Market 2 Market

A forward view of the global economy and financial markets

November 2020

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Confirmation Bias

"It's going to disappear. One day, it's like a miracle – it will disappear".
Donald Trump January 2020

Source: Wikipedia

As this is the final article of 2020 I felt that it was worth looking back at the Pandemic to see what we might be able to learn from how governments reacted to this unforeseen crisis. I came across an excellent article in the Harvard Business Review which specifically looked at how the government reacted in Italy following the discovery of the first COVID-19 case on 21st February this year. The reason why they focused on Italy was because many other European countries and the USA repeated the mistakes that Italy made.

The problem that Italian politicians faced was that in the early stages of the COVID-19 crisis it did not look like a crisis although the evidence to the contrary from China was there. The Chinese had already started taking drastic measures after some initial mistakes and it was clear that the virus had the capacity to spread very quickly.

The first 'State of Emergency' measures in Italy were met with scepticism by both the public and politicians alike even though the scientists had been warning of a potential catastrophe for weeks. It should be noted that most governments do have contingency plans for emergencies, and it is true to say that in both Europe and the USA these contingency plans were ignored by politicians who did not want to declare an emergency in the early stages. In late February a number of Italian politicians engaged in public handshaking in Milan to make the point that the economy should not panic and stop because of the virus. A week later one of these politicians was diagnosed with COVID-19. How many politicians have subsequently tested positive in Europe and the USA?

The initial reaction to the COVID-19 pandemic was similar in many other countries besides Italy, which highlights what behavioural scientists call *confirmation bias*, which is a tendency to seize upon information that confirms our preferred opinion or initial hypothesis. In the case of the pandemic it started as a very small outbreak but very quickly spread into an epidemic in Italy. Politicians thought that they could spare the economy by imposing local lockdowns and when that failed they imposed a lockdown in the north of Italy. To no one's surprise many northerners headed south and immediately spread the virus to the whole country.

We have being doing the same thing in England. We impose a lockdown in one area, which then means that people will simply travel out of the sanctioned zone and head to a pub in a neighbouring county for a drink with a substantial meal. We sent the University students back in September knowing that this would mean tens of thousands of students moving around the country and then mixing in close proximity. It is no wonder that the areas in England that have seen the largest spikes in the number of reported cases has matched the population density of where students are. We have also suffered from the home nations all taking slightly different approaches in trying to halt the spread of the virus. Dare I say that nationalist politicians have made a point of taking a different set of measures to show that they are independent from Westminster?

One of the lessons that we have learned from the Italian experience is that strong measures need to be taken early on a national level. Australia and New Zealand have shown us that this approach, though very painful, works. The USA has shown us that a disjointed approach and a lack of leadership from the Oval office has resulted in the US having the worst number of deaths and infections and they are still by no means out of the woods yet.

In the UK we are persisting with a tiered system but one has to ask whether this will be completely effective and whether it is fair. The jury is still out and we have the Christmas holidays to negotiate when families will be restricted in the number of people that they can mix with. Hopefully the general public will abide by the rules and hopefully this will mean that the R Rate continues to fall. A successful vaccine will be a game changer but we are still some months away from a vaccine getting us back to normal. It will not be until the majority of the population has been vaccinated before we can even begin to think of getting back to our normal way of life.

A very happy and safe Christmas to all of you and your families.

Richard Harper
Head of Aset Allocation
GHC Capital Markets Limited

GHC Capital Markets

Asset Allocation

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

The COVID pandemic will leave a profound economic legacy

Unlike previous crises, this will not necessarily manifest itself in much weaker rates of long-term economic growth. Instead, the economic legacy of the pandemic will be felt in changes to economic structures, a fractured global economy, and the need for a period of ultra-low interest rates to manage debt burdens. At some point, the virus will be beaten – either through herd immunity or a vaccine. But the economic consequences will persist for years, even decades. The pandemic will deliver a lasting blow to output and the global economy will be substantially smaller by the end of this new decade than would otherwise have been the case.

