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State of Play

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Our Investment Specialist, Simon Durling, shares his thoughts in our latest update. As we approach 19 July, when all legal restrictions in England are scheduled to be lifted, what are the prospects for investors in the future?

As we edge closer and closer to normality it is reasonable to expect many investors to ask the question 'what will happen next'? Whilst it is impossible to predict future events (and even more impossible to predict exactly how investment markets will react to those events) it is worthwhile exploring some of the key factors that may influence investment outcomes in the short-term and shape longer-term trends and investment returns. Whilst the factors identified below are not an exhaustive list and there are hundreds if not thousands of different events that trigger changes in share values, bond yields or property prices, I have tried to identify some key factors and why they might be important.

England's reopening

Assuming the UK Government proceeds with the decision to finish all legal restrictions on 19 July, the economy will, for the first time in over a year, be able to operate freely, albeit the full implementation back to normal could take many months. Clearly each sector of the economy will be affected in different ways and the time span it takes to return to normal will also differ, with some only returning to a new normal instead.

Firstly, the logistics for many companies bringing employees back into the office will not be an easy task. Importantly, with 18 months of data, results and feedback from staff, it is likely there will be a 'new' way of working for many. Offering flexible working has always been an aspiration for companies trying to attract the best people to join them. After this experience, employers have realised some individuals thrive working from home, fitting their family life around their job and being more productive because of this flexibility. A compromise between the office and home is likely to become the norm with many already agreeing to split the working week to achieve this.

One lasting impact for many commercial businesses will be a re-evaluation of their physical workspaces, whether these be offices, warehouses or other property sites. Flexible working may lead to a reduction in office space leased, impacting commercial property owners already navigating the protection afforded to those renting this space by the UK Government in an attempt to prevent evictions. It may also impact plans already in place for new developments, especially in large cities as more and more people work from home and avoid the commute.

For the sectors most affected by lockdowns the final lifting of all restrictions is a destination many didn't expect to survive long enough to reach. Travel, tourism, and hospitality have endured their worst period since records began leaving behind a trail of commercial victims. Clearly, the nervousness about the Delta variant has continued to hang over the foreign holiday sector. The UK Government are due to review their traffic light system next Monday (28 June) with pressure on them to allow those who have been fully vaccinated to travel abroad and not have to isolate on their return. Foreign holiday destinations current loss is the UK tourism and hospitality's gain with many deciding to avoid the uncertainty and taking a holiday in the UK, for some for the second year in a row. Bookings for 'staycations' have rocketed and each destination's local hospitality and activities will also benefit.

Having accelerated their vaccination programme at a faster pace than almost all the larger developed economies around the world, investors worldwide will have one eye on the UK in the hope it may provide answers to the burning questions driving markets and investor sentiment alike:

- How big is the pent-up demand?
- How much of the savings put away during the pandemic will be spent and how quickly?
- When the financial support packages are withdrawn how many companies will survive and which ones will flourish?
- How many more people will lose their jobs when furlough ends?
- What change in behaviours brought about by the pandemic will remain?
- How many of these behaviours will return to normal once confidence has grown?
- Are share valuations too high?
- Will bond yields rise faster than expected?

Inflation concerns

The first of these questions is important because it links directly to inflation. Since the start of the year markets have obsessed about rising inflation, driving much of the volatility and at times market selloffs. Any investor might rightly ask, 'why is inflation so important?' If you peer into the history books, whether this be in the UK or elsewhere in the world, one dominating factor that influences much of the financial world we live in, is inflation. Interest rates, wage rises, economic growth, supply of goods, manufacturing costs, trade tariffs, consumer demand, the list is huge, and all affect in one way or another the rise in the cost of goods and services we consume.

In the late 1970's and much of the 1980's, inflation cast a shadow over economic progress and productivity. This period probably provided the most important lesson for policy makers, politicians, central banks, and financial institutions. Very high sustained inflation acts as a drag on productivity and economic growth, and whilst it provides the easiest route to devalue government debt, it is recognised as one of biggest economic risk factors affecting government and monetary policy decisions across the world today.

The pandemic caused the global economy to grind almost to a standstill whilst measures were put in place to protect lives. Financial interventions and support have been provided on an unprecedented scale. Many millions of jobs worldwide have been saved whilst their respective governments picked up the wage bill. Many purchases have been delayed during this period creating pent up demand. The tricky bit is knowing which part of the consumption has been simply put off and which will not now take place regardless.

If pent up demand outstrips supply, as is expected when economies recover, prices will rise. The simple rule for inflation is if there is more demand than supply too much money chases too few goods forcing up the price of these goods and services. If you add trillions of dollars of savings into this mix, pent up demand may not be the only driver of rising prices. Some commentators may argue that the vast majority of those able to save during the pandemic already had savings in the first place and instead of buying goods and services have simply invested it.

Another important factor of the financial reaction to the pandemic is twofold. Central banks cut interest rates to zero or near zero and started printing more money to provide confidence and liquidity to investment and financial markets. This process is referred to as quantitative easing - where central banks buy back not just government debt but also some corporate debt to provide a life raft and security to calm nerves. This financial support helped investors as share prices recovered and, in many cases, rose much higher than the economic conditions would warrant. When your investment alternatives are zero or limited, investors may increase their risk in search of returns, driving up share prices further.

