Investment Newsletter April 2020

EQUILIBRIUM

Who's going to pay?

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At the start of February it became clear that the COVID-19 virus would have a significant impact on the global economy.

Most investors and economists initially began to worry about what the impact would be on the incomes of companies and individuals. Now, the focus is shifting to rising debt levels.

The ability to bring forward future income – which is all debt is – is a fundamental part of our economic system. You and I, and even goliath companies like BP, have strict limits on how much debt we can have, but most governments do not.

To their credit (if you pardon the pun) many governments have moved quickly and substantially to provide fiscal support to individuals and companies in the face of the economic impact of the COVID-19 pandemic. But clearly this will need to be paid for somehow.

Table one, shows the size of the financial packages announced so far in some of the major economies.

Table one

		Fiscal stimulus	2019 GDP	% 2019 GDP
US	US$bn	2,300	21,427	10.7%
Japan	¥tn	60	553	10.8%
UK	£bn	350	2,215	15.8%
Germany	€bn	750	3,436	21.8%
France	€bn	345	2,420	14.3%
Italy	€bn	25	1,788	1.4%
Spain	€bn	200	1,245	16.1%
Australia	A$bn	214	1,995	10.7%

Source: Jefferies

As you can see from the table, the UK government so far has committed £350bn of additional spending and lending which amounts to 16% of last year's gross domestic product (GDP). This additional borrowing will further push up the UK's national debt to around £2tn.

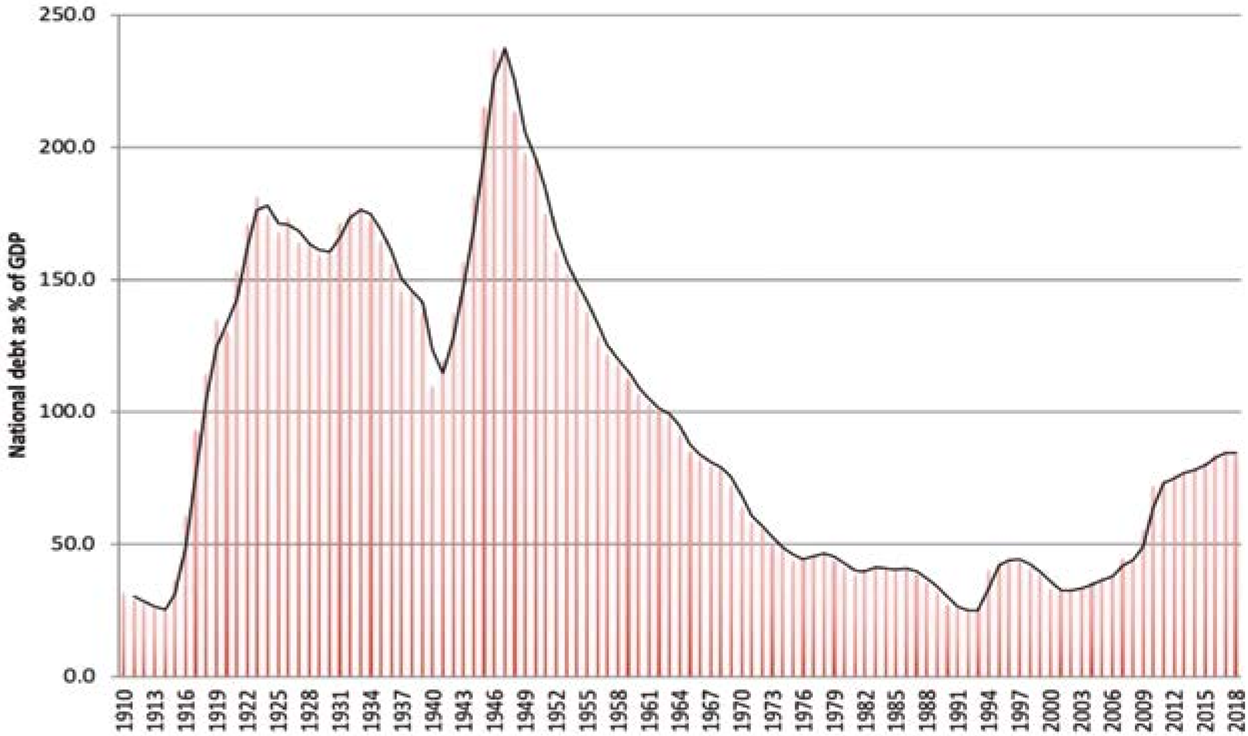
Chart one, below, gives the long-term history of this figure which clearly shows that it has been much higher in the aftermath of the two world wars when UK debt was over 200% of GDP.

