

# INVESTMENT STRATEGY GROUP MEETING NOTES

OCTOBER 2021

## TANG PING

Markets have moved on from anticipating recovery from the Covid pandemic to looking for evidence of it in the economic data. At the same time, the geo-political framework has moved centre-stage, with China, under the aegis of Xi Jinping, becoming increasingly authoritarian and in many ways turning the clock back to the period prevailing before the reforms introduced by Deng Xiaoping.

## RECOVERY FROM COVID

Despite localised surges in infections, the mortality data surrounding Covid strongly suggests that the pandemic is coming to an end. Global mortality peaked at 70,000 deaths per week in February 2021 and has fallen to less than 10,000 per week to the end of July as vaccinations have been rolled out in developed economies.

Clearly there is a risk of new variant strains emerging but even here, the “war” on Covid has accelerated research into vaccine development, shortening development times from decades to months. The world is better prepared for further, new variant, outbreaks than it ever has been. Nonetheless, as per the “flu” or common cold, scientific opinion seems to be that Covid and Covid variants will remain a permanent but perhaps seasonal vector for infection.

Investors should turn their focus to the durability of the recovery, to the global policy framework, to geo-political developments, and to climate change rather than resurgent Covid as major risk-factors.

Business surveys suggest that confidence is returning, led by Europe. The most recent survey in Germany points to rising confidence which is above trend and accelerating. In Italy, the primary beneficiary of the European reconstruction program, businesses are also rapidly gaining in confidence.

It is in the European North-South divide where the real “levelling-up” agenda is most pressing.

Elsewhere, US businesses have anticipated recovery and business confidence is rolling-over from its peak.

In the UK, confidence is declining, perhaps as some of the logistical bottlenecks in respect of Britain's withdrawal from the single market begin to bite. Recent petrol shortages will not help post-Covid reconstruction and more generally, unanticipated labour shortages in “unattractive” jobs, most obviously in transport and agricultural production, look likely to persist, putting upward pressure on wages.

Asian business surveys are less buoyant although they have recovered strongly from mid-pandemic lows. China casts a broad shadow, and it is not yet clear how far the recalibration of economic policy in China is going to go.

The US is also something of an outlier in respect of consumer sentiment. US consumer confidence has turned down recently and has never regained the levels seen immediately pre-pandemic. By contrast, European consumers, led by the UK and France, are extremely buoyant.

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Since European lockdowns were considerably more severe than that in the US, there is probably a greater degree of “pent-up” demand to be released and as noted below, middle-class finances are in remarkably good shape across the developed world.

## STRONGER THAN EXPECTED

The recovery that economic survey evidence has pointed to is increasingly visible in the hard data with all major economies swinging from negative readings in quarterly GDP to positive, with Spain and Italy enjoying a particularly strong rebound from the declines of last year.

The recovery has been so strong that some commentators have raised fears of inflation with CPI readings around the world well in excess of the broadly accepted 2% target. However, few alarm bells are ringing in central banks; for example, the 3.2% and 5.3% rise in the annual rate of increase in CPI in the UK and US is regarded as “transitory.” High inflation readings, for the moment, are due largely to the combination of base effects and a sharp recovery in energy prices.

Nonetheless, there are some grounds for believing that the inflation outlook is not quite as benign as the central authorities would like.

In previous meetings we have noted the scale of the official support to the world economy throughout the pandemic. Despite the unprecedentedly sharp contraction in GDP, it is very notable that this support has succeeded in keeping firms afloat. The rate of corporate bankruptcy is lower even than that which prevailed before the global financial crisis (GFC) in 2007.

At the same time, the rate of new company formation, regarded as a yardstick of economic vitality, is beginning to accelerate, most sharply in the UK and France but also in the rest of the developed world. In the short-run, labour shortages are likely to moderate this acceleration but ironically, in the longer-term, labour constraints would tend to generate improvements in productivity: stronger incentives, higher wages, increased Capex.

## WAGES

It has been well documented that since the turn of the century real wage growth has been extremely weak, averaging barely 1% per annum. There is some emerging evidence that this is beginning to turn, led by the US.