The central banks these days act as the independent decision makers on base interest rates in their respective location. These decisions are influenced by a number of factors, but their target for inflation is the most important. If the economy overheats and demand outstrips supply and prices rise beyond their target they are obliged to react, normally by raising interest rates. High borrowing costs for businesses and individuals' curbs spending and cools the economy which lowers prices or slows their rise. Raise rates too soon and the slowing of the economy could quickly turn into a recession if the decision turns out to be an error.

Higher interest rates normally feed into higher borrowing costs which in turn feeds into higher bond yields. When yields rise the value of the bond falls lowering capital values for investors. If investors can invest at a lower risk for an improved return, their expectations for the returns from shares increases drawing them down the risk scale and lowering demand for shares, in turn forcing share prices to fall. Also, higher borrowing costs directly impact company revenues and profit reducing future investment returns expected from income received, again also forcing share prices to fall.

So, investors are now very sensitive to any changes in expectation or forecasts in future inflation because of the impact this may have on investment returns if interest rates rise faster and sooner than expected. If central banks are right, and the recent spike in inflation is simply temporary affected in large part by the base effects comparing prices from last year, then investor confidence will return driving share prices higher. If, however, it transpires that other factors like savings being spent, capacity constraints for manufacturers reducing supply and demand persists for longer than anticipated causing higher sustained inflation, the markets are likely to take cover once again.

Change in behaviours

Consumer behaviour, whether this be the goods they buy or the services they use normally changes gradually over long periods of time driven by trends, social values, new ideas and technological evolution. We have seen how much influence the internet and technology has had on our day-to-day lives, whether this be mobile phones, buying online or the impact of social media on our values and desires. Many commentators agree the pandemic has had an enormous impact in changing consumer behaviours in a very short space of time – with many elderly people who prior to the pandemic avoided technology were forced to embrace it, as shielding at home meant online grocery shopping and facetiming their relatives to stay in touch was essential.

Also, many turned to buying more goods as they were unable to use the day-to-day services like gyms, cinemas, and leisure facilities due to restrictions. Despite the phased reopening from 12 April which included non-essential shops, data released since then indicates that some of the shoppers who would have preferred to shop in person prior to the pandemic have continued to buy much of their goods online. Online delivery or click and collect for groceries have endured and supermarket businesses have had to adapt accordingly, increasing their delivery capacity with more vans and drivers, and increasing the number of staff who 'pick' in the store to fulfil these online orders. The latest data which tracks the traffic in towns and cities across the UK indicates that local traffic has increased much quicker than cities like London, Manchester and Birmingham as more of us work from home and pop out to visit a local shop or café at lunchtime. There are hundreds of examples demonstrating a change in behaviour due to the pandemic, some of which will remain, some of which may go back to how things were before COVID-19 was identified. Investors are keen to understand these differences, with investment managers busy trying to pick the winners and avoid the losers.

Financial support coming to an end

The financial support over the last year has been unprecedented even when comparing against the financial crisis in 2008. By far the most effective measure put in place I would argue has been the furlough scheme in the UK and similar schemes globally. It was designed to provide the link between the employee and employer as the taxpayer picked up the wage bill providing a lifeline for companies across the world. Early estimates from central banks and economists painted a very gloomy picture for unemployment with most predicting double-digit unemployment rates as workers were expected to be laid off in their millions. Unemployment rose from a low of 3.8% in 2019 to hit 5.1% last autumn. It has since fallen to 4.7% as companies have weaned themselves off the furlough scheme to bring back their staff to start the recovery. Whilst the Bank of England expect the rate to rise again when the scheme finishes at the end of September to 5.5%, this is well below the doom predicted.

At its peak the furlough scheme paid the wages of nearly 10 million people in the UK if you include the support for the self-employed. Whilst over 800,000 people have lost their jobs since the pandemic began, this number was expected to be much higher if it were not for the furlough scheme. Crucially it remains to be seen how companies will perform once the financial safety blankets are removed. The furlough scheme was not the only financial support on offer, and all of this has to end soon. Which companies have made changes to their businesses to adapt to a post-COVID-19 world and which have simply delayed the inevitable ending? Only time will tell. Fund managers and investors will look at different sectors differently trying to uncover clues to any trends or alarm bells before making investment decisions.

This brings us to the final factor I want to raise - valuations, which play a large part in investment decisions. Sectors like technology benefited the most from the lockdowns and their share prices have risen accordingly. As we return to somewhere near normal these shares have remained volatile, whilst shares in companies damaged most by the pandemic have risen sharply since the vaccine announcements last November. Markets will continue to assess this rotation and the earnings and revenue announcements to identify the winners and losers over time. One thing is for sure, navigating the reopening after lockdowns is as tricky for investors and fund managers as navigating the pandemic itself. Remaining diversified across asset classes, geographies and sectors normally provides the best chance for investors to achieve their goals whilst remaining aligned to the right level of risk they are comfortable with.

Find out more!

Click **here** to read our latest A Month in the Markets, where our Head of Multi-Asset Solutions Stefano Amato looks at how key themes impacted markets in May.

Note: Data as at 22 June 2021.

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