Investor Insight

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THE PATH OF POLICY
Governments are ready to support the economy while pandemic disruption persists.

HIGHER INFLATION?
There are reasons why inflation may be higher in the coming years.

DISINFLATIONARY FORCES MAY PREVAIL FOR NOW
A weak outlook for demand may weigh on inflationary pressures near term.

Close Brothers
Asset Management

Lasting change for the global economy

SUMMARY

- Markets have been calmer in the second half of 2020, though volatility remains elevated
- Certain areas of the market seem expensive by some measures
- The efficacy of health policy will be key in determining how long the pandemic lasts – further monetary and fiscal support is likely
- Changes to the global economy may cause higher inflation in the future but, near term, weaker demand is likely to limit a general increase in prices
- Active management will continue to be key – investors must identify the winners in the post-pandemic world

INTRODUCTION

After a volatile first half of the year, markets have behaved in a more sanguine fashion since June. The VIX index, a key measure of volatility, anticipating price moves in the S&P 500, shows that while volatility remains higher than it was before the pandemic, it has fallen significantly from its highs (see Figure 1).

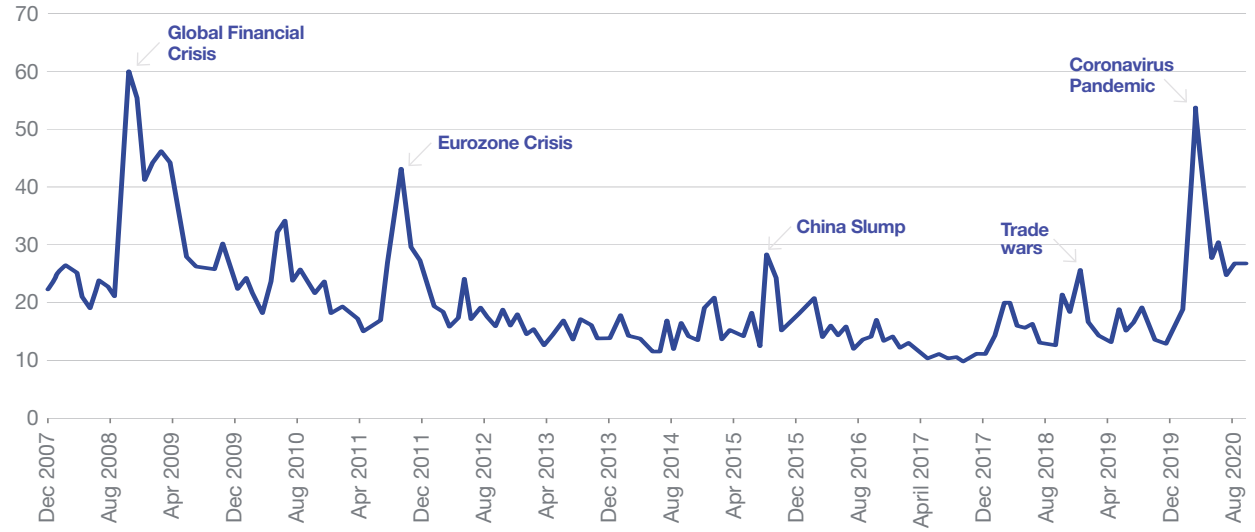
Asset performance has been remarkably favourable. The global equity index ended September close to its pre-pandemic highs, though most of the gains are attributable to a handful of well-known technology stocks. This sector continues to surge higher, despite concerns over demanding valuations causing shares to correct from time to time. Some areas of the market have benefitted less – the energy sector remains over 40% below the February peak, on account of a weak outlook for oil demand. Other cyclical areas, such as industrials and financials have also lagged.

Within bonds, yields on government debt have fallen in all developed markets and across all durations, signalling that investors are willing to accept lower returns for a perceived safe-haven asset. This has had a ripple effect up the risk spectrum, causing bond yields to fall in the corporate space, too.

Lower bond yields also impact other areas of the market. For equity analysts, for example, they lower a key variable used to discount company earnings in their financial models, which magnifies the present value – or what analysts are willing to pay today – for a share of future earnings. This has helped sectors of the market where a greater emphasis is put on long term earnings growth – such as the aforementioned technology sector.

With bond yields tight and certain areas of the market richly valued, what are the factors driving growth from here and how are we approaching valuation?

Figure 1: VIX Index



Source: Close Brothers Asset Management

THE PATH OF POLICY

Governments are ready to support the economy while pandemic disruption persists

Some six months on from its outbreak, it is clear that the economic impact of the coronavirus pandemic has been more profound than any event in living memory (see Figure 2). As an example, consensus forecasts of the impact on the UK economy in 2020 anticipate a decline larger than the global financial crisis or Second World War. For the most part this is due to the fact that the need for social distancing in order to manage the spread of the pandemic has severely disrupted business, making some activities impossible to carry out.

