State of Play

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Our Investment Specialist, Simon Durling, shares his thoughts in our latest update.

As the next stage of re-opening begins, attention turns to the economic recovery

Early signs are encouraging with long queues on high streets to enter shops and pub reservations being made weeks in advance for the chance to enjoy a drink, albeit in a sunny but freezing pub garden. Most of the economic forecasts vary widely, which in many ways is the norm for economists predicting any financial future, but all agree that the recovery is likely to be swift as pent up demand looks to provide the ultimate antidote.

The British public has saved billions of pounds since the pandemic began - how much of it will now be directed at a holiday, a new car perhaps, home improvements or a new wardrobe? This is the challenge for investors - anticipating how we will react over the weeks and months ahead. Human behaviour is often referred to as habitual as the routines and rituals of daily life programme our brains to behave and react in a repetitive way, making life easier to navigate as we have to think less about some of the more mundane tasks or activities. One of the many reasons forecasting how the economy responds over the next few months is problematic is precisely because nobody is certain how the public will behave when normality returns. Already businesses across different sectors have started adjusting their long-term plans to accommodate the findings of lockdowns. Many have announced office closures, permanent flexible working arrangements and the number of physical shops or department stores will be reduced as online shopping, for many, has become second nature.

The other important aspect of the billions saved is who was able to save during lockdown? The hundreds of thousands of job losses over the last 12 months have been concentrated in certain sectors and affected mainly the young. Average

earnings have risen since the pandemic began mainly due to those job losses occurring in many low paid jobs in sectors like hospitality and tourism. In some ways the gap between the poorest and richest in society has probably grown. If those who have been able to save already had savings or investments to turn to, will they be willing to spend now and how much? Guessing how much and how quickly consumers will spend is part of the conundrum. Why does any of this really matter? In terms of investment markets all of this is crucial. Navigating investment decisions during more normal economic cycles is difficult enough, trying to second guess how consumers and businesses will act, both here and abroad, during and after a global pandemic is much more difficult. Put simply – the impact of unrestrained consumer spending would be profound.

Prices or the value of goods are dictated by the simple balance between supply and demand. If too much money chases too few goods, prices rise. So, if all the savings put aside by consumers was immediately spent in a short space of time it will drive inflation up sharply, especially given that the statistics measure only a 12-month rolling period. A year ago, the UK economy shrank in the second quarter by the largest amount since records began as demand plummeted - meaning the comparison between last spring and the potential sudden demand spike now would be stark. As an example, petrol prices fell suddenly last year as the price of oil fell with global demand slumping due to flights being grounded, factories closing and people mandated to stay in their homes to protect health services and slow the spread of the virus reducing car journeys by as much as 90%. The comparison between then and now could mean very steep rises in short-term inflation causing markets to pause for thought. Also, businesses have a large part to play in price rises. If they are unable or unwilling to invest in building supply quickly enough, even if consumers are cautious in their response to lockdown easing, if there are not enough goods and services available to buy, again prices will rise.

Finally, there is the impact of financial stimulus and monetary policy. To support jobs and the wider economy globally central banks and governments have co-ordinated to provide trillions of dollars of aid to the most vulnerable via additional welfare, job support schemes and loans to businesses to help them through the damaging economic slowdown. Central banks have reduced interest rates and printed money to use it to buy debt to free up more money for banks and the markets to lend to businesses. The simple consequence of quantitative easing is to amplify the supply versus demand balance creating more demand. Central banks have also indicated on many occasions that they are willing to tolerate above target inflation for a sustained period to protect the economic recovery. What this means in practice is interest rates will remain lower for longer before any rate rises are implemented.

Regardless of how central banks react to short-term inflation, investment markets will not shy away from pricing in rate rises much earlier than central banks say that they will. In part this has already started to play out since the start of the year as bond yields have risen sharply with markets anticipating reopening and start to reprice not just bonds but share prices as well. The predicted future

earnings from a company will be worth much less in real terms if inflation is higher than first thought and with increases in interest rates that may follow, the borrowing costs will also rise and therefore may affect their future profits and earnings.

The key question for most investors right now is what will happen to markets over the next few months? As I have demonstrated this question is nearly impossible to answer confidently, especially given that different countries around the world are in a different place with the pandemic. Some are experiencing severe second or third waves with new variants causing concerns in addition to the differing speeds of vaccination programmes. One likely consequence of the last 12-months is that not all companies and sectors will bounce back in the same way or even survive.

An excellent example of this was the UK housebuilders sector directly after the financial crisis in 2008. At the time the sector was made up of many different size businesses, from one-man band builders through to the giants like Taylor Wimpey or Berkley Homes. Within just a few months of the financial crisis many small and medium size builders went bust, narrowing the sector providers to a small number of larger companies who were best able to weather the financial storm. This dynamic to a certain extent still hangs over the sector today as although there are thousands of small builders who have managed to carve out a successful business, the vast majority of new build homes are constructed by just a handful of companies who have profited from their market share since the crisis struck.

I suspect that this may be replicated today across the market place in different sectors, either because some businesses are unable to survive despite the financial support from governments or because lockdown has shifted consumer trends in a direction that is a disadvantage to certain companies. Understanding these potential winners and losers is likely to play a big part in the shape of the economic recovery and importantly the investment returns experienced by investors over the next few years.

The UK economy records modest growth in February

According to the Office for National Statistics (ONS) Britain's economy grew modestly in February albeit slightly below expectations. Gross domestic product (GDP) rose by 0.4% after a 2.2% decline in January, revised upwards from a 2.9% fall, official figures showed. A spokeswoman for the ONS said: 'Wholesalers and retailers both saw sales pick up a little, while manufacturing improved with car producers experiencing a partial recovery from a poor January. Construction grew strongly'. Exports to the European Union (EU) rose by 47% in February to £11.6bn after a record 40% fall at the start of the year due to Brexit. Imports from the EU also rose but by a much smaller 7.3%, after a fall of 29.7% in January. The closely watched purchasing managers' index surveys for March revealed a surge in activity as services, manufacturing and construction companies prepared for a release of pent-up demand from an easing of lockdown restrictions under the UK Government's road map.

Market update

Stock markets have continued to grind higher since the start of April fuelled by the success of vaccines and the prospect of economies reopening. The recent inflation concerns appear to have dissipated for now - helping the technology sector rebound following the recent rotation in markets best reflected in the NASDAQ 100 Index which has risen over 5% since 1 April 2021. This has also been evident in bond yields which have somewhat stabilised following the sharp rises in the first quarter of 2021. Whilst they may continue to rise over the next few months the speed of the rise appears to have slowed.

Find out more

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Note: Data as at 13 April 2021.

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