In many crises economies do not return to their pre-crisis trend

As the global financial crisis showed, post-crisis output becomes lodged below its previous path on a permanent basis. Three reasons stand out: (1) The pre-crisis trend was unsustainable. In many cases, pre-crisis growth is boosted by factors that cannot last and very often end up sowing the seeds of the crisis itself. As a result, the post-crisis trend is necessarily lower. (2) Crises can destroy supply potential. Capital is rendered obsolete and high and persistent levels of unemployment cause skills to atrophy. This reduces the capacity of the economy to produce goods and services and lowers the post-crisis growth path. (3) Finally, crises often result in a prolonged period of weak demand, because households and businesses are forced to restrain spending to repair their balance sheets. While this post-crisis state may not be permanent and demand may ultimately return, the period of adjustment can last for long enough to give the impression of having reduced trend growth. Indeed, it may actually do so if it causes permanent scarring of the labour market.

The behaviour of consumers and businesses will change in a post-COVID world

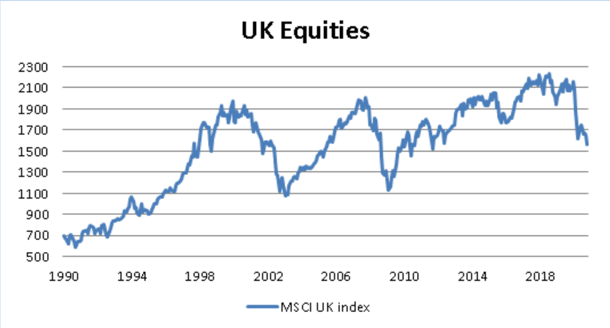
The lesson from past pandemics is that, while they do not tend to trigger behavioural changes "out of the blue", they do accelerate changes that were already underway. In a post-COVID world, we should expect more working from home, more online shopping, and less business travel. This will have implications for the sectoral make-up of economies. While some sectors, particularly around digital technology, are likely to grow, others are likely to shrink. These are generally lower productivity ones, such as hospitality and leisure. While some capital stock has been rendered obsolete (e.g. airlines, office space), the consequences of these shifts will be profound, particularly for property markets. We have reduced our portfolio positions in real estate to a de minimis level.

An extended period of weak demand is the chief concern about the effects of the virus on GDP

For now, the impact on demand is being mitigated by wide-scale fiscal support. This raises challenging questions about how to fund governments. Taxes are likely to have to rise, albeit only once we return to full employment. An additional dose of austerity to bring down public debt levels may even be applied. For some countries, a combination of economic growth, low interest rates and the passage of time may be enough to erode debt burdens gradually. In addition, governments and central banks may not just become more tolerant of higher inflation – they may even actively target it. Our view is that monetary policy will be kept extremely loose, in part to help manage the increase in public debt that has resulted from the crisis. If we are right, then real interest rates will remain in negative territory for some time – perhaps for the rest of this new decade. With sovereign bond yields so low, we harvest portfolio return from corporate and emerging market debt, where carry is evident. In the environment of low real and nominal medium-term returns from sovereign debt, we are investigating alternative investments ideas to improve the risk-return balance of our portfolios. Robotics, AI and Healthcare are among recent investment themes that we have developed.

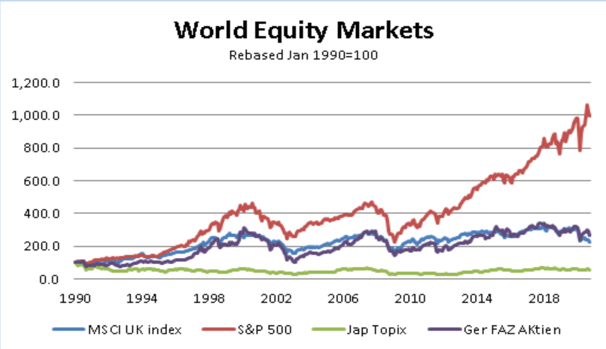
In this environment, the returns from equities are likely to beat those from government bonds. Given wide valuation differences, we suspect the outperformance of large-cap US equities will come to an end and we have positioned our portfolios to capture recovery in UK and emerging market equities, as they play catch-up.

