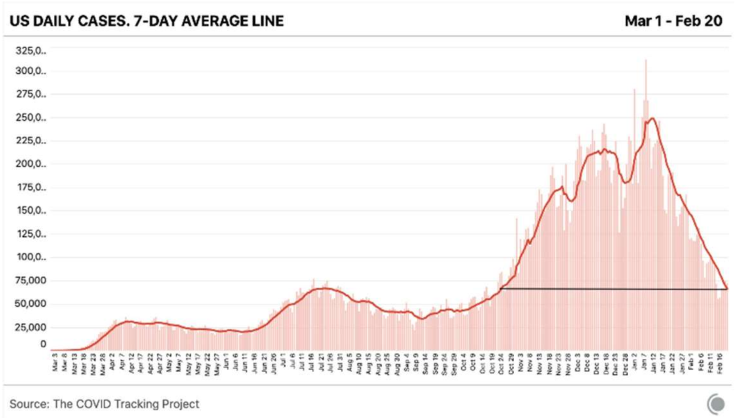
Economic Background – February 2021

Future's Bright[1]

It has been an eventful and fast-moving start to the new year. Where countries have access to Covid-19 vaccinations, they have been delivered at speed. In the UK at least a third of the adult population has been vaccinated and the NHS are delivering a remarkable 250 vaccinations a minute! The Prime Minister has laid out a timetable for an easing of lockdown restrictions, starting with children returning to school on 8 March and the opening of the economy through the Spring and Summer.

The early success of the AstraZeneca, Pfizer and Moderna vaccines pointed towards a route to normality, however no one knew how fast. With the challenges of timely vaccination production, logistics of distribution and the take up from the general population all key to the effectiveness. All challenges have seemingly been met so far and the UK is a leader in the vaccination program. We need to have some caution, however. New, more infectious strains could become dominant and a further lockdown would be

In the United States too, vaccinations have increased, the average daily case volume is in decline and hospitalisations are being reduced. The effectiveness data from Israel of the Pfizer / BioNtech vaccine suggests that the vaccine is 85% effective 15-28 days after one dose and the Israel Health Ministry data shows that it is 99.2% effective from preventing serious disease from Covid-19 after 14 days from dose 2.



[1] Future's Bright, The Adjustment Bureau, Richard Ashcroft, 2011

Positive Signs

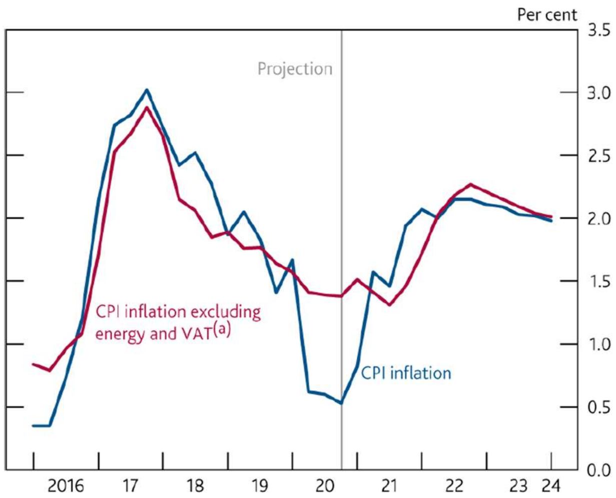
With the positive news from the vaccination programs we have also seen strength coming from the global economy.

US GDP growth in quarter 4 2020 is likely to be slightly above the 4.0% consensus estimate. US retail sales in January have grew 5.3% and are now 7.4% higher than a year ago (pre Covid). Sales rose across all major categories in January, reflecting stimulus spending approved in late December. US Industrial production increased 0.9% and was revised up for prior months. The gain in industrial production was led by manufacturing (excl. auto), increased 1.1% in January. This is the ninth month in the row that this production measure has increased. Estimates for GDP growth in the first quarter are at 6.0% annual rate with some including the Atlanta Fed's GDP Now model projecting a 9.5% growth rate.

