Weekly Digest

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Taxman

One of the benefits of the latest social restrictions is that there has been much less to distract me from completing my tax return, and for the first time in living memory it was submitted to HMRC before the end of November. Much as I try to simplify my tax affairs through the PAYE system and the use of tax-efficient savings wrappers, there is always that depressing moment when I find out there is an outstanding liability, and this year was no exception. Still, it will end up putting a (small) smile on the face of the Chancellor of the Exchequer.

Last week Mr Sunak presented his Spending Review for 2020, and it revealed the true horror of the country's finances. The Office for Budget Responsibility projects that the UK economy will shrink by 11.3% this year, the sharpest decline since the Great Frost of 1709. And although it is expected to bounce back next year, initial projections suggest a recovery of just 5.5%, meaning that the prior economic peak will not be reached until 2022 at the earliest. As a result of this, public borrowing is expected to rise to £394bn in the current fiscal year to April 2021. That represents a stunning 19% of GDP (which is itself, admittedly, depressed), almost twice the levels experienced during the great financial crisis (GFC). Indeed, only during World War I (28%) and World War II (27%) can we find bigger deficits as a percentage of GDP. No wonder politicians often use wartime metaphors to describe the current situation.

Such alarming numbers might normally be associated with panic in the bond market, but that certainly has not been the case. The yield on the 10-year Gilt remains very low at just 0.29%. Yes, yields have risen since the trough of just 0.07% in August, but are still less than a tenth of where they were a decade ago – the post GFC peak was 4.23% in February 2010. That means that debt issued ten years ago can be refinanced at a substantially lower cost today. Somewhat counterintuitively, as our debts go up our overall interest payments could come down! This was very much the case in Japan, where a six-fold increase in gross government debt in the two decades following the collapse of the financial bubble in 1990 resulted in lower interest bills. The UK will benefit further from the fact that it has a relatively long average duration for its debt, currently 15 years according to Bloomberg data. In 2007, 10-year Gilt yields were more than 5%.

Of course, all of this requires the connivance of other actors. A few weeks ago I wrote about the timely coincidence of the Bank of England's expansion of its asset purchase programme with the Chancellor's extension of furlough. The European Central Bank is also expected to increase the scope of its PEPP (Pandemic Emergency Purchase Programme) by €500bn to €1,250bn at this month's meeting. The US Federal Reserve (Fed) is not expected to be quite as expansive at December's gathering, but there are predictions that it will extend the maturity of its bond purchases, which would help to flatten the yield curve – good for holders and

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issuers of debt, perhaps, but not necessarily helpful for new investors looking for a return - nor for banks (whose profits tend to increase with a steeper yield curve).

Another interesting development on this front came last week with US President-elect Joe Biden's confirmation that Janet Yellen will be his choice for Treasury Secretary (subject to senate confirmation, which should be a rubber stamp job). Ms Yellen was Chair of the Fed for four years from 2014 to 2018. Having been nominated by a Democrat President (Obama), it was hardly a surprise that she was replaced – although (according to a Washington Post article) President Trump "told aides on the National Economic Council on several occasions that the 5-foot tall economist was not tall enough to lead the central bank". Mind you, I'm not sure he would have approved of the 6 foot, 7 inch inflation hawk Paul Volcker either. Yellen's appointment suggests a very close, even symbiotic, relationship between the Treasury and the Fed in future. This could be further enhanced if current Chair Jay Powell is replaced by Lael Brainard in 2020. She is a card-carrying Democrat, and was herself hotly tipped for the Treasury position.

Where am I going with all of this? Back to those debts. Are they sustainable? And, if so, for how long? Mr Sunak, for all his fighting talk about curtailing the furlough scheme and reining in the deficit has, so far, always caved in to the reality of the situation. One wonders if his plan to freeze wages for public sector workers will survive contact with the reality of fierce protest. There is plenty of "wise after the event" analysis of the exit from the GFC, and a general agreement now that austerity policies in the name of prudence were premature. The consensus belief today is that it is much better to the get the economy back on its feet first. That's why central bank support will remain crucial to keeping bond yields under control.

Although there is talk of tax rises, these are likely to be limited for now. If governments can get economies growing faster than debt levels rise, then debt/GDP ratios can fall "organically", especially with those low interest rates. That would be the least painful way to reset deficits to more normal levels, although would take a long time. The danger is that the global economy hits another obstacle before the objectives are achieved.

From an investment perspective, all these factors will continue to influence behavior. Such low rates for "safe" investments will continue to force many investors to take on greater risk to achieve their required returns. This might not necessarily be the case for individual investors, who could choose instead to curtail their lifestyle choices. But it is more certainly the case for, say, pension schemes that are obligated to make certain levels of payouts to their members.

If we put all of this together, along with the vaccine news that we have discussed in recent weeks, it supports the case for equity markets to make further progress. Such an assertion might seem a little dangerous when global share indices have just hit new all-time highs and when it looks as though November is going to be one of the best (possibly the best) performing months ever for equity markets, but that's what the evidence is telling us. We can start worrying more when there are clearer signs of monetary and fiscal policy reversal.

Last week’s Economic Highlights

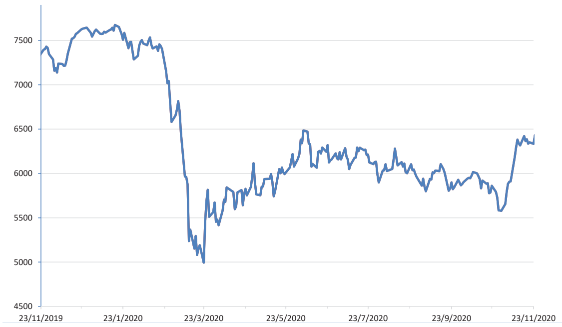
FTSE 100 Weekly Winners

Glencore PLC	9.5%
Antofagasta PLC	9.0%
Royal Dutch Shell PLC Class B	9.0%
Rolls-Royce Holdings PLC	8.3%
Royal Dutch Shell PLC Class A	7.6%
Flutter Entertainment PLC	7.6%
BP PLC	7.6%

FTSE 100 Weekly Losers

Experian PLC	-11.0%
JD Sports Fashion PLC	-11.0%
Intertek Group PLC	-10.4%
Home Serve PLC	-9.8%
Spirax-Sacro Engineering PLC	-7.7%
Hamla PLC	-6.8%
AstraZeneca PLC	-6.6%

FTSE 100 Index, Past 12 Months



Source:FactSet

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