Economic Background – November 2020

Change of Heart Pt. 2[1]

After the uncertainty of October, November saw confidence return to markets following the US presidential election and the announcement of a number of viable coronavirus vaccines.

Relief and a new direction

Whilst Joe Biden's victory of the US Presidential race to be President elect was positive news for some (although Donald Trump still refuses to concede defeat), US technology and healthcare investors were relieved by the fact that the Senate was not won by the Democrats. A 'Blue Wave', feared by investors in technology and healthcare due to the promise of increased taxes and regulation that would be imposed on the sectors. Despite this being a key part of the Biden-Harris campaign for now this is unlikely to happen with Republicans in control of the lower house.

There is concern from those that bought into the progressive policy programme of the Biden-Harris campaign that they will face an uphill political struggle like Obama did, to enact their policies. After passing the initial $3 trillion on government spending in the Spring, the White House and Congress have since failed to reach agreement on further stimulus in response to the pandemic crisis. If the Democrats had control of the Senate, markets would expect a large fiscal stimulus and huge infrastructure spend. This has caused others to believe that the US Federal Reserve (Fed) will be more 'simulative' than it might have been otherwise in the coming years.

Hope

It was the news of a Coronavirus vaccine that was met with hope for people, families, businesses and the global economy that sent depressed sectors soaring in the markets. Within weeks it was not one vaccine but two and possibly three, with 90%+ efficacy, little side effects and which can be distributed widely. Production of the Pfizer/BioTech and Moderna vaccines will commence as soon as practicable, with the belief that some doses will be available pre-Christmas with a ramping up of production likely to happen in the New Year.

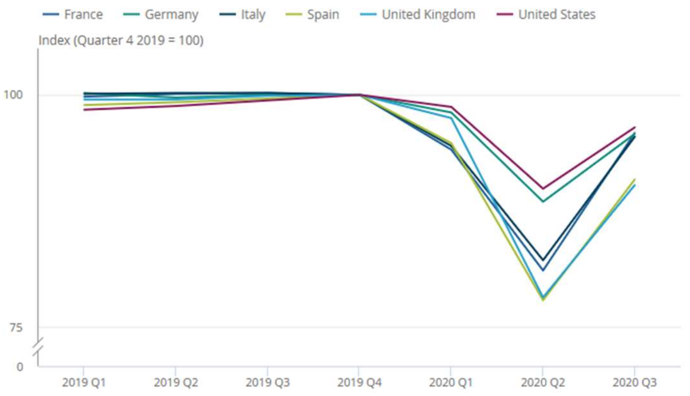
Whilst the vaccine is fantastic news, the coronavirus has had a huge effect on the global economy over the last month with country and regional lockdowns throughout Europe. Although France is in lockdown 2 million people have been diagnosed with coronavirus and in Germany the number of coronavirus cases has risen to over 800,000 from 520,000 at the end of October. The hope is that the businesses can overcome this period of inactivity before the growth in number of cases slows and the vaccination programs start. European Central Bank President Christine Lagarde hinted that the bank would expand its bond buying programme and ultra-cheap loans, in order to support the eurozone economy through the coronavirus pandemic. While she welcomed the "encouraging" news of a potential Covid-19 vaccine breakthrough, she warned that the second wave of the pandemic still presented "new challenges and risks" for the eurozone economy. More monetary stimulus comes as the European Union's (EU) €1.8tn response to the pandemic comes under threat from Poland and Hungary. The point of tension centres on the disbursement of funds being between member states is conditional on governments' respect for fundamental principles including the independence of the judiciary. Poland and Hungary oppose the idea

[1] Change of Heart Pt.2, The Vaccines, 2012

and are vetoing the seven year budget, including the emergency relief package unless the rule of law mechanism is substantially modified.

UK gross domestic product expanded 15.5% in the three months to September 2020, partially recovering from a record contraction of 19.8% in Q2. This was the strongest pace of expansion in the economy since the series began in 1955, reflecting the continued easing of lockdown restrictions. This leaves GDP down 9.7% over the year to 30 September. England started its second national lockdown this month which will impact the UK economy in Q4 data although it is expected to not be the same detrimental effect as in Q2 this year. To mitigate some of the damage the Chancellor Rishi Sunak announced that the UK furlough scheme will be extended until March 2021. Mr Sunak also announced an additional £2bn for the devolved administrations in Scotland Wales and Northern Ireland. The Bank of England have announced it will increase the issuance of Government Bonds by a further £150 billion bringing the total to £900 billion so far (the market does not believe that this is likely to be the last extension). This extends the global debt mountain to $272 trillion (rising by $15 trillion since 2019) in Q3 and it is expected to reach $277 trillion (365% of global GDP) by the end of the year.[2] In the UK the Bank of England now owns 45% of the outstanding government debt in the market.

