Macro update

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Steven Bell
Chief Economist

Contact us

bmogam.com

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Key risk

The value of investments and any income derived from them can go down as well as up as a result of market or currency movements and investors may not get back the original amount invested.

Looking beyond lockdown

In this month's update, we'll take a look at the prospects for this pandemic and highlight the differences in the prospects for the US, UK and European economies. And when we look at the prospects for the markets, I'll examine a crucial question: will bond yields keep on rising, and do they threaten to end the bull market in equities? We will also cover the vaccine roll-outs, the upcoming UK budget, the new Italian Prime Minister, Mario Draghi, and the new US president.

The end of the festive season and easing healthcare pressures are positive

In terms of new cases, the virus is in retreat. Since the peak in early January, new cases have fallen by 67% – that's massive. The US alone accounts for half the drop. Vaccines explain a small part of the drop, but really it's too early. It is the seasonality that is important – the end of the December holiday season, and better adherence to social distancing, and more people wearing masks. All of this means that the infamous R number is well below 1.

But when it comes to easing lockdown restrictions, and therefore when it comes to economic recovery and better corporate profits, it's not new cases that matter, it's not even the number of fatalities – bleak as they are. It is the pressures on health care systems that matter for governments. And here the news is very good. Especially here in the UK. The number of people with Covid in hospital has tumbled, falling by over 20% per week, and is now less than half the peak of last month.

> If the UK is winning the vaccine race, the US is way ahead in the equivalent economy contest with a more flexible economy, less stringent lockdowns, and a massive fiscal stimulus.

The balancing act for governments is to ease restrictions without pushing the R number back above 1. And that's where vaccines come in. I won't go through the important distinction between efficacy in terms of symptoms, hospitalisations and transmission, but the evidence is good on all these fronts.

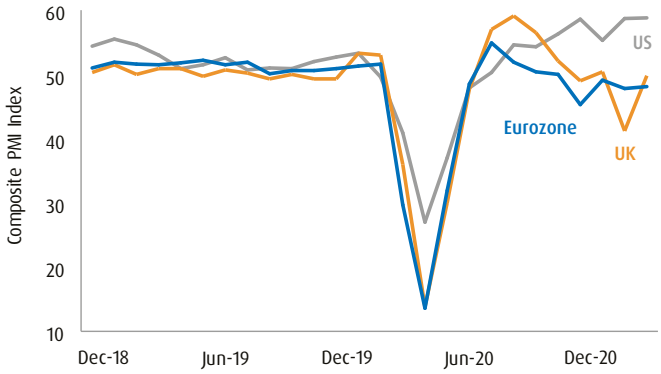
The UK is ahead in the vaccine race...

The vaccine roll-out has taken place at very different speeds in different countries. The UK is way ahead of other OECD countries, especially Europe, with the UK's approach of a 12-week gap between doses helping to reach the population much quicker. The US, for example, has inoculated 13% of its population – with 6% getting two jabs. The equivalent UK numbers are 27% and 1%. The evidence strongly supports the UK approach, although it does involve a degree of risk.

...while the US economy races ahead

If the UK is winning the vaccine race, the US is way ahead in the equivalent economy contest. Chart 1 shows the composite Purchasing Managers' Indices, which best correspond to overall GDP. With a more flexible economy, less stringent lockdowns, and a massive fiscal stimulus, the US comes in at a 'boomy' 58.8. Europe is contracting. The UK is also weak, but the flash estimate just released shows a big improvement.

Chart 1: PMIs diverge



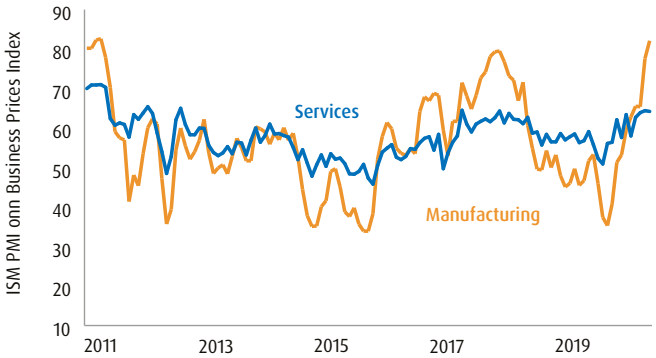
Source: Bloomberg, BMO Global Asset Management, as at 31-Jan-21

The US consumer is sitting on a pile of cash. They haven't spent much of last year's fiscal stimulus and they're about to get a whole lot more. Once they are able to spend it, we're in for a massive boom in the US. And that means better profits for US companies, it also means unemployment will tumble.

The big question is: will inflation rise?

There's plenty to worry about. The money supply has exploded, courtesy of the Fed funding all that fiscal stimulus via quantitative easing. Survey data shows price pressures are rising, so far this has mainly been in manufacturing, and services will surely follow. Added to this, commodity prices are already booming. Each commodity sector has their own individual story: poor harvests for soft commodities, China's construction boom for metals, Saudi Arabia's output cuts for oil. But it surely also reflects the abundant global liquidity.

