Investor Insight

SUMMER 2021

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HEALTH REALLY IS WEALTH

Vaccination programmes have allowed growth to recover.

THE FISCAL FILLIP

Fiscal policy looks set to be supportive for longer.

THE POLICY PREDICAMENT

The reopening rebound is starting and inflation is rising.

Close Brothers
Asset Management

What does a policy triangle mean for investors?

Over a year on from the start of the pandemic, the global economy is recovering from the economic shock precipitated by the social restrictions necessary to slow the spread of Covid-19.

Global economic growth is currently determined by three areas that form a policy triangle: health policy, fiscal policy and monetary policy. Policy makers can compensate for weak performance in one area by boosting another, calibrating the economy to support growth. Likewise, where the economy is in danger of overheating, policy makers may tighten measures to avoid high inflation.

With the recovery underway, we examine each of these policy areas, how they are impacting global growth and what they mean for investors.

HEALTH REALLY IS WEALTH

Vaccination programmes have allowed growth to recover

For the first time in living memory, the economic performance of most of the globe has hinged on the efficacy of health policies. This is because, without effective health policies, economies have had to curtail activity under the social restrictions necessary to slow the spread of Covid-19.

Genomic surveillance, population testing and contact tracing measures have all made a significant difference to national outcomes, especially early on in the pandemic.

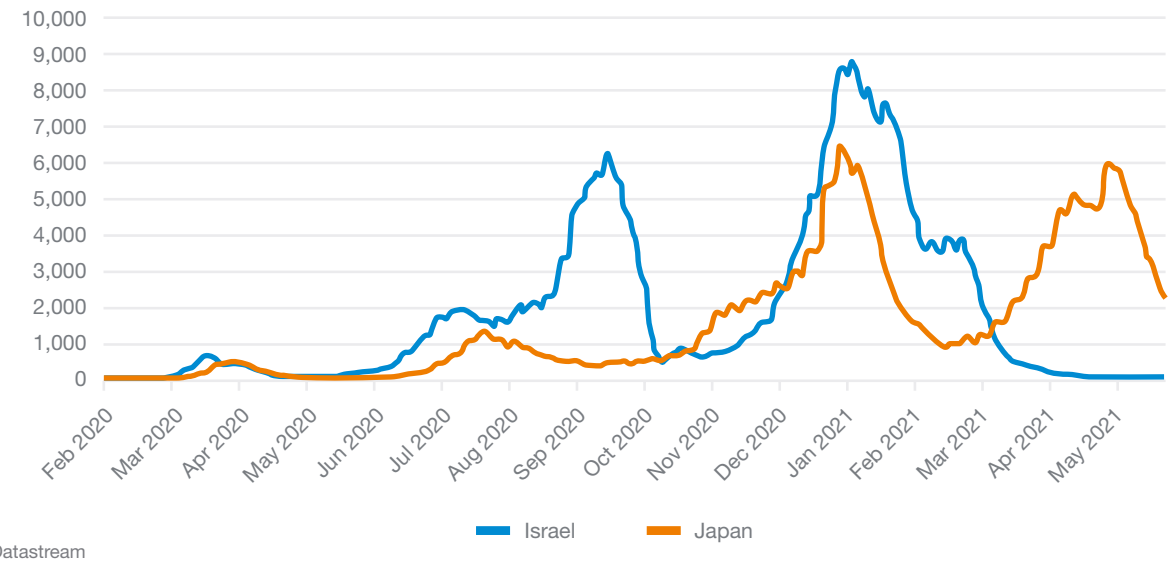
However, inoculation programmes are the measure currently making the biggest difference to how quickly an economy can reopen.

While vaccinations may not halt the spread of Covid-19 altogether, data does show that they have led to significantly lower infection, hospitalisation and mortality rates, allowing social restrictions to ease in a number of countries. The plight of Japan, and other countries where vaccine rollout programmes have been delayed, illustrates why vaccinations are so important.

While the UK administered its first vaccine in early December, having fast-tracked approval based on trial data, Japan did not begin vaccinations until the second half of February. The delay was largely due to Japanese regulators opting to run their own trials in Japan, in order to combat low public confidence in vaccines following a number of historical vaccine scandals. Vaccinations only really picked up steam in May, with the result that only just over 10% of the total population had received at least one dose by the beginning of June.

