Economic Background – December 2020

It's a feeling that you can't control[1]

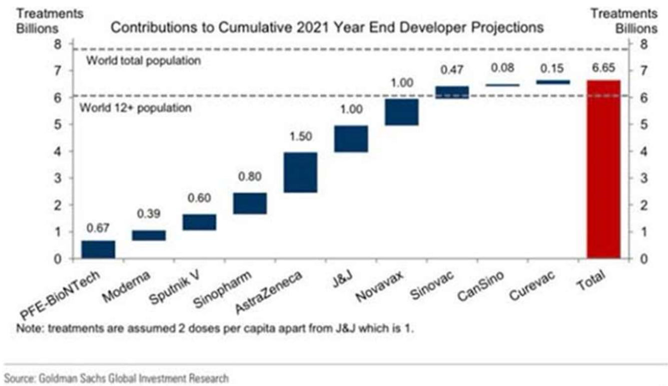
As the Covid-19 vaccines are being rolled out in the UK and US markets are focussing on the economic recovery in the second quarter of 2021 and beyond. For a decade the economic backdrop has been one with low inflation, as the world recovers whether this will remain the case is unclear.

Foundations for a recovery

The first few months of 2021 are likely to be very difficult for many sectors of the global economy. Heightened restrictions will hamper any material recovery as governments balance the infection rate and the health of the public and their economies, before the vaccines become effective. Goldman Sachs highlight that as we head into 2021 …

"Global vaccine supply is likely to become plentiful ... The point at which 50% of the population is vaccinated looks realistic in April for the US and UK, May for Canada, June for the EU and Australia, and July for Japan."

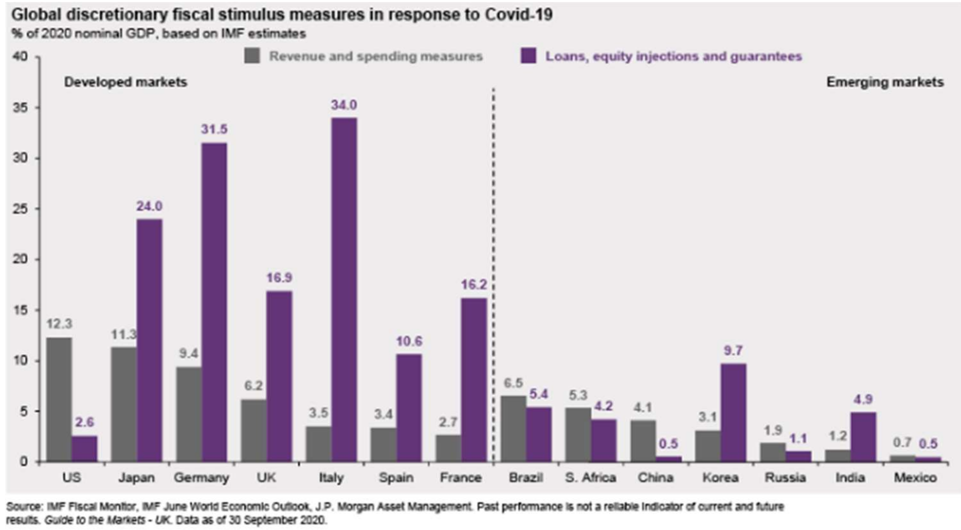
Projections of top-10 Vaccines correspond to treatments for 85% of the World in 2021



For now, assistance continues to be provided for businesses and consumers through supportive central banks and governments. The unemployment rate in the UK has increased to 4.9% in the three months to October 2020 from 3.8% a year earlier. This would be much higher but for the UK governments furlough scheme, which has been extended to April 2021. Although unemployment will rise further it will likely be steady rather than great swathes of job losses.

