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'I've heard the Budget has some unpleasant side effects. I might refuse it'

Source: Matt, 3 March 2021

Stock markets are finding they cannot have it both ways

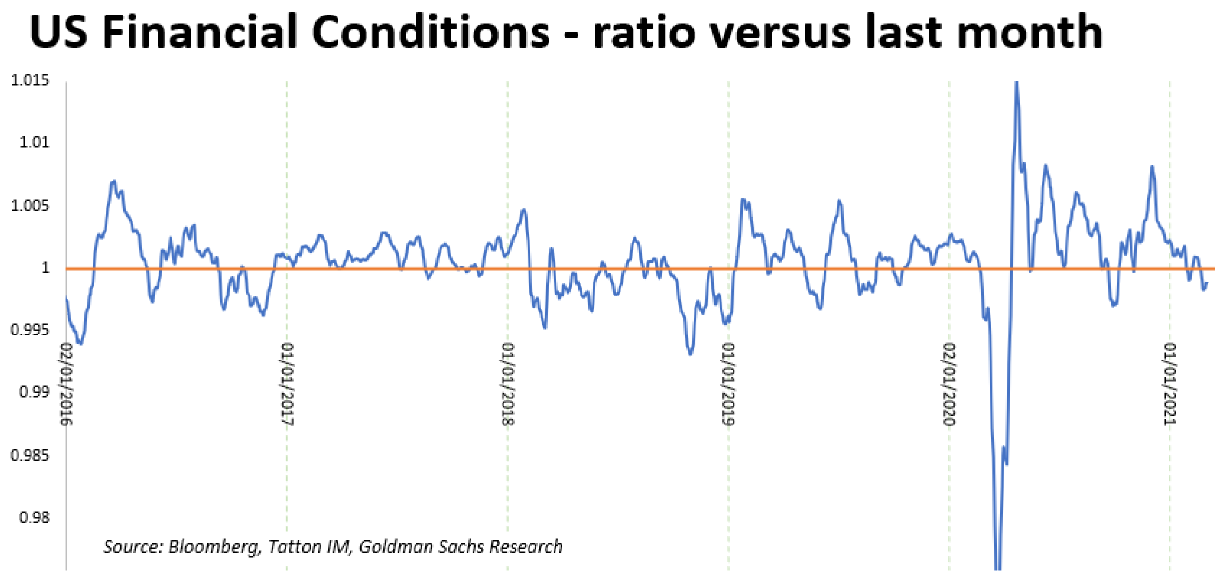
Another week of bond market price falls has pushed ten-year government bond yields upwards everywhere except Japan. The US ten-year yield experienced the biggest rise of the developed world, up almost 20 basis points (0.2%) since the previous Friday to a yield of 1.6%. As was the case over the previous week, that fed through to US equity markets, with the S&P 500 down about 2% and the NASDAQ 100 down 4%, with a knock-on to global equity markets. UK equity and bond markets are flat in sterling terms, partly because the GBP is about 2% weaker against the USD, which is rising against most currencies.

Global financial conditions are relatively easy but, at the moment, they are not getting easier. We have reached one of those fascinating, if unfortunate, points where capital markets are, in themselves, quite a big determinant of how economic growth turns out later this year. And that is when market moves become a real focal point for central banks.

The US economy is a massive part of the global economy, but its markets are even more dominant. When US bond markets and US equity markets start falling, it has an outsize impact on the global economy. The total asset value of the market has declined, and that inevitably affects liquidity. When the US dollar also starts rising, that has an additional tightening impact.

Goldman Sachs has a set of Financial Conditions Indices designed to show how short-term rates, currencies, bonds and equity markets are likely to impact economies. Their work has shown that the indicators' levels matter and there is a lot of comfort to be taken from the fact that the US indicator remains very close to its historically very low levels. Elsewhere, financial conditions appear to be reasonably supportive, albeit not at historic lows.

However, the changes in the index level also matter. In this respect, the recent moves on the US index send a more mixed message for growth. Europe's indicator is still easing marginally but, for China and the UK, their respective financial conditions indices have – like in the US – been moving tighter since the start of the year. Now the dominant US indicator has started an upswing. The chart below shows that US indicator as a ratio of its level one month ago.



