Market2Market

A forward view of the global economy and financial markets

July 2020

GHC Capital Markets Limited

22–30 Horsefair Street
Leicester
LE1 5BD

T: 0116 204 5500

E: marketing@ghcl.co.uk

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The EU Rescue Package

"The bargain that yields mutual satisfaction is the only one that is apt to be repeated"

B.C. Forbes

Source: Wikipedia

The second longest EU summit came to an end on 21st July after just over 90 hours of heated debate in Brussels with a deal being agreed on a stimulus package of €750bn to rescue economies hardest hit by the coronavirus. It has been reported that during the negotiations President Macron of France banged his head on the table and there were severe disagreements between the "Frugal Four", Holland, Denmark, Austria and Finland, and other member states.

The main disagreements were that countries such as Spain and Italy did not want to take on yet more cheap loans as they have already have too much debt so they argued for outright grants. The initial bargaining position was for there to be €500bn in grants and the remainder in cheap long term loans offered to countries that could afford to take on more debt. The "Frugal Four" were not prepared to agree to such a figure and they wanted to have a say in how any grants would be spent. Another sticking point was trying to make the release of any funds conditional on a member state adhering to EU rulings on such things as justice and freedom of the press. Unsurprisingly Poland and Hungary refused to even consider this.

In the finest traditions of the EU a compromise package was finally agreed with the main point being:

- The European Commission (EC) will be allowed to raise funds on capital markets i.e. issue EU Bonds.
- €390bn will be distributed in grants with Italy, Spain and France being the largest recipients. The balance of the €750bn will be made up of cheap loans repayable by 2058.
- The "Frugal Four" have been offered larger rebates to their normal contributions.
- Member States will have to put forward detailed plans on how they will spend the money.
- A single country can stall recovery payments if a recipient of funds is not adhering to its reform plans.

Perhaps the biggest item of the recovery package is that the EC will undertake large scale borrowing in its own name for the very first time. This will create a new asset class and offer Bonds underwritten by the EC and will rival US Treasuries as safe haven assets. This concession was only made possible by Germany, who had always refused to allow this in the past. Once the genie is out of the bottle the EC will have precedent to issue bonds in the future whenever it needs funding.

The European Parliament will have to agree the package but that doesn't appear to be a major hurdle. However, there are some serious problems that may erupt further down the line. For instance, if Holland decided that Italy was not adhering to its agreed reform plan and invoked the "Emergency Brake" on Italy's funding, the consequences of such any action could lead to a disagreement that would harm the unity of the EU. Italy could respond by blocking new directives and they could potentially become a very disruptive force inside the EU. This is supposition and everything could run smoothly over the next five years but history tells us that simmering disagreements rarely go away quietly. History also tells us that Italy has never delivered properly on a reform package since 1945.

The German Parliament will be watching developments very closely with regard to the EC issuing bonds on the capital markets. Any expansion beyond the agreed limits will be met with Teutonic displeasure and as Germany has the largest cheque book they will have to be listened to.

EU leaders have agreed on an historic rescue package which should go a long way to helping in the economic recovery of the Union, however, I do not think it will be plain sailing over the next two years.

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 Asset Allocation decisions

Shades of grey

Watching the US equity market recover to where it started the year, investors are trying to figure out the seeming disconnect with the still high and growing number of COVID-19 cases. One cannot characterise a very complicated situation within a simple framework: it's either going to be okay or it's the end of the world; it's a buy, or it's a sell. Rather the world financial markets represent shades of grey: some markets have run strongly, but not all; economic data may start to disappoint, but policymakers are still heavily engaged.

Some markets may have run ahead of themselves, but this is not universally true. The global equity market return of -3% year-to-date masks a diversity of performances by country and by sector. While the US and Asia-ex Japan are close to flat, the Eurostoxx 50 index is down 12% and the UK equity market down 19%. A few emerging countries such as Russia, Saudi Arabia and Brazil are also down by double-digit percentages. By sector, global energy is down 37% year-to-date, global banks down 30%, whereas global info-technology is up 15%. Hence the rally in equity markets has been narrow. For some technology stocks, earnings forecasts have risen since the start of the year, and the US 10-year treasury bond yield is down from 1.8% to 0.6% at Friday's close – a double positive. Also, many of those large growth stocks are capital (and employee) light businesses that have the flexibility to deal with the challenges at hand compared to the equity market leaders of the past.

