Weekly Digest

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Slowly Turning Up The Dimmer Switch

Last week finally felt like one of few real surprises. Extraordinary as it might seem, we have become inured to record falls in economic activity, tens of thousands of permanent job cuts being announced and High Street retail brands going into administration. Normal service was resumed on the political front too. Those longing for the news not to be dominated by COVID-19 can look forward to the next instalment of the Brexit saga, and the Labour Party under new leadership seems to have rediscovered its role as the party of opposition. You can judge for yourself how constructive that might be, but my feeling is that they had a damning riposte prepared for whatever the Prime Minister might have announced last night.

And it is the first stage of ending the lockdown to which today's title refers. It is fairly clear now that we cannot just flick a switch and return everything to normal. The power needs to be gradually reintroduced to make sure we don't overload the system. (Apologies to any electricians reading for what I know is not an entirely accurate metaphor!) We are not alone in taking this approach, and we can already see some evidence of how it is playing out in other countries. The good news (so far at least, as it can take up to fourteen days for new symptomatic cases to appear) is that there have not been widespread spikes higher in new cases and hospital admissions. No doubt most people are taking extra precautions, which helps, as does the application of physical distancing regulations. Over the weekend one new hotspot has been reported in South Korea, but if there is one country that appears to be well equipped to test, track and trace, then South Korea is it.

So that's the good news. But at what cost does it come? I wouldn't want to rely entirely on anecdotal evidence gleaned from the media, but activity levels, while recovering in some areas, are far from normal. We might be impressed by the fact that there were 115 million tourist trips undertaken in China over the May Day weekend, but last year there were 195 million. Similarly, traffic congestion figures for major Chinese cities seem to reflect a mass return to work, but could also be a sign of people shunning public transport. An Italian café owner in central Milan reported takings to be down 90% compared to the pre-virus world. An automotive manufacturer in the same country said that it has had to reduce daily production from 410 to 208 vehicles to comply with new safety rules, while a components maker in the UK reckons that where it used to employ four people in one area who could churn out 500 components per hour, it will now have to employ two. And the laws of productivity, in this case, mean that they don't produce 250 components per hour, but perhaps only as many as 100. Volkswagen has already cited a shortage a car parts leading to price inflation, much of which it will probably have to bear in its own profit margin.

On a more positive note, productivity is increasing in other areas, notably through the use of web-based communications. The Royal College of General Practitioners reports that 71% of GP consultations in a recent four week period were conducted remotely, up from 25% a year ago. This is a habit that could stick, freeing up capacity to see more patients and also reducing the unproductive time spent getting to and from the surgery (often requiring time off work) and sitting in a waiting room full of germs. The justice system also appears to have discovered that on-line proceedings are viable, which could be effective in de-clogging the courts. A friend of mine who works in the real estate industry was regularly summoned from Oxford to London for meetings with investors. Now those meetings are done and dusted within an hour online rather than what used to be a six hour door-to-door round trip. That's not to say that face-to-face meetings will disappear altogether, but there will be fewer of them in the future.

This sort of shift to new technologies and applications is one reason why Technology shares have been such strong performers, with the US's tech-heavy NASDAQ Index now in positive territory for the year. But even then, it has not all been plain sailing for big "new economy" names, which emphasises the benefits of the differentiation delivered by a more active stock-picking process. Uber, Lyft and Airbnb have all shed workers in the last couple of weeks. Airbnb, once considered (and possibly still) to be 2020's marquee Initial Public Offering, recently raised new funds at an equity valuation of $18bn, down from $31bn last time. Not only that, but it also had to pay an interest rate of more than 10% on new debt. As I have mentioned before, the good news is that credit markets are open to provide capital, but the price can be very high: no zero interest rates for riskier borrowers. Norwegian Cruise lines, right at the sharp end of the Covid crisis, issued new debt with a 13% yield-to-maturity (YTM) last week.

