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Asset Management

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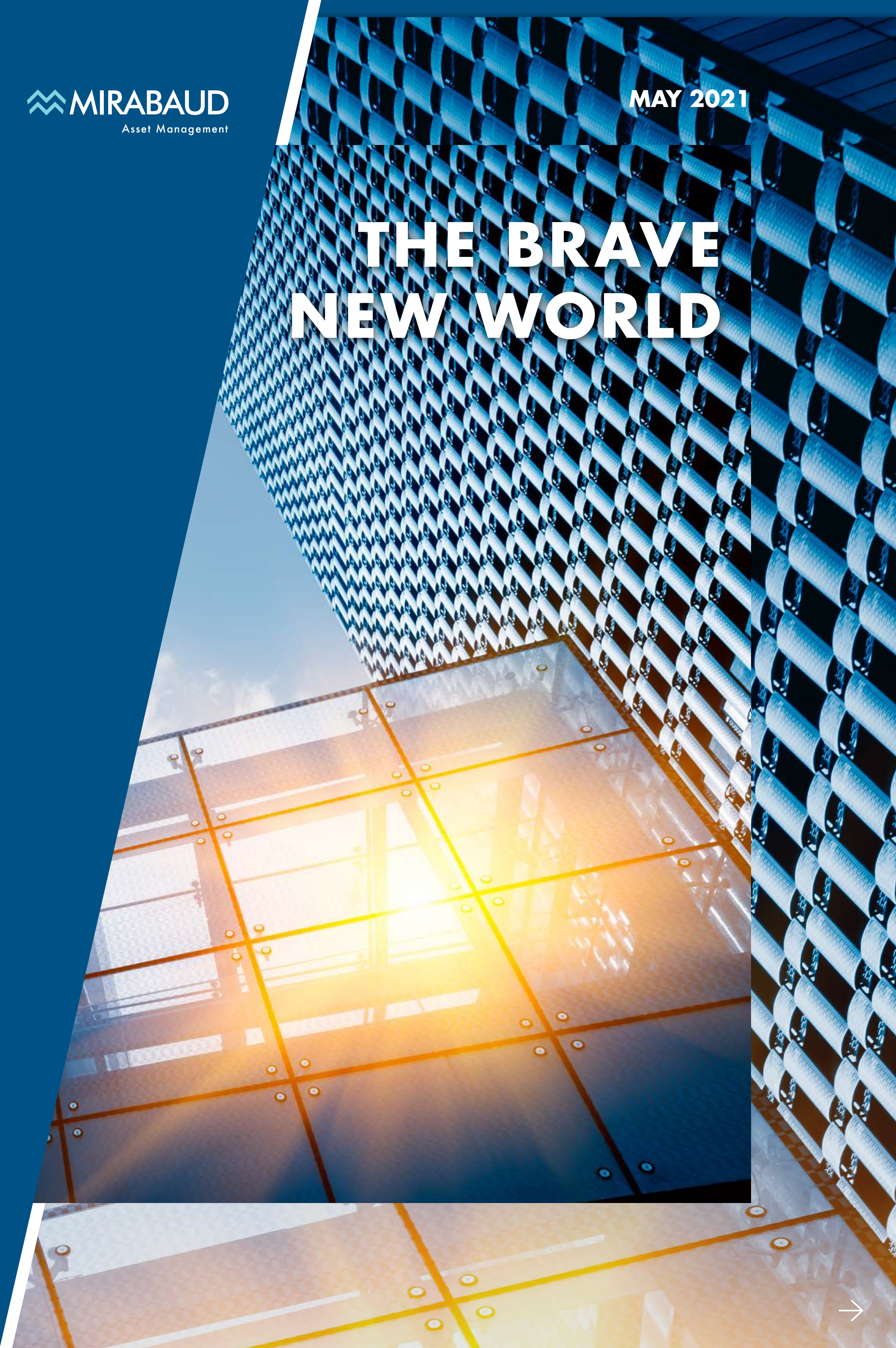
THE BRAVE NEW WORLD