[1] Electricity, Elton John, 2005

In the European Union (EU), the leaders of Hungary and Poland have dropped their vetoes allowing the €1.8 trillion budget to be adopted. This removes the barrier to the implementation of the €750bn recovery fund, laying a foundation for a potential recovery. Member states have until the end of April 2021 to submit their spending plans and the European Commission will have up to two months to approve them. This means that the recovery fund is unlikely to be up and running before the second half of 2021. The funds will only then be disbursed progressively, so investors will have to wait for 2022 for the fund to have a meaningful economic impact in Southern European countries.



Following Joe Biden's victory in the US presidential election Democrats have been holding out for a huge, potentially $3 trillion fiscal package. Republicans are more wary. Nonetheless, with infection rates continuing to hamper the recovery, a new package is needed to bridge the gap for many. Commentators believe a more narrowed deal somewhere between $500 billion and $1 trillion will happen in the coming months. The person who will provide the link to the US Federal Reserve and the US Treasury is Janet

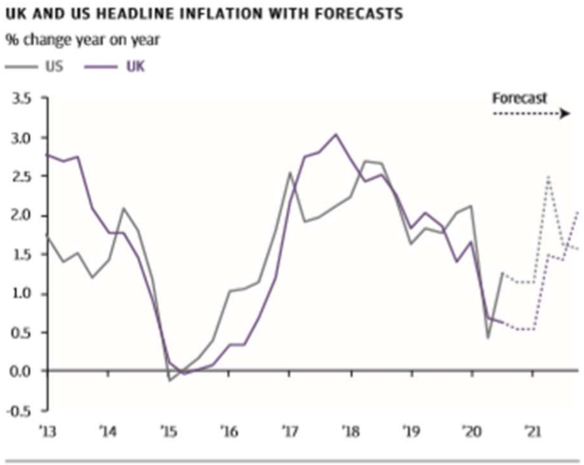
Yellen. Ms Yellen, the former Chair of the US Federal Reserve is to lead the US Treasury providing the prospect that fiscal and monetary policy might begin pulling in the same direction.

These huge fiscal support programs come on the top of central banks increasing their balance sheets by $7.3 trillion since March and promising a low interest rate environment for years to come. With the (hopeful) end in sight to the pandemic offers policymakers the confidence to keep extending their schemes, and corporates hope to plough on through the difficult winter months. The likelihood that strong companies who survive this disruption will gain customers as their rivals disappear.

Inflation

A risk to the low interest environment is if inflation escalates out of control. This risk has been a point of discussion among investors for some time but hasn't yet materialized. There is the risk of complacency as the probability of inflation increasing will be higher with global policymakers using every tool available (with more force than during the global financial crisis) to accelerate economic activity.

Conversely, the arguments for continued deflation remain in place: too much debt, the downward pressure technology is exerting on prices, too much capacity and a lack of demand are easy to understand. Faced with negative real interest rates, Western governments will be trying to avoid following Japan's persistent deflationary example.



Source: BLS, ONS, J.P. Morgan Securities Research, J.P. Morgan Asset Management. Forecasts are from J.P. Morgan Securities Research and are from Q4 2020 onwards. Data as of 17 November 2020.

From the second quarter in 2020 onwards, we should have synchronised growth, an improving economy and healthier levels of prices against those seen in the darkest days of the first lockdown. Over the next 6 months the data released will look high in percentage terms compared to the previous 12 months, with the denominator being so low. Whilst the rise in inflation may be inevitable given the large expansion in money supply, the velocity of money has collapsed. This has happened as people have simply held onto money or sought safety since December 2019. As sentiment improves and more cash holdings decline, we should see a return to normal velocity.

If inflation does return, the response of central banks will be key for markets. Central bankers have told us that they will let economies (inflation) run high to get back to full employment. This will mean that yield curves will steepen, as the short end of the curve remains locked and the long end factors in future rises, unless they try to hold down longer-term rates (unlikely).

Net Zero

Chinese stimulus measures have seemingly worked in curbing the worst effects of the pandemic, with China's industrial production reported to be up 7% over the year in November 2020. This has driven industrial metal pricing higher, with the price of Copper rising 22% in 2020 to a seven-year high due to Chinese demand. Brent Crude rose 27% in November and is now trading above $50 (per barrel).

