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Policy reversals, Andy Davey, 21 Jan 2021

Sigh of relief

As Joe Biden was inaugurated as the 46th president of the United States last Wednesday, a collective sigh of relief, at the return of civility, decency and a genuine interest in the wellbeing of all citizens, could be felt around the world. Perhaps not one of the great inaugural speeches of US history, and one delivered by a man with qualities best described as moderate temperament and unifying empathy rather than ambitious dynamism. Yet Biden brought himself out of retirement to face arguably the most challenging set of circumstances ever presented to an incoming president. A raging pandemic and its economic consequences, a flailing US democracy, systemic racism, America's fallen standing in the world and the "cry of survival from the planet itself". Only time will tell whether Biden can rise to this challenge and echo contributions made by those past holders of the office also labelled 'moderate in character', such as George Washington, Abraham Lincoln and FD Roosevelt.

Despite his strong centrist credentials, Biden's greatest challenge could be in persuading Republicans to join forces with his side to 'build back, better and greener'. This is by no means a given, but he is hitting the ground running with an experienced team already in place. One of his 'heavy hitter' appointments is Janet Yellen as Treasury Secretary. When Yellen faced the Senate Finance Committee for approval of her nomination on Wednesday, the former chair of the US Federal Reserve (Fed) urged lawmakers on Tuesday to "act big" on coronavirus relief spending, arguing that the economic benefits far outweigh the risks of a higher debt burden.

Yellen also indicated that she would like the Treasury to "term-out" the debt – going beyond the current longest of 30-year debt, issuing 50-year and 100-year bonds. This would effectively neutralise the cost of near-term debt servicing by tying it to the prevailing ultra-low interest rate levels, while postponing repayment into the very far distant future – 'kicking the can' into the next century.

We estimate, under current bond market conditions, a US Treasury of 100-year maturity would carry a yield of a bit under 2¼%. That level is consistent with the mandate of maintaining a stable debt-to-GDP ratio, as it roughly matches longer-term GDP growth expectations and would therefore be acceptable to the Treasury, and perhaps would even help to convince fiscally conservative Republicans that this constitutes a viable investment, rather than merely a millstone of debt for future generations.

So the Fed's meeting this week is very important for both bond and equity markets. Despite Yellen's promises of brave actions, long-dated yields hardly budged last week. The expectation is that the Fed will soak up the new issuance. It will need to indicate a willingness to buy more, and that it will be willing to buy long – decisions which were partially expected in December but not forthcoming. It will be crucial for the Fed to get its tone right, avoiding accusations of losing independence by bowing to political pressure, or being over-constrained by Treasury dogma.

Stock markets appeared happy enough and continued to rise, providing one of the most positive receptions of an inauguration in history. While pleasing for investors – ours included – it is increasingly putting markets out of alignment with the most optimistic of assumptions. As we have noted before, and consider in more depth in the separate article on earnings below, current valuation levels are deemed 'rationally exuberant' – on the basis that declined corporate earnings yields are still exceeding the even lower government bond yields by roughly the same margin as they have historically. As earnings are anticipated to recover when pent up demand catapults the economy back to above the previous rate of growth, valuation levels should normalise, while potentially providing further market upside should the recovery prove stronger than anticipated. Unfortunately, this also assumes central banks will keep interest rates and bond yields supressed, even if economic activity roars back to life – a scenario at odds with itself.

This chain of assumptions makes markets vulnerable to setbacks, due either to future corporate earnings growth or changes in bond yields, with or without further central bank action. The latter is why our second article this week discusses the prospect of inflationary pressures arising from the new US President's fiscal stimulus plan. It is true that central banks have stated they are willing to tolerate a temporary overshooting of their inflation targets, but the question is by how much and for how long, or rather whether markets are pricing-in higher levels of (inflation-driving) growth than central bankers may deem acceptable if they want to remain aligned with their longer-term monetary stability targets.

So, 'inflation watch' has become essential viewing for investors in 2021, but it is not just for this reason that inflation has re-entered broader media coverage recently. People's experience is that excessive government spending fuelled by central banks buying up debt eventually leads to runaway inflation, which undermines monetary stability and in its wake the economy and prosperity. While this observation has historical merit, it is not quite that simple. Put simply, if there is more demand which is also backed up by more money at hand than there is supply, then prices are bid up. However, such price pushes only turn into inflation (sustained periods of rising prices), if wage earners can compensate those rising prices through rising wages. Economists currently neither expect that there will be a sustained lack of supply of goods and services, nor do they expect wage earners will have a strong enough a negotiating position to realise inflation-beating pay rises while there is also mass unemployment.

If the uber-optimists have their way, and economies bounce within the shortest of time periods from the worst recession on record to the biggest economic boom on record, then it is conceivable that mass unemployment will turn to wage-increasing labour shortage. However, that is not a particularly realistic

expectation, and so it is probable that (just as was the case in the multi-year period before the pandemic), low levels of unemployment do not lead to galloping wage inflation.

