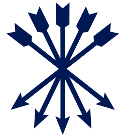


Market Perspective

Sitting tight

Issue 122 | 12 November 2020

Rothschild & Co
Wealth Management

Foreword

A distributable vaccine may be a little closer, and the new US administration may be both more predictable and less capable of damaging business, but in other respects the mood has been darkening as European governments have responded to the second wave of contagion by closing parts of the economy anew.

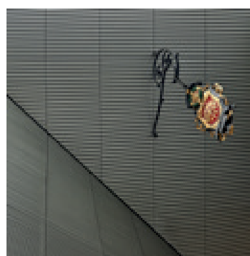
Whether local growth slows, stalls or goes into reverse depends on the severity and duration of the resumed closures. Elsewhere, China seems to be avoiding a second wave, while US closures – at least under the outgoing administration – remain more modest in scale.

The remarkably V-shaped revival in output through to September at least – faster even than we'd pencilled in – tells us that economies can still grow when they're permitted to. People still want to travel, mingle and prosper: talk of a changed, less materialistic Western consumer always looked fanciful (many households simply can't afford not to spend).

The risk of permanent damage is rising once more. But policy will again try to reduce that risk. The question for us as investors – thankfully we don't have to tackle the wider social arithmetic – is whether to focus on renewed short-term losses and risks, or the continued probability of an eventual rebound. As in the spring, we advise sitting tight, with a bias towards business-related assets. We have not been expecting a distributable vaccine soon, but if one emerges, so much the better.

This edition of *Market Perspective* contains a selection of edited posts from our strategy blog. The topics tackled are as weighty as ever, including: a new US administration; the partial returns to lockdown; and – most remarkable perhaps – and an International Monetary Fund that says it's okay to borrow.

Kevin Gardiner and **Victor Balfour**
Global Investment Strategists



Cover:
A very public symbol of the heritage and values of the family business is the Rothschild shield positioned on the exterior wall of our New Court office in St Swithin's Lane, London. The five arrows combined with the family motto is the only advertisement for the business within.

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Values: all data as at 31st October 2020.
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Biden time

The result… took a while, but was clear, nationally and in the electoral college. A successful legal challenge from the loser looks even less likely than a magnanimous concession speech. However, the 'blue wave' was more of a 'blue ripple' – even if the Democrats eventually win the undecided Senate seats – hence the stock market's positive response. A less idiosyncratic president offers a more stable world, while a stymied Congress will keep many anti-business measures at arm's length.

The policies… may not change that much, though executive orders can get a lot done (such as rejoining the Paris climate accord). Trade talks will become more diplomatic, but the US will likely remain hawkish on China – as we've suggested, Trump had a point. In terms of the bigger pictures that pundits love to draw, the centre of gravity in US politics has not shifted far, if at all, in the collectivist direction. There will be more regulation – even with a divided Congress – and the market power of big tech and social media will remain under scrutiny, as will the financial sector (though healthcare may be less at risk than it could have been). But higher business taxes and major spending initiatives are unlikely.

The relevance… of the election to portfolios may be overstated (its wider implications may not be, of course). There are many moving parts in the investment process, and other things often matter more. We suspect, for example, that continuing economic recovery from the suppression of COVID-19 is more important, and likely. Once the immediate response is past, markets may yet take on a more cyclical complexion (a rotation away from tech and communications and a steeper yield curve), even without the blue wave. A short-term fiscal support package is likely (perhaps in the New Year).

Figure 1 reminds us that US markets and the economy have often done better when there has been a Democrat president. However, this was not because of their policies, but because they often had the good fortune to be in office in good times (such as the sixties), while Republican presidents saw more testing times (such as the mid seventies and early noughties). Similarly, divided Congresses have often been associated with disappointing markets – but largely because they coincided with bad news that had little to do with that division (such as the onset of the Great Depression and the bursting of the 2000 tech bubble).

