Market 2 Market

A forward view of the global economy and financial markets

July 2021

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The show must go on

"Sport and health are so important to our nation that they deserve to be right at the front of prople's minds".
Daley Thompson - Athlete

Source: Wikipedia

The COVID Pandemic has certainly brought up many new talking points for the nation to debate. How severe should a lockdown be? Who is exempt other than political advisers, politicians and UEFA officials? Should we have the same rules as Wales, Scotland and Northern Ireland? What countries can we travel to and what sort of tests and quarantine periods should apply?

A recurring debate has been over how the COVID precautions should be followed by sports in general. In 2020 the Olympics and many other tournaments were cancelled altogether which seemed sensible at the time as we didn't have a vaccine and there was a real danger that health systems would be completely overwhelmed. Worst of all the number of deaths being attributed to COVID were rising rapidly.

As we entered 2021 we had the good news surrounding vaccine development but this was counterbalanced by the infection rates soaring around the world. However, the experience of the previous lockdowns had shown that people needed to exercise and that sport had a beneficial effect on the overall morale of the general public. Sport also generates massive economic benefit which is a polite way of saying that sport means big bucks.

So far this year we have had the Superbowl, which is the culmination of a full American Football season. The football season in Europe was completed with domestic and European competitions being played behind closed doors or to very small crowds. As the year has gone on the sporting calendar has recovered to the point where we had sixty thousand fans allowed into the European Championship final with about as much social distancing going on as you would normally see during rush hour on the London Underground.

Wimbledon, cricket, golf and racing are all in full swing. In Japan the medical reasons for cancelling the Olympic Games looked overwhelming but the scientists, medical professionals and the majority of the population have been overruled. Why you may ask? There are a number of reasons but I would suggest that money comes first. Japan has spent an estimated $15.4 billion on preparing for the games and the postponement from last year has cost a further $3 billion. 60 Japanese companies had paid a combined total of $3 billion to sponsor the games and they paid a further $200m to extend their contracts into 2021. These figures don't include deals made by top tier sponsors such as Toyota who have direct deals with the International Olympic Committee plus all the television rights and finally the potential cost to the insurance companies is estimated at between $2 and $3 billion. Money talks.

There is an argument that the Olympics keeps people at home as they watch lots more television during the Games. The Indian Premier Cricket League (IPL) was suspended indefinitely in May, but serious attempts were made to keep it going due to the hundreds of millions of Indians who watch cricket. The fact that this option was even considered is astonishing as India was dealing with a spiralling death rate and an ever increasing infection rate at that time. The fact that the IPL is the biggest generator of sports revenue in India was the reason why national policy was almost overridden.

In the UK it is fair to say that the sports calendar is almost back to normal and the argument about the spread of disease by crowds has come down to whether people will need to show proof of having had two vaccinations or a negative test result within one week in order to gain entry to an event. Night club and theatre owners are not amused as they have been subject to much stricter rules but the truth is that they don't have the same number of followers or supporters as major sports do and they certainly don't generate anywhere near the amount of money that major sports does with their global television audiences. I am afraid that for all the arguments about mental health and personal wellbeing "couch potatoes" who watch sports matter more than theatre-goers or disco dancers.

Richard Harper
Head of Asset Allocation
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

Inflation is influencing policy makers and markets' reactions

Conventional wisdom six months ago was that higher inflation would prove transitory, as the world economy recovered from last year's extreme falls. Low base effects from a year ago, logistical dislocation and some supply shortages would lead to a short-term spike and then the world would settle into a more even pattern of growth. Well, not only is inflation today proving somewhat stickier in many mature economies, but economists are trimming their growth forecasts in several countries too – not an ideal mix for investors, which explains why the US and Europe are leading the way over most emerging equity markets in the year-to-date.

After another strong set of US CPI data, there is less support for the view that it will prove transitory. US inflation for June was 5.4% year-on-year; core inflation was at 4.5%. The rise in inflation has occurred without any significant increase in oil prices or the cost of medical services. However, the basic elements of the consumer basket are witnessing a spike – food prices are up 6.4% q-o-q annualised, clothing is up 9.0%, while household furniture and bedding is up 19.2%.