This does not mean inflation will never rear its ugly head again, but it is far more likely to be an issue further into the future, if de-globalisation and a shrinking working age population – coupled with migration prevention – reverses the deflationary forces of the past decades and rebalances the distribution of GDP between capital and labour. Not something of global concern for the next couple of years maybe, but perhaps a more isolated issue for countries seeking societal salvation in erecting barriers to exchange of both goods and labour.

Nevertheless, even in the absence of actual inflation, the mere fear of it could become a risk to 2021's equity markets, which have grown dependent on low interest rates, while also requiring forthcoming above-average economic growth. We remain positive about the prospects for the global economy, but at the same time retain our professional wariness which has us monitor the economic and capital market variables very closely, as we steer investment portfolios though these uncharted waters.

Are earnings keeping up with expectations?

Despite the upheaval of the past year, in investment terms we have started 2021 in much the same position we were 12 months ago – before the pandemic. The extraordinary support provided by central banks has kept the global financial system awash with liquidity. US stock markets are trading at all-time highs, while major equity indices all over the world have rallied to their highest levels in months. Inevitably, corporate earnings underlying equity prices have not kept pace. Market moves have been driven not by current economic reality, but by economic expectations – the promise that strong growth is just around the corner. In the meantime, equity earnings yields are still much better than central bank-suppressed bond yields. This somewhat rational share price exuberance is giving some investors valuation vertigo, believing that markets have become too expensive and fearing that – sooner or later – reality will have to set in.

This is why corporate earnings reports are crucial. We are quite some way into the reporting season for the last quarter of 2020 but, of course, these results give us only a partial hint of where company profits are heading in 2021.

The US equity markets are the world's largest and tend to dominate global market moves during reporting seasons. Coming into this earnings season, consensus expectations were that US companies would report an aggregate fall in earnings per share (EPS) of around 10%. But from the early data, those expectations seem to be too bearish.

Earnings surprises can sometimes be a bit of a game, with companies intentionally downgrading EPS forecasts as reporting season approaches, so that they can smash those dour expectations and boost share prices. As such, EPS surprises are usually more important for what they say about direction of travel rather than the absolute numbers.

It is good news, then, that 91% of the S&P 500 companies that have reported so far have beat consensus earnings expectations. That is well ahead of the 75% average rate seen over the last four quarters. The size of these surprises is also impressive. So far, companies are reporting aggregate EPS 21.5% above

expectations – compared to the 11.5% average for the last four quarters. In absolute terms, the year-on-year figures still make for dire reading, but Goldman Sachs economists expect that growth still improved relative to Q3, when aggregate EPS for the S&P 500 fell by 8%.

Results and forecasts vary across different sectors, with more cyclical companies expected to post the largest declines. Financials, meanwhile, have fared well. US investment bank Morgan Stanley reported a 51% jump in EPS over the final three months of the year, with revenues and profits both smashing analyst expectations. The results give the bank its highest annual earnings figure and cap a positive earnings season for US investment banks. Goldman Sachs posted similarly buoyant figures, while Bank of America – much more heavily involved in consumer lending – had more muted results. This highlights the different fortunes of America's investment-focused versus lending-focused banks. The capital market traders have had a good time once again.

Preview reports have suggested the positive surprises are down to overly-pessimistic downgrades in Q2 and Q3 of last year, as well as a better-than-expected macroeconomic backdrop. Policy has been a key support for businesses throughout the pandemic, and this is still very much the case. Extraordinary monetary easing combined with fiscal stimulus measures have staved off the worst case – mass bankruptcies – for many, while allowing those who can, to operate in favourable conditions.

These reporting results are, of course, backward-looking. But the fact that earnings have held up better than expected – even as the pandemic became significantly worse into the year-end – is a positive sign. The first quarter of this year could well be as difficult for businesses and individuals as any during the crisis, but the outlook after that looks significantly better.

Policy will once again prove crucial. The appointment of former US Federal Reserve Chair Janet Yellen as US Treasury Secretary is a sign that monetary and fiscal stimulus will be significant and coordinated – to the benefit of the US economy. Markets have also reacted positively to the Democratic Party taking control of the US Senate, as the Biden administration will now have more power to enact spending measures. Goldman Sachs subsequently upgraded their aggregate EPS forecast for the S&P.

Earnings expectations from here – particularly into Q2 and beyond – will be critical for market movements. The chart on the next page shows Bank of America's Global Earnings Revision Ratio, which last month jumped to a two-year high. In this sort of environment, equities tend to do very well. According to the bank, this "suggests a sustained earnings recovery could support the next leg of an equity market".

