Rathbones
Look forward

Review of the Week

20 July 2020

Harder than you think

For months, the American economy has shrugged off a muddled response to the pandemic, posting better-than-expected numbers. Reality may finally have caught up, notes chief investment officer Julian Chillingworth.

Can you outrun reality? That's the question that tumbled through my mind several weeks ago when many US states reopened despite data showing they were still in the throes of infection. Even worse were those states where the virus had yet to really land: they brushed aside virtually all restrictions and precautions and declared it would be business as usual.

We have all been watching the worrying consequences of these decisions. They came to a terrible crescendo last week, with the US adding between 60,000 and 70,000 cases each day. Many state leaders have swiftly reassessed their *laissez-faire* stance on distancing measures, mask use and the need for lockdowns to combat rampant epidemics.

The continued pick-up in COVID-19 cases in the southern and western US doesn't bode well for the pace of recovery in the world's largest economy. For weeks the US economy has seemingly defied gravity, bulldozing on despite the spread of the virus. The Citi US Economic Surprise Index, a measure of how much economic figures are outpacing expectations, has surged above +250 (historically, it has never broken +100). Yet, it looks like that progress has been in exchange for greater virus spread. That is not a sustainable recovery. Real-time data, such as footfall figures, mobile tracking data and traffic congestion, had shown economic activity was headed in the right direction, but they have since reversed course.

US President Donald Trump and the Republican leadership have been negotiating with the Democrats over the country's fifth pandemic relief package. Both sides of the aisle support the measure, but they have different ideas about what it should contain. Democrats want to direct hundreds of billions of dollars towards state and local governments and schools and universities. They also want the generous $600 a week federal fillip to unemployment insurance to remain in place. About 25 million Americans are currently drawing on the emergency lifeline at a staggering cost of $15bn a week.

Republicans are leery of continuing with the emergency unemployment cheques - not only because of the gargantuan cost, but because they set unemployment benefits above the minimum wage in many states. This is a powerful discouragement for people to return to work. They want to cut the weekly boost to $200-$400, essentially trying to taper the benefit to promote returning to work while not upending those in real need. Another feature Republicans have put on the table is a legal shield for businesses against COVID-related lawsuits, a helpful addition for such a litigious society.

Meanwhile, Mr Trump has demanded that the bill contain a payroll tax cut - he apparently won't sign it into law otherwise. This is a classic Trump idea: eye-catching, expensive and misguided. Giving employed people more cash during a pandemic isn't going to push them out into the shops. They will be worried about getting sick and losing their paycheck - or worse. Instead, it would encourage the well-off to hoard yet more money while adding to the geyser of cash spraying out of Capitol Hill. To top it off, according to the Wall Street Journal, the White House doesn't want to give any more money to the Center for Disease Control, including funding for the distribution of a vaccine. The administration is even trying to shout down spending any more money on testing and contact tracing schemes.

Taking the temperature

A quick and rough thermometer check of the world's economic recovery delivered a heartening improvement last week.

The JPMorgan Global PMI survey is mix of hard data, such as business orders and production, and soft data, like confidence in the future and hiring plans. It jumped by a record 11.4 points to 47.7 in June, following a 10.1-point rise in May. Yet this great trajectory won't include the effects of many outbreaks in the second half of July. There have been infection resurgences in parts of Israel, Spain, the UK, Germany, Belgium and, of course, the US. It's also continuing to run rampant in many emerging markets, especially in South America, Mexico and India.

This seems likely to be the reality for most nations in coming months. The tension between trying to contain the virus while also allowing economies to reopen to prevent widespread business failure means erring on the side of flexibility. Yet as soon as cases spike towards a dangerous level, towns and regions will be sent back into localised lockdowns. You can sympathise with this strategy, but it could turn out to be much more disruptive than a nationwide shuttering. Centralised lockdowns came with explicit government support, yet localised ones would be happening as governments reduce the generosity of these measures. And jumping in and out of operation would be a logistical nightmare - particularly for hospitality firms, which are most vulnerable to becoming a vector for the virus. They are also most likely to be storing perishables, so a sudden shuttering could ruin their supplies and their business.

Meanwhile, a showdown is building between the West and China, which has pushed its luck harder and further than for some time. Right when the world is dealing with the tremendously costly consequences of China's inability to police food hygiene standards, and a bitter American president is constantly casting around for scapegoats for his precarious presidency. Suffice to say, it's not the best timing. China's power grab in Hong Kong has been met with stiffer resistance than we have come to expect. Its skirmishes with India have also earned retaliation. Europe is stirring and increasingly becoming cooler toward its major trading partner, as well. Another escalation of the trade war could be in the offing, and not only from America.

2020 will be a bumpy road for all of us. But the markets seem to be floating easily overtop. Bond prices, both government and corporate, are extremely high (and therefore yields extremely low) because of huge central bank asset-buying schemes. Most developed stock markets have recovered handily from the depths of March as well. The value of the S&P 500 is now 22.3 times the profits expected from the index over the coming 12 months. Over the past five years this price-earnings (PE) ratio has averaged just 16.9x; the 10-year average is 15.2x. After the first week of the second-quarter earnings season, about a tenth of the S&P 500 have announced earnings so far, putting the index on track for a 44% 12-month slump in profits. Investors are banking on a spectacular improvement in early 2021 profits to justify this stock market level.

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