Markets at a glance



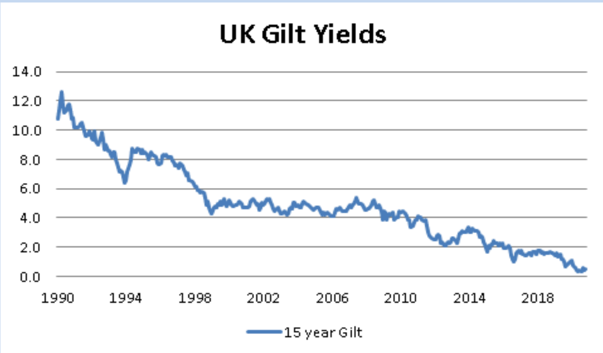
Source: Lipper for Investment Management

We believe that UK equities will stop underperforming global markets and will continue their fourth quarter rally into the new year. However, Brexit uncertainty and a second wave of COVID-19 cases in the UK pose a downside risk. The FTSE 100 underperformance against US and emerging markets in part reflects the high weight within the index of sectors hit hardest by the pandemic: e.g. Energy has a weighting of about 10% in FTSE 100 compared to 2.5% in the S&P 500. Brexit worries are a factor too, with the possibility of "no deal" or a poor deal on 31st December and medium-term economic dislocation weighing on equity prices. However, if a Brexit deal is not agreed, the boost to foreign earnings in sterling terms from a fall in the pound would prevent a big fall in the FTSE 100, as it did in the aftermath of the EU referendum.



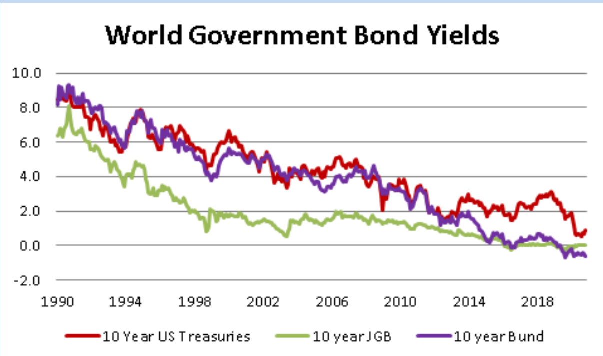
Source: Lipper for Investment Management

We expect equities to make further gains, as the global economy recovers from the effects of the pandemic, even if only gradually. We suspect that equities in parts of the emerging world will be the best performers over the next 12-18 months. The recovery in risk appetite and the fall in US interest rates relative to those elsewhere will continue to weigh on the US dollar, although uncertainty about the post-virus outlook and the risk of a re-escalation of US-China tensions may keep the dollar from falling much further in the near term. Crucially, though, our forecasts rest on the assumption that the major economies manage the coronavirus pandemic without slamming the brakes on activity again beyond this year.



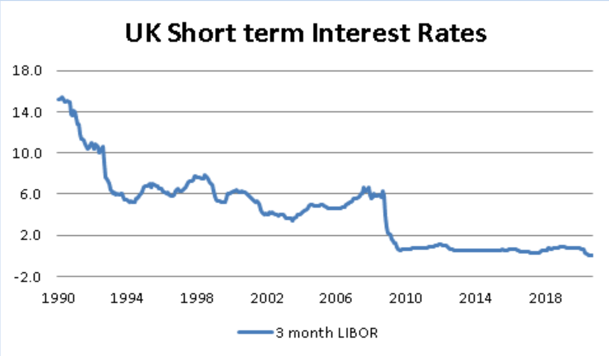
Source: Lipper for Investment Management

Extremely low official interest rates and more quantitative easing will keep gilt yields anchored close to their record lows over the next few years. 10-year nominal gilt yields recently rose to their highest level since March, widening the gap between 5-year and 30-year borrowing costs to its most since January 2019. While the Bank of England seems unlikely to reduce the Bank Rate below zero, 2-year gilt yields remain negative, in line with 2-year yields in Japan. Even though the Bank is now buying fewer gilts per week than are being issued, we think that a likely further £250bn expansion of QE to fund government expenditure and continued rock bottom rates will keep gilt yields low for many years.