And, in the end, it's the debt that usually brings you down. J.Crew, the US clothing retailer, joined the lengthening queue to file for Chapter 11 bankruptcy last week despite most recently reporting an operating profit of $71.5m. Trouble was the interest payments of $147m – an average interest rate of 8.9% on its $1.65bn debt obligations. Such is the mechanism of Chapter 11 that J.Crew will probably not disappear forever. The bondholders will convert their ownership to equity and a much less leveraged entity will emerge. However, even then, it's not clear that it will escape the retail trends that helped push it to its current state.

We recently wrote about the price of oil going negative. Something not quite as outlandish, but equally salient, happened in the real estate sector last week. Orion, a private equity company, had previously negotiated to buy six retail parks from Hammerson. But rather than shelling out the agreed £380m, it decided it would be better off paying Hammerson £21m to walk away from the deal. We can infer from this that those retail parks are now worth less than £359m (at best).

At the other end of the interest rate scale, most governments are still able to borrow at rock bottom rates despite burgeoning debt piles. Last week the UK Treasury issued a new short-dated Gilt that matures in 2025 with a YTM of just 0.017%. That suggests little immediate strain on the public finances. But why are sovereign rates so low when a company with a similar balance sheet would be paying double-digit rates? Well there's always the fact that governments have revenue raising capabilities (tax!) that can be extended. Demand for government bonds continues to come from financial institutions who are required by regulation to hold government debt as part of their capital. Balanced portfolio investors will never sell out completely owing to a mix of regulatory constraint and the need to hold a modicum of "insurance" assets. Then there are those who believe that economic conditions are only going to deteriorate further, taking Gilts into negative territory to join, for example, Germany and Switzerland, and thus delivering capital gains. Neither must we ignore central bank purchases in the new round of Quantitative Easing, along with thoughts that they will in future exercise "Yield Curve Control" to pin rates down. Finally, there remains the idea of "excess savings", which has been prevalent for many years now. This postulates that there are insufficient profitable opportunities to invest savings in the real economy, therefore driving savers into financial assets, thereby pushing yields lower. It is a theory closely associated with Larry Summers, the American economist who is credited with coining the term "Secular Stagnation". I listened to a conference call with him last week, and he continues to believe that secular stagnation persists. Indeed, if anything, it is reinforced by the current situation.

Another key outcome of secular stagnation has been very low inflation. Summers thinks this will persist, especially in the short term while demand is so weak. However, he did admit that the "dispersion of possible outcomes" is now wider, suggesting some need to build defences against higher inflation in future. The inflation debate is definitely winding up again, although with little sign of a consensus being formed. Making the correct call will be crucial to portfolio construction over the next decade. It is a subject to which I will return in more detail in the future.

Last week's Economic Highlights

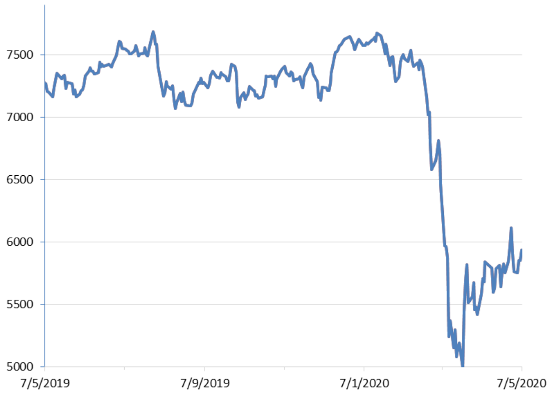
FTSE 100 Weekly Winners

Ocado Group	16.2%
Experian	9.5%
RSA Insurance Group	9.0%
Halma	6.8%
Smith & Nephew	6.4%
Just Eat Takeaway.com	6.4%
Schroders	5.2%

FTSE 100 Weekly Losers

TUI AG	-16.3%
Carnival	-14.5%
IAG	-14.2%
Rolls-Royce	-13.0%
EasyJet	-11.9%
John Wood Group	-11.1%
BT Group	-9.6%

FTSE 100 Index, Past 12 Months



Source:FactSet

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