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Economic Outlook and Update March 2021- Markets in Transition?

The post 2008 Financial Crisis period saw for the first decade a focus by policy makers on monetary policy to resuscitate the global economy. Outside of China there was very little fiscal stimulus with most governments concerned that further increasing fiscal deficits would result in upward pressure on borrowing costs and slower economic growth. Many countries in Europe which came out of the Financial Crisis with significantly higher debt to GDP ratios saw their borrowing costs soar, even though they were within the Eurozone. This was a period when governments focused on trying to repair their own balance sheets as tax revenues had collapsed following the GFC. The lack of solidarity in the Eurozone resulted in the Euro crisis only solved by Draghi's "do whatever it takes" moment in the summer of 2012. While the US had delivered some level of increased fiscal spending following the election of Donald Trump, Congress at that time was opposed to significantly increasing the US deficit.

The post Crisis period has been dominated by an era "secular stagnation", a term coined by US Treasury Secretary Lawrence Summers, meaning a period of low growth and low inflation in a world with an excess of savings. A decade of low, then zero, and in some cases negative interest rates, combined with QE, had failed to significantly shift the dial on growth and when Covid-19 struck and governments were forced to impose shutdowns on local economies there was rapid recognition that the austerity policies which resulted from the Financial Crisis would have disastrous consequences for the global economy if they were re-introduced. Globally, governments stepped up with the developed world far better placed than the emerging world to put in place stimulus packages well in excess of 10% of GDP. This resulted in markets being able to look through the pandemic driven slowdown and in anticipation of economic recovery stock markets ended the year on a buoyant note boosted by positive vaccine announcements.

The US election in November had resulted in hopes of a significant fiscal package to support the economy if there was a democrat Blue wave, but initial results showed the Senate likely to remain in Republican hands. In Georgia, the contests for Senate seats was so close a January re-run was scheduled, and after the Capital Hill insurrection resulted in a previously unexpected gain of two Senate seats for the Democrats, leaving them in control of both Houses of Congress. As a result, President Biden has been able to put in place a further significant stimulus package of US$ 1.9 trillion, worth approximately 8% of US national income. The global effect of this is not insignificant, which when combined with the rapid roll out of vaccinations should lift global income by 1% this year. This package, together with the vaccine announcements, has resulted in significant upgrades to global growth forecasts for 2021 and beyond. A booming US economy has implications for the rest of the world and manufacturing partners of the US, which includes much of Asia, Mexico, and Canada, should benefit from the US rebound and for other advanced economies who can borrow in their own currency faster US growth is a positive. Not only is there the potential for higher exports, but also the potential for resurgence of animal spirits, a term John Maynard Keynes used to describe the instincts that influence and guide human behaviour, and which can be measured in terms of, for example, consumer confidence and amongst corporates which could boost capex.

The prospects for the emerging world are more nuanced. While many countries will benefit from stronger growth, rising US interest rates or a strengthening Dollar could tighten liquidity conditions in these countries at a time when growth has slipped well below normal trend levels due to the impact of the pandemic. Few countries in the developing world have the fiscal headroom to put in place a source of support packages which have maintained domestic demand in developed countries.

At the back end of 2019, investors focused on the prospects for stronger growth rather than thinking about the implications of an overheating American economy if it were to occur. Bond markets have become concerned that, with significant levels of both monetary and fiscal stimulus, which have not been tried together in the post GFC period, greater demand for goods and services could lead to capacity constraints and cause higher inflation. Market commentators have raised the prospects that once again “bond vigilantes” (bond market investors who challenge monetary or fiscal policies considered inflationary by selling bonds, thus increasing yields) may force governments to change course if longer term borrowing rates rose significantly. The post GFC period has been one where markets have benefitted from declining short and long term interest rates, together with a significant fall in real yields, resulting in a much lower discount rate being applied to the future earnings of corporates. The post Financial Crisis market recovery has not been driven by hopes of higher growth, which was the driver of returns in the late 90’s bull market, but rather a higher price being paid by investors for earnings at a time when cash rates and 10 year bond yields were either close to zero or negative. It is the upward pressure on government bond yields globally that has resulted in the volatility in equity markets in 2021 and why in the short term growth investment styles, especially those focused on defensive growth, have struggled versus the wider market. In fact, in the post vaccine news period from November on, growth defensives have lagged the market, whilst in the final months of last year and the first weeks of January high growth stocks continued to perform well, the more recent upward pressure on bond yields in the States has resulted in a setback in high growth equities, particularly hitting stocks in the technology and innovative healthcare related sectors.

Both the US and UK have implemented vaccine roll out programmes at a rapid pace, certainly compared to Europe, and this has resulted in strength in both their respective currencies. In a global context, US$ strength is important as it can result in a reversal of some of the capital flows that have financed the developing world. Investors can look back to the 2013 “taper tantrum” which describes the surge in US Treasury yields resulting from the Fed announcement of future tapering of its policy of quantitative easing. The Fed announced that it would be reducing the pace of its purchases of Treasury bonds, to reduce the amount of money it was feeding into the economy. The ensuing rise in bond yields in reaction to the announcement was referred to as a taper tantrum in financial media. Countries with current account deficit saw their currencies and bond markets come under pressure, which impacted equities as it became apparent growth forecasts in these countries would be cut. Today, the most exposed countries then are in a better position, but within the emerging world countries not reliant on external Dollar denominated finance are likely to fare best.