At the end of last year, the national debt to GDP figure was around 80% but with the new virus-related expenditure, it is expected to rise to nearer 100%.

In and of itself, this is not an insurmountable problem. After the Second World War, Britain was bailed out with a loan of around $4.3bn (or nearly £30bn in today's terms) from the US and Canada. Even in the 1950s when it was weighed down by debt, the UK avoided default and managed to set up the welfare state and NHS.

However, in the current climate the UK will struggle to borrow much more with private sector savings at a much lower level. In the extreme, if the UK carried on issuing this debt it would run the risk of a credit rating downgrade (leading to higher borrowing costs) or even default.

Chart one: UK national debt



Source: Reinhart, AER and OBR 2019

Big debt? Long grass

One of ways that it can fund this additional debt is by issuing very long-dated bonds.

In 1833 the UK government urgently needed to raise significant levels of debt amounting to 40% of its national budget (£17bn in today's money). To its shame, the UK was to use the money to "compensate 46,000 slave owners for the loss of value" as a result of the Slavery Abolition Act.

The UK government resorted to borrowing the money from bankers Nathan Rothschild and his brother-in-law Moses Montefiore and then issued perpetual (undated) bonds to pay the loan. These consols, as they were known, were finally paid off just five years ago.

Kicking such large debt into the long grass – in the current circumstances by issuing, say, 100-year 'coronavirus bonds' - is one way of dealing with the problem but has its limitations.

Point of no return

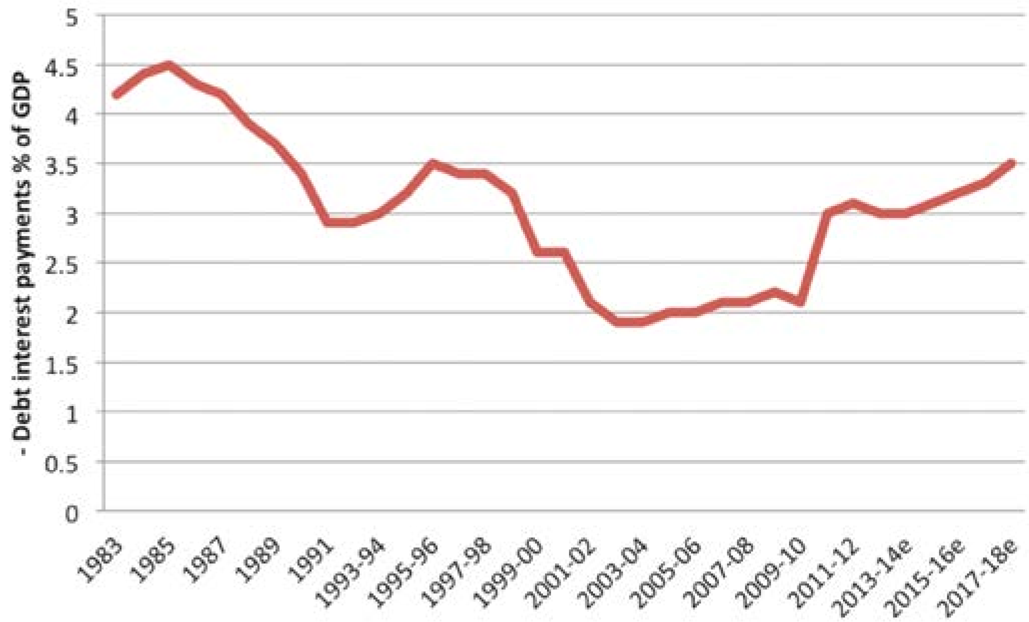
In particular, the problem now will be that government bonds are not so attractive as investments.

Interest rates are now at their lowest level since before the abolition of slavery. The consols paid 4% per annum whereas a 100-year bond today would pay more like 0.4%.

This is a double-edged sword. On the one-hand these historically low interest rates ease the burden on the government's interest costs, as shown in chart two, below.

Whilst that is true, interest costs are still substantial, and the more that is paid for debt the less there is for hospitals, schools, etc. Even before the virus outbreak the UK spent £40bn per year on interest alone which is higher than the entire defence budget.