When the ratio falls below one, this indicates conditions have tightened over the month, and that markets are no longer helping the economy. Note, however, that the impact takes about six months to feed through.

Of course, this does not mean the US economy will start declining. The roughly $1.9 trillion fiscal package promoted by the Democrat Party is on track to pass into law by 14th March, the date when federal employment benefits cease under current legislation. That will almost certainly ensure the US economy will be doing well through this year and into next. Goldman Sachs' economists have now raised their 2021 real GDP growth to 6.9% despite the tightening financial conditions. And elsewhere, as with last week's UK Budget, fiscal measures continue to be supportive.

However, the rise in bond yields may start to be an issue if it goes much further. In the US, the Federal Reserve Open Market Committee is faced with a problem about how to reset market expectations of their behaviour, given the recent policy reset. We discuss this in a separate article below.

Last year, the US Federal Reserve (Fed) made it quite clear the best way to support the economy was by keeping yields at low levels through bond purchases. At the same time, the Fed made it clear the government should also step up to spend. The implication seemed to be, "you issue the bonds, we'll buy them". Now we have reached the point where the government is doing its part, but the market is much less sure the Fed will keep its side of the supposed bargain.

Fed Chair Jerome Powell, in an event hosted by the Wall Street Journal last Thursday, appeared to be rather equivocal about the bond market. He agreed that the Fed would be prepared to step in if the US Treasury market was "disorderly", but offered nothing to suggest current market conditions were in that state. Many bond holders were therefore left wondering precisely where, when, and how the promised support might appear. Perhaps more importantly, there was a distinct sense that current conditions were nowhere near bad enough to bring it about. With not a hint of alarm from the Fed Chair, some have become worried that it might be only at yields a lot higher than current levels. Putting it another way, the stock market-supporting "Fed put" may still be there, but everybody got the strike price wrong.

Still, as noted last week, the growth outlook for equity markets is still good, if perhaps slightly more challenged by the rise in yield levels. Even though financial conditions have tightened relatively, overall policy is still supportive. The global economy will have a path defined by the (probable) end of the pandemic rather than the cost of capital. That means equity markets may suffer stiffer headwinds from bond yields, but as corporate earnings grow at the same time, they are unlikely to be destabilised beyond temporary sell-offs.

We comment on the UK Budget in the next article. The Chancellor of the Exchequer trod a careful path, but the reaction to the proposed 1% NHS pay rise tells us there will be enormous pressure on spending restraints And, when we get to the Autumn Statement, some of those implicit spending restraints may have to loosened, or risk the wrath of an austerity-exhausted electorate.

The Government will be hoping, as are we, for a really solid bounce to the economy over the summer. Not only would this replenish tax coffers, it would also mean a way to avoid making clear those 'hard choices' of spending cuts in real terms that it was simply not politic to discuss in Wednesday's Budget.

February review

February was a positive month for global equity markets which rose 0.5% in sterling terms. The best performing equity market was the UK large cap index up 1.6%, a beneficiary of the vaccine rollout as well as the announcement of a reopening plan for the economy. Cyclical industries continued to benefit from expectations of increased global consumption throughout the rest of 2021.

Whilst the US main market rose 0.9% in February, the growth focused technology sector was impacted by rising inflation expectations and increased scrutiny from competition authorities leading to it falling -0.8%. Fiscal policy was the other key theme discussed with the US Treasury Secretary Janet Yellen indicating an upcoming rise in the corporate taxes to 28% and Rishi Sunak expected to increase corporation tax in the UK budget during March.

Positive global economic data alongside a continuation of easy monetary and fiscal policy led to medium-term global bond yields rising significantly. Rising yields indicate future global growth and potential for interest rates rises. This led to a selloff in major equity markets at the end of the month with specific reference to Emerging Markets as the People's Bank of China signalled policy tightening and Biden indicated a shift of supply chains away from the region. Even on the back of short term weakness in equity markets the outlook for 2021 remains positive with supportive fiscal and monetary policy providing continued support for stock market driving corporate earnings growth on the back of a strong cyclical recovery.

