TPO Investment Market Update

Inflation fears today, taxation comes tomorrow

12th March 2021

The Budget delivered last week by the Chancellor, Rishi Sunak, comes after a year of disruption to economic activity due to COVID-19. The Government has been forced to curtail the freedom of movement and step in with both fiscal and monetary support on a scale not seen in peacetime before (see Figure 1.).

In the Global Financial Crisis (GFC) of 2008 authorities around the world took to pumping money into the system, but this time around the authorities reacted much more quickly to the rapid decline in activity and applied the equivalent stimulus of the entire GFC period in a few months.

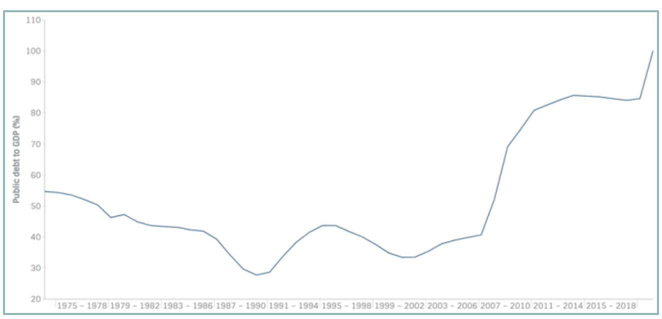

Figure 1. Public sector debt to GDP *(Source: The Global Economy)*

Stepping back now after 12 years of debt-fuelled growth could lead to a negative shock with the economy still in a precarious position, so the Chancellor has no choice but to keep spending.

This increase in debt since the GFC has been made possible by the low cost of borrowing and it is low interest rates that allows the deficit to be financed and the interest payments to be manageable. Therefore, the Government must keep rates low whilst trying to find ways, at some point, to exit this extraordinary period of support. The Budget which was unveiled last Wednesday is therefore carefully balanced to reduce public borrowing without it being a detriment to the UK's economic path to recovery.

The measures taken include increasing corporation tax from 19% to 25% in April 2023 for companies with profits over £250,000 with a marginal sliding scale for those earning below the upper threshold down to those companies which earn below £50,000 in profits which will see the corporate tax rate remain at 19%. This should be taxing big corporations more than small companies. All the personal taxation allowances were frozen, which, with the effect of inflation means they will shrink in real terms over time.

We also saw the announcement of the 'super deduction,' which is a temporary tax relief and will allow eligible companies to claim 130% capital allowance on investments in qualifying plant and machinery. This measure is expected to stimulate £25 billion in business investment in the UK – the key beneficiaries being manufacturing and utility companies and should provide a welcome injection (no pun intended) to the economy by bringing cash reserves into the market.

Assuming that the majority of the pandemic fiscal support schemes are removed by 2022 then the new Budget measures implemented should see the UK's borrowing requirement fall in 2023 with £31.8bn being raised through this extra taxation in 2025-26 (see Figure 2.).

We urge you to stay safe and remember that your TPO advisers are here to guide you through this storm. If you have any questions or concerns, please do get in touch.

The value of investments can fall as well as rise. You may not get back what you invest.

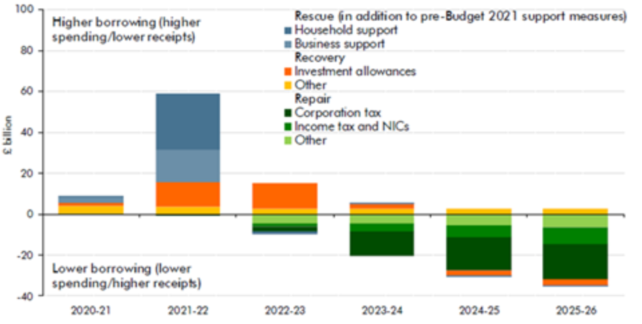

Figure 2. The impact of Budget measures on public sector net borrowing *(Source: OBR)*

Where's Inflation?

The expected improvement in the UK's economy is a positive factor but it does raise the prospect of inflation (again). An increase in inflation would be beneficial for the Government's debt burden as most of its interest payments are fixed, so the real value of its liabilities would fall. After many years of low inflation this possible increase has caused consternation amongst investors.

However, we do not see long term inflation concerns being priced in. Looking at Figure 3. we can see that the 5yr breakeven rate (2.42%) is higher than the 10yr (2.21%) and 30yr (2.14%) rates. This can be interpreted as the market believing that inflation will increase in the short-term but fall in the medium to long term.

Figure 3. US breakeven rates *(Source: FRED)*

Where could inflation come from?

Inflation expectations are currently benign but where could an increase come from?