The economic data has been improving, but it is likely to be more mixed going forward.

A near term headwind is the likelihood that economic data will disappoint the markets in the coming weeks after a stronger showing since April's lows. Weaker than expected US jobless claims number are maybe a taste of what is to come. In the Eurozone, economic data continues to beat expectations, but with worries over a second wave of COVID-19, there is a risk that data will weaken in coming weeks. The still-high levels of cases around the world are worrying: the level of COVID-19 cases in the United States has flattened out at a very high level, requiring some States to reimpose varieties of lockdown. Also, a country like Spain reversing some of its reopening gives cause to worry that global economic activity may be about to lose momentum. In Hong Kong and the Philippines, the cases of COVID-19 have re-accelerated after an economic reopening. However, Asia may benefit from recent signs of a recovery in the Japanese economy and the relative strength of the Chinese economy, despite the severity of recent floods in central and eastern regions.

US policymakers, at least for the moment, are less convincing.

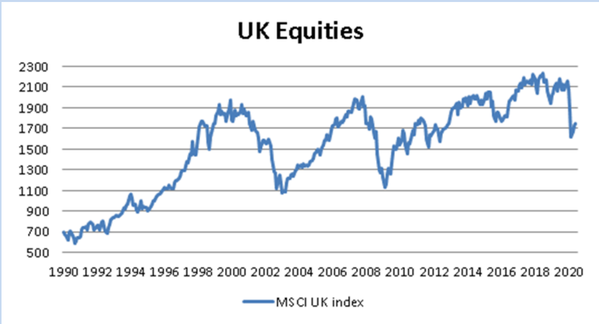
They have been unable to deliver a follow up to the income support program, expiring at the end of July. A compromise agreement might be found to inject a further $1 trillion of income support. The EU has recently delivered a multi-year budget and recovery fund deal. Markets will soon have to contend with the US November elections coming onto the horizon and the real risk that the Republican Party loses both the White House and the Senate.

We are prepared for more volatility in markets

As we navigate volatile market conditions, it is worth reminding ourselves that even if the COVID-19 is still creating problems in the global economy through the third quarter, we are awaiting results from at least four different drugs that are either in or about to be going through stage three trials. In the past there has been an 85% success rate of stage III vaccine achieving successful approval. Note that the medical community cautions that just because a drug is approved doesn't mean it is ultimately the panacea needed to solve the problem.

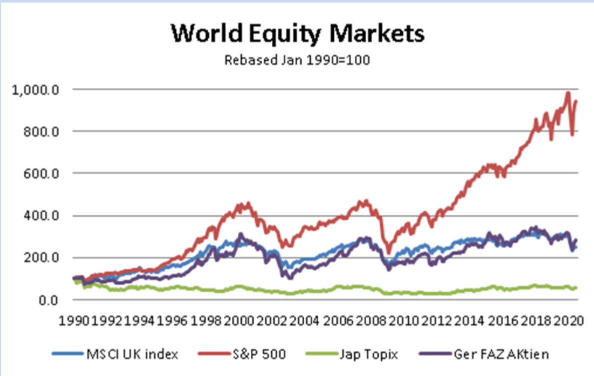
The momentum of the near-term economic news may worsen. Is there something hopelessly wrong about the valuation of assets? In our opinion, not at this stage. Policymakers have not run out of money. Most of the major central banks of the world can print more money and give every support to their respective governments to prop up their economies through further difficult times. Therefore, we remain invested in equity and corporate bond markets across a broad range of sectors and economies.