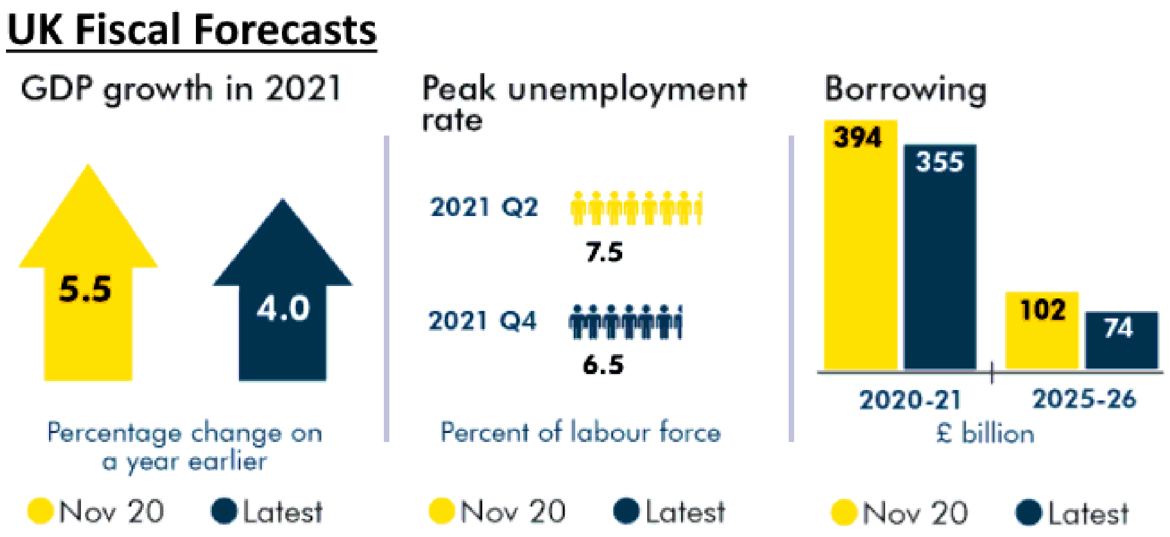
Asset Class	Index	February	YTD	12 months	3-yr rolling annualised	5-yr rolling annualised
Equities	FTSE 100 (UK)	1.6	0.8	1.3	-	-
	FTSE4Good 50 (UK Ethical Index)	1.1	-0.1	-1.4	-2.2	1.9
	MSCI Europe ex-UK	0.3	-2.0	13.2	5.7	7.9
	S&P 500 (USA)	0.9	-0.5	19.9	13.6	16.8
	NASDAQ (US Technology)	-0.8	0.2	41.9	23.2	25.0
	Nikkei 225 (Japan)	-0.3	-1.7	17.3	5.1	10.0
	MSCI All Countries World	0.5	-0.4	19.0	10.3	14.2
	MSCI Emerging Markets	-1.0	1.5	24.3	6.3	15.2
Bonds	FTSE Gilts All Stocks	-5.7	-7.3	-4.2	3.2	2.9
	£-Sterling Corporate Bond Index	-3.2	-4.2	2.0	4.8	5.9
	Barclays Global Aggregate Bond Index	-3.5	-4.8	-4.7	3.3	3.5
Commodities	Goldman Sachs Commodity Index	8.6	13.5	-1.0	-3.5	2.6
	Brent Crude Oil Price	15.0	21.6	18.5	-0.2	12.0
	LBMA Spot Gold Price	-6.4	-8.7	-0.8	10.2	7.4
Inflation	UK Consumer Price Index (annual rate)	0.1	-0.2	0.3	-	-
Cash rates	Libor 3 month GBP	0.0	0.0	0.3	0.6	0.6
Property	UK Commercial Property (IA Sector)*	-0.4	-0.1	-4.3	-	-

Data sourced from Morningstar Direct as at 28/02/21. * to end of previous month (31/01/21). All returns in GBP.

A Tactical Budget

Rishi Sunak's second Budget Statement was a hotly anticipated affair. After setting out the roadmap to navigate the COVID crisis, the Chancellor was able to mark down the route out of economic crisis. The pandemic has left a black hole in Britain's public finances and, while vaccines and gently easing restrictions will help get things back on track, there is no doubt that the UK economy still needs a big helping hand from the Treasury. A strong and sustained recovery will not happen miraculously. The good news, then, is that it was a budget full of superlatives.

