Weekly Digest

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Wake-Up Call

Following several weeks of near-unbroken positive sentiment in markets about the pace of economic recovery and the apparent diminution of Covid-19-related risks, we had something of a wake-up call last week – and, after a short snooze, the alarm is ringing today as well. While we don't want to become too entangled in the short-term fluctuations of published data, it is still worth examining what has shifted in investors' collective brain.

Looking for someone to blame, many people are pointing the finger at Jerome Powell, the Chairman of the Federal Reserve (Fed), the central bank of the United States. Last week the Fed delivered a particularly downbeat message about the current state of the US economy, as well as about the pace of recovery. Looking out as far as the end of 2022, it saw an unemployment rate of 5.5%, which, even though much lower than the current 13.3%, is still a lot higher than it was back in February at 3.5%. Core inflation is forecast to remain dormant at 1.7%, and interest rates are going to remain at effectively 0%. Indeed, he said that "we are not even thinking about thinking about raising rates". But there was also disappointment that this bitter outlook pill was not sugared with promises of even looser monetary policy. It seems a bit churlish that he should be made the scapegoat for falls in equity markets just for telling it like it is, but such are the responsibilities of holding the fate of global financial markets in your hands.

It didn't help that Mr Powell's words coincided with very poor economic data from the UK and Europe. It was confirmed that April's Gross Domestic Product in the UK was 20.4% lower than in March, following a 5.8% month-on-month decline in March itself. That means that overall activity in April was about a quarter less than it was in February, a shortfall not experienced in living memory. Across the Channel, Industrial Production in Germany, France and Italy fell by 25.3%, 34.2% and 42.5% respectively from a year ago. Even though we are as convinced as we can be that April marked the trough in overall activity, it is feared that the sheer scale of the downturn will create "economic scarring", a phrase that we could be hearing a lot more in future, which weighs on the recovery.

The latest market setback was not just about economic data, though. Despite that fact that today marks the re-opening of a swathe of non-essential retailers in the UK, it comes at a time when worries about a second wave of Covid-19 infections are increasing. Of course, the first wave is still ongoing in some parts of the world, notably in several emerging economies such as Brazil and India. Rather coldly, but perhaps pragmatically, investors have been willing to downplay the impact on the global economy and major stock markets as long as the news improved in North America, Europe, China and South-East Asia. That is no

longer necessarily the case. Concerns have been raised over the weekend about a new wave of infections in Beijing, which, while less than a hundred confirmed cases so far, could become a lot worse owing to the location of the breakout in the world's largest food market which also sits next door to a national high-speed rail hub. So far, new lockdown measures have been restricted to the locality, but we are about to see just how effective China's testing and tracking methods are.

Meanwhile in the United States, there are worrying signs of an uptick in infection rates in several large states, especially California, Texas and Florida, the three largest by population (although New York creeps into third on a GDP measure). It is slightly worrying that all of these states would be considered "warm and sunny" in terms of climate, suggesting that heat and a good dose of sunshine are not sufficient to control the spread of the virus. One new website (rt.live – for which I make no guarantee of accuracy, but provide for informational purposes) suggests that Rt, or the effective transmission rate, for all three of these states is currently 1.0 or higher. That means that the number of cases is expected to grow. Remember that the natural rate of transmission (R zero) for Covid-19 is generally thought to be between 2.5 and 3. The latest Rt for the UK is in the range of 0.7-0.9, although 0.8-1.0 in England. The only major country so far to declare itself Covid-free is New Zealand, and it had to drive the effective transmission rate below 0.5 to achieve that.

I am no epidemiologist, and I can only offer an opinion, hopefully informed by widespread reading of and listening to people who have qualifications and years of experience. It does appear that we are in danger of being lulled into a false sense of security by the fact that Rt has fallen so far relative to R zero. This has only been accomplished by stringent social distancing. As soon as that is relaxed, the current infection rate will tend higher as long as the virus is present somewhere in the community. To some degree it will be capped below the natural rate by newly-acquired caution and behavioural changes such as hand-washing. The fact that some have achieved immunity through infection will also help, but we are nowhere near the 60%-plus level deemed necessary to provide "herd immunity". The UK's Office of National Statistics calculates that just 6.8% of our population has had the virus.

Bearing all of this in mind, we continue to be circumspect in our investment stance. While we can have a reasonable degree of confidence in evaluating risk and making long-term asset allocation decisions accordingly, current levels of uncertainty (which are much harder, if not impossible, to price) reduce the appetite for, or advisability of, making big calls.

Finally, a few people appear to have been unnerved by references to a "wealth tax" in last week's Digest. The comment referred to an opinion poll carried out by YouGov, which asked 1,682 people if they would support a tax on "net worth over £750,000, excluding any personal pension savings and their main home". Overall support for such as tax was 61%, which is hardly surprising because the percentage of the population who will have non-pension and primary residence assets in that bracket is going to be low (sorry, but I can't find exact data). It would go massively against the grain for the current government to impose such a tax, but the fact that it is being touted is worrying enough. Spain, Norway, Switzerland and Belgium currently do levy a wealth tax. The danger for the economy is that if people worry that one will be imposed, they will just save more, further depressing growth. Just another thing to add to the apparently ever-expanding list of variables we need to consider.

Last week's Economic Highlights

FTSE 100 Weekly Winners

Fresnillo	10.7%
Pearson	7.9%
Rio Tinto	1.0%
Centrica	0.9%
Reckitt Benckiser	0.5%
National Grid	-0.3%
Rentokil Initial	-0.6%

FTSE 100 Weekly Losers

Melrose Industries	-20.4%
Just Eat Takeaway.com	-16.1%
IAG	-15.9%
John Wood Group	-15.3%
Whitbread	-13.9%
Compass Group	-13.9%
Micro Focus International	-13.6%

FTSE 100 Index, Past 12 Months

Source:FactSet

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