Chart 10: Global Earnings Revision Ratio

Source: BofA Global Quantitative Strategy, MSCI, IBES

Our own work, using a slightly different dataset from Factset, shows the revision ratio may have reached a peak a week ago and may have turned slightly lower since. The change in the revision ratio (rather than its level) may be as important for equity prices. Earnings news will have to remain very positive in the latter part of the season to maintain its impact on markets

The enormous variability of current conditions makes judging earnings for this year difficult, but the reports for the end of 2020 tell us that companies are resilient and resourceful. Positive signs are certainly there.

The Biden reflation

Officials within the Biden administration have stated that the new US government "will take action – not just to reverse the gravest damages of the Trump administration – but also to start moving our country forward". Few things on the agenda promise to move the US forward more than Biden's fiscal plans.

The White House has already lined up a $1.9 trillion COVID relief package – only a month after Congress agreed $900 billion to support the virus-ravaged economy. The plans have already faced a backlash from fiscally conservative Republicans (who only seem to care about the deficit when in opposition), but with Biden's Democratic Party now controlling both Houses of Congress, there is only so much Republicans can do to dilute the measures. The total size of the package could be pushed as low as $1 trillion, but even at that level it would mean a fiscal boost of 8.5% of GDP.

Further spending is sure to follow, and not just on emergency relief. Infrastructure and green investment plans to "Build Back Better" were pillars of the Biden campaign and, with at least two years of Democrat control of the US legislative ahead, the fiscal drive is bound to accelerate, even if spending of a more structural nature will require increased bipartisan support.

Given the recent uptrend in stock markets, the market verdict on this seems clear. In the midst of the deepest global recession on record, productive public spending should override fears of adding to the national debt pile. Nevertheless, recent media coverage has warned of the affect this may have on inflation,

in both the long and short-term. Given the current recessionary environment – and the global disinflationary pressures we have seen for more than a decade – this may be somewhat surprising. But the context of Biden's spending measures is, of course, the extraordinarily accommodative monetary policy by the Fed that paves the way for taking on more debt at much diminished cost.

Not only is it pinning down interest rates and pumping liquidity into the financial system through its bond purchases, the Fed has also committed to a new framework for monetary policy – one that is structurally biased toward reducing unemployment while having a broader view on the definition of price stability. The consensus drawn from various Fed speeches and statements is that it will tolerate overshooting its 2% inflation target for at least a year before it considers tightening policy. And, with growth-intensive policies coming out of the US Treasury via Janet Yellen, all the policy dials are being turned towards expansion.

It is important here to distinguish between short and long-term inflationary impacts. The pandemic has crushed global demand and sent unemployment skyward – both of which put downward pressure on most prices that will not quickly reverse. Inflation in the very near-term is unlikely to come from gushing demand, but can really only come from supply side constraints, either through higher commodity prices or supply bottlenecks. While these can harm the recovery, cost-push inflation usually does not become sustained, as it is more likely to either wash out over time, or be translated into just incremental price rises across the wider economy when demand is strong enough.

More sustained inflation usually comes from a tightening labour market. If employment bounces back strongly later in the year, inflation could feed into higher wages. Policymakers firing both monetary and fiscal stimulus barrels will support these dynamics. Inflation making a return in this way is not necessarily something to be feared in the short term. Indeed, it is likely to be welcomed by markets and central banks as a spur for global growth. But regardless, just as has been the case during recent years of historically low unemployment, there are many factors that will likely stop prices from running away. Technological progress and productivity growth tend to be well-known variables preventing run-away inflation. A more general consideration is also whether the ageing global population will tilt increasingly from consumption towards savings or investment, with a higher propensity to save usually keeping down price rises. On the latter, the jury is still out, but another intriguing question is whether a result of the pandemic is that people generally prefer having some more "money under the mattress" as they have lived through months of uncertainty.

Over the longer-term though, policy will likely take a backseat to structural changes as a driver of inflation dynamics. Competitive pressures from globalisation have been a key factor in keeping inflation down for decades, but in recent years this trend has reversed. Even with Trump no longer declaring trade wars, global supply chains could still become more regionally focused – particularly given the disruption of the pandemic. And again, developments in the global labour market are likely to be key. The global labour supply has been strong for decades, thanks to the integration of China and other developing economies with their growing populations into the world order. But there is only so far this can go. We are already witnessing the growth of China's middle-income population, no longer willing to provide the work bench for the western world's consumers, while population growth is also slowing. Whether the resulting cost of labour price drivers can be offset by increases in productivity cannot be taken for granted.

These longer-term inflation trends are one thing, but what it means for investment in the shorter-term is another. The demand stimulation brought about by the extraordinary monetary and fiscal support

throughout this crisis has made the post-pandemic reflation trade look like a good bet. Good exposure to this comes in the form of inflation-linked bonds, which have been rising in price ever since the market sell-off in March.