First up comes spending, with the furlough scheme now set to be phased out in September. The Chancellor has given companies a chance for a "super-deduction" on tax bills, which he claims amounts to the "biggest business tax cut in modern history". And yet, at the other end, the emergency support measures have left the Government with a forecasted £355 billion in borrowing for 2020-21, the most since the Second World War (the Office for Budget Responsibility published updated forecasts on Budget day). That borrowing pushed Sunak into announcing a (delayed) increase in both personal and corporation tax that will leave Britain with its highest tax burden since the 1960s.



Source: Office of Budget Responsibility

Let's take these in turn. With the immediate priority of extending emergency support, the Government will continue to foot 80% of companies' wage bills, extend the extra Universal Credit of £20 a week and also the stamp duty holiday on properties under £500,000. These amount to an extra £40 billion in spending above previous expectations, bringing the Government's total pandemic spending to £344 billion. That translates to around 16% of GDP, well above the current 13.3% COVID-induced average for advanced economies.

The Budget was about much more than plugging the gap between now and normality, though. Eight new freeports will be built in the English regions, while a new infrastructure bank in Leeds will be given £12 billion to invest. These measures are a good sign, but as a long-term spending package, it falls some way short of the comprehensive fiscal plans being discussed elsewhere, such as the US.

One thing clear from the Budget is that the Chancellor expects much of the economic (and tax revenue) recovery to come from the private sector. The Treasury's planned super-deduction for businesses is designed to aid this. For the next two years, companies will be able to deduct 130% of the value of physical capital investments from their tax bill. The tax relief applies to spending on "plant and machinery", and should give businesses an extra £25 billion toward new production. While the overall tax rate will rise in 2023, in 2022 many companies could see their short-term tax bills fall by a quarter, as the Government effectively subsidises a wave of capital spending.

So, the incentive to frontload business investment over the next two years will be high, meaning that capex in Britain should pick up almost immediately. This will be a boon for the wider economy, the primary beneficiaries being capital-intensive businesses, such as manufacturers or utilities companies, with secondary beneficiaries being companies and workers in the construction industry. To put it another way, the Chancellor has chosen to target the support where the multiplier (spill-over effect) for wider economic activity is highest.

While it might seem unfair, because there is (probably) a lower multiplier, there are no equivalent investment boosts for Britain's struggling services sector. The hope here is that the rapid vaccination programme will be enough of a stimulus on its own to help out service providers.

The Chancellor's supposed "biggest business tax cut in modern history" is all the more significant for what comes after it. Two years down the line, the bill comes due for businesses, with plans to raise corporation tax from 19% to 25%. Sunak was keen to stress that this would still leave the UK with the lowest corporation tax rate in the G7, but when adjusted for allowances and deductions it leaves British businesses with a heavier tax burden than most advanced economies (the Inland Revenue is better at its job of collection than most other countries' tax collectors). The 6% hike is more than business leaders had been expecting, equivalent to £17 billion extra a year by 2025.

Economically speaking, signalling a tightening of fiscal policy has the potential to harm confidence and endanger a fragile recovery. So, the rationale for the announcement was more political than economic. The Chancellor needed to calm those in his own party worried about a heavy government debt burden. Realistically, with global yields still at historic lows, debt sustainability is not a current issue. But the Budget sent the message that the Tory Party is still the party of balanced budgets, and will continue to be once the pandemic is over. In 2018, the Government expected a stable debt-to-GDP ratio; in 2021, it still expects a stable debt-to-GDP ratio. All that has changed is that in 2018, it was 72%, whereas now it is 98%.

This Budget – with headline tax hikes for corporates – marks a big break from previous Conservative policy. The pandemic has only increased the sense among the public that tax-shy corporations have been the big winners while everyone else is falling further behind.

There has been some media criticism over how Sunak's announcement will affect Britain's ability to attract business investment – with fears that companies may hop over the Irish Sea for more favourable rates. This is particularly apparent given the effects of Brexit, and the previous promises on becoming more business-friendly. But the UK is far from the only country planning to raise corporation tax. The new US administration is planning a tax hike of its own – above Sunak's proposed rate – while talk of a financial transaction tax is ongoing in the European Union. When governments compete with each other over the most attractive tax rates, businesses are the big beneficiaries. But we are now seeing a global movement toward heavier corporate tax, leaving international companies with nowhere to hide. The Chancellor said as much himself, using the proposed tax hike in the US as justification for his own.