OUR INVESTMENT COLLECTIVE CONTRIBUTORS

Gero Jung, Chief Economist at Mirabaud Asset Management
Andrew Lake, Head of Global Fixed Income
Nicolas Cremieux, Co-Head of Convertibles
Dan Moreno, Head of Emerging Market Debt
David Kneale, Head of UK Equities
Hywel Franklin, Head of European Equities

THE BRAVE NEW WORLD

We are at the dawn of a new business cycle and approaching the tail end of the Covid-19 pandemic as a result of wide-scale vaccination programmes. Savings rates are higher and there is pent-up demand among consumers after prolonged lockdowns, driving expectations of increased spending in the second half of this year as economies reopen. However, this is set against a backdrop of record-high public debt levels and deficits after governments sought to protect jobs and prop up economies during the pandemic.

The International Monetary Fund (IMF) estimates that the world economy shrank by as much as 3.5% in 2020[1]. So what are the longer-term impacts of the pandemic beyond 2021?

[1]Source: *https://www.investopedia.com/government-stimulus-and-relief-efforts-to-fight-the-covid-19-crisis-5113980*

We asked our investment collective for their views on where the global economy will go next. We know the path beyond the pandemic is unlikely to be smooth as there will likely be setbacks along the way and the recovery will progress at different speeds around the world. This environment will most likely suit investors that can make tactical decisions as they navigate the road ahead, highlighting the benefits of active management.

It's interesting to note that the main difference between the current crisis and the Great Financial Crisis more than 10 years ago is the current absence of a banking crisis. Indeed, today the banking sector is in decent shape unlike in 2007-08. The second difference is that, this time around, there was a large and rapid response from governments and central banks in the form of fiscal and monetary support for businesses, people and markets.

Central Bank Balance sheets by country (millions)

April 2021[2]		December 2019[3]	
Euro Area	7,567,945 (Euros)	Euro Area	4,570,000 (Euros)
USA	7,780,962 (US dollars)	USA	4,173,626 (USD)
UK	951,774 (GBP)	UK	473,150 (GBP)

[2]Source: *trendingeconomics.com, May 2021 – data from April 2021*
[3]Source: *Federal Reserve (Dec 2019), Central Bank of England (Dec 2019) and European Central Bank (Dec 2019)*

OUR INVESTMENT COLLECTIVE HAS A RANGE OF VIEWS ABOUT THE TRAJECTORY OF ECONOMIC GROWTH GOING FORWARD.

Gero Jung, Chief Economist at Mirabaud Asset Management, expects a strong global recovery in economic activity later in 2021. On a worldwide scale, he thinks the two main growth engines will be centred on the US and China. However, given the uncertainty regarding the vaccine rollout – in particular in continental Europe – there will likely be bumps along the way. Currently, Jung believes the recovery in Europe will follow a K-shaped path, where different parts of the economy recover at different times. In particular, he expects manufacturing to do well, helped by strong global demand. This sector is better shielded from the pandemic because, unlike the services sector, it has not had to pause operations during recent lockdowns.

Meanwhile, Hywel Franklin, Head of European Equities at Mirabaud Asset Management, expects an uneven recovery. He believes sectors of the economy that were under pressure before the pandemic will remain challenged and not fully recover. Many of the trends that were already emerging before the Covid-19 pandemic, such as sustainability and digitalisation, have been accelerated. As a result, he expects a nuanced recovery that will create winners and losers.