Chart two: UK debt interest payments - % of GDP



Source: ONS and Office for Budget responsibility

Big bank bond buyer

On the other hand, if bond yields are so low, surely this is not going to be attractive for investors to buy them? Who is going to buy all these government bonds? The key buyer is the central bank. As we know, central banks, including our own Bank of England, have been big buyers of the government's bonds through their quantitative easing (QE) programmes since the credit crisis.

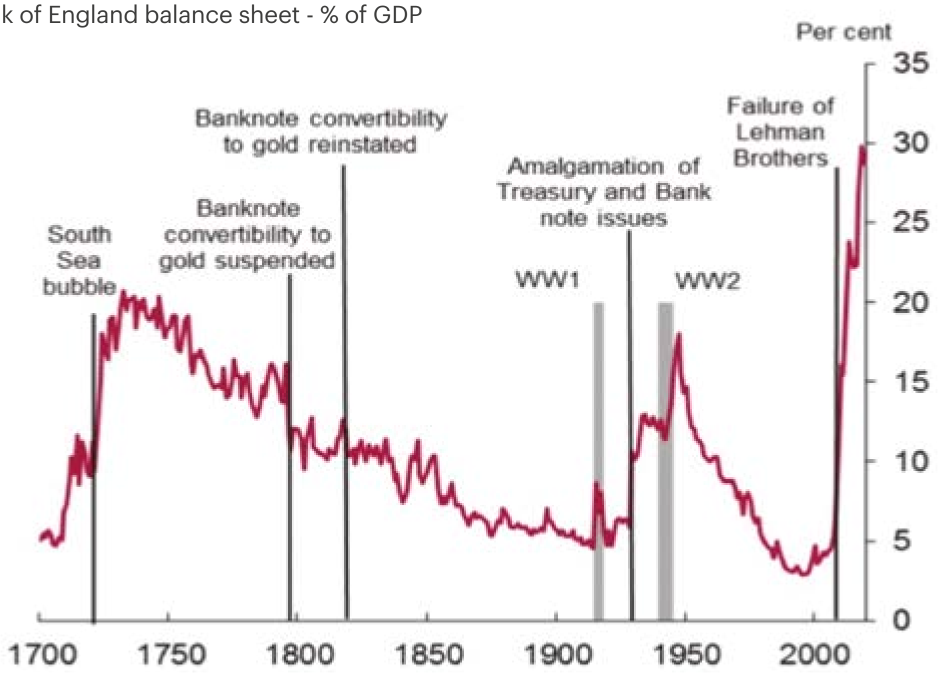
The Bank of England can do this because essentially, like all central banks, it acts as a printing press. As well as creating new money they are able to buy government bonds on their balance sheet - pushing the price up and (given the inverse relationship), bringing yields down and thus, in theory, stimulating the economy.

Chart three shows the Bank of England's balance sheet, shown as % of GDP, over the last 320 years.

As can be seen, the Bank's balance sheet as a percentage of income has never been higher. The additional bond buying announced so far will take the figure up by another 9% to around 40%.

Because they are effectively buying up so many of the government bonds the Bank of England already owns around a third of all gilts and this will also rise sharply.

Chart three: Bank of England balance sheet - % of GDP



Source: Bank of England

Profligacy and prices

The objective of QE was to provide temporary stimulus in lowering interest rates and encourage banks to lend. The intention was that the Bank would sell the bonds back into the market in happier times.

However QE has become a permanent feature of monetary policy. This effectively means that the UK government can print and spend money knowing the Bank will buy and hold the bonds – a process called 'monetisation'. Indeed, many have asked why not miss out the bond selling and buying bit and just let the Bank issue money straight to the government.

As you would expect, such 'free money' does have consequences. As well as encouraging government profligacy, as more money is pumped into an economy, prices normally rise and inflation takes grip. In the extreme, you could end up with a situation like Zimbabwe which saw inflation hit 540% last month.

The UK is not alone – between them the central banks of the United States, European Union, UK and Japan will buy $5tn of bonds this year, two and half times as much as during the financial crisis peak.