So, Sunak needed more revenue and, as a good global citizen, had to go with the flow in taxing companies. But, in our opinion, he is very likely to limit corporate taxation from rising further. His party will be hoping the fixed personal allowances will mean substantially better revenues derived from a motoring economy. Hidden in the detail of the Budget, constraints on public spending and the attempt to hold NHS pay rises to 1% also suggests that, in the future, faced with decisions between tax and spend, we are more likely to experience spending cuts rather than higher taxes.

Taking a step back, the Chancellor began his Budget Statement with an impossible task – continue to support all those who are badly affected by pandemic restrictions until they end, but without letting the budget deficit get out of hand, or raising taxes for the broader electorate, and without mentioning any return to austerity. What Sunak chose to do was all the above, but with different time settings, while gambling on a massive economic bounce-back – and outsized increases in tax revenues – that will allow him to outgrow the budget deficit question. Sunak's second Budget was many things, but our overriding sense is that it was both politically astute and an innovative break from past Conservative policy.

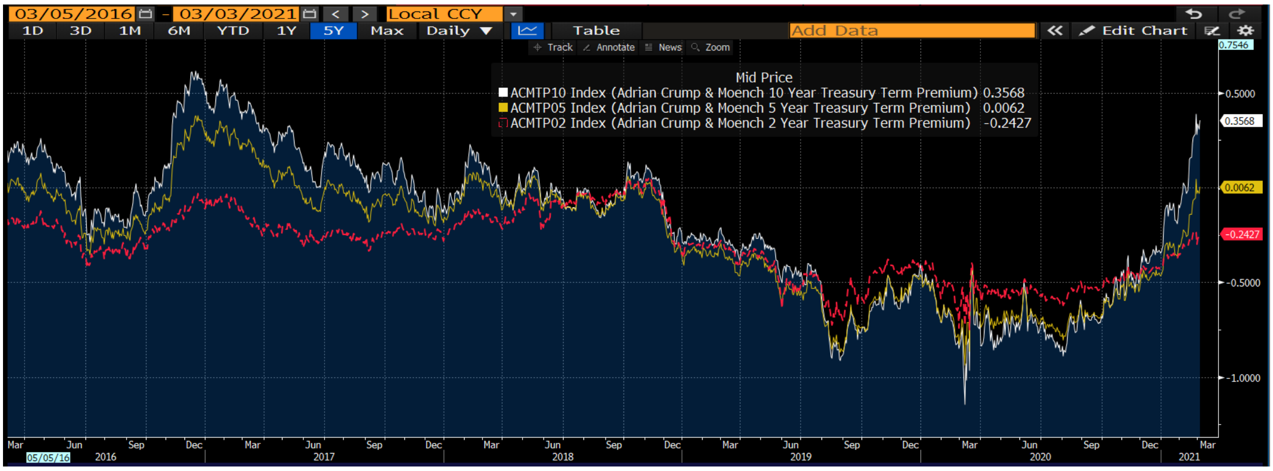
Gauging the new Fed policy rule

One of the more worrying trends of late has been the uptick in US government bond yields. Throughout the pandemic, the 'risk-free' rate of US Treasury yields has been virtually non-existent. The effect on capital markets, and the wider economy, cannot be overstated. Not only has it allowed governments fiscal free rein in combating the worst of the economic fallout, but it also pushes return-seeking investors into riskier assets, thereby supporting equity values. Rising yields are therefore worth keeping a close eye on. Thankfully, this trend has stabilised lately, with bonds levelling out, and most importantly real yields (yields adjusted for inflation) still in the negative. Nevertheless, tensions persist under the surface.

At the heat of the bond dilemma is a tug of war between the long-anticipated recovery and the need to keep financial conditions loose. In the second half of this year, the global economy is expected to return to strong growth, with a healthy dose of inflation and also the cyclical changes usually associated with an early-stage recovery. This puts upward pressure on bond yields, as investors rotate toward other assets and demand a higher return to protect against inflation. At the same time, the Biden administration is unleashing a $1.9 trillion wave of fiscal stimulus, funded by deficit spending. This massively increases the supply of US Treasuries, pushing bond prices down (and therefore yields up).