9 November — Kevin Gardiner, Victor Balfour

Figure 1: Markets have fared better under Democrat presidents

Republican presidents tend to be in power during more testing times

President	Inauguration	US stocks (%)	GDP (%)	Inflation (%)	Unemployment (%)
FDR / Truman	1945	6.3	-2.4	2.9	3.3
Truman	1949	23.0	6.8	2.7	4.4
Eisenhower	1953	20.0	2.9	0.9	4.2
Eisenhower	1957	8.0	2.1	1.9	5.4
JFK / Johnson	1961	12.6	5.3	1.2	5.8
Johnson	1961	5.8	5.1	3.3	4.0
Nixon	1969	2.4	3.3	4.5	4.9
Nixon / Ford	1973	-8.8	2.2	8.3	6.6
Carter	1977	1.8	3.2	10.3	6.6
Reagan	1981	6.5	3.3	5.1	8.5
Reagan	1985	15.4	3.8	3.4	6.5
Bush	1989	12.6	2.2	4.2	6.2
Clinton	1993	15.3	3.3	2.8	6.1
Clinton	1997	15.6	4.3	2.4	4.5
Bush	2001	-3.1	2.5	2.4	5.4
Bush	2005	-8.4	1.2	2.5	5.0
Obama	2009	13.0	1.5	2.3	8.8
Obama	2013	13.5	2.4	1.2	6.0
Trump	2017	12.1	1.0	1.8	4.9
Entire period		9.6	2.8	3.4	5.6
Democrat		12.4	3.3	3.2	5.5
Republican		6.8	2.5	3.5	5.8

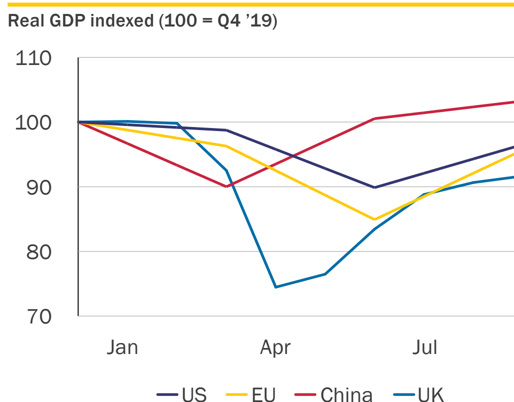
Sources: BEA, BLS, Bloomberg, Rothschild & Co.
Notes: US stock returns are calculated on a 'total return' basis, adjusted for inflation and annualised. GDP and Inflation calculated as compound rates over each discrete presidential term. The unemployment rate (U3) represents an average over the duration of the presidential term.
Past performance should not be taken as a guide to future performance.

So far, so V

Sometimes a picture really is worth a thousand words. Figure 2 shows GDP indices as at the end of the third quarter. Where these lines go next is being called into question by those renewed measures being introduced by governments (see below), but to date the rebound has, if anything, been faster even than we'd dared hope. As the Bank of England (BoE) chief economist suggested back in the summer: "So far, so V".

2 November — Kevin Gardiner, Victor Balfour

Figure 2: Recovering lost ground



Sources: Rothschild & Co.
Past performance should not be taken as a guide to future performance.

A darker mood

Governments are edging back towards wider lockdowns: France and Germany (*and, as announced on 31st October, England*) have announced tougher measures for a month, and other governments are following suit or under pressure to do so.

Our worries, as always, are being amplified and reflected back at us by a reliably sensational media (unsatisfied with a mere pandemic, pessimistic pundits are increasingly drawing comparisons with the plague). Here in the northern hemisphere, the temperature is dropping and the days are shortening. Perspective is scarce again. Renewed volatility has not been surprising: corporate recovery in Europe at least now seems likely to stall or even reverse for a while.

How should investors respond?

We suggest sitting tight, with a bias towards business-related assets. Short-term volatility is scary and unpredictable, but market sentiment tends to overreact (in both directions, admittedly).

There has been progress on treatment since the spring, and for the time being at least fatality rates thankfully remain significantly lower. Most European schools are still open, which helps many parents continue to work. US suppression remains lighter. We don't need a vaccine to move forwards: adaptation – a more socially-distanced world, though not a locked-down one – will do.

Market-wise, stocks have risen a long way since March's low, spurred by a mix of anticipated economic recovery and lower expected interest rates.

We expected economies to rebound briskly, but the bounce has been more V-shaped even than we had been anticipating. Western economies have retraced more than half of the lost ground. China's economy (first in, first out) is bigger than it was beforehand, and faces no second wave.

Clearly, economies can still grow – when they are allowed to. Even with some slowing, in the West we might have been looking at pre-COVID-19 levels of GDP again in 2021 (we still could be, depending on those renewed lockdowns).

At the micro level, evidence from the response to the summer's eased lockdowns, and from online spending throughout, should have put paid to the idea that we are facing a new, non-materialistic world in which people will not want to travel, eat out, be entertained or indeed consume at all.

Arguably, with policy settings likely to stay generous even as economies recover more fully – now with the official blessing of the IMF – the possibility of a period of above-trend, catch-up growth beyond 2021 is rising (European policymakers have in fact responded to the threat of renewed lockdowns with still more monetary and fiscal support). As in the spring, however, we should remember that the immediate impact will be limited: the authorities are not going to close the economy with one hand only to try to keep it open with the other.