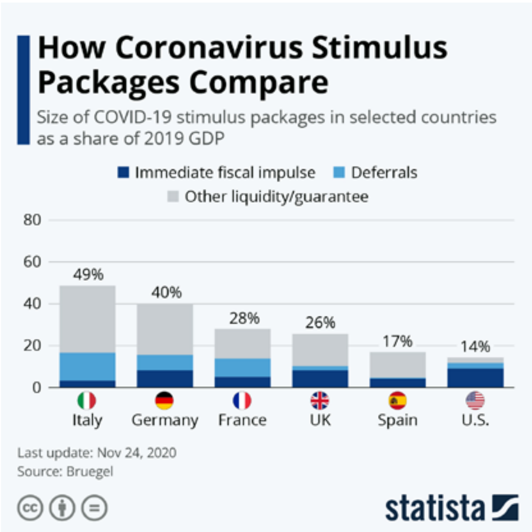
Dan Moreno, Head of Emerging Market debt at Mirabaud Asset Management, points out that China is the only major economy in the world out of the G20 that has grown in 2020. Indeed, China is probably the only country in the world that is likely to come out of the pandemic in slightly better health than when it began. China's policy response in dealing with the pandemic has been resolute with both fiscal and monetary expansion, injecting liquidity into the system. Overall, the Chinese government's finances are as strong as they were prior to the onset of Covid-19.

> The IMF is expecting 5.5 % growth for the world economy in 2021, but the recovery is likely to be uneven
>
> **Dan Moreno**

The International Monetary Fund is expecting 5.5 % growth for the world economy in 2021, but the recovery is likely to be uneven. Some countries will recover at a faster pace than others. For instance, in the emerging markets, there is China and then there is the rest of the world. Low-income countries, in particular, have had a very difficult time during the pandemic with a lack of resources and funding. The majority sought debt relief from the G7 in 2020 – and almost all have applied for funding. In larger emerging market economies, some have fared better than others.

BORROWING COSTS HAVE RISEN AND LARGE STIMULUS MEASURES REMAIN. WILL THEY CAUSE A PROBLEM AND WILL POLICY SUPPORT BE REMOVED?

This is perhaps the most common question we hear from our clients and it doesn't come as a surprise given the large government and central bank stimulus packages around the globe. As governments have pulled out the stops to support businesses and people affected by the pandemic, government borrowing has increased significantly. This has many observers wondering if this is storing up problems that will emerge in the future.



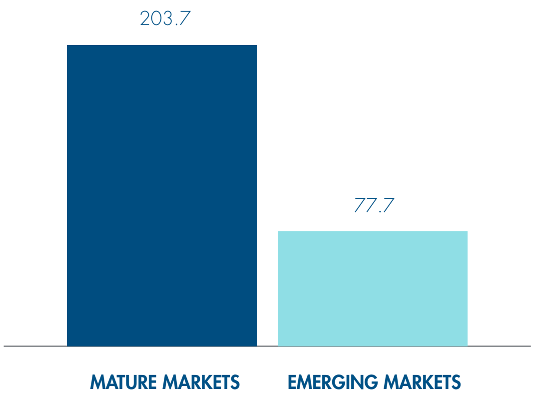
Gero Jung believes interest rates will continue to rise in the current environment. The question is whether this rise will be gradual or more abrupt, as this is key to the servicing of long-term debt. Sharp interest rate rises can make it harder to service debt. Currently, Jung adds, government borrowing costs are still extremely low, even when compared to pre-pandemic levels.

On debt sustainability, he thinks this is a forward-looking concept, with a very long horizon. Public debt projections are sensitive to assumptions about growth, budget outcomes and interest rates. As a rule of thumb, as long as the growth rate of the economy is faster than the interest rate paid on government debt (in nominal terms), debt sustainability issues are not a primary concern, he says. Given the current outlook, many industrialised countries will likely record strong economic activity this year, while lending rates for these governments remain low. The issue of debt sustainability is more of a focus for developing countries, especially those that are vulnerable to capital outflows, which in turn could lead to higher borrowing costs for these governments.