GDP Growth (rebased to2019 Q4, 100)



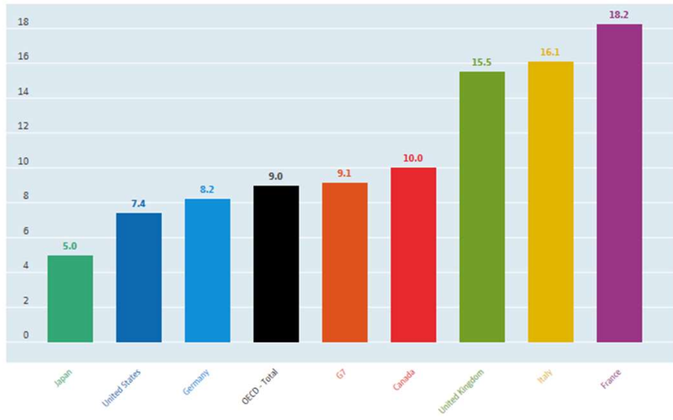
Source: Office of National Statistics

After deadlines have come and passed, in recent days there are increased hopes too of a UK-EU trade deal, with press briefings signalling a compromise from both sides. The same sticking points (fishing rights in UK waters, regulation and competition rules) will need concessions from both and as we know "nothing is agreed until everything is agreed". How the political 'optics' will be choreographed so that each side is able to sell the deal as a 'win' is the challenge. The UK is leaving the single market and customs union, it is whether we are leaving the EU with a deal or not.

In the US the number of infections has accelerated, surpassing 11 million in total, with more than 1 million cases in the last week and hospitalisations at record levels. Across America, with no nationwide decree's states have had to act accordingly. California's governor is activating an "emergency brake" and applying tougher restrictions to businesses, schools and social gatherings. From New Jersey to New Mexico restrictions on indoor dining and gatherings have increased with schools and businesses affected. These restrictions are likely to dampen the economic data over the coming weeks and months that until now had continued to show a recovery. Unemployment claims while still high are shrinking, measures in the manufacturing and service sectors are positive and retail sales and industrial production are still positive.

15 economies in Asia, including China, Japan and South Korea signed a free-trade deal in November, one of the largest in history, which aims to gradually reduce tariffs across many areas. The Regional Comprehensive Economic Partnership (RCEP) brings Asia closer to becoming a trading zone, although there is still more to be done with

Q3 GDP by Country



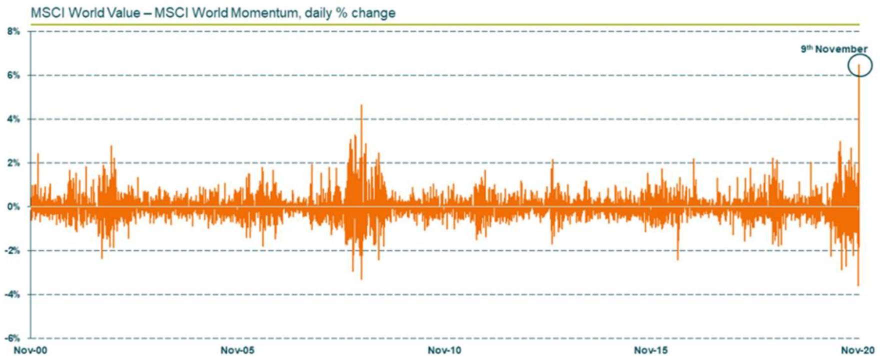
Source: OECD

[2] Source: Institute of International Finance

India not included within the deal. Japan and South Korea are perceived to be the main beneficiaries of the arrangement. It has come at a good time for Japan and coincided with the release of Japanese GDP figures which increased 5% in the third quarter, following contractions in the previous three quarters.

Rotation

Within equity markets we have seen a rotation of sectors and companies over the past weeks following the US election and vaccine announcements. Initially, as the election results became clearer that a Democratic sweep was not occurring, the biggest gains were driven by Growth stocks that have led the market for the past decade. Assisting the growth sector was an initial drop in interest rates as Growth stocks are more sensitive to interest-rate changes because their earnings on average are concentrated further out in the future. From the end of October, the US technology sector was up about 10% by 6 November. When the first vaccine announcement came on 9 November it also sparked a rally, but totally shifted the internal market dynamics, causing a rotation away from the secular Growth stocks to more cyclical value areas of the market like Energy, Financials, Materials and Industrial stocks. As the prospects for much stronger growth in 2021 increase as pandemic fears fade, this caused long-term bond yields to reverse their initial declines moving to new recent highs, with the US 10 Year Bond yield touching 1% at one point.