This slow start has had a high price for Japan – a fourth surge in cases ripped through the country in May, proving

Figure 1: Daily new cases, 7 day moving average



Source: Datastream

to be the most deadly wave yet (see figure 1). As a result, social restrictions remain in place, with no immediate prospect of withdrawal. Japan is due to host the Olympic Games in Tokyo in July, but no overseas spectators will be allowed to attend and there will be mobility limits on domestic spectators. Japan will lose out on tourism revenue as a result.

Because the efficacy of health policy remains the main constraint on a country's economy, the pace of vaccine rollouts is having a powerful effect on economic expectations. Countries with advanced vaccine rollouts are seeing growth forecasts improve, with the US and the UK currently leading the way. While Europe got off to a slow start, many countries have made significant recent progress with inoculations.

While vaccinations are key, there is not yet a serious global commitment to provide doses for the world's population. As a result, new variants will be constantly emerging, some of which may have greater resistance to current vaccines. With this in mind, governments must not neglect genomic surveillance, population testing and contact tracing programmes, or there is a risk that social restrictions will need to be reintroduced.

THE FISCAL FILLIP

Fiscal policy looks set to be supportive for longer

Over the last year, we have seen governments increase spending in a bid to compensate for the lost economic activity caused by the pandemic. The design and size of these measures has differed across economies, as has its economic impact.

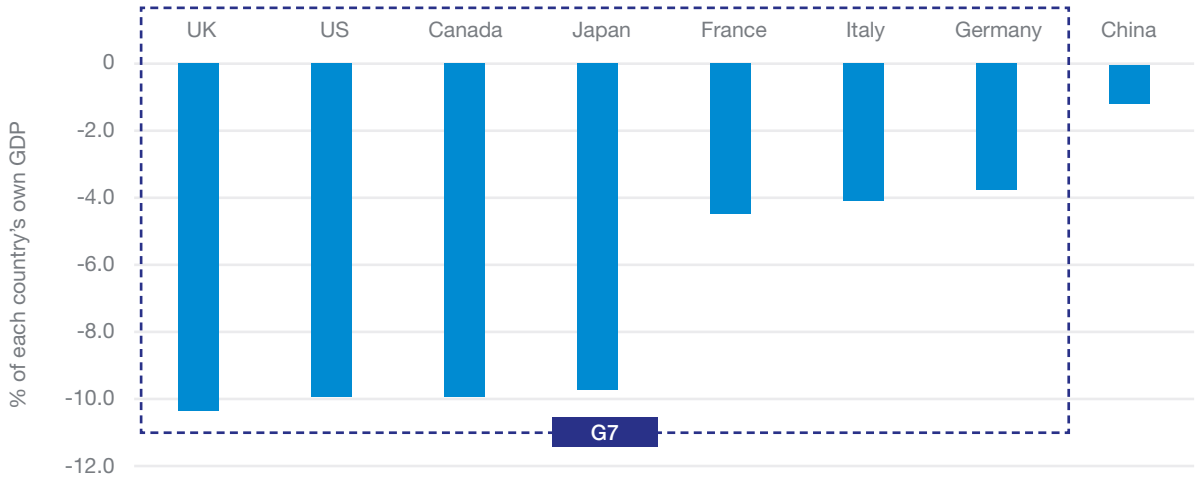
Big packages do not guarantee a rapid recovery, but they certainly seem to help. In terms of size, the UK, Singapore, the US and Canada have increased fiscal support the most – spending in 2020 is estimated to have increased by around 10% of gross domestic product (GDP). In comparison, France is estimated to have increased spending by 4.5% of GDP and Germany by 3.8%. It is noteworthy that China was able to return quickly to positive growth, despite only increasing spending by around 1% of GDP, partly because they were able to strictly manage health policy (see figure 2).

Spending is also set to be extended. The huge increase in spending in 2020 led economists to expect a global fiscal contraction in 2021, as governments let fiscal measures expire once economies were permitted to re-open. However, because we are not yet out of the woods, many governments have extended some spending into 2021. The US has extended spending most significantly, and is expected to spend the same amount again in 2021 as it did in 2020. Much of this took the form of an additional round of stimulus cheques sent directly to citizens in order to turbo charge the economy, with funds hitting bank accounts just as the services sector reopens.

While many countries are extending measures, fiscal policy is still ultimately likely to become less supportive in 2021, as spending measures expire. However, though fiscal policy may contract, the hope is that it will have allowed better economic growth to take the reins from government spending.

