A forward view of the global economy and financial markets

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We're off to sunny, sunny Spain...maybe?

"The reason for my big success in the UK was that the Brits started wanting to go on holidays like Spain and Greece". Denis Roussos - Greek Singer

Source: Wikipedia

A recent study by the Scottish Friendly Society and the Centre for Economics and Business Research showed nearly half of UK citizens have seen their cash savings increase over the past year. Collectively they are estimated to be holding an extra £192 billion. The research found that households plan to spend more than a quarter (26%) – £50 billion in total – of their lockdown savings over the course of 2021. More than a third (34%) of those who plan to spend more money this year say their cash will go towards travel and accommodation for overseas holidays.

These are huge numbers and in 2019 over 18 million Brits visited Spain while around 1.6 million visited Portugal. Apparently the average British tourist spends between £64 to £67 per day when on holiday in Europe so, in spite of the behaviour of some British tourists, it is easy to see why the Spanish want us back.

At the moment the British Government is using a traffic light system for foreign travel and Spain is on the amber list. This means that travel to an amber list country involves more PCR tests, which are expensive, and periods of quarantine on return. The Prime Minister has also advised against visiting a country on the amber list and the first minister of Wales went one step further and advised against any foreign travel at all this year.

In Europe, Spain has just opened its doors to the Brits who will not need a PCR test, while Portugal, which is on the Green list does require visitors to take a PCR test. Confused? Meanwhile, French and German tourists have been allowed into Spain while Spaniards have still been restricted from travelling internally. Germany has banned British visitors as it is worried about the Indian variant of COVID-19 although they don't seem to be worried about Brits mixing with Germans in Spain. We also know that the vaccinations being used in the UK provide protection against the Indian variant. Would I be cynical if I said that politics are involved here as many Germans have been complaining about their poor vaccination programme and holding up the UK programme as an example of how it should have been done? Nothing like bashing the Brits to save face politically in Europe.

While all these shenanigans having been going on the European Commission (EC) seems to be acting in a parallel universe. A visit to the EU website on traveling during the coronavirus pandemic is worth a read as it refers to a one stop shop for safe travel in Europe. The site refers to the EU Digital COVID Certificate following a provisional political agreement reached on the 20th May 2021 by the European Parliament and the Council. They hope to be able to issue a Digital Green Certificate for travellers by the end of August. The best bit about this is the statement; 'The agreement has been reached in record time just two months after the Commission's proposal'. Having said earlier that there is only a provisional agreement it seems that the EC is blowing its trumpet before the agreement has been signed off. I would also make the point that two months is a long time during a pandemic.

The truth of the matter is that countries are acting in their own national interests first. Spain needs the revenue from British tourists and is not going to put barriers in the way if it threatens their tourist industry. Germany has shown that individual countries in Europe will impose their own restrictions and will not wait for the EC even if the EC is breaking its own records for speed of action. There is even a separate paragraph about 'a coordinated approach to travel and transport in response to new variant of coronavirus in the UK' which was published in January but that appears to have gone out of the window. The website goes on for pages and is a bureaucratic masterpiece but of limited value.

The only way out of the pandemic is a vaccination programme for the whole population and a continuous test and trace system that works. Individual countries are best left to get on with it and the EC should admit that a Europe-wide approach has not worked. The worry for British tourists going to Spain for two weeks of sun is not a German stealing the sun lounger but rather the EC coming out with a ban on tourists who do not have a European Digital Green Certificate. Spain may not want to enforce such a rule but it is going to be a European Union regulation which they cannot ignore.

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

What higher inflation means for assets

For years it has been better not to fight the trend: two decades of falling inflation and then just over a decade of central banks fighting a threat of deflation are difficult to erase from investors' mind-sets. Thinking has become anchored on low inflation, low interest rates and easy monetary policy. However, factors are building that show that inflation is not just at hand, but could have far more longevity than the markets currently price.

The current economic data flow is showing that inflation is emphatically at hand.

The US consumer price inflation report for April showed a mighty increase to an increase of +0.8% month-on-month, which marked the largest monthly rise since 1982. Annual US headline inflation now stands at 4.2%. This surge in inflation occurred without a monthly rise in energy prices. Increases in global agricultural products are starting to push grocery prices higher. The producer price index added to the weight of evidence of rising inflation, with overall producer prices rising 6.2% on an annualised basis.

Wage inflation could be the driver for more substantial inflation.