Markets at a glance



Source: Lipper for Investment Management

The economy is showing faltering steps to recovery from an unprecedented hit to GDP of around 25%, triggered by the coronavirus lockdown. Despite the unparalleled monetary and fiscal stimulus, the unemployment rate will probably still leap to 9% and many businesses will go bust once the government's furlough scheme support is limited. By the end of 2022, the cumulative loss pf economic output since the end of 2019 may add up to 15-20% of GDP. Corporate earnings growth is forecast by consensus to fall by over 30% year-on-year and FTSE 100 companies have cut their dividends by over £30 billion this year. The market is supported by price-to-book value considerations, but the shape and speed of the recovery and the path of Brexit trade negotiations will determine further direction in domestic equities, which are lagging most global peers.

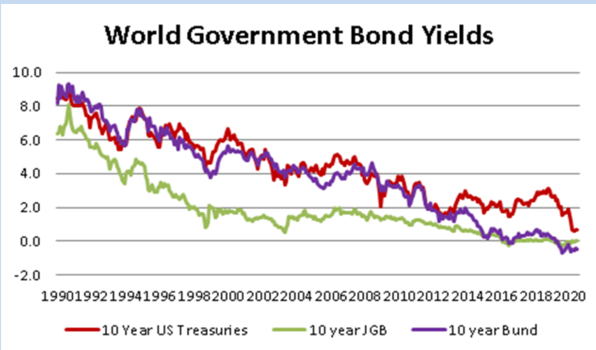


Source: Lipper for Investment Management

Across developed and emerging economies, those stock markets that had fallen the most and earliest 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 major economies, we think that this pattern will continue between now and the end of this year and believe that equities in Asia 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 sought low-risk havens in the light of the impact of COVID-19 on the economy and government finances. The Bank of England is likely to keep policy rates static in the near term. We expect it to wait at least until late-2021 to deliver a rate hike, as it considers inflation pressures and any return to normality in economic 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. We see limited scope for further interest rate cuts if global economies rebound. None of the G10 central banks with negative policy rates before the crisis (including the ECB, BOJ, and Swiss National Bank) have cut further. Reaching the effective lower bound of zero on policy rates should imply steeper yield curves, lower realized and implied volatility, and a worse return distribution for yield duration in general. While forward interest rates may imply 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.

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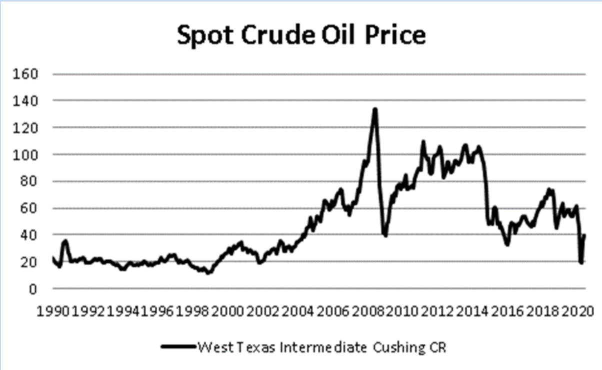
Source: Lipper for Investment Management

The Federal Reserve, ECB, Bank of England and other central banks could consider negative policy rates. However, we see this step as a low-probability outcome, even if the respective 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 future UK – EU trade deal become apparent. Managing inflation risks are offset against political risk interfering with economic prospects.



Source: Lipper for Investment Management

Given the subdued demand backdrop, developments on the supply side for oil are a key determinant of prices. OPEC and its allies have announced deep cuts to output. Even assuming full compliance (which seems unlikely) the market will remain oversupplied until late 2020. That said, US production looks set to fall sharply, given low prevailing prices and a high production cost base. By the end of the year, we expect the oil market to be factoring in stronger demand in 2021 and the Brent oil price to have picked up to around $50 per barrel.

Source: Lipper for Investment Management

Coronavirus fears and falling investor risk appetite have led investors to position their funds 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 has offset weak physical demand, 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 annual allowance is limited to £10,000).	

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%

GHC Capital Markets Limited · Investment Managers & Stockbrokers · 22-30 Horsefair Street, Leicester LE1 5BD
Telephone 0116 204 5500 · www.ghcl.co.uk

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