Policy settings can help markets by muting lasting economic damage, making liquidity available and underpinning valuations. When real interest rates are low, and likely to stay so, the stock market's horizons are lengthened. In this context, the loss even of a full year's earnings – which, globally, we are still very unlikely to see – would account for only a few percentage points of the stock market's total value.

If earnings were to dive anew, prices would fall more sharply than that, of course, as sentiment

over-reacts – but if earnings eventually rebound, prices may rally again in anticipation.

This view might be criticised as a naïve 'buy on dips' strategy. Naïve or not, many sophisticated pundits have been unable to come to terms with it. In fact, buying a falling market is extremely difficult, psychologically – we know it can be the right thing to do, but on the day we always find a reason to wait a bit longer. And we may have to cast our nets widely: UK and Japanese boats have not been lifted sustainably by the global growth tide for a couple of decades now.

So again: this too shall pass. It is not a plague, we can adapt, and people still want to prosper.

30 October — Kevin Gardiner

Inflation: update

Inflation rates across most major developed economies remain low. Fiscal and monetary policies are loose, but spare capacity is still high.

UK inflation reversed its disinflationary trend in September, but remains well below the BoE's 2% inflation target (*and the Monetary Policy Committee's more recent decision to boost quantitative easing was unsurprising*).

The eurozone moved deeper into outright deflationary territory in September, more significantly below the European Central Bank (ECB) target rate of (just below) 2%, encouraging the ECB to flag additional stimulus at its next meeting in December (*even before the latest lockdown developments – see above*).

The US looks the least deflationary, and has seen headline CPI inflation continue to rise, though slowly in September. The Federal Reserve (Fed) inflation target is couched in terms of the core consumer price deflator, not the CPI, but the latest data also show the core rate moving upwards modestly. Recent changes to the central bank's policy framework suggest it will allow inflation to run higher than the targeted 2% for a while to 'make good' some of its recent shortfall. Inflation has been below the Fed's target for quite some time, apart from brief periods in 2012 and 2018.

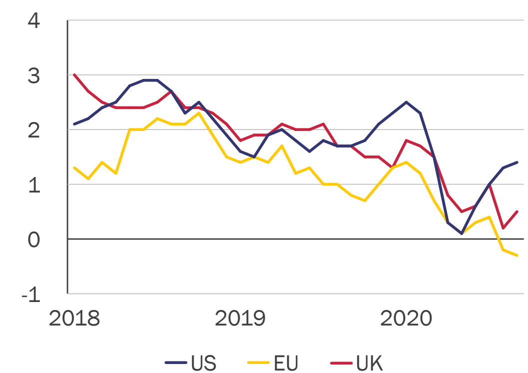
Bond markets implicitly expect inflation to remain low for some time yet. The threat of rising unemployment in coming months, alongside those tighter COVID-19 restrictions, remains a headwind.

For now, then, the forces at play seem more deflationary than inflationary. Longer term, however, we still think inflation will start to dominate. Generous public policy settings may continue to spur demand even as private sector confidence revives, and we see effective demand eventually outpacing supply. And in contrast to much received wisdom, we do not see that as a good thing. Inflation targets exist to limit inflation, not to encourage it.

21 October — Charlie Hines

Figure 3: Headline inflation rates

(year-on-year %)



Sources: Bloomberg, Rothschild & Co.
Note: Correct to 30th September
Past performance should not be taken as a guide to future performance.

Inflation: get real

If inflation does eventually return, what should (or can) investors do about it?

Nominal assets such as cash and bonds usually seem most at risk in such an environment, while more 'real' assets, such as stocks, seem least exposed. Many businesses have some pricing power, and can often pass input costs onto consumers.

However, the oil shock of the 1970s and the period of excessive inflation in the early 1980s saw poor 'real' returns for cash, bonds and stocks (figure 4).

There were many things going wrong then, not just inflation. The oil embargo and surging oil prices hit output and growth; governments failed to keep interest rates above the inflation rate, undermining monetary credibility and the real returns on cash and bonds; and industrial relations were grim, adding to pressures on profitability.

And some sorts of inflation are more difficult for stocks in particular to cope with. The most common demand-pull variety – 'too much money chasing too few goods' – sees profit margins effectively bid higher. But the 'cost-push' inflation of the seventies – driven by surging oil prices and unit wage costs – hit companies without pricing power hard.