Major central banks are maintaining a mantra that inflation is transitory

The Fed, ECB and Bank of England seem unlikely to change policy until there is evidence of both inflation and near-full employment. Unemployment has some way to go, but inflation must be starting to worry them. For example, the US bond market prices a breakeven 5-year inflation rate of 2.5%, but consumers' one-year inflation expectations have hit 4.8% and three-year inflation expectations are at 3.6%

Interestingly, bonds are discounting something other than inflation.

Despite the above, the bond market has failed to react conventionally. Yields have not risen to reflect the rise in risks. The Fed has two policy tools – quantitative easing and interest rates – which have very different impacts on bond yields. The US 10-year treasury yield is currently 1.30%, reflecting a drop of 30bps in yield over the previous three months. This period coincides almost precisely with the sharp rise in inflation. Hence in real terms, investors are now facing the prospect of negative bond yields. Even in the corporate and high yield bond markets, nominal yields mostly fail to compensate investors for inflation.

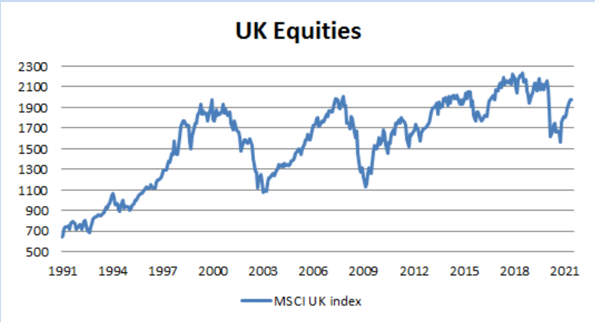
How do we square the rise in inflation with the drop in the long-dated US government yields?

It is possible that the bond market is discounting an economic hard landing and/or policy error. For economic growth to complement current yields, the view must be that there would be a material drop in GDP forecasts. We would have to see growth decline from its current run rate in the US and globally and inflation to recede quickly from current levels. How likely is this scenario? It might involve a policy error from the Fed or a spike in COVID that requires another sudden-stop policy response from governments. Looking at COVID, one could concede that new strains could still upset the current growth trajectory. However, macro statistics from countries with high vaccination rates are more encouraging. So we believe that this scenario is not very likely and, thus, bond yields are no more logical than they were before. There does not appear to be a catalyst to cause a sudden spike in yields to levels above 2%, at least in the immediate future, but the risk is that it will still happen at some point.

Portfolio positioning

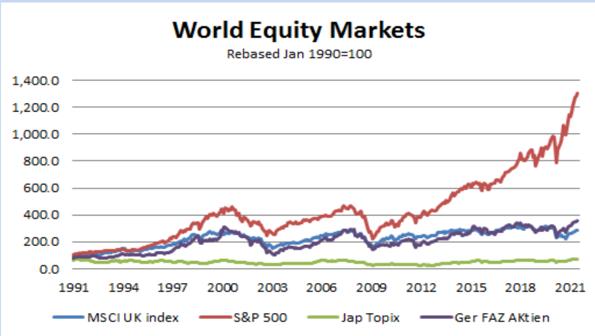
Our increase in protection against inflation risks across our portfolios is doing its job for investors. In the lower risk grades, we added to our UK inflation-linked bond holdings back in April. In the higher risk-seeking strategies, we carry exposure to commodities. Recently, we have added to our weightings of soft commodities (for example, grains after their fall in price). Across all portfolios, we maintain a short duration to our fixed income assets, which has protected portfolios as inflation concerns arose and many government bond markets sold off. Equities remain the clearest growth orientated asset class for global recovery and we have increased exposure to developed markets at the expense of trimming some of our exposure to Asia, where there is some risk that a slowing of growth in China might have a ripple effect with neighbouring economies.

