TPO Investment Market Update

It's all about reflating the World economy

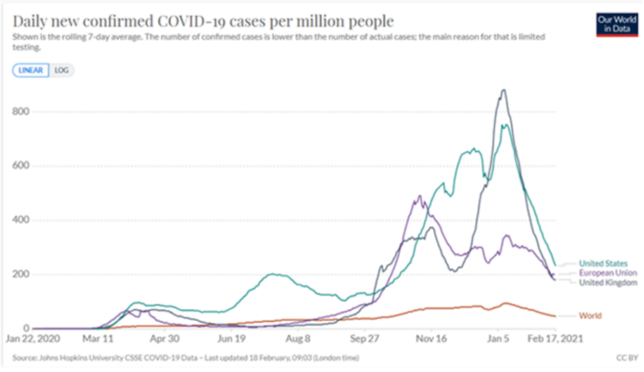
12th February 2021

Last month we talked about the themes for 2021 and how sentiment could be driven by the speed that economic activity gets back to ‘normal’, based on a rollout of various vaccines and backed by continued economic stimulus. Against this there is the continued threat of new virus variants and the relentless spread of infections. Quite often in the world of investment, markets do not wait for confirmation and investors focus instead on what they think will happen next based on available information. This is most definitely the case in 2021, so far, and has resulted in a clear theme within markets. In this update we will look at this theme and offer some of our observations.

Reflation is the theme

Since the global financial crisis (GFC) in 2008, debt levels have risen markedly as authorities have supported economic growth via stimulus packages and low interest rates. The lack of inflation has allowed authorities to maintain this policy stance, which has supported a low but consistent level of economic growth. The pandemic and the disruption to economic activity associated with periodically locking down a high proportion of the global population has led to a very similar policy reaction, but one that dwarfs the previous periods both in terms of speed of application and the magnitude of support. As a result, debt levels are now touching peaks only last seen during the second world war and with the world far from normal they will keep rising.

We entered 2021 with a string of good news on various vaccines, and the commencement of a mammoth global effort to vaccinate against Covid-19. At the same time, there is very little prospect of economic stimulus measures being withdrawn, as to do so too early would be suicide for the global economy. Now we see case numbers, per million people, begin to fall as can we seen in the chart below:



Armed with these thoughts, investors have begun to look beyond a period where the virus dominates freedom of movement. If economies open-up soon then the pent-up savings that have built up over the period of lockdown might be unleashed as spending. Aided by low interest rates and fiscal stimulus economic growth might then reach a point where inflation gets a lasting foothold. Something that has not happened in the post GFC period. Investors have clearly begun the year with this reflationary scenario uppermost in their minds and this is borne out in the performance of asset classes year to date, shown below:

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.

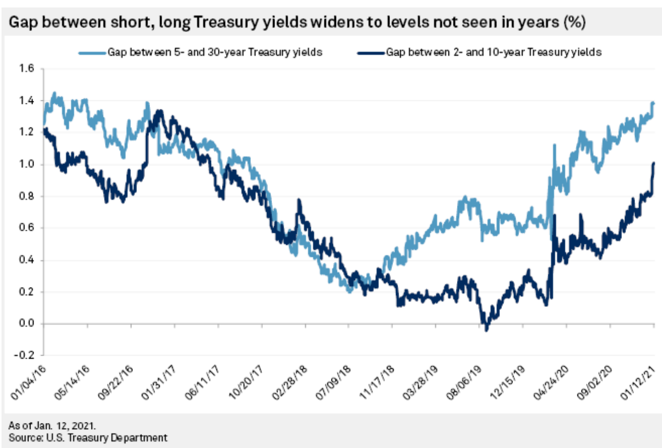
The value of investments can fall as well as rise. You may not get back what you invest.