Real wage growth in America rose to 4.5% y.o.y. in 2020. British and German wages are also beginning to accelerate. In the UK, of course, the ending of free movement will tend to raise competition for workers which cannot now be filled (subject to temporary visa exemptions) by immigrant labour.

At the same time, unemployment is generally on a declining trend in the developed world with employment at levels below the rate at which inflation is expected to accelerate (the old NAIRU model).

There are some oddities here: Southern European unemployment is still high and, in the UK the OECD forecasts unemployment to be rising into 2022/3 as furlough schemes end and the costs and time taken to transition workers between sectors leads to a mismatch in available skills and available jobs.

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Nevertheless, it is striking how robust “middle-class” incomes and balance sheets have become.

Nascent wage growth is part of the mix but, more importantly, it is the long fall in interest and debt service costs, accompanied by deleveraging (post GFC), and increasingly rampant house prices, that have shored up consumer finances. It is quite clear that the world is enjoying a property price boom which, at least in the short run, should both serve to bolster bank security and collateral values whilst underpinning and funding the release of pent-up consumer demand post-pandemic.

The picture that emerges is one of a surprisingly robust recovery coming out of Covid where official support has succeeded in bridging the economic abyss that Covid appeared to portend. The question for investors is whether policy has been too successful and whether it is time for central banks to step back and, like a parent with a toddler, show confidence that the emerging recovery can stand on its own two feet even when it stumbles.

## TIME TO TAPER?

The success of official policy support coupled to dislocations in global supply chains, principally between China and the US, and more locally between the UK and Europe, has raised the possibility of buoyant consumer demand will meet reduced supply, thus raising inflation.

At the same time, as economies recover, central banks will wish to exit emergency support as quickly as they possibly can. The question is how worried should investors be regarding the tapering (ending) of Quantitative Easing and a new era of policy tightening?

The transition to a “normal” policy regime is fraught with complexity.

Officials have recognised the lessons of the post GFC period where assistance was too small and too short-lived in the context of the then drive to fiscal consolidation once the initial crisis 2008/9 was over. Economies never achieved lift-off and they ended the decade more indebted than they were at the beginning despite policies of “austerity” which were explicitly designed to reduce debt.

In this cycle there is a bias to ensure that policy support is maintained until and unless inflation targets are credibly and durably achieved. Given the widespread adoption of “flexible” inflation-targeting regimes, this means that spot inflation readings well above target will be tolerated and even desired.

A problem arises in that, as opposed to the post-GFC period which introduced fiscal austerity, fiscal policy is currently exceptionally loose. Debt consolidation policies have, almost, been abandoned. Adding to the mix are the supply-chain issues noted above which, in the event of central bankers allowing economies to “run hot,” raises the risk of the resurgence of a “demand-pull” inflation overshoot, and thus sharply tighter policy as central banks seek to deflate demand later in the recovery.

The recent meeting at Jackson Hole sought to put to use all the vocabulary of central banking; forward guidance, gradual removal of stimulus, policy driven by data, to reassure markets that the turn in the policy cycle will be slow and measured.

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It does seem likely that a turn in policy is already upon us but that it will happen in three stages:

1. Asset purchases will end commencing Q4 in the US
2. Interest rates will rise commencing Q1 2022
3. Bank balance sheets will be allowed to run-off over an extended period (perhaps decades)

## IMPACT

QE was designed to lower the cost of capital to businesses and consumers by depressing the yield curve, against which all credit is priced.

In addition, the “reach for yield” was intended to force investors to hold riskier assets, principally equities and property, to foster important and positive wealth effects and thus support final consumption.

Essentially, central banks bought their respective bond markets forcing investors to swap their Treasuries for stocks. An unprecedented “debt for equity” swap!

Investors need to model the reverse flow with the important caveat that the “stock” of public debt held by the central banks need not, indeed will not, be placed on the market for sale. However, the “flows” of new purchases will cease, and these are significant.

Annualising monthly data from the NIPA tables published by the Bureau of Economic Analysis (BEA), private incomes in the US total \$248 trillion of which about \$2 trillion is saved per month (the savings rate has oscillated widely throughout the pandemic peaking at 26% of disposable incomes).