While some economists were fretting over the lack of substantive jobs growth, the latest 0.7% month-on-month increase in average US hourly earnings is more telling. Wage inflation corroborates other evidence that staff are demanding higher wages to return to work. It is also worth reframing the ranges for wage inflation. Consider that US wage growth averaged 6.1% from 1960 until 2021, reaching an all-time high of 13.8% in January 1979. There are genuine labour shortages in both the manufacturing and service sectors. Those labour shortages are both due to the reluctance of people to return to work and severe skill shortages. In a recent survey, 28% of small businesses said they were increasing salaries to attract staff. Broader surveys of wage inflation showed the most significant increases in wages since 2007. This wage inflation is taking place despite still very high levels of unemployment. US workers are empowered by funding from the government to sit out the next six to nine months and wait for higher wages.

Structural issues only add to the current upward pressures on prices.

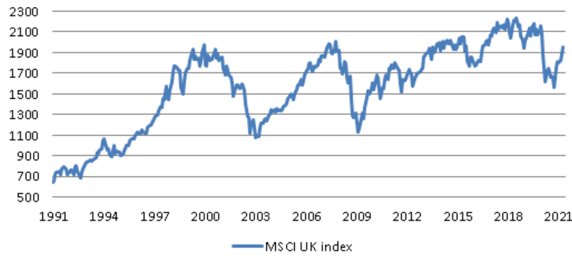
Our COVID-affected world is only accelerating some of these effects. The world seems to be reflecting more on the meaning of life: trying to tackle climate issues and the unequal distribution of wealth with more vigour. Tackling climate change will require a marked acceleration in the phasing out of energy sources with large carbon footprints. However, using alternative energy sources means a very substantial increase in demand for copper and lithium, both of which are in short supply. For example, a battery-powered electric vehicle uses 83 kg of copper, compared to a combustion engine of only 23 kg of copper. Renewable energy sources are also heavily dependent on copper in their construction; wind energy requires, on average, 2,000 tons of copper per gigawatt, solar energy 5,000 tons of copper per gigawatt.

Combining these factors with evidence of supply chain strains explains why the Materials sector is performing so well, rising 11.6% this quarter to date, compared with 2.5% for the S&P Info Tech Index. The move is some reversal from a year ago when the market saw the technology sector as the only sector capable of delivering strong earnings growth under the strain of the pandemic. The tables have turned, as the heady valuations of the technology sector weigh against it in the face of the old-school sectors that stand to gain from the resource-heavy demand we are witnessing.

Almost all of the major central banks in the world want more inflation.

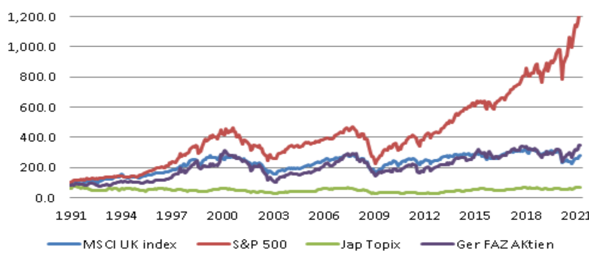
The Fed, for example, has a stated policy of increasing inflation above its target. Many heavily indebted governments in the world would not mind a burst of inflation to reduce the real value of their debt burden. We have introduced more protection against inflation risks across our portfolios. In the lower risk grades, this involves adding to our UK inflation-linked bond holdings. In the higher risk-seeking strategies, we have increased holdings in our industrial commodities exposures at the expense of corporate bond funds. 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, so we maintain a good exposure to developed markets here.

Markets at a glance



Source: Lipper for Investment Management

There are signs that the UK economy is picking up from Brexit and COVID-19 induced weakness. As life returns to normal, the retail and construction sectors are rising quickly, although the dominant service sector is performing less boisterously. Global trade is improving and we expect UK equities to continue their catch-up to major global equity markets. Last year's 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, Banks and Retail. The latest rally in equities is driven by some recovery of the very sectors that suffered most in the recent downturn, such as Industrial Materials.

