Rathbones
Look forward

Review of the week

18 Janaury 2021

E pluribus unum

One President will be sworn in as his predecessor is set to be impeached. What matters for the US now is a united front from lawmakers to support the economy against the latest wave of COVID-19.

On Wednesday, the 46th President of the United States will be sworn in surrounded by 20,000 national guardsmen and no public spectators. It's an odd time.

The threat of domestic terrorism is apparently so great that the Secret Service is taking no chances following the violent storming of Congress earlier this month. Much of downtown Washington, DC, will be locked down for Joe Biden's inauguration and the event will not be open to the public due to concerns about the pandemic. There must be mixed emotions for Mr Biden. When he was at President Barack Obama's side during the inauguration of 2009, the pair faced an economic crisis that was being compared to the Great Depression. Twelve years later, he is once again inheriting a nation in dire straits, perhaps this time it's even worse. And the level of partisanship is now off the charts. The sitting President is up for impeachment on the charge of inciting insurrection and a chunky majority of the opposition party voted against the ratification of the new President as the rightful winner of last year's election.

There is reason for hope, however. For all Donald Trump's boasts of his skills as dealmaker, it is Mr Biden who really deserves the moniker. His decades-long career in the Senate was as a moderate who was never been afraid to cross the aisle and seek compromise. Over his career, the Bipartisan Index ranks him in the top fifth of all elected officials on this measure. This instinct, hopefully, will help reason and progress prevail in America.

His first challenge will be pushing his $1.9 trillion pandemic response package through a Congress that Democrats control by a whisker. His plan to accelerate vaccinations to 100 million doses within his first 100 days should be uncontentious and relatively easy to hit. The fiscal components will be trickier. He wants to boost federal unemployment support to $400 a week until September and send out one-off cheques for $1,400 to every American who earns less than £75,000. This has broad support. Yet most unemployment support is provided by states, which badly need propping up with federal cash. This has been resisted tooth and nail in the past by Republicans. Also, included in the COVID response bill is a clause raising the federal minimum wage to $15. This is anathema to Republican lawmakers, particularly as many states already have minimum wages above that proposed floor. The overall effect of this move would be pretty low according to economic researchers, if it takes 10 years to phase in, because nine out of 10 minimum wage earners already earn more than the federal minimum wage. Yet politically it is a thorny one. It would likely lead to hikes in the wages of low-paid workers mostly in Republican states, which could upset Republican donors. Yet most voters - including many moderate Republicans - agree with a $15 minimum wage.

Meanwhile, investors worry that, to pay for the support of states and increasing workers' wages (many affected workers are in the public sector), taxes will have to rise. This led markets to dip slightly last week. The package has passed the House of Representatives, most legislation needs 60 votes to be approved by the Senate; the Democrats have just 51. More negotiations will have to happen before an agreement is inked, so watch this space.

Republicans in the Senate will be ultra-hot on the amount of debt that the US holds and will bristle at any attempts to increase it. This is despite themselves racking up huge debts through the tax cuts of 2017 and their own pandemic response spending. Yet economic reality should make them amenable despite themselves. The latest wave of COVID-19 US has started to drag on the nation's recovery. Employers are cutting jobs for the first time since April. In December, 140,000 more workers were laid off than were hired by American businesses.

It is in the interests of both sides to come to agreement and support US households and businesses. Mr Biden wants his presidency to get off on a productive footing. And if the Republicans are seen to be intentionally spiking the Democrats' proposals, public opinion could well turn even more severely against the Grand Old Party.

The price of unemployment

UK inflation will be released on Wednesday. It is expected to rise ever so slightly to 0.5%, well below target. Inflation is unlikely to move much higher until economies rebound. With most of the world still battling the virus, GDP won't return to pre-pandemic levels until 2022/23. When inflation does return, we believe it will spike because of the "base effect" – a statistical quirk of recovery from extremely low levels – and then remain much as it has for years and years: muted.

Inflation is a complicated and multi-faceted phenomenon. Yet there are several reasons why we believe it won't be increasing in a sustained fashion anytime soon. First, the sheer number of people who have lost their jobs because of COVID will take a long time to work through. Even when people get re-employed, they tend to take jobs that pay less than the ones they lost. The scarring from the shock of this experience tends to linger. People are more cautious with their decisions and their money. True, this recession is an unusual one in that some people haven't been as affected by the dislocation and will no doubt spend up a storm once they are allowed out once more. But exactly how much of the amassed savings will be spent and how much will languish in the bank is hard to determine.

Meanwhile, wage growth will probably stall once again. With unemployment likely to remain elevated for some time, the ability to argue for pay rises is negated. Meanwhile, the piles of debt governments have amassed mean many people will be expecting future tax hikes (or closures of loopholes and tax credits), which may encourage them to save more or pay down debt instead of spending.

As long as inflation remains low, central banks will continue to keep the money taps flowing into financial markets. US Federal Reserve (Fed) Chair Jay Powell has reaffirmed his bank's stance: he doesn't see the Fed reducing the amount of government bonds it buys each month for the foreseeable future. That will keep bond prices supported and yields low. He has also said that the Fed's interest rates would be on hold till 2023 at least. Both of these should underpin stock markets as well.

Meanwhile, the European Central Bank, which meets Thursday, has also pledged itself to keeping its policy loose. It has said that, while it expects a rebound from pent-up demand later in the year, it won't be large enough to push it into tightening its policy. As for the Bank of England (BoE), it believes the UK is facing a double-dip recession. BoE Governor Andrew Bailey says that UK unemployment is probably closer to 6.5%, not the 4.9% reported by official figures. The extension of the furlough scheme means that the 7%-8% forecast unemployment peak may be revised, however. Mr Bailey also touched on the phenomenon we mentioned earlier: the bifurcation in fortunes between those in struggling industries and those who have been able to carry on working. Large amounts of extra savings in the UK are concentrated among wealthier and older people. How this will impact the eventual effect of pent-up demand is a difficult question to answer, as we noted above.

There is one nation that has recovered well from the pandemic: China. Its fourth-quarter growth rate of 6.5% outstripped its expansion in the period just before COVID struck and meant it was the only major economy to increase its GDP at all during 2020. China grew 2.3% for the year. China hauled itself out of recession by way of soaring industrial production, much of it in sparked by heightened demand from locked-down populations who switched their spending from travelling and going out to cinemas, bars and restaurants to buying TVs, fridges and other things round the house. Chinese retail demand has been slower to rebound, and its core inflation rate (stripping out food and energy) has been just 0.5%, the lowest level in a decade.

We see this as yet another example of how depressed inflation is worldwide right now.

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