The demand for commodities is likely to be fuelled further with the global desire to reduce greenhouse gas emissions to "net zero". In the UK's case by 2050. Prime minister Boris Johnson has set a target of reducing the UK 's emissions by 68% (relative to 1990 levels) by 2030. For global commitments on "net zero" to be achieved there must be tens of trillions of Dollars spent in infrastructure spending for maintenance, upgrades and increased capacity. The shift to battery technology will also fuel demand for industrial metals. China, the world's biggest car market, is intent on going electric and in the UK Boris Johnson outlined recently that the government will spend £12bn on the "Green Industrial Revolution" with £2.8bn on

> "lacing the land with charging points and creating long lasting batteries in UK gigafactories. This will allow us to end the sale of new petrol in diesel cars and vans in 2030."

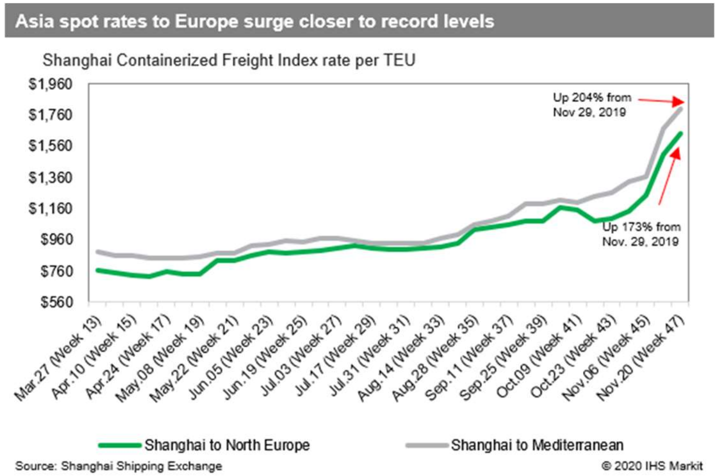
Electric vehicles need four times more copper than a conventional car and the charging infrastructure will use up even more of it. Given that miners and energy firms are spending a third of what they spent on exploration just 6 years ago, supply is unlikely to catch up with demand soon.

Trade

As expectations of a post-Brexit trade deal between the UK and EU rise and fall markets are gyrating with the positive and negative briefings emanating from both sides. Contingency planning for a no-deal Brexit has increased on both sides of the channel, with disruptions in trade flows seen as likely early in the new year even if a deal is reached.

Importers are seeking to bring in goods ahead of the deadline to be well prepared for a potential no-deal scenario. This has resulted in a significant spike in demand in recent weeks, leaving container rates from North Asia to the UK significantly higher.

> *"On top of this increase in demand come logistical problems at UK ports, which are struggling to deal with the influx of demand, resulting in significantly longer wait times at UK ports, further affecting the rising freight rates," "Some carriers are imposing congestion surcharges on this route on top of the already rising base ocean freight rates." Source: Platts.*



Container spot freight rates from Asia to northern Europe have broken the $2,000 (per container) level for the first time in a decade after rising by more than a quarter at the end of November. The Shanghai Containerised Freight Index reported rates of $2,091 (per container) on the Asia-northern Europe trade. The last time rates were this high was during the period that followed the global financial crisis, when rates topped £2,100 (per container) in May 2010.

Summary

The volatility we have experienced in 2020 could well continue into 2021. We would urge investors to remain focused on valuations and the long term rather than trying to time the ups and downs of short-term market gyrations. The highly unusual nature of the Covid-19 recession has generated stark differences between perceived winners and losers across sectors, styles and regions.

In the summer, the gap in valuation between growth and value stocks reached levels not seen since the technology bubble. The news of multiple vaccines has seen some shift in this narrative as we move into 2021. The question remains for next year as to whether this shift from the winners to the losers will be sustained.

Chris Davis
Chief Investment Officer