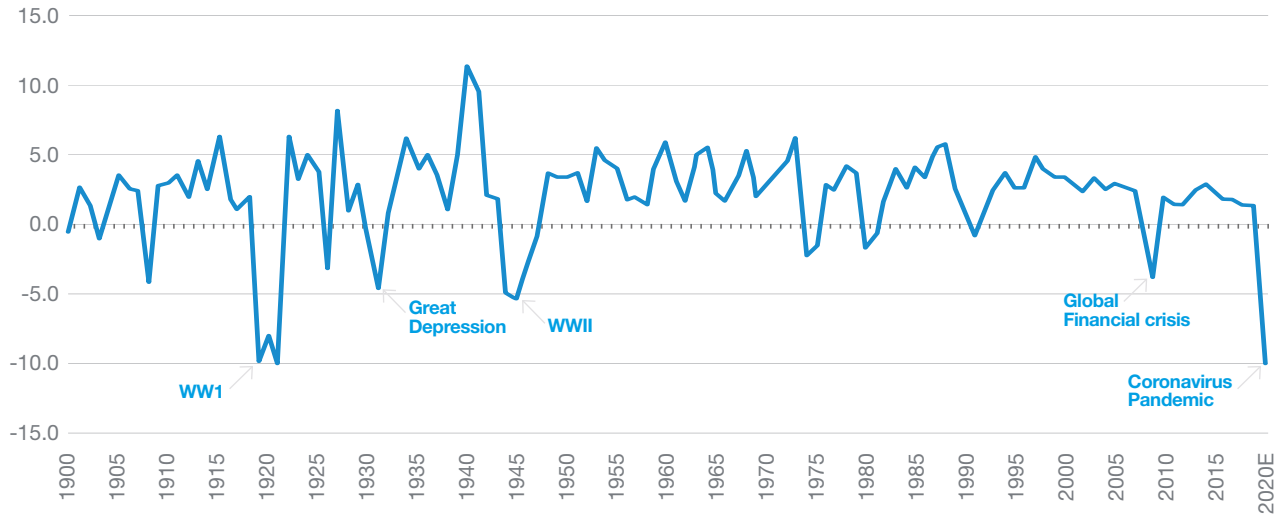
Governments around the world have increased spending significantly in order to support the economy through the worst of the health crisis but, unfortunately, the coronavirus pandemic is not yet over. Renewed social restrictions and the onset of the northern winter are coinciding with a rise in cases in many parts of the world. Research progress into therapies and vaccines continues, with hope that an effective vaccine will be available in 2021. Given that economic disruption is likely to persist for some time, spending policies designed to last a few months may be required for longer.

With this in mind, the health of the economy will continue to depend on policy makers' ability to manage the spread of the virus, limiting the economic impact as much as possible, probably through localised lockdowns and restrictions.

While our understanding of how the virus spreads is improving, research in the area remains nascent, and it is only recently that policy makers have had data with which to assess which social distancing measures are most important. Testing technologies are improving, but availability remains a logistical challenge in some countries. However, the data we do have is allowing policy makers to take a more targeted approach in how and where social restrictions are imposed.

With disruption expected to continue for some time, governments stand ready to support the economy with higher spending. While the initial emergency measures have come to an end in the US and are reducing in the UK, we see scope for further support if necessary. While the magnitude of measures has been enormous, very low yields on government debt place limited pressure on governments to stint on spending for now.

Figure 2: UK GDP YoY%



Source: Close Brothers Asset Management

HIGHER INFLATION?

There are reasons why inflation may be higher in the coming years

Much ink has been spilt in recent months on the topic of inflation and there are three factors which may contribute to an environment of higher inflation.

DESYNCHRONISATION

The prevailing trend of the global economy over the last two decades has been that of globalisation – increasingly sophisticated supply chains allowed businesses to source materials and labour worldwide and just-in-time production technology eliminated the requirement for businesses to hold much inventory.

The experience of the pandemic has revealed the importance of supply chains being not only efficient, but also resilient. For strategically important goods, this is likely to lead to a partial re-shoring of production, reducing the supply chain's vulnerability to shocks along the line. While this does not signal the end of globalisation, we may see some fragmentation in global trade, and a period of disruption while supply chains re-orientate. A side effect of this change may be that costs increase.

THE POLICY MIX

Across the globe, central banks and governments have adopted accommodative fiscal and monetary policies in order to support the economy. This policy mix is the most supportive combination for economic growth. Once the economy begins to recover, it is possible that inflation may accelerate rapidly.

INFLATION TARGETS

The challenge presented by the pandemic has caused central bankers to examine the efficacy of the tools available to them and to review policies. The monetary policy committee of the US Federal Reserve has led the charge on this, formally adjusting its inflation-targeting mandate to an average rate of inflation over time. The significance of this is that the Committee has signalled a willingness to tolerate inflation above 2% for some time without raising interest rates. This makes it possible that inflation could range somewhat higher.