Pandemic response helped add $24 trillion to the global debt mountain in 2020, bringing it to a new high of $281 trillion

– Institute of International Finance, February 2021[4]

Total indebtedness (US$ trillion)
Q4, 2020



In the UK, it is a different story. David Kneale, Head of UK Equities at Mirabaud Asset Management, says the UK has a materially longer average duration of borrowing than other countries. This makes the cost adjustments from re-pricing far less dramatic and offers an extra release valve to lower costs. David observes that the UK spends about £30 billion servicing around £2 trillion of debt. This is roughly a 1.5% rate of interest, or 3.3% of tax receipts. In the near term, every year around £100 billion of debt matures (which heavily over-indexes to short duration); nevertheless, if we assume that the interest rate on all the maturing debt trebles to 4.5% (a weighted average interest cost that is higher than any point in the past 20 years), in 2025 the cost of debt will have increased to 2.8%. Assuming tax receipts grow at 4% a year, the debt interest burden rises to 7% of tax receipts, in line with 2012. If we take a less apocalyptic forecast, in which average interest rates doubled to 3%, the cost of debt would rise to 5% of tax receipts, the average level of the past 20 years.

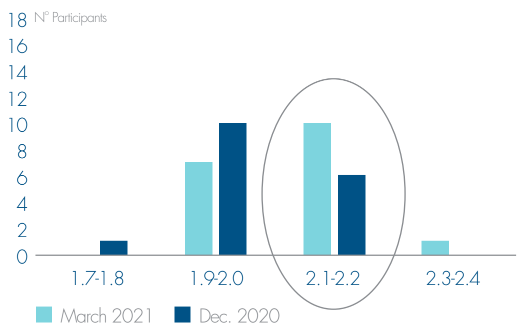
[4]Source: *Institute of International Finance, February 2021*

IS INFLATION A GROWING ISSUE?

Hywel Franklin says central banks have been trying to achieve 2% inflation for years, but have seen little sustained success. Given that inflation is currently at low levels, even a small rise can seem significant – this is what is known as the low base effect. Franklin believes it is still far from clear that inflation will take off in the near term, particularly when many disinflationary forces, such as plentiful cheap labour in emerging markets and automation, remain in place.

The majority of FOMC members predict inflation in the US of above 2%

US Federal Reserve: Distribution of participants' projections for core PCE inflation, 2023 (in%)



Source: *Federal Reserve*

In the UK, consumer price inflation is currently around 0.5%. However, David Kneale highlights that it is difficult to measure or forecast inflation when the basket of goods and services used for measuring is itself in a state of flux. For example, are holidays being included in the data or not, and will dining in restaurants be back on the menu? If so, what proportion of restaurants will be in a position to open in any given month? More significantly, no one really knows how smooth the supply response for resumed consumer demand will be as the economy begins to return to normal.

Because of this, Kneale believes that the more structural driver of sustained higher inflation is coming from wage growth. He adds that the best indicator of wage inflation is not unemployment, but under-employment (the proportion of the working-age population actively seeking more hours of work). With that in mind, the most likely inflationary outcome appears to be one of a brief period of higher inflation as we move away from the disruptive events of 2020 and experience the effects of a higher oil price, supply chain disruptions and the return of hospitality services. This will likely be followed by a period of happy medium, with the absence of wage-price inflation keeping a lid on consumer price inflation.

From Dan Moreno's perspective, there is no evidence that inflation will be higher in the US, apart from a short-term rebound from current levels. Prior to the pandemic, there were quite a few deflationary forces already at play, such as changing demographics and technological transformation. However, last year the US Federal Reserve updated its inflation policy to 'average inflation targeting' of 2%. Moreno believes this is why inflation expectations have risen so dramatically recently. By changing its inflation policy, the Fed is likely expecting higher inflation and, as a result, is managing expectations.

Nicolas Cremieux, Co-Head of Global Convertibles, comments that the main story now is about rotation away from growth and tech and towards value and cyclical sectors. The reflation trade has gone a long way. However, we anticipate a continuation of the outperformance of more cyclical sectors, including materials, Industrials and consumer discretionary, as we expect the successful rollout of vaccines. This will lead to a quicker reopening of economies, especially if consumers revert to their pre-pandemic ways, which will force companies to replace lean inventories.