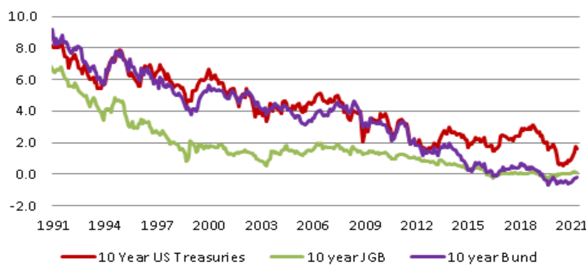


Source: Lipper for Investment Management

We expect global equities to make gains, as the world economy recovers from the effects of the pandemic. We believe that equities in Asia will be the best performers over the next 12-18 months. The recovery in investor risk appetite will weigh on the US dollar, although uncertainty about the post-virus outlook and the continuing risk of US-China tensions, even with a new US administration, may keep the dollar from falling much further in the near term. Our forecasts assume that the major economies manage the coronavirus pandemic without affecting activity, even as policymakers debate the inflationary consequences of their actions. Corporate earnings forecasts suggest sizeable recoveries in many countries this year.

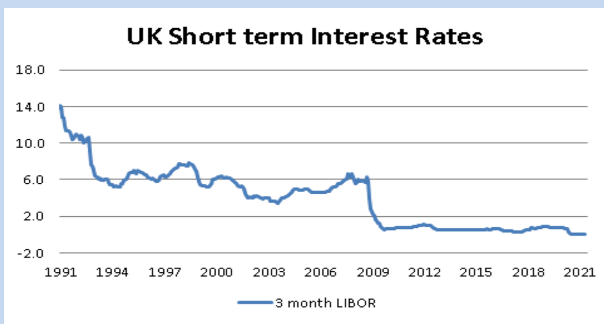
Source: Lipper for Investment Management

Gilt yields are rising at medium and longer durations, as inflation concerns arise. This is sourced from shortages of components and materials and wage pressures, given labour shortages in sectors, such as retail and hospitality. Extremely low official interest rates and more quantitative easing had kept gilt yields close to their record lows. Policymakers suggest that they are waiting and seeing on inflation risks, so no near term interest rate intervention is foreseen in the major G7 economies. 10-year nominal gilt yields have risen to their highest level for a year, widening the gap between 5-year and 30-year borrowing costs to a two-year peak. The Bank is now buying fewer gilts per week than are being issued. However, we expect a further £250 billion expansion of QE to fund government expenditure. Expect gilt yield curve steepening from here.



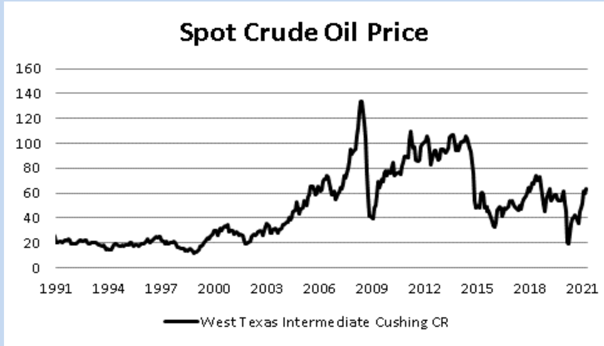
Source: Infront

Government bond yields in the US, Germany, and Japan have picked up across their respective curves, as markets scrutinise central banks for clues about interest rate policy in light of concerns that inflation might be creeping up after expansionist monetary policy. Bond yields in the euro-zone "periphery" have also risen. Policy messages seem to be "wait and see" with respect to growth and inflation risks. We believe that monetary policy will remain loose and that 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 risen. As economies recover, there is more scope for spreads of high-yield bonds to fall than 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 in the next 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. Use of LIBOR interest rates is to be replaced by December 2021. Meantime, 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%. LIBOR spreads in the UK and the Euro Area are below those in the US.



Source: Lipper for Investment Management

Oil prices peaked near $70 per barrel in early 2021 and have traded a little below that since. We think these prices could be supported, as OPEC persists with deep supply cuts and lockdown restrictions start to be eased in developed economies. US crude production has already fallen sharply, given a high production cost base. However, the higher oil prices of the last six months will incentivise new supply, which will likely weigh down on prices later in the year. If Iran succeeds in a new international deal on its nuclear production, this may allow a further increase in oil supply from within OPEC. Furthermore, as the gradual withdrawal of stimulus measures leads to slower growth in China's economy, demand may level off.

Source: Lipper for Investment Management

The gold price has lost 15% from its peak and the prices of all the precious metals have drifted lower since the autumn. Prices had been supported by a weaker US dollar and falling real yields. A further easing in investment demand will weigh on the price of gold, despite ultra-low real bond yields and higher inflation expectations. 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 recent 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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