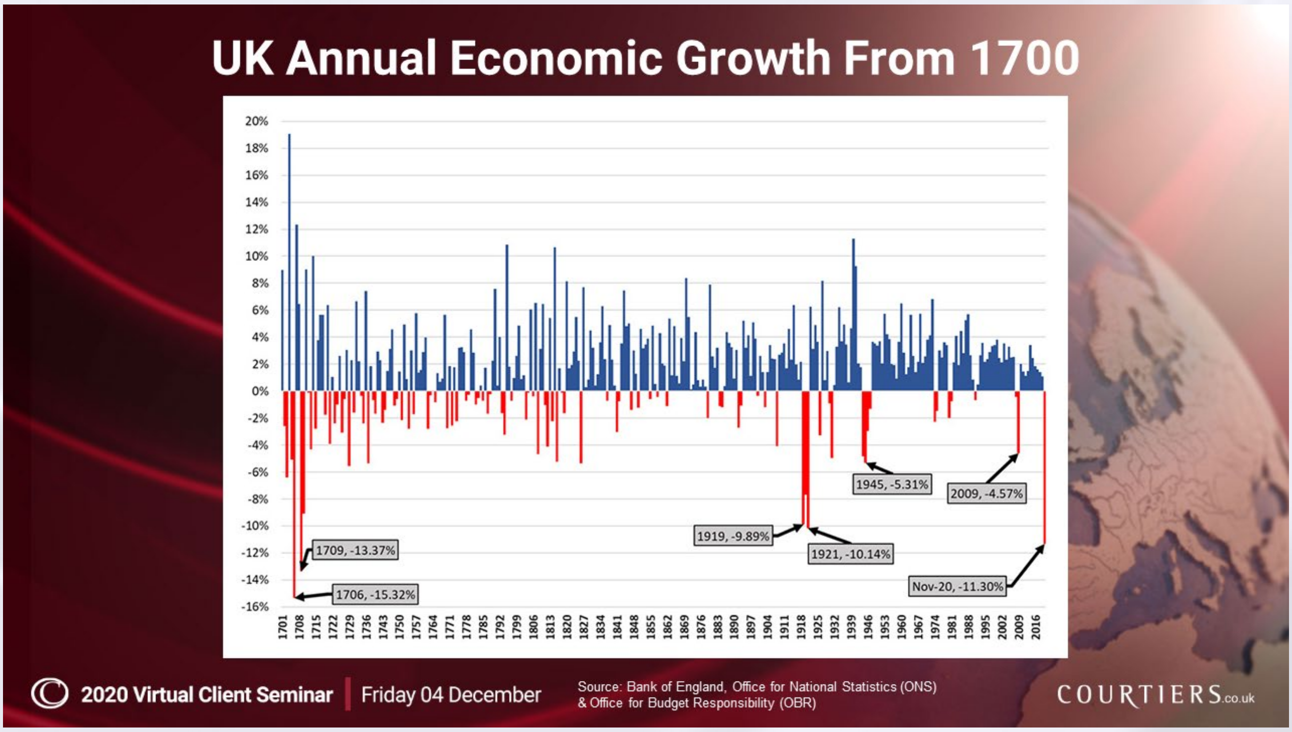
By Gary Reynolds, Chief Investment Officer

2020 has been a tempestuous year for western economies. The OBR (Office for Budget Responsibility) forecasts a decline in UK GDP of -11.30%, which will be the worst performance since the Great Frost of 1709 when GDP fell by -13.37%. [see Chart A]

Chart A



The word 'unprecedented' has been overused in relation to this pandemic. Covid-19 is not the first virus to blight our country. There have been three others in just over a hundred years, the worst being the 1918 Spanish Flu Pandemic, which killed significantly more people than Covid-19.

What is unprecedented is that this is the first time that massive economic damage has been self-inflicted. One may argue that part of the reduction in demand for goods and services is a result of a change in people's habits resulting from them wishing to reduce the risk of catching Coronavirus, but the vast majority of the reduction in GDP has been caused by the government shutting down vast swathes of our economy.