A key factor is the unemployment rate, as slack in the labour markets means the bargaining power of individuals to command a higher wage is reduced – there is a surplus of (potential) workers for available job opportunities shown by the increase in unemployment. Unemployment in the UK is estimated to be 5.1% (a five-year high) following the continued impact of the pandemic. This figure excludes those on furlough as well, which at the scheme's peak saw 30% of the UK's workforce being paid by the system, so it does raise the question of what the impact might be when this scheme is removed.

The unemployment rate also tends to lag in a recovery following a negative shock; In Figure 4. we can see that during the GFC the unemployment rate peaked at 8.4% and took until 2014 to recover to pre-GFC levels, despite the recovery in GDP being seen in 2010.

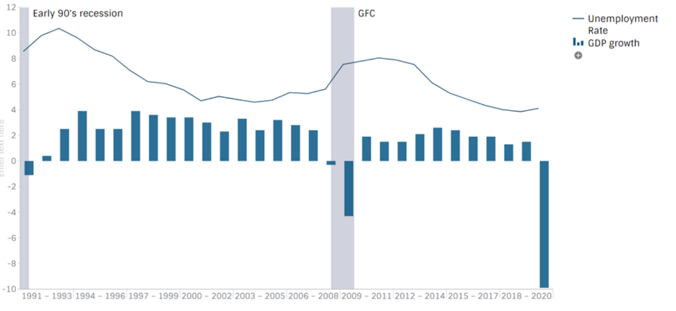

Figure 4. UK unemployment and GDP data *(Source: The Global Economy)*

Market Update

Inflation is a primary concern for bond market investors as increases in inflation reduces the 'real' value of the income and capital you receive. This means any increase in inflation expectations are typically seen in bond markets first.

US bond markets experienced significant volatility with the 10-year yield reaching an intraday high of 1.61% on 25th February which was the highest figure recorded in the last 12 months. Also, there was a lack of buyer demand for the $62bn 7-year bond auction which saw the primary dealers (those who underwrite the bond sales) have to buy 40% of the auction which was an intriguing development for one of the world's most liquid markets.

This caused a fallout in equity markets as investors began to rotate from growth stocks into unloved value stocks, whose performance is typically more closely related to the overall health of the economy. Specifically, we saw the tech-heavy Nasdaq fall 4.70% in February, whereas a composite of US banks returned 12.91% over the same period, a stronger economy is seen as a tailwind to bank profitability.

In the UK we saw markets respond positively following the Budget as the fiscal stimulus was larger than expected and with the Office for Budget Responsibility forecasting that the lifting of restrictions would see output growing 7.3% in 2022. The rotation into cheap stocks and the weakness in the British pound (falling from 1.41 against the US Dollar to 1.39) saw internationally diverse large cap companies return 0.62% in February with more domestically focused mid-cap companies returning 2.62%.

Europe continues to struggle with the fallout of the pandemic and, whilst a target has been set to vaccinate 70% of the adult population by the end of the summer, there is the expectation of further sporadic lockdowns until then. This also means that no aggressive changes to monetary policy are expected with European Central Bank board member Fabio Panetta going as far as saying that policies need to be "harder, better, faster and stronger."

China in comparison to its economic peers has not had to resort to aggressive stimulus measures and is now moving from a 'growth at all costs' approach to focusing on reducing China's sizeable debt burden. Even with this deleveraging, the country is targeting at least 6% growth rate this year and continuing with its increase in R&D spending which will reduce its reliance on the US.

Summary

With so much spare capacity in the world, in the form of unemployed and furloughed workers, there is plenty of room to grow before we can expect inflation that is here to stay. Authorities cannot afford to raise interest rates (debt costs) or withdraw support (economic downturn) too early, yet Governments have been trying to get inflation to rise above economic growth for more than a decade. Central banks have indicated they are happy to see above target inflation. We expect more extreme policy changes in the future.

So, while investors may, from time to time, be concerned about what all this means to the long-term, central banks and monetary authorities should, in theory, rejoice and remain nervous because the plan is finally (hopefully) working.

We feel that the expected sprint of economic recovery will not, therefore, convince the authorities that the long-term marathon that started after the GFC 2008 is over. If they blink and raise rates too soon, they risk ending the race before the finish line with nothing left in the tank.

Whilst inflation fears are with us, we should not expect bonds to perform as well as they have done in previous years. Equities on the other hand are likely to enjoy signs of economic recovery and can tolerate controlled inflation as it is helpful to company revenue growth. That said, the road to economic recovery as the world opens up again is likely to be bumpy so the authorities need to hold their nerve and investors must do likewise. A well-diversified and balanced risk adjusted Portfolio remains the best place for long term money.