DISINFLATIONARY FORCES MAY PREVAIL FOR NOW

A weak outlook for demand may weigh on inflationary pressures near term

While it is possible that inflation may rise in coming years, near term there are factors which may weigh on it.

In the immediate term, labour market weakness is expected across a number of economies. In the US, unemployment surged in the second quarter, and has fallen back sharply, but remains at double the pre-pandemic rate. In the UK, where the furlough scheme has largely obscured the impact on employment, unemployment is creeping higher as schemes are being withdrawn or watered down. The Eurozone has also seen a rise in unemployment, with tourism-focussed economies suffering worst. In short, spare capacity in labour markets ought to hinder higher inflation.

A weak labour market weighs on inflation in a few ways. Firstly, wage growth tends to accelerate when the labour market is tight. Conversely, the more competition there is between workers for jobs, the greater the likelihood that workers will accept lower wages. While the relationship between wage growth and inflation is not straight forward, labour costs are a significant share of production costs and are likely to remain subdued.

Secondly, consumption growth has a strong relationship with wage growth. In an environment of weak wage growth, consumers cannot consume more without borrowing more. It is harder for retailers to pass on price increases to consumers if demand is moribund, breaking the transmission mechanism for inflation.

Thirdly, we should remember that other trends which pre-date the pandemic may also be disinflationary. These would include technological advances and the de-unionisation of labour forces, which weaken workers' collective bargaining power. In time, we expect the labour market to recover but history suggests that the longer pandemic-related disruption lasts, the greater the scarring effects on the labour market are likely to be.

Finally, an unintended consequence of furlough schemes and other fiscal support in the long-run may be that stagnant companies and industries are kept going at the expense of allowing emergent ones to grow more quickly. Efficient capital allocation in this regard will be key in helping workers to retrain and economies revive in a post-pandemic world. There will be winners and losers, and our style of active investment management will help us to identify them.

POSITIONING PORTFOLIOS

The coronavirus pandemic has had a significant transitory effect on the global economy, causing disruption to businesses, as well as spurring longer-term changes. With this in mind, investors must establish which assets will prosper longer-term, and at what price.

While it may take some time, we do expect the global economy to recover from the heavy economic blow caused by the pandemic. Progress towards a vaccine would be the most decisive factor facilitating recovery but health policy is also likely to become more efficient, and businesses are finding new ways to reach customers. Central bankers and governments have also demonstrated their readiness to step in.

Even though we do expect a cyclical recovery in time, we believe it is also important to understand the longer term implications of the pandemic. The disruption caused by the pandemic is likely to precipitate lasting change in the global economy and it is this change that investors must identify.

Risk assets, such as shares, are long term investments and current prices must theoretically reflect the present value of all future earnings, not just those in the next twelve months. Because of these structural changes, it seems likely that assets may respond differently in coming years to how they have previously. This is particularly important to bear in mind when looking at cyclical areas of the equity market. While these sectors have lagged behind the broader index and may be on less demanding valuations, some industries may face enduring structural challenges.

With this in mind, we believe that in this environment, active management will be even more important. Investors must consider which industries are best positioned to adapt to the new normal of the post-pandemic world. Across shares and corporate bonds, our research focus remains on businesses with ample working capital and those set to benefit from changes to the economy in the wake of the pandemic. For now, we continue to find more of these opportunities in the US equity market.

Within the bond market, the new outlook for global growth makes it likely that interest rates will remain at new lows for longer, which is generally supportive for fixed income instruments. With government yields so low, further monetary accommodation may be required in order to eke out further price performance from these richly priced assets, and yields may rise sharply when evidence of stronger economic activity arrives. Given the scope for shocks to the economy, bonds play an important role within multi asset portfolios, but we see more attractive opportunities, and better protection, in less richly valued assets.

KEY VIEWS

Though the year is almost over, two key political risks remain. In the US, the November election is likely to shape the political agenda for the next four years. With Biden ahead in the polls, markets appear to have come to terms with the notion that a Democratic victory may mean tighter regulation and higher US taxes in time. Near term, if either party is able to win both the upper and lower houses, we would expect further fiscal stimulus to be significant, boosting growth.

In the UK, the end of the Brexit transition period is fast approaching. Given the narrow scope of the deal under discussion, we expect significant change for the UK economy with or without a deal. Bearing this in mind, coupled with the weak outlook for UK growth in the wake of the pandemic, we remain more cautious on UK assets.

Views	Asset allocation impact
Bonds richly valued	Underweight bonds
US growth likely to outperform	Overweight US shares
UK growth likely to underperform	Underweight UK assets – shares, bonds & property

CONCLUSION

With the initial turmoil of this unprecedented health and economic emergency behind us, we are focussing on the longer term implications of the pandemic. We continue to closely monitor the evolution of the health data in order to better gauge the likely duration of this period of weak growth, and to analyse in detail individual securities, in order to find those with the greatest near term resilience and long term prospects.

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