June 2020 MACRO BRIEF

In association with Cormorant Capital.

TOWN CLOSE
Financial Planning

Very Far From Depression

April and May were bad. June will be better. July and August will be good. That's my forecast for the virus, the policy response to the virus (the lockdown) and for economic activity.

It's not a place I occupy with regularity, but I find myself on the optimistic flank of the investment management herd. A great many of my fellow grazers are concerned that the lockdowns will stay in place for longer – spurred by a second wave of infections – and that ultra-low levels of economic activity will persist for longer too. They worry that things will not return to 'normal' for a very long time and that the post-March increase in equity prices is precipitated by a false hope.

I think the majority are wrong, though some are more wrong than others of course.

Those that make particularly egregious errors of judgment are drawn to comparisons with the Spanish Flu or with the Great Depression.

I'll leave the pathological comparisons between the Spanish Flu and Covid-19 to others better qualified, but I think those that believe the comparison to be a valid one have a lot of work to do to substantiate those claims.

Those drawing on the Great Depression for their model are fooled by the numbers. It's true, if we squint our eyes, the dramatic declines in economic output, falls in stock prices and huge run up in the unemployment count do look a little like those associated with the Great Depression. But that is where the comparison ends.

The Great Depression in the 1930s and the Great Recession in 2008 have their similarities. They were both precipitated by failing financial markets. Failed financial markets don't just see large declines in asset prices, the real damage is the sustained impediment in the flow of credit with banking crises being one of the more visible aspects. Aside from the immediate economic impact, dysfunctional financial systems are an obstruction to recovery. The Great Depression was almost inescapable for that reason and policy mistakes encouraged setback after setback.

The 2008 Great Recession was associated with far fewer policy errors but still, a failed financial system saw the British economy shrink by 6.0 percent over the course of 15 months and it took another 60 months, or 5 years, to recover the lost output.

It looks likely that we will lose in the region of 8.0 or 9.0 percent of output this year. Even more stunning is that almost all of that loss will likely come in just three months. Estimates vary greatly but I'm guessing that the April to June period (Q2) will see output fall by 16.0 to 18.0 percent. To pile guesses on top of guesses, I'm guessing that Q3 brings about an increase of 9.0 to 11.0 percent and that is followed by further gains in Q4 to cut the total loss back to the 8.0 or 9.0 percent range I mentioned earlier.

As big as those numbers are, though, what nourishes my optimism is an awareness that the financial system has weathered this storm. Markets have remained functional throughout; largely owed to a competent policy response from both the Bank of England and HM Treasury at home and other central banks abroad. That being the case, we have all that we need in place for a vigorous recovery as and when the time is right.

And in that regard, my position is not so different from those in the herd forming the centre ground. I expect it will take not much more, if indeed it is more, than two years for us to recover to pre-pandemic levels of output. As far as I can tell, those in the centre ground are beginning to gather somewhere between there and the 3-year mark.

My beef is not with them. It is with those that think what we are facing today is as damaging as the with the Great Depression. It is not.

© 2020 Town Close Financial Planning

5. Some of the spending foregone during enforced social distancing is assumed to be made up. A quarter of the recorded fall in consumption and 10% of foregone investment spending is assumed to be recovered gradually rather than lost forever.
6. Low confidence and high levels of uncertainty encourage a voluntary form of social distancing to persist, easing slowly over the course of a full year and damping spending throughout.
7. Falls in asset prices weigh on GDP, with tighter financial conditions making capital market funding (bond issuance) more costly and limiting the availability of mortgages with higher loan-to-value ratios.
8. Monetary policy (the Bank) and fiscal policy (the government/HM Treasury) supports spending.
9. The UK moves to a comprehensive free trade agreement with the EU on 01 January 2021. (I know, that's the bit that raised my eyebrows too).

Number 9 aside, that all seems quite reasonable to me. Now the conclusions…

1. GDP falls 3.0 percent in Q1 and another 25 percent in Q2 before a recovery of sorts in Q3 and Q4 to bring about a full year contraction of 14 percent.
2. GDP increases 15 percent next year before settling a little above trend at 3.0 percent in 2022. Pre-Covid levels of GDP are reached some time in the second half of next year.
3. Lower demand asserts downward pressure on inflation. CPI inflation averages 0.6 percent between now and the end of the year when it drops briefly to zero percent.
4. Inflation rises duriduring 2021 and averages 2.0 percent during 2022.

There's nothing shocking in the conclusions reached by the Bank. Indeed, their illustrative scenario is not far off the average of independent forecasts. Having said that, I think you'll agree instinctively with me that the risks are weighed to the downside.

In that regard, the Bank has laid out what they consider to be some of the 'key sensitives' or changed conditions which might tip the economy further into the red or slow the pace of recovery.

