A forward view of the global economy and financial markets

May 2020

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GHC Capital Markets

It's A New World

"Life isn't about wating for the storm to pass, it's about learning to dance in the rain"
Vivian Greene – American Author

Source: Wikipedia

I must begin this article by offering our condolences to any reader that has lost a relative, friend or loved one during this crisis. Our thoughts are with you and your family at this difficult time.

We have heard the word "Unprecedented" used on an almost daily basis as the Coronavirus Crisis has unfolded and it has been justified. Who could have imagined that the Government would effectively have been paying the wages of millions of workers from the private sector, but that is exactly what the Chancellor has done by introducing the Furlough Scheme. Statista has reported that on 10th May 2020 7.5 million jobs have come under the job retention scheme in the UK. At the same time the Bank of England has increased the Asset Purchase Programme, otherwise known as QE, by £375 billion, which equated to about 20% of GDP. The total QE bond buying programme now stands at £645 billion, which is unprecedented. The Bank has also cut the base rate to 0.10% which is the lowest it has ever been and as I write this article the gross redemption yield on a two year gilt gives a negative return, which is also unprecedented.

The UK is not alone in taking drastic measures to support both its work force and the economy and I would suggest that there is more to come as the Government will be asked to give financial support to large companies that may be faced with making huge job cuts or in the worst case scenario going to the wall. The Government will be faced with making some tough decisions as it cannot come to the rescue of every company that is in dire financial trouble as a result of the Coronavirus Crisis. I would imagine that the Government will be creating a batting order which will be headed by critical industries and followed by strategically vital industries. You would imagine that critical industries are healthcare, energy suppliers and food production with strategically vital industries being the finance and banking along with defence and homeland security.

The question is where to draw the line. BA is a huge employer and it would argue that maintaining our largest airline is vital for the economy. The problem is that BA is part of the International Airlines Group (IAG), which is a Spanish registered company with its shares being traded on the Spanish and London Stock Exchanges. BA has said that it will make 12,000 job cuts and it has ceased operations from Gatwick for the time being but the British Government may well ask the Spanish and Irish Governments to take part in any rescue package as IAG also owns Iberia, Vueling and Aer Lingus.

Reuters has reported that Lufthansa is in advanced talks with the German government's economic stabilisation fund over a rescue deal worth up to 9 billion Euros and would see the German Government owning 20% of the shares in Lufthansa. The EU competition rules on state subsidies have been kicked into the long grass as most European governments will have to support industries and companies that they deem as vital to their own economies. It may be the car industry in Germany, which is the largest employer, or tourism in Greece but it will all come down to a lot more State ownership and a lot more government debt. Economic and political thinking has already changed as Governments have had to take extraordinary measures to try and protect society and bring the virus under control. Rebuilding economies will be the priority once the virus has been brought under control and this will also require a change in political ideology for many governments and a different economic strategy to make sure that there is an economic recovery in 2021.

We thank you for entrusting us with the management of your assets. We fully understand our responsibilities to you during this extraordinary period and we are here to support you now as well as help you find investment opportunities once the world returns to health again.

Richard Harper
GHC Capital Markets Limited

Asset Allocation

In which **Tim Harris**, the Chair of our Asset Allocation Committee, describes the factors influencing our latest

Time to reopen

Signs that widespread economic shutdowns, social distancing and other mitigation measures have slowed the spread of COVID-19 in parts of Europe and the US, combined with increasing visibility on the economic devastation of such measures, is prompting many countries to implement a reopening of their respective economies. This follows in the footsteps of mainland China, where almost all businesses and factories have now restarted. In the US, the Trump Administration has rolled out national reopening guidelines, with all states beginning to put their own reopening plans into action in recent days. But, in the absence of herd immunity or a vaccine for COVID19 — neither of which is likely in the near term — such reopenings come with a high risk of disease resurgence. Yet global capital markets are positioning for a better future, if driven by a slow and patchy recovery. Equities valuations are well above their lows, although developed market sovereign bond yields remain very low, in many cases driven by the mass purchasing programmes (quantitative easing) of respective governments.

What a safe reopening might look like

How well-positioned major economies are to achieve one and how quickly reopening would really translate into economic recovery will be the core drivers of market returns in the second half of 2020. We must see more improvement in the disease trajectory in most areas before economies can safely reopen, which should be conducted in phases (with reopening of non-essential businesses that require close contact and relaxation of protections for vulnerable populations coming later) and increased testing and contact tracing is necessary to ensure a safe reopening (both in terms of being able to better gauge where we are in the progression of the pandemic and to identify and isolate asymptomatic carriers, which will be critical to avoiding/containing potential flare-ups).

Public virus control measures have a large, negative impact on infections

Removing them prematurely or indiscriminately therefore raises the risk of a second wave of infection. China's economic reopening provides a useful roadmap for other countries. Some of the challenges that China has faced in reopening — including the risk of resurgence and an uneven economic recovery — are unfortunately also likely to be features elsewhere around the world. But some of the drivers behind China's overall success in reopening — such as extensive use of surveillance technology to closely monitor and control the spread of the virus as well as pressure and assistance for factory and business restarts from a centralized government — may not be.