Chart 2: Price pressures are rising in the US



Source: Bloomberg, BMO Global Asset Management, as at 31-Jan-21

Break-even inflation rates are going up in the US as expectations of economic recovery have improved. And this is a welcome development – welcomed by the Fed who want inflation to sustain a rise above their 2% target. Until recently, they'd kept a lid on conventional Treasury yields so that TIPS – Treasury Inflation-Protection Securities, the best measure of the risk-free rate in my opinion – stayed at record lows of minus 1%. A terrific

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support for risk assets. Until the last week or two, that is. After a remarkable period of stability for the yield on TIPS, when conventional 10-year yields rose 50 basis points in the months following the good news on the vaccines, they have jumped by over 25 basis points in the last two weeks.

Rising bond yields don't necessarily signal the end of the bull market

And this raises the important question: if the bull market in equities has been fuelled by ultra-low rates, surely it is threatened when bond yields rise? And my answer is this: when bond yields rise because growth prospects improve, equities do well. Even if real yields and inflation expectations rise too.

There's a limit of course, and that would be if the Fed decide inflation is getting out of control. But we're a long way off that yet. As Jerome Powell made clear in his testimony to the Senate earlier this week, the Fed welcomes this rise in inflation. Bull markets are not ended by an upturn in interest rates, it's the downturn in the economy that signals the end of the bull market, and the economy is currently definitely turning up.

Here's a list of some of the policy moves planned by President Biden, but the key focus at present is the fiscal package. And that keeps getting bigger now at a shade under $2 trillion, which is a truly massive amount. Far from leading to divisions within his own party, the widespread support of the stimulus among the American people is leading to splits within the Republican party.

Too much good news from an economist – so let's turn to Europe!

Lockdowns aren't being eased in Europe, they're being tightened. There's no big fiscal stimulus, and as for the reforms in France, Italy and elsewhere, they're on hold. But while the European Commission has fumbled the vaccine roll-out so far, they've got the message loud and clear and have now firm orders for over 2 billion doses. More than enough to give everyone 4 jabs. Yes, it'll take time but that's measured in months.

In the UK, we have the Budget and there'll be lots of money thrown at the green agenda and levelling up. But don't expect any tax rises.

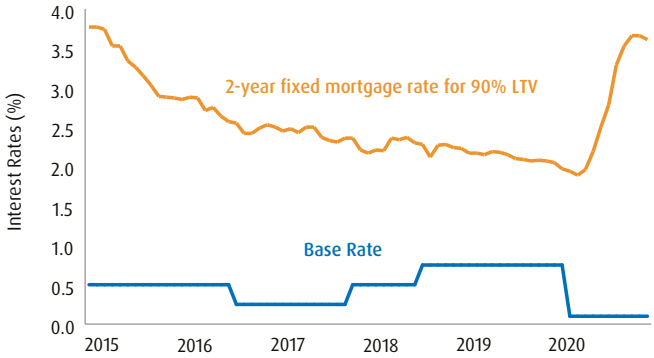
Then there's the European Recovery Fund, ironically set to get going just as the pandemic begins to recede. And to qualify for the grants and loans, countries need to set out plans. Spain and Italy see this as a carrot for carrying out these much-needed reforms, and if anyone can implement them in Italy, it's 'Super' Mario Draghi. This could be a medium-term game changer. None of this will happen soon, but we should see a marked pick-up in Europe in the second half of the year, and possibly the medium term.

UK housing market will benefit from extended stamp duty holiday

Meanwhile back in the UK, we have the Budget and there'll be lots of money thrown at the green agenda and levelling up. But don't expect any tax rises, despite all the rumours, not for this year. Instead, they will be in the Finance Bill for years to come. Higher corporation tax, freezing of income tax brackets – all in keeping with the manifesto commitments, but no wealth tax or new property taxes.

And we've heard in the last few days that the Chancellor will be extending the stamp duty holiday, I think he'll phase-in the phase-out. He'll take a similar approach to many of the other measures taken to support the economy during the pandemic, but I expect them all to go by the end of this year.

Chart 3: Mortgage rates



Source: Bloomberg, BMO Global Asset Management, as at 31-Jan-21

On the subject of the housing market, there have been some interesting developments aside from the stamp duty holiday. Chart 3 shows the UK Base Rate over the last 5 years – little change. In contrast, mortgage rates have been all over the place. Before the pandemic started, fierce competition by lenders pushed down the rate on high loan-to-value (LTV) mortgages dramatically even as base rates rose – it halved. This time last year, the housing market was starting to fizz, then the pandemic struck. Lenders got wind about the prospects for the housing

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market and the rate jumped. Now, the decision by National Savings to cut their key deposit rate from 1% to just 0.15% is a major boost. We'll have to see how this pans out.

Emerging markets have fared better

As for China, their economy is in great shape. The latest PMI numbers did show a dip in the service sector, but construction and manufacturing are very strong. Things may change after the National People's Congress is over next month, but the good thing is that inflation is low. And that's true for emerging markets in general. So, despite often inadequate healthcare systems, emerging market economies have actually fared better than developed economies. The rate cutting cycle is probably now over, but the upswing in global growth means that emerging market equities remain attractive.

The outlook is positive for US corporates and risk assets

With regards to the US market, based on the outlook for the US economy, we expect big upward revisions in analysts' expectations of corporate earnings, so the outlook for US corporate profits is very positive.

In conclusion, Europe's economy is set to lag the US and the UK with a catch up in the second half of the year. Rising growth is raising inflation expectations and bond yields. But the boost to corporate profits should win out. It'll be a bumpy ride, but I expect risk assets to continue to outperform.

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