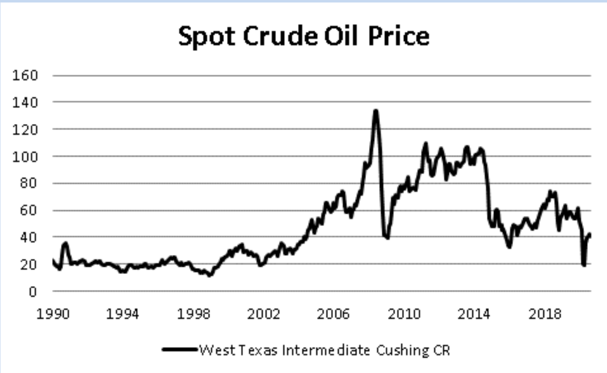
Source: Infront

Government bond yields in the US, Germany, and Japan remain at rock bottom levels across respective curves, as central banks continue to keep rates low and to purchase large amounts of bonds. Bond yields in the euro-zone "periphery" have also declined sharply, as EU governments agree debt-funded fiscal stimulus. As an example, the Portuguese 10-year sovereign bond yield is now negative. We believe that monetary policy will remain extremely loose and that yields will remain very low or even fall further from now to end-2021. The yields of investment-grade corporate bonds in the Euro Area, the UK and the US have also declined, as a recovery in risky assets and direct purchases by central banks have put downward pressure on credit spreads. As economies reopen, there is more scope for spreads of high -yield bonds to fall than those of investment-grade bonds.



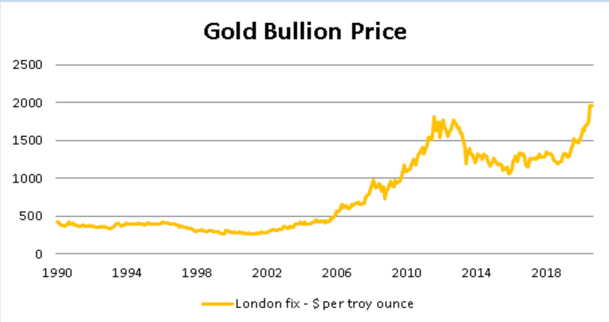
Source: Lipper for Investment Management

LIBOR interest rates may edge up over the coming months, as markets tone down their expectations of negative policy interest rates. But we expect LIBOR rates to remain close to their historic lows for many years, as we doubt the Bank Rate will be raised above the current rate of 0.10% for five years. Low market rates have nothing to do with perceptions of risk, as LIBOR spreads have been stable. Spreads in the UK are just as low as in the Euro Area, but are lower than in the US. Instead, the markets have priced in a chance of negative interest rates. That has left UK rate expectations between those in the Euro Area, where the policy rate is already negative, and those in the US, where the Fed has ruled out negative rates. Meanwhile, more quantitative easing is on the way.



Source: Lipper for Investment Management

OPEC's oil production has risen through the autumn and the winter heating season is now underway. If concerns persist about the recovery in global oil demand, then we suspect that OPEC may decide to extend its previous production cuts in the new year. These were announced earlier in the summer. Even assuming full compliance, the market remains oversupplied. That said, US production is falling sharply, given 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 justify a level around $50 per barrel.



Source: Lipper for Investment Management

The prices of all the precious metals, including gold, have been firmer though the autumn, although the gold price has now retreated by 10% from its all-time high. The gold price surge was supported by a weaker US dollar and falling real yields. We expect the Federal Reserve's adoption of average inflation targeting to lead to even lower real bond yields, supporting the prices of gold and other precious metals in the medium-term. In contrast, the physical market for gold remains weak. Despite a rebound in India's gold imports, China's gold imports are very weak this year. We don't expect physical demand to recover to pre-virus levels for some time.

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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