On the other hand, rising bond yields mean a general tightening of financial conditions – one that could be disastrous for recovery prospects if allowed to go unchecked. That is why the US Federal Reserve (Fed), along with the world's other major central banks, is so intent on using its asset purchase programme to keep a lid on yields. After switching its long-term policy framework to a form of average inflation targeting, the Fed is effectively locked into a dovish stance. This is the main factor putting downward pressure on yields, making 'Fed-watch' a vital part of any investment outlook. Investors are monitoring not just the pace of the Fed's asset purchases, but the maturities of the bonds it buys – which are currently focused on the shorter end of the maturity spectrum.

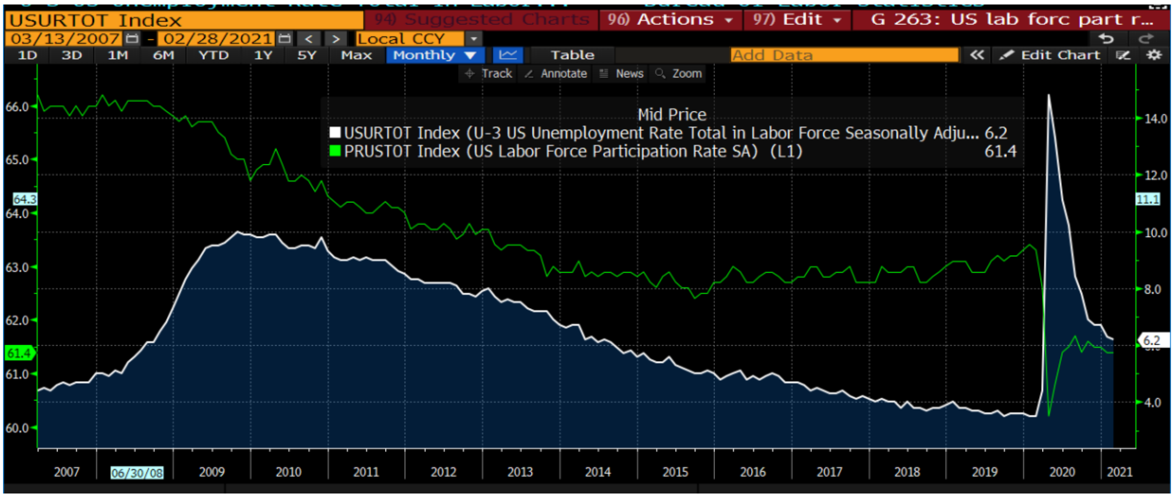
Interestingly, despite inflation expectations being a key component of the upward pressure on yields, the recent inflation outlook has been stable. And yet, rates on longer-dated bonds have continued to spike upwards. The 'term premium' (the excess return bondholders demand beyond the expected path in short-term yields) has been rising. This is reflective of increased uncertainty about the future path of Fed policy – instead of long yields going up because of investor expectations, they are going up because investors just do not know what to expect.



We should add a word of caution here. It is often tempting to over-analyse short-term market moves looking for clues, but it is perhaps best not to read too much into what the 'quick money' does. This is particularly true in the modern day, where market makers often do not hold the same inventory levels they used to. Short-term swings can therefore be more pronounced, as liquidity dries up faster. Nonetheless, we do think recent price moves say something about the current mood in bond markets. In particular, they reflect a broader ongoing debate about the Fed's new policy regime – which is nicely reflected in the term-premium spike at the ten-year mark.

As noted, the Fed has recently undergone a big change in its policy framework. At its most recent review, it began pursuing flexible average inflation targets, rather than the fixed 2% level it had aimed at before. This essentially means inflation will be allowed to run above the 2% level for a significant amount of time, just so long as inflation averages out over the long-term. Given the recent prolonged history of undershooting its target, this effectively commits the Fed to overshooting for the foreseeable future.

The Fed also wants to focus more on employment as the key determinant of labour market strength, rather than the supposed equilibrium unemployment rate. The most recent review was effectively a recognition that the old policy was structurally biased towards measures of slack in the economy – proxied by the unemployment rate – as opposed to activity (read employment) created. So, importantly, the Fed now uses the ratio of how many people have jobs in relation to the population (of those able to work; called the participation rate) as the needle in their compass. When reaching this objective of maximum employment, signs of wage inflation should also come through – allowing the Fed to fulfil its dual mandate of stable prices and employment. In consequence, before considering tightening policy, the labour market must heal. That is clearly some way off, given there are still around 9.5 million American jobs lost since the start of the pandemic.