In no particular order…

1. Growth elsewhere in the world might be higher or lower than is assumed (-12 percent in aggregate this year, +15 percent next year). Lower growth will weigh on UK exports, higher growth will support UK exports.
2. The timing of the recovery may be later, and the speed of the recovery may be slower. Enforced social distancing measures might be in place for a longer period or a shorter period, so too might government support measures like the Coronavirus Job Retention Scheme. At the same time, more of the spending which was foregone during the recovery might prove lost for good.
3. Economic 'scarring' might be more severe. The Bank assumes that productivity levels are lower in the post-pandemic economy – reflecting lower investment, lower R&D, work-from-home effects and less on-the-job training – but productivity could turn out to be lower still.
4. Inflation might drift higher or lower.

Point 4, is worth expanding on. Here's what the Bank have to say…

'In the medium term, CPI inflation will depend importantly on how domestically generated price pressures evolve. But the responsiveness of domestic prices to the Covid-19 shock is very uncertain, given the sharp fall and recovery in demand in the scenario, the partial closure of some markets and significant heterogeneity in

© 2020 Town Close Financial Planning

Experiences across sectors. There is little evidence from past pandemics to draw upon.'

Indeed, as far as I am aware past pandemics are not unambiguously linked with consequent periods of high inflation.

This one might be, or it might not be.

Notwithstanding the uncertainty over the medium term, it is apparent that inflation expectations (both survey-based and market -inferred) remain 'well anchored' around the 2.0 percent target for now.

Barring something outside of the scope of this report (shenanigans in the Straits of Hormuz for example), CPI inflation is likely to drift lower over the course of 2020.

The more demanding question is what will inflation look like three or four years hence. In that regard, and with a benign near -term inflation outlook, there is little need to act early.

The next 6 months or so - up to and including the US presidential elections - will provide us with an opportunity to gather more information and develop our thoughts.

© 2020 Town Close Financial Planning

NOTES.

While a reasonable course of action regarding investments may be formulated from the application of our research, at no time will specific recommendations or customised advice be given, and at no time may a reader be justified in inferring that any such advice is intended. Although the information contained in this document is expressed in good faith, it is not guaranteed. Cormorant Capital Strategies Limited will not accept liability for any errors or loss arising from the use of this document. Readers are directed to our terms and conditions.

Cormorant Capital Strategies Limited, registered in England, number 05346579. Our registered address is 84 Bromefield, Stanmore, HA7 1AQ.

Crown copyright material is reproduced with the permission of the Controller Office of Public Sector Information (OPSI). Bank of England data reproduced with kind permission of the Bank of England.

(1) MSCI United Kingdom Value, Bats 100, Bats 250, Bats UK Small Companies, S&P 500, Euro Stoxx 50, Nikkei 225, MSCI Brazil, MSCI Russia, MSCI India, MSCI China, Financial Analytics (2) MSCI United Kingdom, MSCI World ex Value, MSCI Emerging Markets, MSCI United Kingdom Value, Bats 100, Bats 250, Bats UK Small Companies, Barclays Gilt 1 – 5 Years, Barclays Sterling Gilts, Barclays Sterling Gilts 15+, Barclays UK Government Inflation Linked Bond, Financial Analytics (3) MSCI World, Barclays Global Convertibles, Barclays Global Treasury, MSCI World ex UK Large Cap, MSCI World ex UK Small Cap, MSCI World ex UK Value, MSCI World ex UK Growth, MSCI World, MSCI World Equal Weighted, MSCI World High Dividend, MSCI World Minimum Volatility, MSCI World Momentum, Financial Analytics (4) MSCI World Consumer Discretionary, MSCI World Consumer Staples, MSCI World Financials, MSCI World Health Care, MSCI Industrials, MSCI World Materials, MSCI World REITs, MSCI World Technology Hardware & Equipment, MSCI Telecommunications Services, MSCI World Utilities, Financial Analytics (5) SPDR FTSE UK All Share ETF, SPDR S&P 500 ETF, SPDR MSCI EMU ETF, SPDR MSCI Japan ETF, SPDR MSCI Emerging Markets ETF, SPDR Barclays Gilt, iShares Index-Linked Gilts, iShares Global Corporate Bond ETF, iShares Global High Yield Corporate Bond ETF, Mixed Assets assume separate equal weighted parcels of equity and bond exposure (6) Financial Analytics, overseas exposure assumes equal weight in US, Europe, Japan and Asia (7) Reference National Life Tables, Office for National Statistics, sustainable income assumes life expectancy, a gross 5 percent growth rate, annual income paid out at the start of the period.

© 2020 Town Close Financial Planning

www.townclosefp.co.uk

Town Close Financial Planning Limited is authorised and regulated by the Financial Conduct Authority, reference number 608526. Registered Office: Suite 2, 258A High Road, Loughton IG10 1RB. Registered in England and Wales, Company Number 08390032.

Copyright © Town Close Financial Planning

Suite 2, 258a High Road

Loughton

IG10 1RB

Tel: 020 7993 4898

Email: advice@townclosefp.co.uk