Moreover, while we should not expect to see the sort of year-on-year increases in spending that we witnessed in 2020, the tide appears to have turned on fiscal policy. Leaders of the world's leading economies

Figure 2: The change in cyclically-adjusted primary balance for 2020



Source: Datastream

increasingly seem more willing to permit higher levels of government spending than was previously the case, with an associated increase in government debt. In order to help finance higher spending, many governments have identified tax changes that could help raise revenues.

Corporate tax reform is one potential source of revenue, and finance ministers from the G7 group of nations recently endorsed a global minimum corporate tax rate, which could discourage large multinational companies from booking profits in lower-tax jurisdictions.

THE POLICY PREDICAMENT

The reopening rebound is starting and inflation is rising

At the start of the summer, social restrictions are easing in many of the world's largest economies and expansionary fiscal policy has supported growth. Consumers, flush with cash from deferred spending and generous income support measures, are likely to embark upon some 'catch-up consumption', and we are seeing the early evidence of this stronger demand.

On the supply side, there is evidence of labour market tightness in those economies where social restrictions are easing. US job openings have seen a record surge (see figure 3), and more people are moving jobs, though hiring numbers remain constrained, painting a picture of tight labour supply.

Goods demand is also strong, with many industries still restocking in the wake of the China-US trade dispute before the pandemic. Production disruptions and the blocking of the Suez Canal earlier this year have further contributed to tight supply and demand.

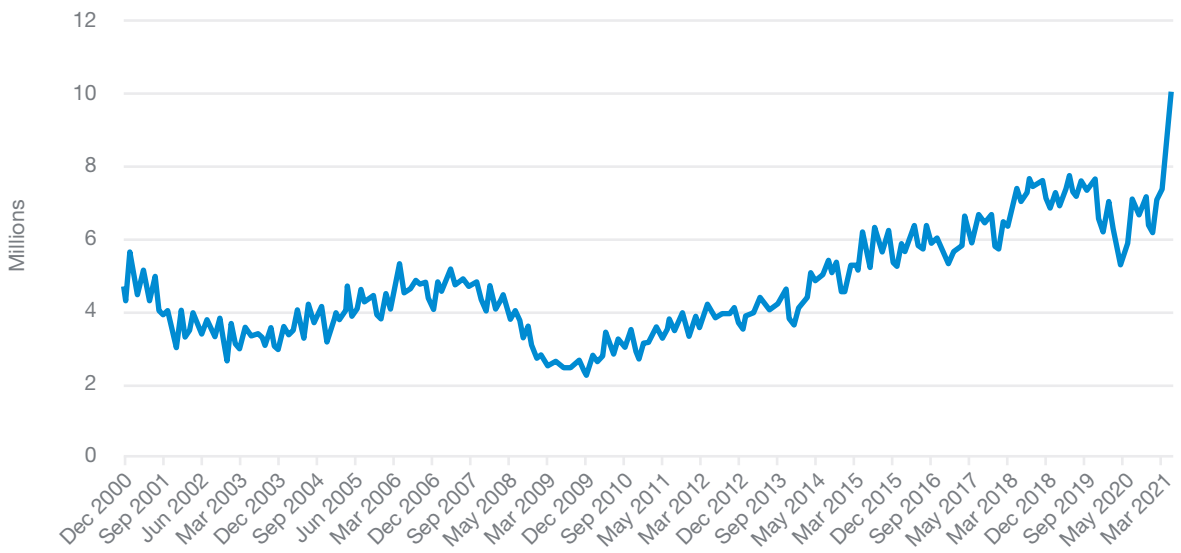
The combination of strong demand for goods and services, and tight supply of goods and labour is already resulting in inflation. In China, producer price inflation surged to 9% annually, causing the government to intervene in some raw materials markets. In the US, wages grew by 0.5% in May, despite an unfavourable mix effect due to many more workers in low wage jobs re-entering employment. Headline inflation rates across the world's main economies vary, but all are rising.

While inflation is accelerating, it is difficult to predict how long it will last. Moreover, significant changes may be afoot in the global economy that could have an impact on inflation. Structural shifts including the aging population, increased automation, greening the economy, and deglobalisation may all play a part.

Expectations of a sustained inflationary revival remain muted in Europe and Japan (where inflation had concerned central bankers by its absence prior to the pandemic), but are nevertheless showing signs of reviving. In the US, where unemployment was low before the pandemic and fiscal stimulus is boosting the post-pandemic rebound, expected rates of inflation and interest rates have already risen.