In the past, markets have had a good sense of what central bank policy will be going forward. But now the Fed has changed its rulebook and policymakers are learning how to apply the new regime. Markets too do not know quite how to react, and expectations are still adjusting. The Fed's changing policy framework has certainly increased inflation expectations already, but one could argue there is still some way to go. Moreover, these adjustments are not just about the short-term outlook; inflation expectations may have to go structurally higher over the long term.

For now, the Fed has to find a delicate balance. On one hand, it must allow some market forces to influence bond yields – lest they be seen as just a government printing press facility, pushing inflation expectations significantly higher. On the other, it has to keep financial conditions loose enough to allow the promised recovery to actually come through. Anything less would amount to a premature tightening of policy, choking off growth before it can even get going. Finding that balance will be vital for capital markets. We will be watching real bond yields and inflation expectations closely.

CAMBRIDGE INVESTMENTS LIMITED

8th March 2021

Global Equity Markets

Market	Fri 16:15	% 1 Week*	1 W	Technical: Short	Technical: Medium
FTSE 100	6655	+2.7	+172	→	⬀
FTSE 250	21038	+0.6	+128	⬀	↗
FTSE AS	3786	+2.2	+83	→	↗
FTSE Small	6567	+1.4	+90	⬀	↗
CAC	5798	+1.7	+95	⬀	↗
DAX	13953	+1.2	+167	→	↗
Dow	30829	-0.3	-104	→	↗
S&P 500	3750	-1.6	-61	→	↗
Nasdaq	12427	-5.8	-765	↘	↗
Nikkei	28864	-0.4	-102	→	↗
MSCI World	2706	-0.7	-20	→	↗
CSI 300	5263	-1.4	-74	→	↗
MSCI EM	1346	+0.5	+7	→	↗

Top 5 Gainers

Company	%
Micro Focus Int'l	+18.7
BT	+15.7
Persimmon	+13.0
BP	+9.9
Taylor Wimpey	+9.1

Top 5 Decliners

Company	%
Scot Mtge Inv Trust	-9.0
Rio Tinto	-4.8
Hiscox	-4.8
Ocado	-4.7
Admiral	-4.5

Currencies

Pair	last	%1W
USD/GBP	1.381	-0.9
GBP/EUR	0.862	+0.5
USD/EUR	1.19	-1.3
JPY/USD	108.23	-1.5
CNY/USD	6.50	-0.3
Bitcoin/$	47,295	+3.6

Commodities

Cmdty	last	%1W
Oil	68.67	+3.8
Gold	1698.0	-2.1
Silver	25.10	-5.9
Copper	408.8	-0.2
Aluminium	2153.5	-3.6
Soft Cmdties	440.4	-1.3

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.3	20.2	14.7	14.0
FTSE 250	1.8	18.3	22.3	15.3
FTSE AS	3.0	19.7	16.6	14.1
FTSE Small x Inv_Tsts	1.4	18.5	-	14.8
CAC	1.9	22.4	18.2	14.5
DAX	2.5	21.9	15.5	13.2
Dow	2.0	21.4	20.2	16.0
S&P 500	1.5	26.6	21.8	17.1
Nasdaq	0.7	32.1	30.7	22.0
Nikkei	1.4	26.8	22.1	17.4
MSCI World	1.8	24.9	20.6	16.2
CSI 300	1.6	19.2	14.5	12.4
MSCI EM	1.8	21.1	16.0	12.3

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.75	-0.07
UK 15-Yr	1.11	-0.07
US 10-Yr	1.56	+0.16
French 10-Yr	-0.05	-0.04
German 10-Yr	-0.30	-0.04
Japanese 10-Yr	0.10	-0.07

UK Mortgage Rates

Mortgage Rates	Feb	Jan
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.75	1.78
3-yr Fixed Rate	2.08	2.06
5-yr Fixed Rate	1.93	1.96
10-yr Fixed Rate	2.53	2.53
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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8th March 2021

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.

The value of your investments can go down as well as up and you may get back less than you originally invested.

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