Reflections & Insight

QUARTER FOUR 2020

"There was nothing separate about her days. Like drops on the window-pane, they ran together and trickled away." *–Dorothy Parker*

It has been interesting watching the seasons change through the window, but that is about the best one can say about still working from home. It is not that productivity suffers or that technology lets you down, but the feeling that something is missing is hard to dispel. Humans are social animals, and while 'business as usual' can go on in a locked-down world, the creative spark generated by working face to face with others is gradually dimming. In these reviews, uncertainty has been the dominant theme of the post-pandemic world. Sadly, that continues into the autumn.

The social nature of humanity has allowed the virus to exploit any easing of lockdown and pushed most of the developed world back into semi-hibernation. It is possible, even likely, that therapeutic solutions to the virus will mitigate its impact and that an effective vaccine is not far away, but the next six months will still be tough.

Economic activity everywhere bounced very sharply in the third quarter of the year. There was pent-up demand for all forms of goods and services and the world breathed an (infectious) sigh of relief. Consumer spending has bounced back to pre-pandemic levels (in many countries), while construction is booming, especially in the US. China will deliver positive economic growth this year, as will smaller Asian countries like Vietnam, which have navigated COVID deftly.

For more developed economies, the picture is less optimistic. While further generalised lockdowns look unlikely, the so-called second wave of infection has led to further restrictions on activity, which will mute the recovery. Normally in an economic downturn, the damage done by the economic contraction is short-lived. The only recent exception to this was the Great Financial Crisis of 2008, which destroyed some productive capacity and took several years to correct. Even so, and albeit extreme, it was an event which slotted into the historical record.

What we are going through now is something different. There is a cyclical downturn triggered by the restrictions on activity, although this has hitherto been partly mitigated, at least in rich countries, by unprecedented fiscal largesse. At the same time, many industries – which before COVID were adapting gradually to new technologies, digitisation and so on – have been brutally disrupted. Many will not survive. These are secular shifts of the sort seen, for example, during the depression of the 1930s, as the consumer economy started to displace agriculture. As the fiscal foot on the accelerator lightens a little and job protection schemes put more burden on employers, unemployment is likely to increase, and prospects will have dimmed because skills useful during the 'consumer' era are no longer so necessary in the 'knowledge' economy.

A Different Look

Retraining for the post-COVID era is not something that can be turned on like a tap. It requires a strategic approach and a generational outlook. This is not to say that a post-COVID world will be unrecognisable, but it will look different – who will go back to a daily commute to work in a city centre office five days a week? Who will go back to a conventional department store? Who will travel as much as they did before? The list goes on and each question has consequences for employment. By the same token, the opportunities in areas like digitisation, green technology, healthcare and so on will only increase.

Government responses to these challenges vary from place to place. The common thread is monetary and fiscal generosity. Interest rates are almost zero almost everywhere. Since our last commentary, it is now clear that they are going to stay low for the foreseeable future, which in this case means several years. Indeed, the Federal Reserve in the US has indicated that it would tolerate inflation above its target range. It is worried about the fragility of the economy. When borrowing is on the scale required to provide the fiscal support which has stopped the developed world from falling into depression, there is nothing that governments would like more than a little inflation. For now, the outlook is more deflationary than inflationary.

It is worth taking a brief detour into the underlying factors that will determine the inflationary outlook. Firstly, demographics has been an important contributor to low inflation. An increasing supply of labour, as China and other countries integrated themselves into the global economy, held down wages. Demand also fell. Thirty years after the baby boom, household formation had put upward pressure on goods pricing, and that is what we saw in the 70s and 80s. Now, 70 years after the start of the baby boom, this has reversed – older people buy fewer things.

We now appear to face the opposite of the conditions that led to the great disinflation. With aging populations across the world, you have the prospect of shrinking supply (less workers), which in normal circumstances would equal higher wages and higher prices, but the demand side complicates the picture. There are two other longer-term factors to consider. First is the effect of technological adoption and advancement, both consumer's increasing power of price discovery allowed by technology (for example, Amazon) as well as enterprise's reduced costs of labour and capital with increasing automation and process efficiencies. Second is the destruction of traditional industries, accelerated by COVID. Both are big deflationary forces whose full effects we have yet to understand.