The challenge for central bankers is that monetary policy, the final tool in the policy triangle, takes time to take effect and so needs to be calibrated in anticipation of economic conditions. While US monetary policy makers continue to favour supporting the recovery for long enough to ensure that workers from the most disadvantaged groups also benefit from the improvement in economic conditions, guidance is beginning to hint at the need for tighter monetary policy. UK policy makers have also turned more constructive, with attention turning to the sequencing of monetary policy tightening.

Figure 3: US job openings (total non-farm)



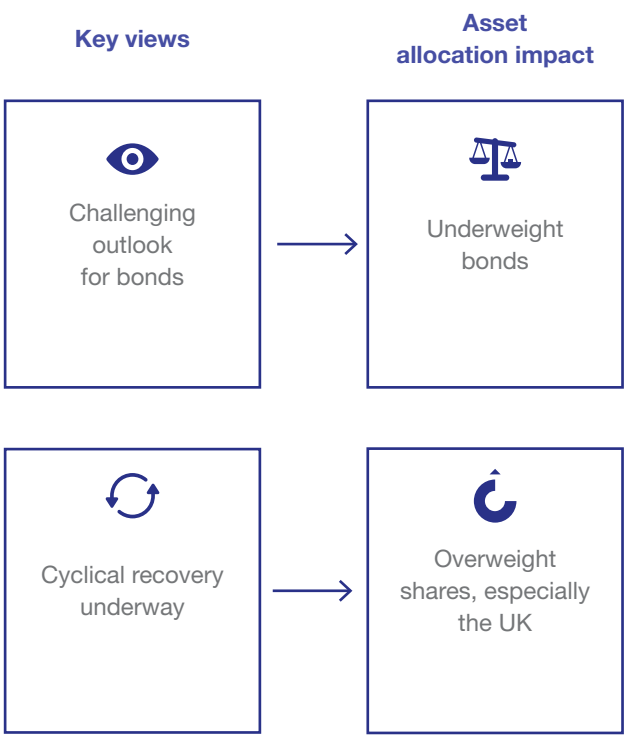
Source: Datastream

POSITIONING PORTFOLIOS

The effective rollout of vaccinations across many of the world's largest economies has allowed social restrictions to ease and economic activity to recommence. Coupled with supportive fiscal policy and loose monetary conditions, this is allowing a surge in growth which could be sustained for the rest of 2021, assuming social restrictions do not need to be reintroduced.

The recovery in growth is contributing to higher inflation, and the expectation that monetary policy will tighten in time. The prospect of higher interest rates causes bond yields to rise, and therefore bond prices to fall, weighing on fixed income performance. This can also undermine the valuations of shares, because interest rates are used to value the future earnings of companies. Companies in growth sectors have been more sensitive to these movements, as a higher proportion of the value of such companies is due to high growth expectations in the future. However, shares also have exposure to the real economy, and earnings expectations should receive a boost from expectations of better economic growth. We continue to favour those sectors and regions with exposure to the cyclical upswing in economic conditions.

While US monetary policy will have a powerful effect on the whole of the global economy, we expect health policies to continue to be more desynchronised. Those economies with effective health programmes are likely to experience the strongest recovery, including the UK.



Conclusion

The outlook for growth points, with increasing confidence, to recovery. Inflation is rising, but the dynamics that would support a more sustained change in the inflationary environment are not yet well understood. With this in mind, we consider it prudent to acknowledge the risk that the period of low inflation which has persisted since at least the financial crisis may be at an end. This presents an opportunity for investors to gain exposure to equity sectors that are geared to the economic cycle and will prosper in the upswing, and a reason to be cautious on bonds.

At the same time, we continue to believe that a number of structural changes are in play within the global economy, and that businesses exposed to these themes can make attractive investments. Moments of market turbulence, when shares in these often richly valued sectors are repriced lower, may present a buying opportunity.

Close Brothers Asset Management
10 Crown Place
London EC2A 4FT
www.closebrothersam.com

Private clients please contact:
Your investment adviser or the client services team
Tel: 0800 988 8565
enquiriesam@closebrothers.com

Intermediaries please contact:
Darren Saddler
Head of Investment Business Development
Tel: 020 7426 4187
darren.saddler@closebrothers.com

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