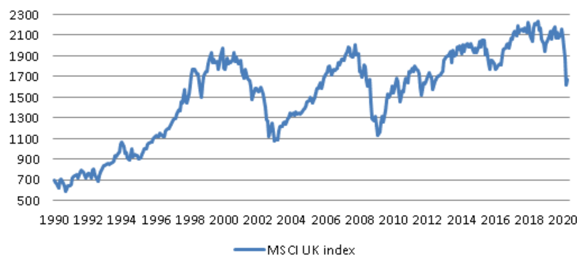
A near-term reopening of the UK, US and European economies may not deliver much of an economic reprieve, emphasizing that the current economic damage may be less a function of businesses being closed — i.e., a supply-side problem — and more of a function of the public's health fears — i.e., a demand-side problem. Until countries implement robust testing and contact tracing regimes that ease these fears, just hanging an "open" sign on the door won't solve this problem.

We are cautious about the pace of reopening

However, we also see some encouraging signs, such as the fact that most of the massive global employee layoffs have so far been temporary. On balance, we assume a gradual growth recovery beginning in May, albeit from very low levels. However, the global economy is likely to end 2020 at least 4% smaller than the previous year. All that said, development of herd immunity or discovery of effective treatments and ultimately a vaccine for COVID-19 will mark critical turning points for economic normalization. We may be up to 18 months away from a vaccine. Even this would be a record-fast timeline, given revolutionary advances in vaccine development and mutation of the virus may not be a problem for the effectiveness of future vaccines. It is possible that we will find useful treatments for the virus long before we have a vaccine — as early as this autumn.

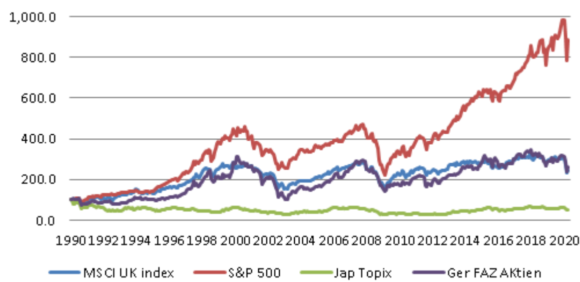
With the above in mind, we believe that markets will continue to position for better days, albeit selectively — many companies and sectors of the economy are permanently damaged or changed. Equity valuations are well supported by metrics, such as balance sheet book values, although 2020 earnings and dividend drivers are shot to pieces. That said, many equity markets look cheap on reasonable 2021 assumptions. That combined with very low bond yields has encouraged us to put some risk capital back to work in portfolios.

Markets at a glance



Source: Lipper for Investment Management

It will take the economy a few years to recover from an unprecedented hit to GDP of around 25% triggered by the coronavirus lockdown. Despite the unparalleled speed and size of the monetary and fiscal stimulus, the unemployment rate will probably still leap from 4% to 9% and many businesses will go bust. By the end of 2022, the economy may be 5% smaller than it would have been if the virus never existed and the cumulative loss since the end of 2019 may add up to a huge 20% of GDP. Corporate earnings growth is currently forecast by consensus to fall by over 30% year-on-year and over 40 FTSE 100 companies have cut their dividends this year. While the market is well supported by price-to-book value considerations, the shape and speed of the recovery will determine further upside in equities.

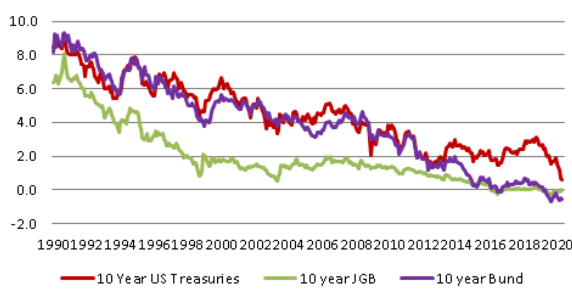


Source: Lipper for Investment Management

Across developed and emerging economies, those stock markets that had fallen the most after fears emerged about the coronavirus outbreak have generally bounced back more strongly since such concerns have eased somewhat. Provided that the virus is contained in most major economies, we think that this pattern will continue between now and the end of this year and suspect that equities in parts of the emerging world will be the best performers in those circumstances. Nonetheless, we doubt that risky assets in general will make up all of the ground that they have lost.

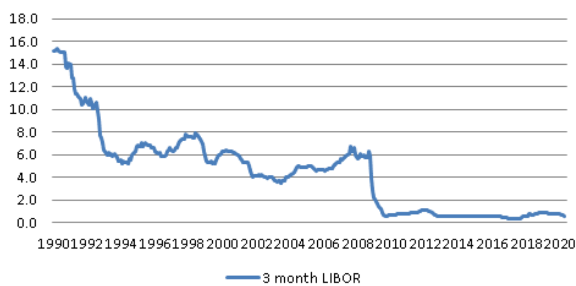
Source: Lipper for Investment Management

UK Gilt yields have hit multi-generation lows, as investors have flown to low-risk havens in the light of the impact of COVID-19 on the economy and central government finances. The Bank of England is likely to keep policy rates static in the near term, having eased to 300-year lows. We expect it to wait at least until mid-2021 to deliver a rate hike, as it considers inflation pressures and any return to normality in UK and macroeconomic conditions. Further Brexit risks will become clearer later this year. Inflation has eased, although weak sterling and a massive expansion of the central bank's balance sheet imply inflation risks further ahead when the economy starts moving ahead again.