Recovery from recessions can be painfully slow. When prospects for increases in GDP look weak employers tend to delay recruitment, lay people off and suspend investment. This means that the productive capacity of an economy can be damaged through: -

1. Redundancies creating a fall in demand
2. Laid-off workers losing skills
3. Youngsters that have completed their education and training failing to get a job and therefore seeing a plateau in their development
4. Companies cutting back investment
5. Companies cutting R&D (research and development) and stifling future innovation

The 2007/2008 Global Financial Crisis caused all of the above and added an additional risk in the form of banks that were so weak they were forced to pare back lending which made it more difficult for companies to access finance for growth, especially small and medium size enterprises (SMEs). A long period of economic stagnation followed.

Stock markets are said to discount the future, and in 2008 they did just that - stock prices plummeted and remained depressed for months. That is a huge contrast to 2020.

In this year, despite a much worse recession than in 2007/2008, share prices around the world have rapidly bounced back from their March low points and the US has done so well that its major index, the S&P 500, reached a record high on 24th November. Incredibly, the US 'Big 5' (Amazon, Apple, Facebook, Google and Microsoft) rose, on average, by over 45% between 31st December 2019 and 24th November 2020. So why are markets defying history and ignoring the low economic growth which can often follow as a result of hysteresis ("scarring") during a nasty recession?

The answer is fourfold: -

1. Markets are assuming that the efforts of western governments have staved-off any nasty long term effects to their economies. They also assume that, as this recession is self-inflicted through lock-downs, it can be quickly reversed when things open up.
2. The market is assuming that despite the 'second wave' running through most western economies a vaccine will allow things to return to normal sometime next spring.
3. The market assumes that central banks will continue to run loose monetary policy, keeping current interests rates low with rock bottom base rates and reducing long term costs of borrowing through buying-up government and investment grade bonds. [see Chart B]
4. The market has seen governments use fiscal policy (cash handouts, deferred taxes and extra spending) without any undue effect on bond prices. Markets therefore assume that governments will be forced to spend more in an effort to boost their economies, improve the lot of the unemployed and lower paid and reduce the effect of the inequality that lose monetary policy has created (lower interest rates push up asset prices, which benefits those that own them – i.e. the wealthy). In the UK, despite much hand-wringing about the ballooning of borrowing, government debt to GDP has only just risen above its long term average. [see Chart C]