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	YTD	January 21	Year to 5th Feb
UK CASH	0.6%	0.5%	0.5%	0.5%	0.5%	0.4%	0.3%	0.6%	0.7%	0.2%	0.0%	0.0%	0.0%
US DOLLAR	1.5%	-0.5%	0.3%	12.8%	9.3%	3.6%	-9.9%	4.4%	0.2%	-6.7%	1.2%	0.7%	1.2%
UK GILTS	15.6%	2.7%	-3.9%	13.9%	0.6%	10.1%	1.8%	0.6%	6.9%	8.3%	-3.8%	1.7%	-3.8%
US TREASURIES	9.8%	2.0%	-2.7%	5.1%	0.8%	1.0%	2.3%	0.9%	6.9%	8.0%	-1.6%	1.0%	-1.6%
GLOBAL CORPORATE BONDS	4.6%	10.8%	-0.1%	2.9%	-3.6%	3.7%	8.9%	-3.2%	10.7%	10.0%	-1.5%	0.9%	-1.5%
GLOBAL HIGH YIELD BONDS	3.1%	19.6%	7.3%	0.0%	-2.7%	14.3%	10.4%	-4.1%	12.6%	7.0%	0.5%	0.2%	0.5%
S&P 500	2.1%	16.0%	32.4%	13.7%	1.4%	12.0%	21.8%	-4.4%	31.5%	18.4%	3.6%	1.0%	3.6%
FTSE ALL SHARE INDEX	-6.7%	8.2%	16.7%	-2.1%	-2.5%	12.5%	9.0%	-13.0%	14.2%	-12.5%	1.0%	0.9%	1.0%
EUROPE STOXX 600	-11.3%	14.4%	17.4%	4.4%	6.8%	-1.2%	7.7%	-13.2%	23.2%	-4.0%	2.6%	0.8%	2.6%
TOPIX INDEX	-18.9%	18.0%	51.5%	8.1%	9.9%	-1.9%	19.7%	-17.8%	15.2%	4.8%	4.8%	0.2%	4.8%
ASIA EX-JAPAN	-14.9%	19.3%	5.9%	7.4%	-5.6%	6.1%	35.6%	-12.3%	17.9%	22.4%	9.8%	4.5%	9.8%
EMERGING MARKETS	-20.4%	15.1%	-5.0%	-4.6%	-17.0%	8.6%	34.3%	-16.6%	15.4%	15.8%	8.1%	3.0%	8.1%
COMMODITIES	-0.4%	-4.3%	-3.1%	-28.9%	-29.0%	32.8%	-3.4%	-8.5%	13.1%	-26.1%	9.3%	4.5%	9.3%
GOLD	9.6%	6.1%	-28.7%	-1.7%	-10.9%	7.7%	12.8%	-2.8%	18.0%	20.9%	-4.5%	2.6%	-4.5%
HEDGE FUNDS	-8.9%	3.5%	6.7%	-0.6%	-3.6%	2.5%	6.0%	-6.7%	8.6%	6.6%	1.3%	0.2%	1.3%

Total Return - Local Currency

Source; Collidr Jan 21 updated to Feb 21

Above average growth in economic activity, even with rising inflation, would be good in the short term for equities as it potentially boosts revenues and profits for companies. But what is good for equities is not always good for bonds. Rising inflation would lead investors to demand higher yields from bonds and if yields rise then the price of a bond falls. The expectation of rising inflation can be seen in the price moves year to date of government issued debt (Gilts in the UK) and the steepening of the yield curve across different timeframes. In fact, the yield curve in the US is now the steepest it has been since 2015:

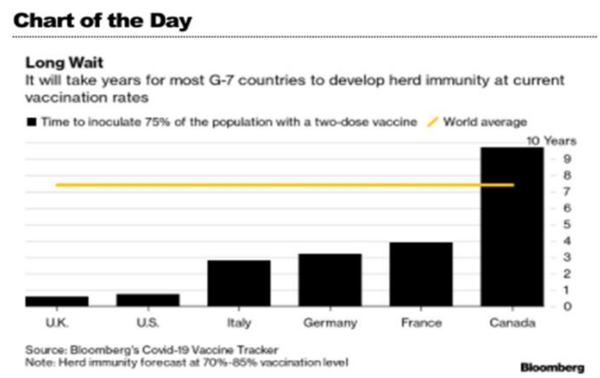


The scenario that markets are discounting looks very similar to what would be expected in the early stages of an economic recovery and this has been borne out in the regions and sectors that have been doing better than the rest in performance terms. Smaller companies are more sensitive to the economic environment and have been outperforming the equity prices of larger businesses in recent market moves. Emerging market equities have been the stand-out performers so far this year. Undoubtedly, they have been boosted by hopes for an economic recovery, but they also benefit from a loose policy environment in the US, especially if it keeps the value of the US Dollar down, as these countries often have Dollar denominated debts to pay back.

Commodities have been rising across the board as investors factor in a pick-up in demand in markets where the supply cannot react as quickly to a positive change in circumstances.

Vaccinating the world will take time

We would all love to get excited about the prospects for life after the virus, but the plain fact is that there is still a long way to go before any 'normal' level of activity can return across the world. Some countries, like the UK and Israel have made an excellent start to their vaccination effort. But as the experience of Israel has shown, if you rush to open up your economy then you risk a resurgence in case numbers even if by vaccinating the most vulnerable first might lead to a lower mortality rate. Other countries and regions are clearly lagging as they were either slow to start their programmes or cannot secure adequate supplies of vaccine. As the chart below shows, at the current run rate it would take some years for G7 countries to reach herd immunity and this not being factored-in to market thinking:

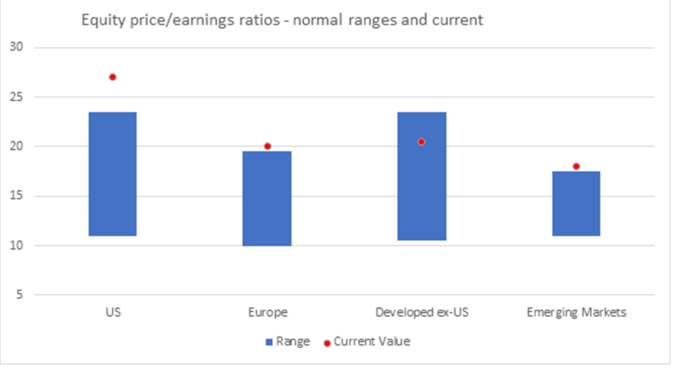


Year-on- year comparisons offer both tailwinds and headwinds

The act of comparing one year to the next will afford 2021 some interesting shots in the arm, excuse the pun, or kicks in the teeth. Either way investors must look through the temporary and focus on the value of what they are buying and here starting valuations play a part. But before we talk about that, what of the year-on-year comparisons?

2020 was a strange year that was characterised by periods of relative freedom mixed with lockdown, the like of which we hope not to see on a regular basis. If 2021 started in a similar fashion to how the last year ended there is the possibility that things could get progressively better as the year plays out. By the end of 2021 it is a fair assumption that companies will have earnt more profits this year than last. Company earnings are expected to grow by over 20% in the US this year and even if expectations are not exceeded this will be welcomed by investors, as it goes some way to reducing the valuation of what they are paying for in the equity market. The comparisons year-on-year will look particularly good for earnings in the second quarter of 2021.

Unfortunately, not all the year-on-year periods of comparison will look good for economic numbers as a more level playing field comparison for economic activity should be evident in the second half of 2021. It is at this point that we will be able to see how long it will take to get back to the growth trajectory that the world was enjoying pre-Covid-19.



Source: Northern Trust

Starting valuations are usually a good indication of future returns and we enter 2021 with many markets not 'cheap' on some measures or metrices. However, that does not factor in a world where interest rates should remain low for some time, and the possibility that expectations underestimate the prospects for a world free of Covid-19. Policy makers have long sought to create inflation, in part to help reduce the real value of the debt burden that the world has accumulated but also as a proof statement that growth has finally reached a level that can be self-sustaining without the need for excessive government intervention. Monetary authorities have said that they are willing to accept inflation whilst keeping interest rates low and we are inclined to think that they will stick to their word. Inflation this year might also be another year-on-year effect as we open up economies. There is sufficient spare capacity in the world, in the form of unemployed or furloughed workers to surmise that a return to full employment might be harder to achieve than markets think. Which could mean that 2022 onwards the rate of inflation proves hard to sustain.

Will taxes rise to pay for Covid-19 support?

In recent months, the debate in the UK has intensified about the prospect of when, how and by whom, we will start to pay back some of the unprecedented support that the economy has witnessed. The scale of fiscal support has been huge, so it is reasonable to expect taxation to rise in the future to help to pay for this commitment and all eyes have been on the budget planned for 3rd March 2021. We think that it is premature to start talking about major tax increases and it seems that the government agrees. The focus of the 'road map' out of the current lockdown in England due to be announced on 22nd February, and then the budget will be about the support that is still needed to get the UK economy through what we all hope will be the last period of major disruption. State support programmes for companies and households are currently due to expire at the end of March or — in the case of the furlough scheme the end of April — and Mr Sunak is expected to use his Budget to extend them until the economy can reopen. It will simply be, keep spending now and tax much later down the line. We expect the same to be true in other major western economies. Any day now, there is likely to be agreement on a further $1.9trn.

Conclusion

There is clearly a light at the end of the tunnel that investors have focused on as 2021 gets under way. Whilst we share this optimism, we caution that the road out of the current pandemic will not be without bumps or bends that will have to be navigated or questioned. Equity and commodity markets have made a good start to the year but there is a long-way to go and as always it is best to focus on the long-term, whilst building a diversified portfolio of investments able to withstand more than the short-term shocks that markets can throw at it.

Without doubt using our tax allowances is a sensible thing to do within a long-term plan, as there will be changes ahead, and do not forget this tax year end will rush up on us soon.

Summary

- We are still in a lower world for longer
    - Interest rates low- too much debt for anything else
    - Inflation under control after a period of Year on Year pick up
    - There is spare capacity
- Activity will bounce, but the comparisons get harder in the second half of 2021 and 'normal' is some way off
- Economic stimulus has to continue, tax comes later
- And with interest rates staying low this may help equity markets
- Bonds may struggle for returns in the coming months, but lack of default events will keep moves within a range
- Takeover activity may pick up in a number of sectors as companies take advantage of access to capital and the opportunity to buy up rivals