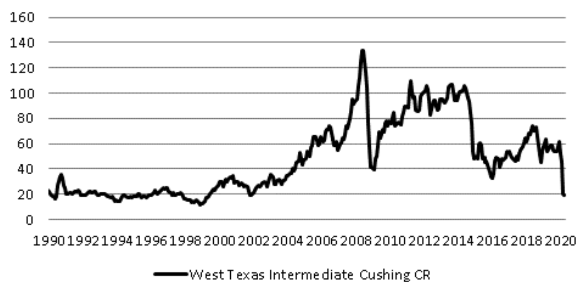
Source: FactSet

High quality bond yields have plummeted through the health crisis. However, we see limited scope for further interest rate cuts. If global economies rebound, traditional central bank rate cuts have probably run their course. Reaching the effective lower bound on policy rates should imply steeper yield curves, lower realized and implied volatility, and a worse return distribution for yield duration in general. None of the G10 central banks with negative policy rates before the corona-crisis (including the ECB, BOJ, and Swiss National Bank) have cut further. While forward rates may price-in negative policy rates from time to time, we expect the Treasury bond market and most other G10 sovereign bond markets to trade as if the effective lower bound on policy rates is binding.



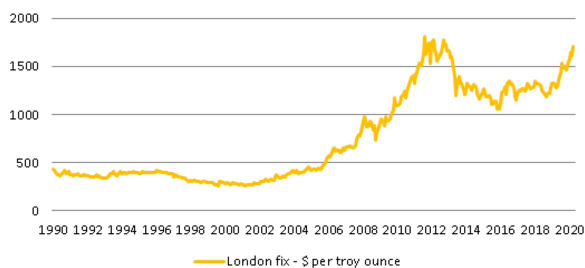
Source: Lipper for Investment Management

The Federal Reserve, Bank of England and other central banks could consider negative policy rates. However, we see this step as a relatively low-probability outcome, even if the economies perform worse than expected. Fed officials have reiterated that negative rates are not their preferred policy tool. Despite stable inflation and higher wage growth, slow consumer spending and economic disruption concerns are leading the Bank of England to hold off interest rate increases in the short term. The Bank will not raise rates unless Coronavirus fears dissipate and clear progress on a UK – EU trade become apparent. Managing inflation risks are offset against political risk interfering with economic growth prospects.



Source: Lipper for Investment Management

Given the subdued demand backdrop, developments on the supply side for oil will be a key determinant of prices. OPEC and its allies have announced deep cuts to output. By our reckoning, and even assuming full compliance (which seems unlikely) the market will remain oversupplied until Q4. That said, US production looks set to fall sharply, given low prevailing prices. By the end of the year, we expect oil market participants to be factoring in stronger demand in 2021 and for the Brent oil price to have picked up to around $45 per barrel.



Source: Lipper for Investment Management

Coronavirus fears and falling investor risk appetite has led investors to position in 'safe assets'. Gold's two-year rally continues and we see possibilities of further upside in the short- to medium-term. While a surge in ETF inflows offset weak physical demand in Q1, we don't expect this to be repeated over the coming quarters. Many of the factors that have boosted the investment appeal of gold are likely to fade, and central bank purchases are set to decline in the months ahead. As a result, we expect the gold price to ease back by year-end.

Note that where an MSCI Index has been used for illustration. This has been sourced with permission from MSCI Inc.

Quick facts

ISA Allowance 2020/2021	Stocks & Shares ISA Cash ISA Junior ISA	£20,000 £20,000 £9,000
Pension Allowance 2020/2021	The limit is the greater of £3,600 and 100% of salary, subject to the annual allowance of £40,000 (unless money has been accessed through flexi drawdown in which case the	

Tax facts

Income Tax	Personal Allowance 2020/2021	Up to £12,500
	Basic Rate @ 20%	£12,501 to £50,000
	Higher Rate @ 40%	£50,001 to £150,000
	Additional Rate @ 45%	Over £150,000
	Married couple's allowance: Older spouse born before 6 April 1935	£8,445
Capital Gains Tax	Annual Exemption - Individuals	£12,300
	Basic Rate tax band (residential property)	18%
	Basic Rate tax band (other assets)	10%
	Higher Rate tax band (residential property)	28%
	Higher Rate tax band (other assets)	20%
	Entrepreneurs' relief rate	10%
	Entrepreneurs' relief lifetime limit of gains	£10,000,000
Inheritance Tax	Threshold up to £325,000	Nil
	Over £325,000	40%
Corporation Tax	Full Rate	19%
	Small Companies Rate (SCR)	19%

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