Finally, Andrew Lake, Head of Global Fixed Income, believes that we will continue to see higher inflation numbers materialise over the coming months. This will be due to a number of reasons: supply chains under pressure, as we have seen with the current microchip shortage; the demand and economic growth boost we expect as economies re-open and consumer activity increases; and year on year comparisons. Furthermore, inflation pressures will be driven by an increase in commodity prices, which will feed through to basic material costs. Lake emphasises that inflation isn't necessarily a bad thing. One can take the view that 'good inflation' with an economic recovery and a boost to livelihoods is a good thing. From his perspective, he continues to see pressure on yield curves moving higher. But whether inflation is transitory or permanent will not become apparent for several more months yet, if not longer.

WHAT'S THE LIKELIHOOD WE'LL SEE THE RETURN OF THE TAPER TANTRUM?

Major central banks, such as the European Central Bank and US Federal Reserve, have recently reconfirmed the continuation of their ultra-accommodative monetary policies. However, Gero Jung believes the Fed will most likely be the first major central bank to begin normalising monetary policy. This is because the US economy is in a stronger position than most other countries, in part because it has been stimulated by large public aid programmes. Therefore, it is likely that the Fed will be the first to start reducing its asset purchases, which are currently running at US$120 billion per month.

The next step in the process will be for the Fed to start raising interest rates, which continue to hover around zero. Communication will be crucial at this point. Fed Chair Powell recently signalled that the Fed is "not even thinking about thinking" to raise rates. It is therefore important that such a move is clearly communicated to financial markets, which will help mitigate the risks of another major taper tantrum.

In 2013 the so-called taper tantrum was directly linked to the Fed's decision to slowly scale back its quantitative easing programme, a scenario that Dan Moreno believes is unlikely to happen again. The reality is that, if central banks decide to stop asset purchases and hike interest rates, global markets will be exceptionally challenged. However, Moreno expects that stimulus progammes will be ongoing because the alternative could lead to further market shocks.

> When the US government issues a bond to fund their expenditure, it's not an investor in the market buying it – it's a central bank. Therefore, I don't currently see an end to QE
>
> **Dan Moreno**

Meanwhile, Andrew Lake believes that there will be no move higher in interest rates this year (as distinct from government bond yields) and equally there will be no withdrawal of underlying fiscal or monetary support.

Lake comments that we would need to see economies on a permanent and sustained road to recovery, an end to the pandemic and a recovery in employment before we see a withdrawal of fiscal and monetary support.

Finally, Nicolas Cremieux highlights that the fiscal stimulus of $1.9 trillion in the US places us in uncharted territory (not including $1 trillion more dollars for infrastructure). The fiscal stimulus is very large for a US economy that is already recovering, alongside a Fed that is committed to maintaining an extremely strong and accommodative monetary policy. Maybe everything will go well, he adds, but there are no guarantees. Cremieux emphasises that we may need to prepare for year-end rates to exceed even the current revised projections if vaccines remain successful and if fiscal stimulus programmes continue.

WILL THERE BE A TIDAL WAVE OF BUSINESS FAILURES DUE TO INCREASING BORROWING COSTS AS A RESULT OF THE PANDEMIC?

There has been a big decline in corporate bankruptcies[5] as central governments around the world have stepped in to help in order to mitigate the business challenges of the pandemic. However, premature withdrawal of supportive government measures could mean a surge in bankruptcies and a new wave of non-performing loans.

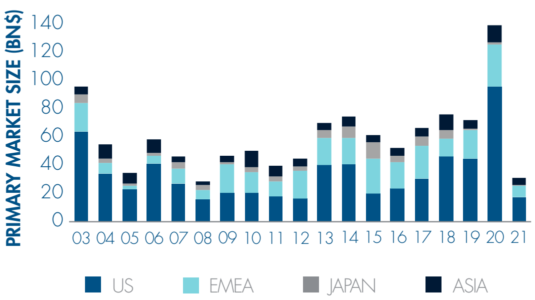
According to Hywel Franklin, a sharp increase in interest rates would cause a raft of companies to fall into deep financial trouble. Few businesses are built to withstand extended periods with almost no revenue, which many have suffered during the pandemic. However, this is not his central expectation. In his view, governments and central banks are aware of the risks and are more likely to position themselves on the side of providing too much support rather than too little. The evidence to date suggests the scale of intervention has been larger and faster than during the 2008 global financial crisis. As the question suggests, though, this means an increase in moral hazard and less urgency for companies to generate cash flow in the short term.