Chart B

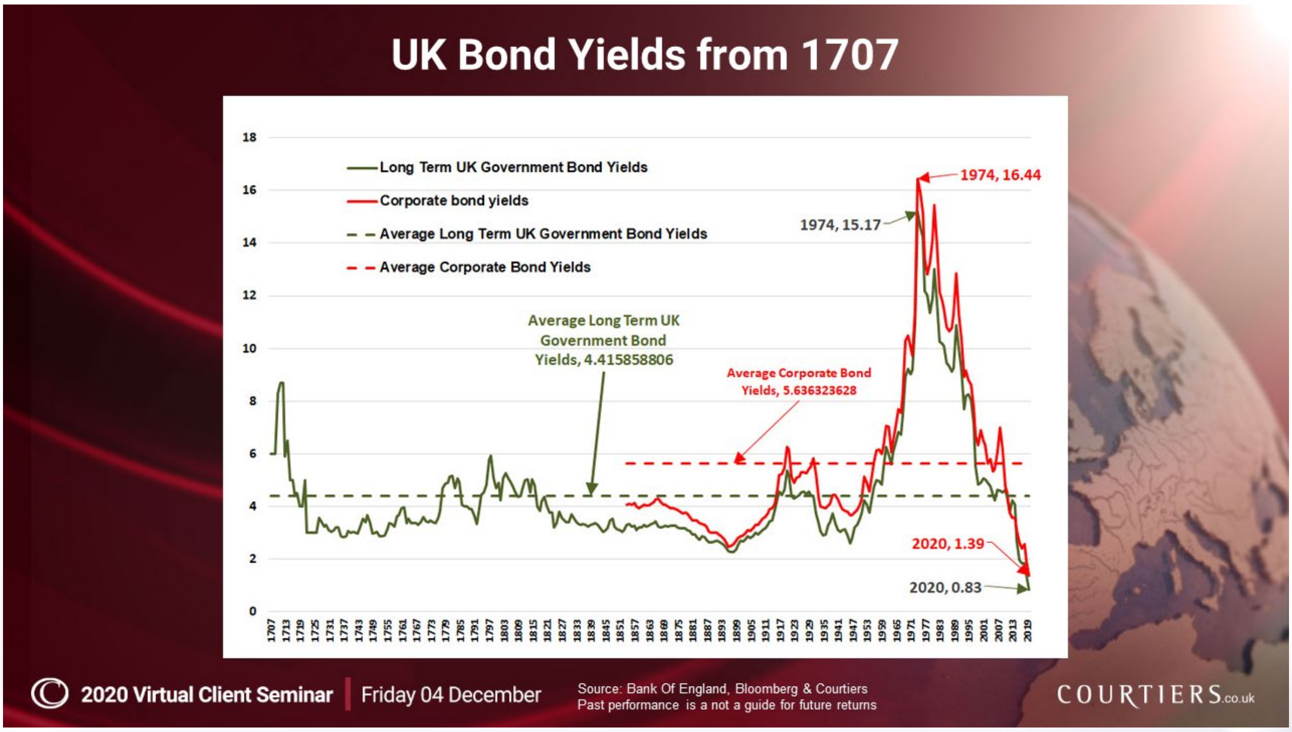
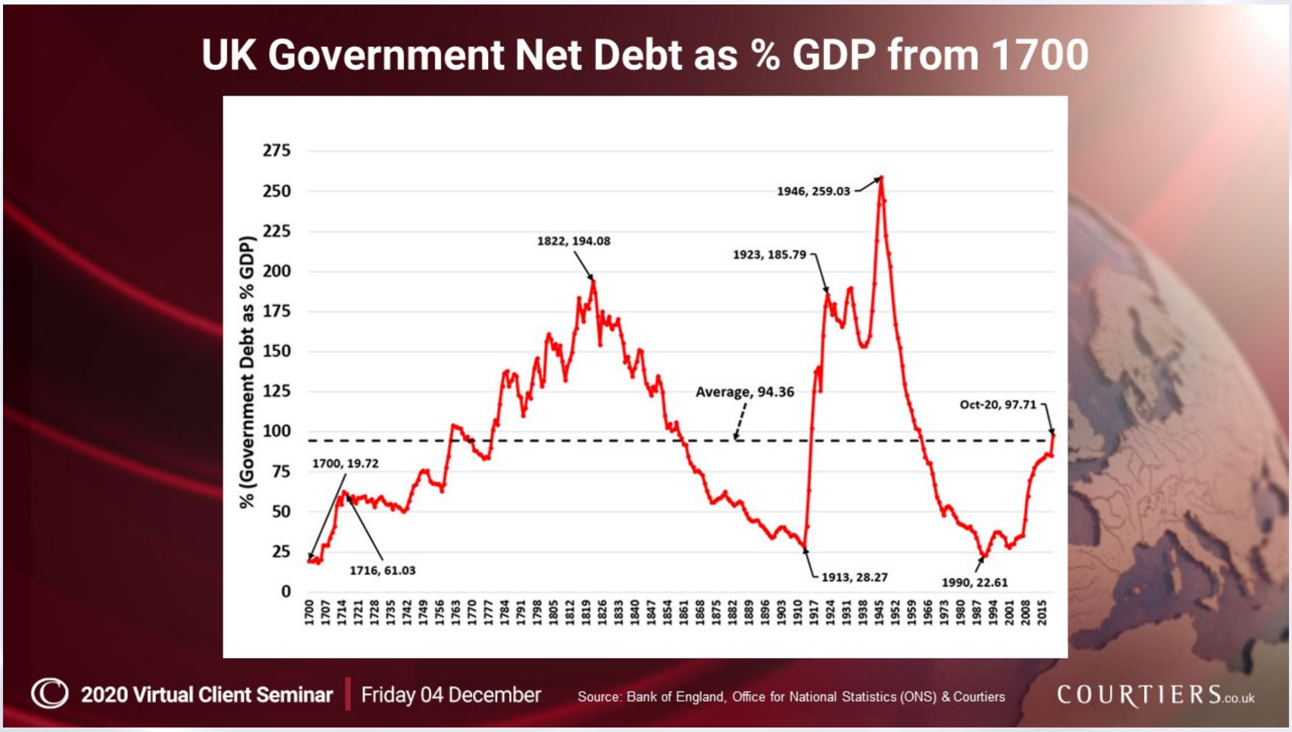


Chart C



I generally agree with all of the above, which is why we concluded that a fairly rapid recovery in share prices was likely after they collapsed in March this year. There is, however, some muddled thinking. If economies do bounce back: if governments do continue their fiscal stimulus: if animal spirits return and businesses start investing again and reemploying, then GDP may not only get back to trend growth, it may overshoot it. If this happens, central banks are likely to start pushing up interest rates, especially if overheating, something we haven't seen for very many years, seems likely. Prospects like these do not justify interest rates at 700 year lows [see Chart D] and, as I've said many times before, all it takes is for UK 30 year government bond (gilt) yields to return to their long term average [see Chart E] and people holding them will see their market value decline by 50%, and these are supposed to be 'safe' investments!