What this adds up to is that people who are worrying about generalised inflation in the near-term are likely to be wrong because both cyclical and secular influences point the other way. There are some other factors too, such as economic behaviour when interest rates are close to zero – if you think the outlook is uncertain, why would you borrow to invest today if you know interest rates are not going up? This behaviour pushes economy activity into the future.

Bringing Consumption Forward

Looking over the next few years, we are likely to see a jagged cyclical recovery. If the threat of COVID fades, it will become less volatile. At the same time, we will witness increased unemployment and severe disruption in certain industries. It is worth remembering that most service sectors (hotels, restaurants, airlines, theme parks etc.) are not viable at 50% occupancy. Many are not viable at much higher levels of occupancy. Even without COVID, many of these businesses will not survive as demand will be subdued, and behaviour will change – the longer the virus threat remains, the more embedded those changes will become. Inflation will stay low, or prices may even fall. Interest rates will be close to zero. In order to minimise the risk of social unrest, governments will be forced to continue with fiscal generosity, piling on debt for future generations to sort out. One thing on which most economists agree is that large amounts of borrowing are like bringing consumption forward – the implication being that it is not there in the future. This is why the evidence points to the unfortunate conclusion that heavy borrowing leads to weak growth.

As an aside, one of the reasons that UK economic performance has been amongst the worst of the developed world is because it is the economy most exposed to the service sector, where supply almost disappeared from March to June. Specific problems in the UK may also arise because of BREXIT, where it remains unclear how the cards will fall. At the time of of writing, some disruption to 'business as usual' looks inevitable. Although the UK market is cheap by international standards, that reflects both this risk and the fact that it is heavily weighted to sectors that are currently unfashionable – such as energy, financials and resources.

Capital markets are going through one of those phases where they seem to occupy a parallel universe. Dig deeper, though and the behaviour is not so illogical. Firstly, interest rates are so low, that high valuations can be justified statistically; secondly, under the surface, the markets are less homogenous than they have been for decades. For the major US index (the S&P500), 94% of its constituents have fallen, while 6% account for all the rise (of about 6%) and more. Needless to say, these 'winners' are the businesses well-positioned to benefit from the new world, while the biggest losers are a roll call of energy companies and travel businesses. Lastly, investors may well ask where else they are going to invest.

Markets are obsessed at the moment with politics, in particular the US election. For a non-American, the differences in policy between the two candidates are not so pronounced, although there will undoubtedly be sector effects in areas like healthcare and energy. The bigger political issue is that the thrust of US policy creates an opportunity for China to assert itself economically and militarily.

All of this has implications for portfolio management. As an industry, asset managers are generally slow to accept changes in the landscape. The old saw is that the four (or five, depending on how pedantic you are feeling) most dangerous words in the investment profession are 'This time, it's different'. By definition, that has almost always been true. The problem is that it is not a good guide if things really have changed. We set out below some tentative thoughts on how things might look different in the future:

- The increasing heterogeneity of markets will render traditional regional asset allocation models redundant. It will be about companies and sectors, not about geography, with one or two exceptions;
- For the same reason, the concept of indexing a portfolio to a geographical benchmark will make less and less sense. This should be a boom time for active management;
- What is true for equities is just as true for credit markets. With very low interest rates, an active approach is required, and returns will be harder to eke out than has been the case over the last 40 years;
- Growth will be a scarce factor. Companies which can grow without straining balance sheets are likely to be rewarded with very high valuations which will persist;
- Despite governance issues, the opportunity set in China is likely to produce many of the most promising investment stories of the next decade, although as everywhere, it will be very stock specific;
- There are one or two attractive macro-economic opportunities in the investing world (e.g. Vietnam), but in general, portfolios should be skewed to global exposure and weighted to themes with a secular tailwind;
- Not all investment opportunities are available in public markets. Selective exposure to private markets may well help to diversify risk without reducing returns;
- Despite the fact that it will be difficult to ignite inflation, around the world, most governments would like to see their currencies weaken. For a small part of the portfolio, gold is effective insurance.

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