Weekly Digest

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Homegrown

This week it's time to focus on matters a bit closer to home. There is plenty to deal with domestically, with more Covid-related restrictions coming into force, their impact on the economy, and how the Bank of England might react. And, of course, Brexit rumbles on, with the finishing line now in sight.

I don't intend to assail you with loads of Covid statistics, most of which are readily available through your normal media outlets. Our primary focus has been on the relationship between the reported number of cases and the attributable deaths, with an eye on hospitalisation rates too. We have always acknowledged that, given the government's policy choices, this virus was not going to be eradicated completely in the UK, and that there would inevitably be a series of rolling regional lockdowns, which are now happening.

One cannot be complacent about the number of cases being recorded (which is going to be an understatement anyway owing to the number of asymptomatic people who will never get tested), but everything needs to be put into context. The peak in the seven-day average of positive cases in April was 4,999, which makes today's average of 14,392 look alarming. However, the April number was in the context of daily testing that rarely exceeded ten thousand, and you were only going to get tested if you were already suffering badly or in the front line of duty. Current testing capacity is well into six figures.

The seven-day average of deaths in April peaked at 914 (an apparent mortality rate of 18%). Currently it is 68 (an apparent mortality rate of 0.5%, which is an awful lot closer to original estimates based on early data from China). There are various reasons for this: vulnerable sections of the population are better protected currently (and, sadly, the first wave probably did attack the most vulnerable hosts first); treatment has progressed impressively, with the medical community able to repurpose certain existing drugs to great effect; reported infection rates are now much more heavily weighted towards younger people, who, owing to their more robust immune response, are less likely to display more serious symptoms.

Taking such data into account, we remain of the opinion that the "second wave", serious as it is, will not demand the extent of restrictions that prevailed earlier in the year. That, along with the fiscal and monetary response, has been a key plank of our willingness to retain a full weighting to risk assets.

Even so, as we saw in the economic data reported last week, all of this continues to have a seriously negative effect on the economy in aggregate. Even though Gross Domestic Product (GDP) rose

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another 2.1% in August from July, that result was well short of expectations of 4.6% (although there were some offsetting upward revisions to previous months' data, suggesting that the initial decline was not quite as bad as thought). Things might well have been worse without the Eat Out to Help Out scheme - half of August's growth came from hospitality sectors.

Net net, though, economic activity at the end of August remained 9.2% below its pre-pandemic peak, which is still unprecedented during modern peace time.

The economy would also be in a much worse state without the support of government. Again, we have always been of the opinion that the Chancellor would open his cheque book again as and when it was required. No government is currently being punished for doing so in these exceptional times. Indeed, "austerity" is now a dirty word in politics, and big spending promises win votes (not that that is necessarily a current consideration for the Conservatives). The deficit for the current fiscal year is projected to be north of £350bn, and the floodgates are open. The cost of the latest jobs support package announced last week to offset the enforced closure of certain sectors of the economy will run into the tens of billions. There was another £30 million promised to police forces last week, and then £250 million over the weekend to arts venues. And the yield on a 10-year Gilt is still only 0.27%, and so all of this spending remains affordable.

Of course, the Bank of England has also played a big role in all of this. It cut the base rate to 0.1% early in the pandemic and expanded its asset purchase programme, also known as Quantitative Easing (QE). The latter currently has a capacity of £745 billion, but almost every investment bank economist is expecting this figure to be raised in December by £100 billion. Thus the government's tab is being picked up by the central bank. Again, the UK is far from alone in following such a path. Until there is any sign of a rebellion in either the bond or currency markets, we would expect central banks to push this policy for as far and as long as they are able to. Japan has been doing it for the best part of thirty years!