Markets at a glance



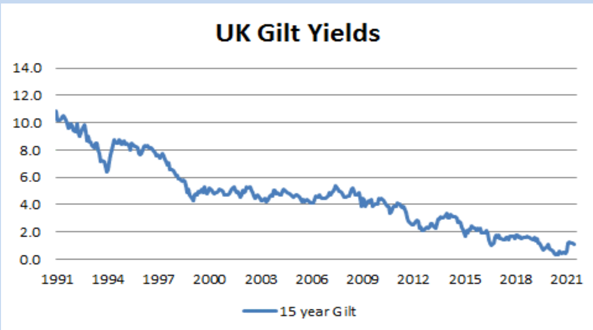
Source: Lipper for Investment Management

The UK equity market has made good progress in the early months of the year, although large cap stocks have recently become becalmed, with FTSE 100 trading around the 7,000 level. Despite a strong earnings and cashflow recovery being recognised for this year, the reasons include rising inflation pressure with a risk that monetary policy may become less accommodative to growth seeking investors. Communications from the Bank of England suggest the policymakers are in no hurry to tighten monetary conditions. However, these risks plus the ever-present COVID risks ("Freedom Day" was something of a damp squib) are keeping the lid on domestic equity prices at present. The UK remains one of the cheapest valued developed equity markets.



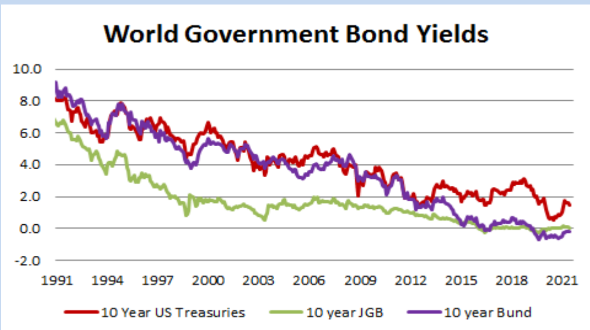
Source: Lipper for Investment Management

Global equity prices have also traded sideways recently, albeit with higher levels of volatility in recent weeks. Europe and the US are leading the way in the year-to-date, as Japanese and Asian equities tread water. Global trade is improving and equity prices are driven by some recovery of the sectors that suffered most in the recent downturn, such as Industrial Materials. If the world continues to recover from the effects of the pandemic, we foresee further upside in prices. However, our forecasts assume that the major economies manage the coronavirus pandemic with limited impact on activity, even as policymakers debate the inflationary consequences of their actions. Corporate earnings are recovering strongly in many countries this year.



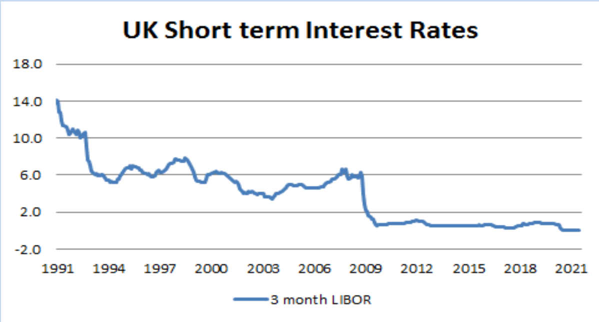
Source: Lipper for Investment Management

Gilt yields have settled at low levels – the 10-year gilt currently yields 0.58% to redemption. This is despite inflation concerns, which reflect shortages of materials and wage pressures, given labour shortages in sectors, such as retail and hospitality. To some degree, the reason for low yields remains extremely low official interest rates and more quantitative easing by the Bank of England. Policymakers suggest that they are waiting and seeing on inflation risks, so no near term interest rate intervention is foreseen. Furthermore, the Bank is now buying fewer gilts per week than are being issued, although we expect a further £250 billion expansion of QE to fund government expenditure. The gap between 5-year and 30-year borrowing costs remains near a two-year peak.



