



Rathbones
Look forward

Review of the Week

13 July 2020

Looking ahead

The situation is a bit foggy right now, so investors are trying to figure out whether economies and companies are generally heading in the right direction. Chief investment officer Julian Chillingworth rounds up earnings and inflation.

Companies are starting to reveal their earnings for the pandemic-ravaged second quarter. Analysts estimate that profits from the American S&P 500 Index will be almost half those of Q2 2019. In Europe, listed companies are expected to report an overall earnings decline of almost 60%. These are punchy numbers. So why are markets holding up so well?

Like everyone else on the planet, investors are very aware that commerce virtually shut down from March to July. They have rock bottom hopes for what will be revealed in 2020. They also have much less guidance than they are used to. When most companies report this quarter, **investors will be thinking about next year and what that means for the next decade.** Whether companies had managed to rejig their business and hustle 5 or 8% more sales in Q2 than the paltry amount expected, or slipped 4 or 7% more than the dart-throw guesstimate of their COVID earnings is sort of irrelevant.

In the Before Times, if a retailer beat earnings by 3%, say, investors could extrapolate that and assume that all future years would benefit from that bump in the baseline. The higher trajectory of cash, when assessed over years and years, is suddenly much more valuable than before. During a pandemic this baseline for growth is more erratic and uncertain, so changes must be much larger before they will be factored into those long-term profit forecasts. What is important is less the exact numbers and instead what they illuminate about a company. Say a retailer whose sales held up much better than anyone expected, perhaps showing a hitherto unknown ability to sell in volume online. Or a manufacturer whose quiet investments in automation set it up nicely for keeping production lines humming during a pandemic. The jump in share prices

they may receive over the coming weeks is less about the cash that came in the door last quarter and more about their ability to contend with future disruptions and grasp tomorrow's opportunities.

A few other businesses will be subject to a more immediate calculus, however. These businesses, labouring under large debts and with limited cash flow, are courting insolvency. They *will* be extremely sensitive to exactly how much cash rolled in the door last quarter because that will determine whether they are even around to make money in 2021, let alone 2030. If the US continues to struggle to bring the virus to heel, the share prices of businesses in this position will become ever wilder. If America doesn't get control of COVID-19, it may lengthen the nation's recession and dampen the shopping appetites of its people. As the world's largest economy, what happens in the US matters for all the other nations because of knock-on effects on trade and supply chains.

There is another issue that is beginning to bubble to the surface, especially on the Continent. Several European nations were quick to reopen for travellers in an attempt to reinvigorate the tourism industries that are crucial to their economies. These nations are experiencing new spikes in infection rates. If this trend continues, it may puncture some of the optimism about the pace with which the world can return to normal. It has to be said, the travel rules don't appear to follow the laws of logic. Keeping your distance from everyone as you make your way to the airport, enjoy a pre-flight coffee and wend your way through security makes little sense if you're then going to be sitting shoulder-to-shoulder with strangers for hours on a plane. Countries may be better off pivoting to catering for domestic visitors and perhaps those nations whose people can arrive *sans avion*.

Inflation is everywhere

This year has been an incredibly disruptive time for all of us. Not least for economic statisticians. Like the rest of us, they have had to deal with staying healthy, teaching

their kids and doing their day job all at the same time. But they've also had to contend with two back-to-back tectonic changes in the global economy.

First, the breakdown of the OPEC oil cartel started to untether the crude market before the pandemic sent oil demand plummeting. Then, global lockdowns fundamentally changed the way people live, work and spend. Both of these phenomena have huge implications for inflation stats.

Inflation is a very important measure. It helps you quantify the spending power of the pound in your pocket, it helps bondholders determine the returns they need to lend companies money, and it helps shareholders judge how their businesses can push through price increases relative to the price level of the overall economy. Yet it is also a very impersonal measure. Everyone's life is different and therefore the stuff they spend money on differs. We all need to eat, but if you're a vegetarian a three-fold increase in the price of pork wouldn't affect you. The value of inflation measures is in coming up with a general 'price level' by looking at a basket of the average goods and services a household would spend money on, from the grocery shop to the barber's and overseas holidays. Watching how that benchmark - both in the cost and composition of its parts - changes over time helps policymakers make decisions. Households and businesses find inflation figures very useful too, which is why CPI and RPI are household acronyms! But, in general, households tend to already have made the changes that then show up in the inflation figures. If the cost of pasta has gone through the roof, for instance, it's highly likely that you have already decided to buy rice instead.

Coming back to a world that has a more unstable oil price and which operates in a very different way to previous years, spare a thought for the statisticians who are having to come up with inflation figures today. For one, the stuff that people buy changed virtually overnight because of the pandemic. No more holidays or nights out and drastically less fuel, meanwhile lots more flour, a few extra

TV streaming services and litres of hand sanitiser. Not only that, but the stats departments gather a lot of their data by actually visiting a sample of stores. No chance of doing that during lockdown!

How many of these changes to the 'typical basket' of good and services will be permanent and how many are transient? How do you gather the price data during a pandemic - and how much comparability is lost due to the differing method? These are tricky questions and how they are answered will have significant impacts on national inflation measures. Also, if countries make different decisions it may make it harder to judge the inflation situation in one economy against another. Many countries will be releasing their inflation stats this week, so we'll be able to get another peek at what's going on under the bonnet of economies.


This is all a bit arcane, but it's important because as the world emerges from the pandemic inflation is preoccupying many investors and market commentators. Will it stay muted, as it has for the past few years, because of lower spending and relatively low corporate investment and construction? Or will it spike because supply chains are curtailed and people are competing with each other for fewer goods? Time will tell. You can, however, take a little insight from your own lives. Is the price of your weekly shop changing? Are you putting some things back when you see a scandalous new price at the register? Are you looking for new holiday destinations because your favourites are now eye-wateringly expensive to get to? How much fuel are you getting through? Did the cost of your first meal out in months sting? How much money have you plunged into lycra after buying that bike?


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