Source: M&G, Reuters

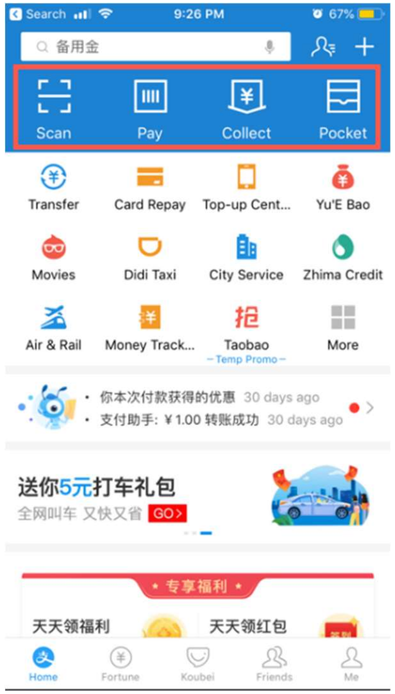
The higher rates were one reason Growth stocks suffered relatively on the vaccine news. In addition, the extreme valuation large Growth stocks had reached relative to value had become finally too stretched. It is still almost two standard deviations above historical norms, the largest valuation gap since the 1999 tech bubble.

As an example of the breadth of performance in funds we monitor the most value orientated UK fund has outperformed a US growth fund by over 20% in the month to date (18 November). It is perhaps too early to confirm that this is significant reversal of longer-term trend as vaccine uncertainties remain. However, there are significant signals that there is light at the end of the tunnel. The valuation gap between Growth and Value stocks has the tailwinds to continue to close in the year ahead. We suspect this expansion will follow that pattern. The pandemic was especially hard on many cyclical sectors and especially beneficial for many high-tech, WFH growth stocks. This sets up a big move back to normal as the pandemic hopefully dissipates over 2021.

Regulatory reality check

Asian capital markets have received a reality check this month. In what was set to be the world's largest capital raising, Ant Group's initial public offering was suspended after the Peoples Republic of China announced new regulations effectively changing Ant's business model. If Ant Group wishes to list in Hong Kong it will have to submit a new IPO prospectus, which could take at least six months.

Ant Group is China's largest financial technology group and was set to raise an eyewatering $37bn in the listing at a price of circa 40x earnings and valuing it higher than the world's largest banks. Ant Group is a financial technology company run by Jack Ma (founder of Alibaba). It has 700 million monthly active users with 80 merchants with Alipay its smartphone application portal, which is ubiquitous within China. It handles $17 trillion on payments in its last financial year. The app allows you to view your current and savings accounts, purchase film tickets etc, pay utility bills, exchange currency, wealth management products, insurance



Source: Ant Group, Alipay App

and get a loan. The new regulations to online micro lending announced by the Chinese regulator impacted Ant's lending business, which drove about 39% of its revenues in in the first half of 2020. The rules require internet platforms to provide at least 30% of the funding of their loans and to cap loans at Rmb300,000 ($44,843) or a third of a borrower's annual salary, whichever is lower. Currently, Ant funds only 2% of its total loans with the rest coming from other sources such as banks, it is effectively a technology matchmaker between banks and borrowers.

The consensus view is that this is the PBOC is stamping its authority and signalling that businesses (and their owners) have to toe the party line. In late October Jack Ma delivered a speech in which he criticised China's regulators and accused China's banks (which are state owned) of having a "pawnshop mentality". To openly challenge the regulator was too much for the regulators, Banks and the State. The official response from the State was the suspension was required to "better maintain the stability of the capital markets and to protect investors' interests". In response and following the unveiling of new antitrust rules for the sector Chinese technology companies lost almost $254bn in market value over two days. So far, the Hong Kong-listed shares in Alibaba have dropped 18% from its peak at the end of October to 19 November slicing $166bn off the company's market capitalisation.

We view China as a significant economic and political player in world markets, but not always a benign one. The actions taken to curb Jack Ma's ambitions are just one facet of a centrally controlled regime with a history of human rights abuses and a disrespect for international law (as per events in Hong Kong) or intellectual property rights (Huawei and others). Despite this a number of Chinese state-controlled businesses currently score highly on measures of ESG (Environmental, Sustainability & Governance). This appears curious to say the least.

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