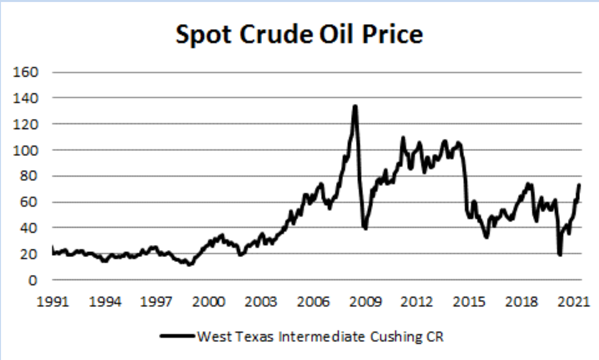
Source: Infront

Government bond yields have fallen across the US, Germany, and Japan. This is despite higher inflation risks and possible resultant policymaker actions earlier than market generally anticipates. We expect the levels of quantitative easing to fall through the remainder of this year and no changes in interest rates across the developed economies. This is despite a number of emerging market central banks raising their domestic rates. We believe that monetary policy will remain loose and yields will remain low to end-2021, although longer dated yields may rise (curve steepening). The yields of investment-grade corporate bonds in the Euro Area, the UK and the US have also fallen. As economies recover, there is scope for spreads of high-yield bonds to fall relative to those of investment-grade bonds.



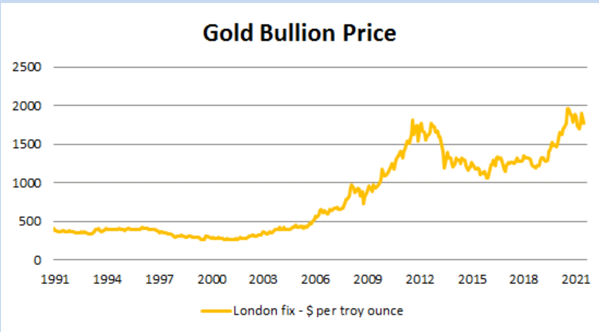
Source: Lipper for Investment Management

Markets are looking to the Bank of England for possible changes in policy guidance, given the rise in headline inflation readings. They have swung from pricing in a chance of negative interest rates to expecting an increase in rates within 18 months. UK rate expectations are between those in the Euro Area, where policy rates are around zero, and those in the US, where the Fed may raise rates by the year-end. We expect LIBOR rates to remain near historic lows, as we doubt the Bank Rate will be raised above the current rate of 0.10% any time soon. LIBOR spreads in the UK and the Euro Area are below those in the US.



Source: Lipper for Investment Management

Assuming that OPEC+ agrees some sort of deal to raise production quotas in the coming weeks, we expect oil prices to rise to around $80 per barrel in Q3 as the recovery in demand continues to outpace the rebound in supply. Beyond Q3, we think prices will fall back, as demand growth slows and supply continues to increase, pushing the global oil market into a surplus. However, if OPEC+ fails to agree to higher quotas, we anticipate one of two scenarios playing out. First, current production quotas could remain in force until next year, widening the deficit in the market and pushing prices higher into 2022, perhaps briefly up to $100 per barrel. Second, negotiations could collapse entirely, in which case OPEC+ output would probably surge. This would swing the market into a surplus sooner and would almost certainly result in a collapse in prices.



Source: Lipper for Investment Management

Gold has recorded its third straight week of higher prices, as the yield on the 10-year Treasury dipped below 1.3% for the first time since February. The highly transmissible Delta variant is now the most dominant strain of coronavirus in the US, threatening economic growth and raising uncertainty about the next interest rate hike. Gold prices are still some 12% below their all-time highs, set last summer. In the short to medium term, it appears as if gold demand will continue to be driven by central bank policy, which should remain accommodative, even as inflation fears increase. The physical market for gold remains weak. Despite a rebound in India's gold imports, China's gold imports are very weak. The key to any rally in the gold price will be investor concerns about global inflation risks – this real asset presents a store of value in inflationary times, as witnessed by a modest rally from early year price lows.

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

Quick facts

ISA Allowance 2021/2022	Stocks & Shares ISA Cash ISA Junior ISA	£20,000 £20,000 £9,000
Pension Allowance 2021/2022	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 £4,000).	

Tax facts

Income Tax	Personal Allowance 2021/2022	Up to £12,570
	Basic Rate @ 20%	£12,571 to £50,270
	Higher Rate @ 40%	£50,271 to £150,000
	Additional Rate @ 45%	Over £150,000
	Married couple's allowance:	Minimum £3,530
	Older spouse born before 6 April 1935	Maximum £9,125
		Up to 10% of the appropiate Min/Max
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%
	Business Asset Disposal Relief	10%
	Business Asset Disposal Relief limit of gains	£1,000,000
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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