How different might the 1970s episode have been if the inflation was accompanied by better growth and positive real rates? Would the deflation of the 1930s have been as bad without the Great Depression? To answer that, we can't simply add back the inflation to the real returns, because those real returns would likely have been very different in different circumstances.

We need to think about the likely context now.

If inflation were to revive alongside heathy growth and with continuing negative real rates, stocks might be able to deliver positive real returns, but cash and bonds would likely struggle. There is probably a range of 'moderate' inflation – above today's but lower than the seventies – in which corporate pricing power is intact and wider disruption is held at bay.

If inflation rises alongside healthy growth and positive real interest rates, there may be more of a case for owning cash, and even bonds, once the higher rates are 'priced in' to bonds and stocks, of course: bonds and stocks are most vulnerable when expected interest rates are rising.

But if inflation were to rebound alongside poor growth and with negative rates persisting, then – as in the 1970s – there might be few places to hide in conventional portfolios.

For the time being, we think the likely eventual revival in inflation will be moderate in scale, and, initially at least, accompanied by respectable growth but continuing low real interest rates – the first of the three scenarios sketched above.

7 November — Victor Balfour

Figure 4: Long term real returns: 1900-2020

(inflation-adjusted and annualised, %)

Inflation regime (proportion of time)	US cash	Treasuries	US stocks	Gold (post '70)
High (23%)	-4.5	-5.9	-2.6	9.1
Moderate (63%)	0.6	3.3	12.0	0.4
Deflation (14%)	5.2	8.8	-1.1	0.2
Total	0.0	1.8	6.7	2.2

Sources: Shiller, Bloomberg, Rothschild & Co.
Notes: Calculated monthly and based on year-over-year US consumer price inflation. High: >5%; Moderate: 1-5%; Deflation: <0%.
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IMF: this time is different

"Nobody told us we could do that" – Sidney Webb, when the Conservative government took the UK off the gold standard in 1931.

As if 2020 weren't strange enough, now the IMF has gone Keynesian. Its latest fiscal monitor argues that even as developed world government debt ratios approach 100% of GDP, politicians shouldn't respond by raising taxes or cutting public spending, but carry on borrowing and invest for growth.

Cutting deficits quickly now, the Fund argues, would put recovery at risk, deepen poverty and exacerbate inequality.

We agree: there is no need for urgent retrenchment. If investors were deeply unhappy about the debt, bond yields would be rising, even in the face of all that central bank buying (quantitative easing). They aren't, and the IMF is knocking on an open door.

Some observers will have mixed feelings. Clearly these are special circumstances – but circumstances have been special in the past, only for the IMF to urge fiscal austerity and monetary rectitude.

Think of the austerity programmes after the Global Financial Crisis; the many emerging economies that had to "adjust" before being offered Fund programmes; and the countless "progressive" ambitions and manifestos criticised for their proposed borrowing plans (figure 5).

As the Labour ex-minister Sidney Webb said when he watched a Conservative government take the UK off the gold standard in pre-IMF days: "Nobody told us we could do that".

Indeed. Nobody told governments they could borrow this much and get away with it. Most people, most of the time, led by the IMF, and cheered on from 2009 by Reinhart and Rogoff's hugely influential book *This time is different*, told them that they couldn't. The irony in that book's title may yet rebound on its authors and the wider economic establishment.

It must all seem rather unfair. Not only are today's (mostly) conservative governments borrowing far more than opposition parties

would have dared to, but the IMF is now positively encouraging them to do so.

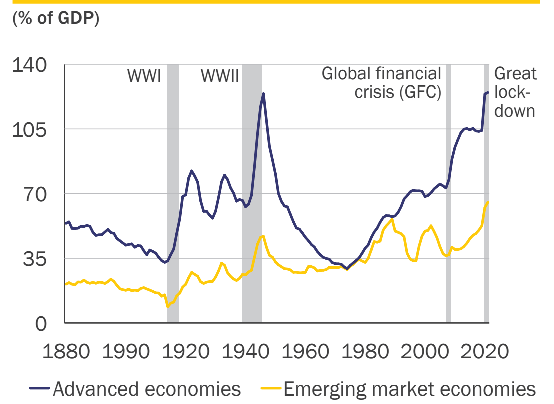
However, while we agree – and have been arguing for many years – that debt levels are more sustainable than feared, and that there is no pressing need to retrench, we nonetheless feel a little uneasy at this latest instance of institutional mission creep.

We can still imagine circumstances in which big borrowing is not tolerated. It may depend on who is doing the borrowing (or, Mr Webb, the devaluing) and why; and what the monetary counterparts to the borrowing are. Borrowing and printing together would be scary.