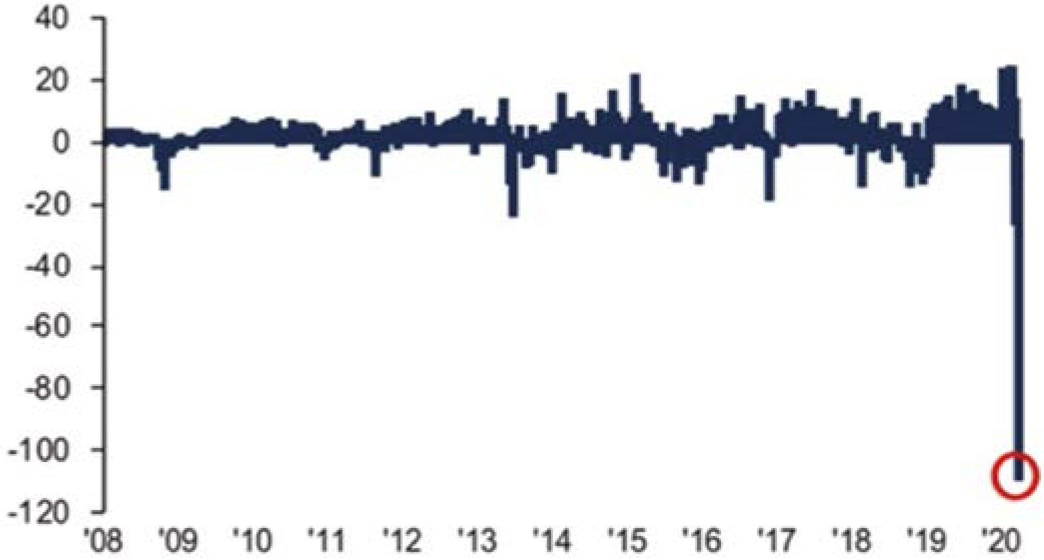
This may mean that prices could be higher than otherwise on a global scale, but we are not expecting sustained higher levels of inflation given the weaker levels of demand, higher unemployment and global supply chains that source from low income countries.

Get me out

Understandably, this caused major upsets in the bond market in March. Not only were bond investors worried about companies becoming insolvent but suddenly there was a potential tsunami of government bonds.

Chart four below shows the weekly flow of purchases and sales of bonds globally since 2008 and the massive $109bn outflow in the third week of March.

Chart four: Weekly bond fund flows ($bn)



Source: Bank of America Global Investment Strategy, EPFR Global

First aid then growth

The financial support announced by the UK government has been necessary but will pile even more borrowings on an already high debt mountain. The figures in these charts are as a % of GDP and this will fall in 2020, increasing the ratios still higher.

The overarching priority in the short term is to tackle the medical challenges.

Conclusions

We have been here before. After running up the national debt over the credit crisis, the UK government embarked on austerity measures and quantitative easing. However, these are not the right solutions this time around.

Yes, government spending growth will need to be moderated over time, but care needs to be taken not to stall the economic recovery by tightening belts too early.

Higher taxation will also need to be part of the answer. This will provide an opportunity to be creative on taxing online businesses, high carbon industries and tackling tax havens.

The almost-zero interest rates will buy us time and paying down debt will take generations but the key will be to get the economy back on its feet again.

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General economic view

The spread of the economic impact is now as wide as the reach of the virus. Governments across the globe have implemented very significant fiscal measures to support individuals and companies whilst central banks have done their part to lower the cost of debt and facilitate more lending.

Whilst the economic news has been bad, there are very early signs that the marginal rates of infection are falling in some countries and if businesses can re-start trading in the near future the hope is that the level of impairment to economic growth will be limited.

Financial markets are forward-looking and, thus far, appear to be treating this as a one-off exogenous shock rather than a precursor to deepening economic contraction.

Equity markets

On a one- to two-year view, we believe equities have significant scope to recover. The UK stock market has been one of the poorer performers due to the higher concentration of commodity stocks but offers good value at current levels. Similarly, other areas such as emerging markets are undervalued and even some areas of the US stock market are now better value.

Fixed interest

Government bonds provided strong protection into the sharp downturn in March but are left offering very little by way of return. Instead, we see better value in corporate bonds at these higher yields given that the severity of the downturn may not be as acute as first believed. New issuance by companies needing to raise new capital are providing opportunities to deploy capital.

Commercial property

Given the rising risks and concerns over liquidity, we have a low property exposure compared to our strategic weighting. Overall, UK property returns are likely to be in the low single-digit percentages although there are a few segments of the market that may offer higher returns, especially if growth in the UK economy remains stable.

Cash

With interest rates remaining at record lows, returns on cash will remain almost zero.

Balanced asset allocation

For a typical balanced portfolio, we are underweight fixed interest and traditional equity, and are very light on property. This is balanced by holdings in defined returns and alternative equity, giving an overall risk/return profile roughly in line with our long-term average position.

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