The data from China in January continued to show expansion albeit at a slower pace than the previous 6 months, however Europe is showing signs of strong manufacturing activity, with factory activity growing at its fastest rate in 3 years, particularly in Germany. In contrast the service sector continues to be weak, with February's data showing the sixth monthly contraction of service sector activity.

In the UK the Bank of England (BoE) voted unanimously to keep its benchmark interest rate on hold at a record low of 0.1% and left its bond-buying programme unchanged. Policymakers noted it would be appropriate to start the preparations so that it could set a negative rate in 6 months but stressed it should not be interpreted as a signal and may not be necessary because the economic outlook has improved. Assuming a smooth vaccination program, their expectations are that a recovery will happen in the second half of the year but are prepared to act if it does not appear. The BoE now expects inflation to rise sharply towards the 2% target in the spring (due VAT and energy prices effects) and that inflation will be close to 2% over 2022 and 2023. They added that they now see the risk to their forecasts as balanced, rather than to the downside, despite revising down their Q1 GDP forecast to -4%. As a result, the government bonds declined, raising yields over the medium and long term. Bond investors have had the worst start to a year since 2015. The UK 10 Year Gilt Yield has moved from 0.32% to 0.76% within February. With the US 10 Year Bond Yields moving to 1.4% from 1% at the end of January. We have also seen Sterling appreciate sharply. Against the US Dollar it has reached the 1.41 (£/US$) level, last seen in April 2018.

BoE: UK CPI inflation excluding energy and VAT



Sources: ONS and Bank calculations.

Why has the bond market reacted so aggressively not just in the UK but around the World? We think there are two reasons: 1) the probability of the better economy in the second half of the year has risen and 2) inflation expectations and potential for a surprise.

Surprise!

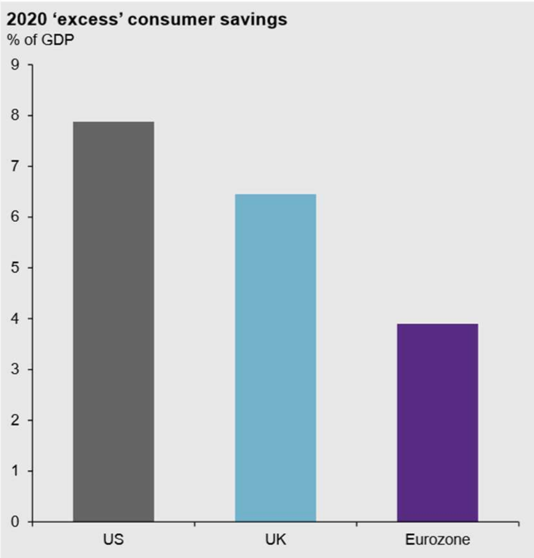
What will happen to inflation over the short to medium term is the big question dominating all asset markets. Central bankers hope and fixed income markets suggest it will move higher from here, but how far, fast, and what kind of inflation will we get?

The background to this has been the massive monetary stimulus from central banks and the fiscal spend governments have made and proposed. In the US lawmakers are deciding upon President Biden's $1.9 trillion package, following the $900 billion stimulus package from December. This fiscal package is 9% of US GDP and there are hopes that he will get another $1 trillion in an infrastructure plan later in the year.

With huge amounts of stimulus around the globe, inflationary signals continue to build across markets during February. We have seen some price rises which are reflecting short term supply issues within food and energy and we should expect some inflationary data due to the base effect of last Spring. From the manufacturing PMI data supplier delivery times have increase markedly, which is then having an impact onto output and input pricing.

> "As a result, cost burdens were pushed higher. The rate of input cost inflation was the sharpest since April 2011, while firms raised their selling prices at the fastest pace since July 2008 in an effort to partially pass on greater input prices."
>
> IHS Markit Flash US Composite PMI

Commodity metal pricing continues to rise, with Copper moving above $9,000 (per ton) for the first time since 2011, up 21% for the year to date. Tin, an important component in the global electronics supply chain is up 31% since the start of the year and 70% from its 2020 low. US Steel prices have more than doubled in the last 6 months and Brent Crude oil is now $67 (per barrel) having been at $20 (per barrel) in April 2020.