QE runs at \$120 billion per month, averaging about 5% of the value of monthly personal savings. This is the immediate quantum of the cessation of asset purchases by the Federal Reserve.

It is these flows that drive some of the price volatility in financial markets and this reduction in asset purchases will be a headwind for financial markets as money is drained to the “real” economy. In the longer run economic growth will restore them via a rise in personal savings flows as growth and incomes improve.

It is not uncommon for stock markets to endure a “Mid-cycle” correction as these processes unfold; money deployed in the real economy comes back in the form of higher incomes and investment via growth generated later in the cycle. QE complicates the picture because it is a large and abnormal, financial flow.

Finally, central banks wish to see higher interest rates, if only, because macro-economic stabilisation via monetary policy is regarded as more effective and predictable than both QE and fiscal policy.

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## CHINA – REDISCOVERING COMMUNISM

The incorporation of Xi Jinping “thought” into the Chinese communist palimpsest puts Xi on the same pedestal as Mao Zedong. The likely abolition in next year’s Party Congress of the term limits introduced by Deng Xiaoping will make Xi leader for life. This coincides, from a Western perspective, with a lurch to a more authoritarian style of governance that has begun explicitly to direct consumer behaviour, business investment and shareholder rewards. It is a reminder that Chinese and Western modes of thought (and production) are antithetical, raising risks that have always been there, but which have seemed dormant and thus largely ignored by Western business.

In the “Tang Ping” or “Lie Flat” movement there is some evidence of some passive resistance to this authoritarian drift although the movement is principally focussed on protesting against the excessive educational demands placed on young Chinese. It is, nevertheless, becoming clear that the complementarity between East and West, specifically the mutual benefit to China and the US in terms of cheap goods and labour in return for high added value research, tech and development is reaching its limits. Complementarity is shifting to geo-political competition, if not, yet outright conflict.

This development is important to investors for several reasons:

1. The flow of cheap goods which has helped suppress global inflation may be impaired.
2. Chinese willingness to sell to the West (US) but not buy from the West will exacerbate already large financial imbalances, affecting the USD and the Yuan. China can either hold dollars acquired through exports in USD assets (typically Treasuries), or repatriate them, driving up the Yuan and driving down the dollar, with the additional strain on the Chinese money supply and thus, inflation outlook.
3. Attention is likely to turn to Taiwan, where, as our guest speaker, Tom Naughton from Prusik, noted, TSMC is the world’s major supplier of semi-conductors and memory chips.
4. In the very near-term markets are unsettled by the impending bankruptcy of China-Evergrande, the world’s largest property company.

Two recent trends are particularly noteworthy:

**Trade:** Chinese exports to the US indicate how dependent the West has become on Chinese manufacturing. Exports are already close to the pre-pandemic peak. By contrast goods imports have recovered but they are on a far slower trajectory and the balance of trade in services has turned down sharply, by 40% since Q1 2020. These imbalances are likely to become a source of further political and financial tension.

**Markets:** Since the arrest of Jack Ma and the crackdown on internet usage and gaming, the China Tech index has lost some 40% of its value underscoring the anti-market turn in Chinese economic policy.

In the immediate aftermath of the GFC China was an important source of demand when Western economies were weak and struggling to recover. Today, China’s debt dynamics and shift in political objectives make that unlikely to be repeated. Investors need to look elsewhere for growth.

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## THE BIDEN PLAN – PROGRESS REPORT

Joe Biden was elected on a comprehensive policy platform, much of it focussed on economic recovery and reconstruction. To date, the Covid Relief Plan of \$1.9 trillion has been passed, along with an Infrastructure plan of \$1 trillion. A further budget proposal of \$3.5 trillion is with Congress.

The President faces the mid-terms in 2022 and current polling suggest he will lose either or possibly both of his majorities in the Senate and House. He needs to legislate quickly to stand any chance of his programme making it into law since a Republican opposition majority will likely turn his presidency into a one-term, lame duck, incumbency.