Gero Jung adds that some of the data on bankruptcies in the current crisis are quite remarkable. For example, in many European countries – including Germany and France – the number of bankruptcies either declined in 2020 or did not follow the trends seen in prior years. While legislative reasons might explain this, financial aid programmes certainly helped. But with financial support from governments likely to run out in the medium term, some firms – particularly those with business models that are no longer viable – will come under further stress.

[5]Source: *https://www.iif.com/Portals/0/Files/content/Global%20Debt%20Monitor_Feb2021_vf.pdf*

Dan Moreno also highlights that governments simply aren't leaving it to markets to decide which companies should survive and which should go under. The amount of intervention performed by the US Federal Reserve in credit markets last year was astronomical. Not only did it pull rates down to zero, it also engaged in quantitative easing by purchasing investment grade and high-yield debt. In effect, the Fed forced borrowing costs to an artificially lower level. Companies that were weak prior to the pandemic were able to extend their lifespans by funding themselves on low rates, but their long-term structural issues may remain.

Nicolas Cremieux adds that this is where an active approach is key in assessing the resiliency of businesses. However, as companies scramble for cash to help bolster balance sheets, it is creating some pockets of opportunity. Cremieux highlights that convertible issuance broke through its prior peak and, in 2020, it reached an all-time record high – with issuance of $138bn (269 deals), the most since 2007, and up 94% versus $71bn in 2019. Consequently, the global convertible market had climbed to about $488bn at the end of last year, across 1000 issues. Another feature in 2020 is that convertibles became a source of rescue financing from pandemic-hit airline, travel and leisure, and retail industries as it became more challenging to source finance from other methods – such as banking.



Source: *Bank of America and Mirabaud Asset Management, January 2021*

Finally, Andrew Lake comments that defaults will not be a cause for concern as low borrowing costs and investors' need for yield have allowed weaker companies to refinance and increase their cash on their balance sheets. The high yield market historically has provided a good gauge of rising defaults and we have not seen the risk premium on non-investment grade bonds increase, despite being at cyclical lows. Moody's expects the number of defaults to fall in 2021, reaching a speculative grade default rate of 4.7% by the end of 2021 from a peak in March 2020 of 7.3%. For companies that default, Lake believes that there will be an unevenness of failures - for example most of these defaults over the last 12 months were concentrated in the Oil & Gas, Retail and Business Services sectors.

FINAL THOUGHTS

As we look ahead to the end of the pandemic and the beginning of a sustainable economic recovery, there are several points to take away. Dan Moreno believes that Covid-19 is generational in nature and, as a result, has deep implications for the global economy. This is because the virus has introduced a degree of risk that did not exist prior to the pandemic and it remains to be seen how this will translate into economic activity in the future. If Covid-19 remains in circulation in the human population indefinitely, much like the flu virus, there is a possibility people's lives and the way they do things will not be the same as before the pandemic hit. We may see a big rise in economic activity initially, but it may begin to tail off once we see what real normalisation looks like.

Heading into a more uncertain future reinforces the importance of high conviction, active investing. During the height of the pandemic, there were clearly stark differences between companies that were more digitally focused and companies relying on their customers gathering in communal places. As news of vaccinations emerged towards the end of 2020, market leadership changed again on the expectations of renewed economic activity post the lockdowns. As we enter into a new business cycle, alongside an economic and market environment that is fluid, this demands active flexibility in managing fixed income and also provides the ideal conditions for active stock pickers.

Our investment collective is uniquely positioned in that each experienced investment team follows their own philosophy and approached that's designed for their area of expertise, which has been developed through years of market experience. Without a house view, this makes our investment collective flexible and nimble to exploit high conviction investing- an approach that we believe helps navigate a more uncertain world.

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