

Divergence among major economies

Monthly Commentary

For wholesale investors only

Economic growth in 2021 looks set to be heavily dependent upon two factors: the impact and size of fiscal stimulus and the pace of the vaccine rollout. The IMF have increased their forecast for global growth this year by 0.3% to 5.5% with expectations of a 'vaccine-powered strengthening of activity... and additional policy support in a few large economies.' To gauge the expected divergence among the major economies we look at the current state of play with respect to these two factors.

If we look at fiscal spending in response to the pandemic, the US looks to be leading the way once again. According to the IMF's latest Fiscal Monitor, the US has spent 16.7% of GDP compared to 16.3% for the UK, 16.2% for Australia, 15.6% for Japan, 11% for Germany, 7.7% for France and an EU average of 3.8%. Importantly, this includes spending that immediately affects the budget deficit of an economy, such as unemployment benefits, stimulus checks, tax cuts etc. It does not include government credit guarantees, or equity and loan injections, of which Europe has done more of. Even more notable is that these figures do not consider the new \$1.9 trillion stimulus package recently proposed by President Biden. Although the new plan will likely be watered down once negotiations in the Senate begin, US fiscal spending since the pandemic will almost certainly be above 20% of GDP or \$5 trillion!

The UK has made impressive progress on the vaccine front. It has, at the time of writing, given 11.25 doses per 100 people, more than the US (7.11) and much more than Germany (2.38) and France (1.49). In fact, it is only behind Israel (49.13) and the UAE (27.95), when it comes to the proportion of its population vaccinated. Europe's vaccine rollout has so far been underwhelming and has resulted in a public spat between the European Commission and AstraZeneca over supply constraints. Japan and Australia are notable examples of where the vaccine rollout has not yet begun and will likely not start till the end of February. The risk, as pointed out by medical professionals is that new mutations of the virus could emerge as countries delay their vaccination programs. Indeed, it is still inconclusive whether the current vaccines are effective against the already present variants from the UK, South Africa and Brazil.

While the forecasts for major economies have differed for 2021, the economic performance, based on data for Q4 of last year was weak across the board. In the US, 140,000 jobs were lost in December, the first negative payroll number since April. Unemployment remains at 6.7%, in other words, there are still 9.8 million fewer jobs relative to the start of the pandemic. Retail sales contracted for the third straight month by 1.9% in the US and 2.9% in the UK and Europe. Furthermore, PMI's in Europe surprised to the downside indicating a double dip contraction as we start the New Year.

Commodities rebound underpinned by China demand

Commodities have continued to rally since Q2 of last year with some analysts already proclaiming the start of a new 'supercycle.' The Bloomberg Spot Commodity index has gained over 55% since March, reaching its highest level since July 2014. Metals and energy have led the boom. Copper and iron Ore prices both hit 9-year highs, while Brent crude is now above \$55 per barrel. The biggest driver behind this move has been the sharp recovery of the Chinese economy. Real GDP in 2020 was a positive 2.3%, beating every other major economy by a stretch. Industrial production, which has been the main driver of the recovery grew by 7.3% in December. Another factor has been a weaker dollar, which has depreciated more than 10% against major currencies since March. Yet these cyclical drivers will arguably provide only a short-term boost to commodities.

A key question is whether structural drivers exist to continue a longer-term rally. Extreme levels of government spending on infrastructure and green projects over the next decade could indeed create persistent demand for certain commodities. Also, the rapid shift to a digital economy has already created a shortage in perhaps the economy's most important 'commodity': semiconductors. Several auto manufacturers have been forced to close factories or reduce production as they can't secure enough semiconductors. This was followed by a warning from Samsung, that the smartphone industry could soon be next affected.



Overvalued bonds used to justify overvalued equities

As we head through February 2021, the market continues to ride a wave of liquidity and consensus optimism centered on a successful vaccine rollout and an assumption that loose monetary and fiscal policy will continue unabated.

Fundamental to the current market optimism are three factors:

- Valuations do not matter anymore
- Interest rates will stay low for an extended period
- Loose monetary and fiscal policy combined with the COVID-19 vaccine will see a return to the investment environment of the prior 5 years

Firstly, valuations matter. Equity markets have moved to ever higher valuations driven by growth stocks with low interest rates used to justify such positions. Overvalued bonds are being used to justify stretched equity valuations providing a fragile market environment. Whilst not our base (short-term) case, any signs of further inflationary pressure could challenge this complacency within growth investing. We saw rates widen through the end of last year, causing growth stocks to sell off. The nominal yield on the US 10-year rose to 1.14 in January and has since come back to around 1%. Real yields remain negative on the US 10-year. It is reasonable to expect signs of an economic recovery, underpinned by a successful vaccine rollout, to push yields higher causing expensive growth stocks to come under pressure.

A reversal of monetary policy remains unlikely given economic growth remains fragile and, whilst vaccine distribution is progressing steadily, we are also seeing production being disrupted at some sites. These production issues will be resolved but the market, as it so often does, is underplaying the risks in executing a global vaccine program. In summary, returns are likely to be lower over the medium-term given there is little room for interest rates and bond yields to fall whilst the efficacy of fiscal stimulus inevitably wanes over time in our heavily indebted world.

Pyrford International

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