What some are speculating on now is whether we will experience demand induced inflation later in the year and into 2022 rather than the 'bottleneck' induced inflation we are experiencing now. Goldman Sachs calculate that 'Excess Savings'[2] in the US is currently $1.5 trillion and will rise to $2.4 trillion (16% of annual consumption or 11% of GDP) by the end of June. JP Morgan provide 'excess' savings estimates as a percentage of GDP for the US, UK and Eurozone in the chart opposite. Whether these consumers spend a small or large amount of these savings when the economies re-open could be the difference between a healthy recovery or an overstimulated one. In normal circumstances governments would react through fiscal policies and tighter monetary policy, however government and central banks may both be reluctant to tighten too soon. The big unknown is how consumers will react to better times ahead. Goldman Sachs forecast that c20% of the 'excess' savings will be spent in the first year (due to income distribution and current usage) in the US. This would lead to 2 percentage points to GDP growth, but as they admit the uncertainty is high and could be anywhere between 1 and 3 percentage points. It is amazing that in the US this will be the first recession ever when consumers will come out of it wealthier than they went in, a function of government distributions of cash and rising asset prices.

2 Excess savings are defined as savings above pre-pandemic rate of saving.

Effects

As discussed earlier, the more positive outlook on the pandemic, global economy and inflation have elevated medium to longer dated government bond yields. In turn this has supported bank and other interest rate sensitive stocks and the rise in metals and oil have boosted Mining and Energy companies. Bank, Mining and Energy sectors, which have been perennial underperformers, especially to the Information Technology sector over the past 10 years, have been outperforming since November.

Performance of MSCI Banks, MSCI Energy, MSCI Metals and Mining and MSCI Information Technology Sectors, 31/10/2020 – 23/02/2021, GBP

Source: Financial Express

However there still remains a speculative fervour in the market around momentum shares such as Tesla, Gamestop et al, and special purpose acquisition companies (SPACs). A SPAC is a 'blank check company', a shell corporation with the purpose of acquiring a private company without going through the laborious and costly process of a traditional initial public offering. In the summer of 2020 Churchill Capital IV (a SPAC led by Investment Banker/Deal Maker Michael Klein who has raised multiple SPACs) raised $1.8 billion in an initial public offering by selling shares at $10 (the standard price for most blank-check companies). After news broke that it was in talks with luxury, loss making, electric car maker Lucid Motors (who also provide the battery packs for all the Formula E cars), shares traded at $65, fuelled by the triumvirate of momentum themes: social media led retail traders, electric cars and special purpose vehicles. However, this was before any details or terms of what a deal might be. Two days after the deal and terms have been announced Churchill shares have fallen below $30 per share. The winner in all this (beside Mr Klein) is Saudi Arabia's Public Investment Fund, whose investment ($1bn in 2018) in Lucid has been rolled into the new investment vehicle at $10 per share and in return will own two thirds of a company with a value around $50bn. Tesla has an market value of $712bn . Can Lucid take market share away from Tesla? The Lucid Air, which set for production later this year, claims to have a 25% greater range than a Tesla long range Model S and a 'recharging system that would replenish hundreds of miles within minutes.' We shall wait and see.

What next

Inflation and bond yields have trended downwards globally for over decade. If consensus is correct this next period will be characterized by the strongest synchronised global growth in 30 years at a time when we have extremely low interest rates, record fiscal spending and capital investment in physical infrastructure.

All this points towards a higher inflationary environment (not necessarily a high inflation one) but certainly there is less fear of deflation. If it also leads to a fuller employment environment, which is the Federal Reserve's focus, markets will start to price in interest rate rises sooner than 2023. This will likely exacerbate the market rotation that we have seen over the past 4 months.

However, this path is not certain, and we must first navigate the world out of the pandemic. Any return of the virus and/or lockdowns will ensure we do have a lower for longer interest rate environment. Therefore, a balanced approach is a prudent one.

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