In 2021, growth has accelerated from a 3.8% contraction in real GDP in 2020 to a near 7% increase for 2021. However, the Congressional Budget Office (CBO) is more pessimistic for the immediate future, forecasting growth in real GDP of barely 1.5% per annum from 2023 to the end of the decade. On the other hand, that weak forecast comes with an equally tepid inflation forecast (for Personal Consumption Expenditures, the variable the Fed watches) of barely 2.2% i.e., at target.

It is an uninspiring picture, yet should Biden's plans for infrastructure, healthcare and education make it to law, there is a very real prospect of a jump in US productivity that would pave the way for an acceleration in non-inflationary growth and per capita wealth creation.

US business investment is already accelerating and has recovered to pre-pandemic levels. Under normal circumstances, government investment would fall as the cycle matures but the Biden plans, if implemented, would point to a synchronous upturn in private and public investment generating a strong uplift to growth, making the CBO forecasts look somewhat underpowered.

The success or failure of the Biden blueprint to make it into law underscores the impact of politics on the world economic outlook at present and shines a spotlight on the difficulties for policymakers in terms of calibrating the tapering of financial support to the economy.

## MARKETS OUTLOOK

Financial markets must deal with an unusual array of competing factors as they head into the autumn. The recovery has been stronger than anticipated, supply constraints may accelerate price inflation and policymakers stand ready to withdraw the financial support that has been key to underpinning recent performance.

At the same time financial asset prices have moved to discount the recovery in growth, and indeed bond markets have begun to discount a slower outlook to growth as yield curves have flattened over the course of the summer. This poses the question: have we seen the best of markets for this cycle?

It seems that the conditions are ripe for perhaps a "Mid-cycle" correction for the reasons outlined above and as markets calibrate what they forecast would happen with the actual outturn of events. In markets, it is sometimes better to travel than to arrive.

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At the same time fiscal support, strong investment plans and robust consumer balance sheets suggest that any slowdown, should one arrive, should be equally short-lived.

Nevertheless, some important trends are evident - deglobalisation, dislocated supply-chains, increasing authoritarianism - that might put pressure on prices forcing central bankers to tighten policy pre-emptively bringing this cycle to a premature conclusion.

## THOUGHTS ON ASSET ALLOCATION

- Equities have rebounded based on unprecedented fiscal and monetary support. Both these legs supporting the recovery are likely to come under pressure as the year progresses: Covid spending will cease, taxes will rise, and QE is likely to begin tapering in the US followed by the other major economies
- Since Covid assistance was designed to bridge the gap pre and post Covid, investors must ask whether the current rate of activity is sufficiently strong to carry valuations forward on the basis of continuing improvement in profitability. Given that markets are forward looking, how much is in the price?
- Clearly, bond markets are sceptical. Yield curves have flattened, and stock markets have dropped from their recent peaks.
- However, this seems counter intuitive: major banks, led by the Federal Reserve, clearly want to see elevated inflation to take average inflation rates above target. The Bank of Japan has asseverated that current policy will continue until and unless the inflation rate reaches target. Effectively, the Bank of Japan is offering unlimited assistance.
- Should inflation targets fail to be met, it is hard to envisage central banks removing support and QE could be restarted.
- However, inflation is currently rising, and the US and UK are currently experiencing sharply “transitory” (?) rising rates of inflation. This is more problematic today than previously since unlike earlier periods where China would flood global markets with cheap goods, that low point seems to have passed: Chinese labour costs have risen, and trade links are deteriorating. At the same time, reduced immigration is raising developed economy labour costs, swinging the balance of power from capital to labour, thus pressurising margins, and shareholder returns.
- Overall, risk factors seem to have deepened over the quarter.
- In the UK, tax policy, trade policy, logistics bottlenecks and supply shortages argue for elevated levels of caution

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## OUR CONCLUSIONS

It was agreed that the outlook was unusually difficult. Overall, however, it was felt that the strength of the economic recovery post-Covid, coupled to robust consumer finances, argued for further growth in demand and final consumption.

The risks highlighted were noted but also that central bankers following the lessons learned from the GFC would err on the side of too much growth and inflation rather than too little. It was also noted that asset tapering when it came could take decades and that stronger growth would offset the decline in financial flows caused by the cessation of quantitative easing.

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