Chart D

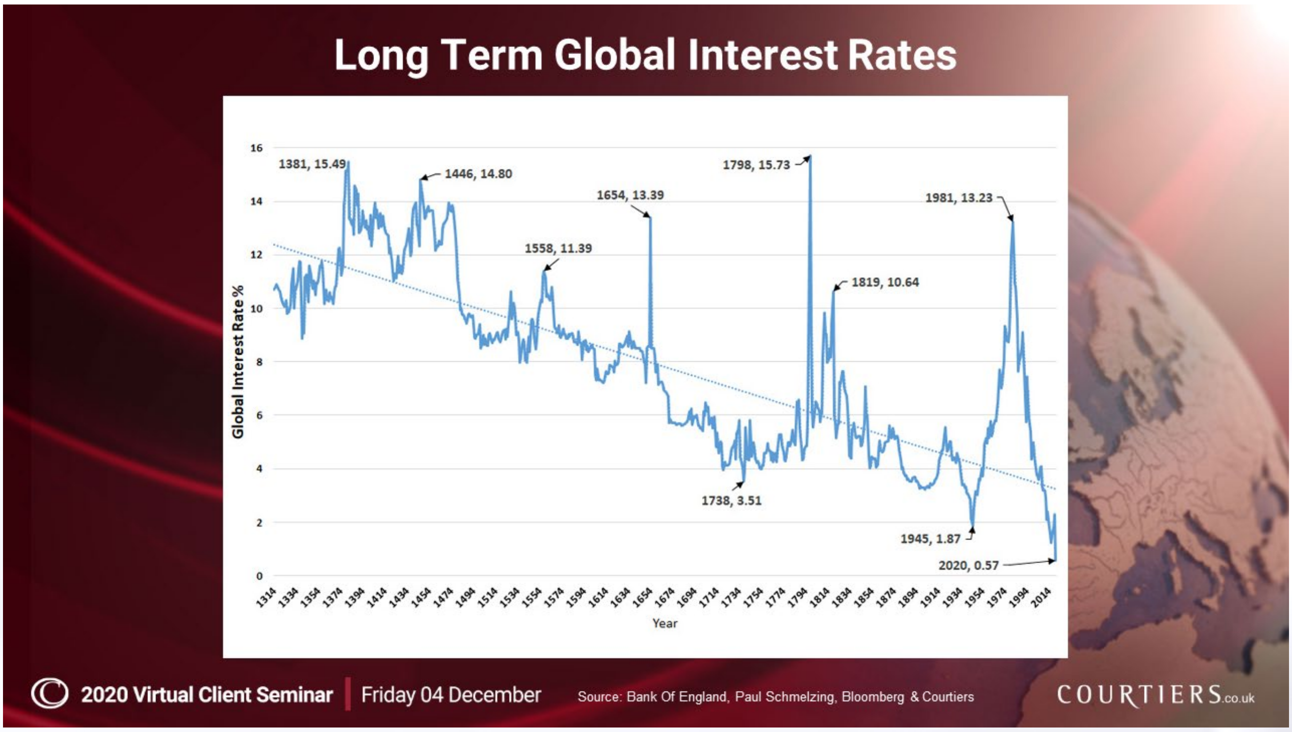
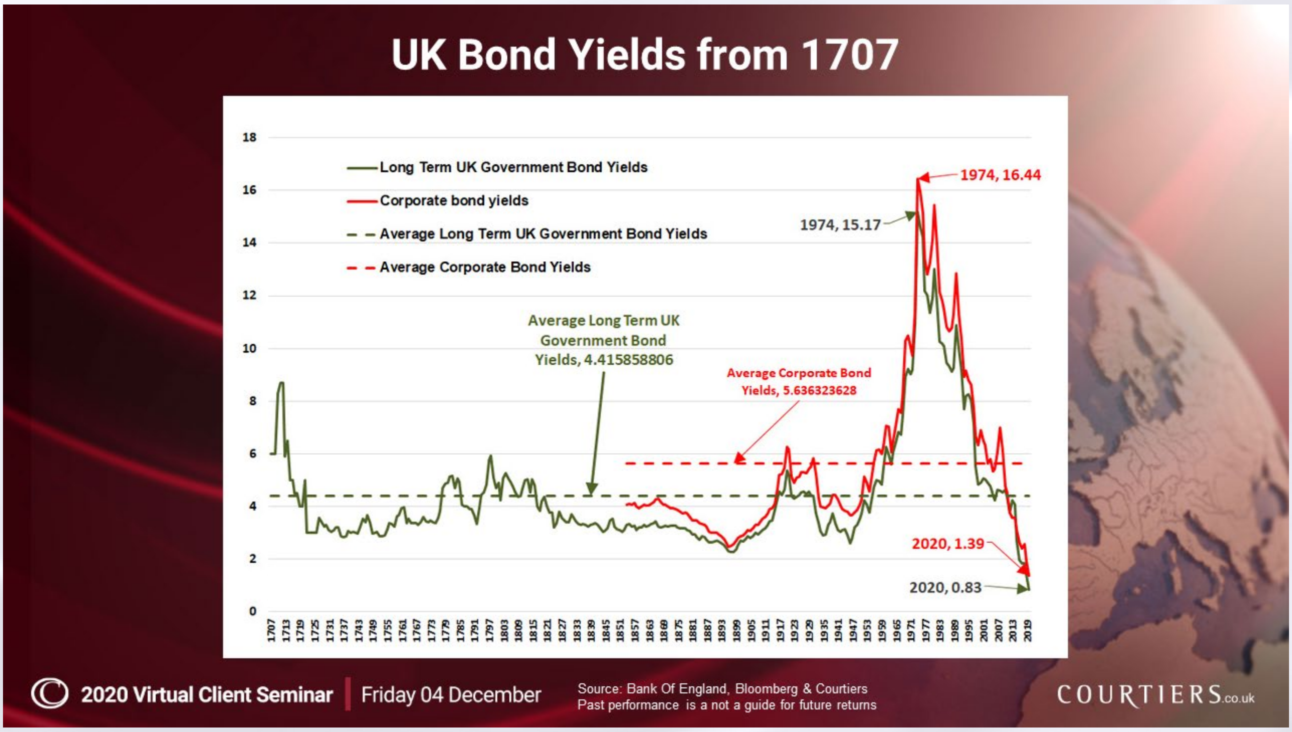