And what of interest rates? We are often asked when depositors might expect to see a more generous return on their savings, and the answer, I'm afraid, is not for a long time yet. Indeed, markets are toying with the concept of the Bank of England following the central banks of Japan, Switzerland and Europe into negative interest rate territory. Such speculation is hardly discouraged by members of the monetary policy committee, who have been flying kites on both sides of the argument in recent weeks. Some cite work from the European Central Bank "proving" that negative rates have been beneficial; others point to the decision by Sweden's central bank to raise rates back to zero owing to the punitive effect on the banking sector (which struggles to make profits in a negative rate environment). Japan's negative rate policy has hardly created much growth or inflation. There is also some evidence that habitually cautious savers will save even more if they can't see a decent safe return in prospect.
I think we can say with a degree of certainty that deposit returns will remain derisory for the foreseeable future, as will those on government bonds.

This will continue to force savers to take greater risk with their investments than they might otherwise have done to generate sufficient returns.

On the Brexit front - at least we know that, in all probability, we are just a few weeks away from knowing our fate. Our central view remains that some sort of deal will emerge because, in the end, it is in both sides' interest not to cause economic chaos. However, it will be a "skinny" deal - what might in the past have been described as a very "hard Brexit". But the market knows this. If the scale of a Brexit shock pre-referendum ranged from zero being a "No Deal" Brexit to one hundred being "Remain", we are now effectively dealing in the zero to ten range.

The mood music changes key almost daily, but the trend appears to be towards a deal of some

sort. In making its choice, the UK has to take into account other factors, including the threat of another Scottish referendum, the stance of the US on a trade deal (not on offer from a Democrat president if the Good Friday Agreement is not upheld), and also the potentially multiplicative negative effects of combining Covid with Brexit. Although the Prime Minister's previously self-imposed deadline expires this week (with the scheduled EU Council meeting), talks will almost definitely roll on into November.

The other big question we are often asked is when will UK equities finally start to perform. The FTSE 100 Index, after all, is lower than it was twenty years ago, with returns only being accrued from dividends (which have themselves just been cruelly curtailed thanks to Covid). The composition of the UK's large capitalisation index means that it will need investors to start rewarding sectors outside Technology and other growth industries, where the UK remains severely underrepresented.

The largest UK sector is Financials (17.6%), which would prosper in a world of higher interest rates and a steeper yield curve. The former, as discussed, is not going to be a factor anytime soon. The latter is possible, especially if inflation expectations start to rise. However, we don't expect central banks to allow bond yields to rise too far owing to those huge fiscal deficits. Next in the table is Healthcare, which is at least a sector with a decent secular growth outlook.

However, in the short term, risks abound from the probability of a Democrat victory in the US, with the party promising to provide more affordable care, which points to lower prices for drugs and services.

After that we are into more cyclical sectors such as Industrials (11.2%) and Materials (10.7%), with the increasingly shunned (for environmental reasons) Energy sector (9.7%) not far behind. Basically, a jolly good synchronised global recovery with trade to the fore would be extremely beneficial. Even then, though, certain European markets and many Emerging Economies have greater exposure, and could well outperform the UK.

One thing seems to be sure, though. Given that the UK's Technology weighting is a mere 1.7% (vs US 29%, EU 9.5%, Japan 12.2% and EM 17.8%), if the most recent trends persist, UK equities will continue to lag.

Last week's Economic Highlights

FTSE 100 Weekly Winners

Rolls-Royce Holdings PLC	96.5%
Melrose Industries	13.4%
International Consolidated Airlines	13.1%
Intermediate Capital Group PLC	12.3%
Whitbread PLC	10.7%
Barratt Developments PLC	10.5%
Taylor Wimpey PLC	10.0%

FTSE 100 Weekly Losers

Ocado Group PLC	-10.4%
Pennon Group PLC	-5.3%
Hargreaves Lansdown	-4.8%
Intertek Group PLC	-3.9%
Mondi PLC	-3.5%
London Stock Exchange Group PLC	-3.5%
Reckitt Benckiser Group PLC	-3.3%

FTSE 100 Index, Past 12 Months

Source:FactSet

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