And just as gross financial liabilities may not be a binding constraint on growth, they are equally unlikely to be a sustainable source of it.

14 October — Kevin Gardiner

Figure 5: Historical patterns of general government debt



Source: IMF, Rothschild & Co.
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Economy and markets: background

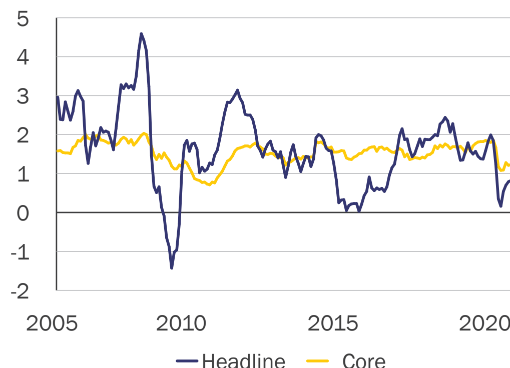
Growth: major economies

Business optimism: standard deviations from trend

Source: Bloomberg, Rothschild & Co
Composite of the forward-looking components of manufacturing surveys from China, Germany, Japan, UK and US loosely weighted by GDP

G7 inflation

%, year-on-year

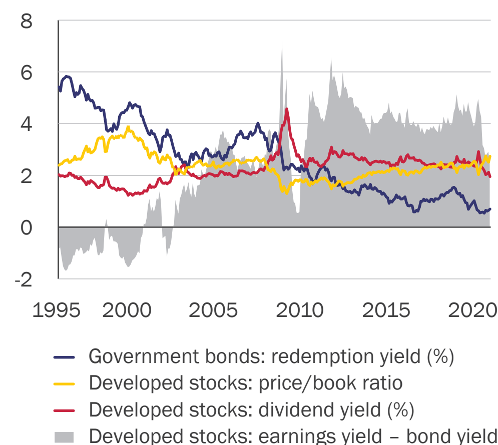


Source: OECD, Bloomberg, Rothschild & Co

Stocks/bonds – relative return index (%)

Source: MSCI, Bank of America Merrill Lynch, Bloomberg, Rothschild & Co

Stocks/bonds – relative valuations



Source: MSCI, Bank of America Merrill Lynch, Bloomberg, Rothschild & Co

Selected bonds

Current yields, recent local currency returns

	Yield (%)	1yr (%)	3yr (%)
10-yr US Treasury	1.0	9.6	19.6
10-yr UK Gilt	0.4	3.5	11.7
10-yr German bund	-0.5	1.5	7.9
10-yr Swiss Govt. bond	-0.4	0.0	2.7
10-yr Japanese Govt. bond	0.0	-0.5	0.9
Global credit: investment grade (USD)	0.9	5.0	15.6
Global credit: high yield (USD)	5.1	4.7	13.8
Emerging (USD)	3.9	5.9	15.8

Source: Bloomberg, Rothschild & Co

Selected stock markets

Dividend yields, recent local currency returns (MSCI indices)

	Yield (%)	1yr (%)	3yr (%)
World: all countries	2.0	10.9	27.8
Developed	1.9	10.3	29.0
Emerging	2.1	14.6	17.9
US	1.6	17.9	45.1
Eurozone	2.2	-4.1	2.5
UK	3.7	-13.1	-6.8
Switzerland	2.8	1.7	21.0
Japan	2.2	2.5	2.7

Source: Bloomberg, Rothschild & Co

Selected exchange rates

Trade-weighted indices, nominal (2000 = 100)

	Level	1yr (%)	3yr (%)
US Dollar (USD)	108	-2.0	2.1
Euro (EUR)	130	5.8	5.4
Yen (JPY)	94	0.6	8.3
Pound Sterling (GBP)	78	-0.3	1.7
Swiss Franc (CHF)	168	5.1	10.2
Chinese Yuan (CNY)	134	3.8	1.3

Source: Bloomberg, Rothschild & Co

Commodities and volatility

	Level	1yr (%)	3yr (%)
CRB spot index (1994 = 100)	154	-15.3	-19.9
Brent crude oil ($/b)	43.6	-30.2	-31.3
Gold ($/oz.)	1,882	29.0	47.6
Industrial metals (1991 = 100)	265	6.0	-0.2
Implied stock volatility: VIX (%)	24.8	105.5	119.7
Implied bond volatility: MOVE (bps)	46.2	-28.3	-2.3

Source: Thomson Reuters, Bloomberg, Rothschild & Co

Data correct as of 31st October 2020.

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Notes

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