China remains the country globally that has recovered the best from the pandemic, and arguably the same could be said in the immediate period post the Financial Crisis. Policy makers in China have successfully managed the country through two crisis periods, which has resulted in China’s economic standing in the world continuing to rise. Today, China as arguably the manufacturer for the world, is benefitting from a global recovery led by manufacturing, with the service sector still constrained in most countries in the developed world by the effect of non-pharmaceutical interventions to control the Coronavirus. Consumers still fortunate enough to be working in locked down economies have diverted service sector spending towards manufactured goods. This year investors have also seen rising commodity prices in oil, hard, and soft commodities, and whilst this will help some developing world exporters, oil importing current account deficit countries could find 2021 more difficult to navigate.

The United States with its successful vaccine roll out has seen upgrades to economic growth forecasts with some private commentators forecasting growth in the 7-8-9% range. Markets are concerned that with the strength in growth and some supply side disruption there will be a comeback in inflation despite its absence for the past 30 years. The US Federal Reserve has indicated it will tolerate an overshoot of its 2% target to compensate for persistently low inflation. Market volatility is occurring as some bond investors worry that when the anticipated rise in inflation occurs in the middle of the year, the Fed will be less comfortable than it is now. In the autumn of 2020 investors grappled with the effects of economic scarring which the pandemic would leave and it now seems clear the United States and North Asia will return to normality quicker than other regions. Covid-19 can then be seen as an exogenous shock and the strong policy response has allowed risk appetite for those consumers remaining in work and some corporates to recover quickly. Forecasts now suggest the US economy will recoup its lost output by the third quarter of this year.

There have been periods before, such as in the second half of 2016, when there was a two way pull on inflation between structural disinflationary forces, which we have termed the 3Ds: disruption, debt, and demographics versus cyclical forces. The difference this time round in the short term is the extent to which expansionary fiscal policy is occurring at a time of loose monetary policy. Morgan Stanley estimate to date US households have lost $49bn in income but have received $1.3tn in transfers. This will increase further with the passing of the Biden fiscal package. This is combined with a US administration where there is a belief that the unemployment rate is understated due to US workers leaving the labour force (when individual benefits end there is no point signing on as unemployed in the States) and US Treasury Secretary Janet Yellen believes that there should be a broad based recovery benefitting Main Street more than Wall Street. Policy makers are more focused on income inequality than financial markets. Yellen herself believes Americans must re-enter the labour force so that they do not become de-skilled or unemployable. Yellen has stated it is right for every American to have a job as fast as possible. The Biden administration does not believe a sustained pickup in inflation is likely, but are prepared to take risks to achieve its political objectives. The most recent meeting at the Federal Reserve reiterated its intent to keep accommodative monetary policy in place despite raising its own growth forecasts. Fed Chair Jay Powell also stated that further substantial economic progress was still needed before the central bank would begin contemplating curtailing its QE bond buying programme. It also forecast interest rates would remain at zero for the next three years, although a number of Board members indicated a rate rise was likely in 2023.

There have been a number of market regimes or equilibriums since the start of 2020. The first was when growth was disrupted by Covid. The second was when significant monetary easing and fiscal support allows markets to rally. At this stage markets priced in a lower for ever interest rate regime. What investors are now seeing is a shift to a lower but not forever mentality on interest rates. Whilst politicians want to see growth come back this period is often a more dangerous one for financial assets. The post GFC period was bad for the economy but good for financial assets. Some commentators labelled QE as welfare for the wealthy. Since 2008 asset price reflation has been a stated policy objective. Today in the States the Biden administration wants to see wage growth and the administration is likely to pursue this policy despite a risk of higher inflation.

Markets are still pricing in the low rate environment until 2023. Bond markets in the face of such a strong fiscal response and economic recovery are testing markets to see if the Fed will be forced to alter its position. An increase in real rates may be cheered by policymakers but feared by markets. Stocks priced off long term interest rates have seen volatility and those with stable but less than stellar growth prospects could continue to struggle. As yet there is no firm evidence inflation will see anything more than a cyclical pick-up in inflationary pressures, with over the medium term long-term secular influences continuing to constrain inflationary pressures. It will take most of 2021 to be certain this view will prevail and as a result markets this year may continue to see elevated levels of volatility as the ‘bond vigilantes’ do battle with the Fed and other central banks. At worst high quality growth stocks may see a reset to their levels of valuation before their earnings growth returns their share prices to a sustained upward trend. Some value stocks can continue to perform in an environment of rising expectations for growth while these persist, but avoiding business in structural decline rather than buying stocks purely on low valuation metrics will be vitally important. As was seen in 2018 even a modest increase in rates impacts heavily in an indebted and low growth world so both inflation and the outperformance of the value styles may prove to be cyclical in nature.

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