Chart E



I think the market is right to be optimistic about the future. We may even find that businesses and employees have upskilled during the pandemic, especially with regard their IT capabilities, and that this triggers improvements in productivity. If this happens and productivity growth returns to its pre-Global Financial Crisis level (around 2% per annum in the UK) then GDP growth could actually overshoot for a while without troubling central banks. This would be extraordinarily positive for share prices, but the bond market will likely discount the inevitability of future rises in interest rates.

All of this could make it more difficult for investors to navigate their way through the post-Covid-19 period than it was to get through the worst of the pandemic in 2020. We see no value whatsoever in medium to long dated bonds and we are extremely cautious about buying-in to the perpetual growth stories for the big IT and communications companies, particularly when they are valuing at stratospheric highs. Companies that are trading on price earnings ratios elevated to these levels need a lot of things to go right in order to simply justify their current share prices. If just one thing goes wrong their market valuations will plummet.

In the Courtiers Investment Team, we spent the initial weeks of this pandemic checking and re-analysing our positions. We wanted to make sure that the companies that we held had decent balance sheets to get them through the recession and share prices that were reasonable having regard to their prospects. We have also been cutting the duration of our bond portfolios to historically low levels, which means we have been holding more T-Bills, acquiring short dated government and international bonds and, latterly, buying FRNs (floating rate notes).

It's been an interesting year, and it may be an even more interesting time post-Covid-19. Through 2020 we've seen some exceptional bargains in the market and there will be lots of opportunities going forward. But there are also many traps for the unwary, especially those who are banking on long dated bond prices remaining stable and share prices of the big tech and communications companies continuing upward.

The next couple of years will be tricky. Markets will offer up many opportunities, but a sea change in government policy is coming and it will dramatically change the fortunes of bond investors. To make money and stay liquid it's essential to avoid the pitfalls, so to echo the words of the legendary Sergeant Phil Esterhaus from the 1980s US TV series Hill Street Blues… *"Let's be careful out there"*.

Gary Reynolds CFA
Chief Investment Officer