With central banks pinning down nominal bond yields, real (inflation-adjusted) yields have kept falling as inflation expectations rose. There are complications here as well. US inflation-linked bonds tend to be heavily influenced by oil prices – which are themselves thought of as a proxy for global economic activity. But the oil market is hugely distorted by supply controls from its biggest producers, as we witnessed spectacularly last year. With oil prices rising, the incentive for suppliers to loosen controls increases, meaning that oil prices can only go so high. Inflation expectations are likely to react to this, but at the same token can get support from a broader rise in prices – as mentioned before more likely to filter through in the form of higher wages.

Regardless, higher inflation expectations as an expression of improving expectations for a strong rebound in growth are also good for equities, particularly in the early stages of a recovery. Post-recession activity rebounds favour a rotation into smaller and mid-cap companies – which we have already seen play out in markets over the past months. Where things go from here will depend – again – on the labour market. Employment is sure to recover as the vaccine rollout takes effect, but these things take time, and even when unemployment fell to its lowest under President Trump, there was very little sign of rapidly rising wages.

The other main determinant is policy. We are only at the beginning of Biden's fiscal flourish, but already there is talk that the recovery could turn too hot and force the Fed to tighten policy quicker than expected. If the central bank did so this year, it would almost certainly choke off any rebound. But sooner or later, strong growth will need to be met by a withdrawal of support. Only then will bond yields see a consistent rise, leading to more rotation in asset markets, not only from defensive to cyclical, but also from those spurred by low rates (Growth) to those disadvantaged by them (Value).

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25th January 2021

Global Equity Markets

Market	Fri 16:00	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	6689.6	-0.7	-46.1	⬀	↗
FTSE 250	20614	-0.0	-1.7	⬀	↗
FTSE AS	3784.1	-0.5	-19.7	⬀	↗
FTSE Small	6387.2	+0.9	+59.7	↗	↗
CAC	5550.3	-1.1	-61.4	→	↗
DAX	13871.5	+0.6	+83.7	↗	↗
Dow	30996	+0.0	+4.4	⬀	↗
S&P 500	3836.2	+1.1	+40.7	⬀	↗
Nasdaq	13514.1	+3.1	+401.5	↗	↗
Nikkei	28631.5	+0.4	+112.3	↗	↗
MSCI World	2765.6	+1.9	+50.8	↗	↗
MSCI EM	1406.1	+3.5	+48.0	↗	↗

Top 5 Gainers

Company	%
Johnson Matthey	+8.1
Sage	+7.1
Ocado	+6.6
Pearson	+6.2
Ashtead	+5.7

Top 5 Decliners

Company	%
John Wood	-13.9
TUI	-11.3
easyJet	-7.3
Int'l Consol Air	-7.2
Micro Focus Int'l	-6.6

Currencies

Pair	last	%1W
USD/GBP	1.368	+0.6
GBP/EUR	0.890	-0.1
USD/EUR	1.22	+0.8
JPY/USD	103.76	+0.1
CNY/USD	6.48	-0.0
Bitcoin/$	32,374	-10.7

Commodities

Cmdty	last	%1W
Oil	55.30	+0.4
Gold	1855.3	+1.5
Silver	25.50	+3.0
Copper	362.8	-1.0
Aluminium	1997.5	-0.4
Soft Cmdties	414.2	-1.5

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.31	+0.02
UK 15-Yr	0.54	+0.02
US 10-Yr	1.09	+0.01
French 10-Yr	-0.28	+0.04
German 10-Yr	-0.51	+0.03
Japanese 10-Yr	0.05	+0.01

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.2	19.7	15.3	13.9
FTSE 250	1.9	19.0	21.1	15.1
FTSE AS	2.9	19.4	16.0	14.0
FTSE Small x Inv_Tsts	1.8	17.8	-	14.9
CAC	2.0	22.6	17.7	14.4
DAX	2.6	23.7	15.9	13.1
Dow	1.9	22.6	20.7	15.9
S&P 500	1.5	28.1	23.2	16.9
Nasdaq	0.7	39.3	31.1	19.3
Nikkei	1.4	29.6	25.2	17.3
MSCI World	1.8	26.6	21.8	16.1
MSCI EM	1.7	22.4	16.9	12.3

UK Mortgage Rates

Mortgage Rates	Jan	Dec
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.79	1.81
3-yr Fixed Rate	2.05	2.05
5-yr Fixed Rate	1.98	2.00
10-yr Fixed Rate	2.55	2.55
Standard Variable	3.62	3.62

* The *% 1 week* relates to the weekly index closing, rather than our Friday p.m. snapshot values
** LTM = last 12 months' (trailing) earnings;
***NTM = Next 12 months estimated (forward) earnings

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Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet and is only valid for the publication date of this document.

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