State of Play

9 September 2021

Our Investment Specialist, Simon Durling, shares his thoughts in our latest update. The UK has just surpassed 80% of adults fully vaccinated. What can investors expect in the next few months – a return to normal or further lockdowns and restrictions? Looking beyond the pandemic, State of Play assesses what factors may influence both investment markets and the economic recovery in the months ahead.

Beyond the pandemic

The last 18 months for many feels like a bit of a blur. Often friends will say that if someone had told them what was about to happen before the COVID-19 virus emerged and spread, they may have expected the story to come from some far-fetched disaster movie. Exaggerated fiction became reality as the world went into lockdowns creating economic consequences and financial responses which have never been seen before.

The speed of vaccine development and roll-out has taken everybody by surprise and has helped provide the key to the gradual unlocking over the last few months of some economies around the world with restrictions being lifted and normality slowly returning. As vaccination rates increase so does economic activity as restrictions ease, albeit with huge disruption to supply chains and high demand pushing up prices and with it wages. So, what can we expect to happen next? What factors will likely drive the market and economic outcomes in the next few months and beyond?

Future restrictions or lockdowns

Many experts have explained that not unlike other viruses COVID-19 will be around in some form for at least the next few years or maybe longer. Governments around the world have spent enormous sums of money trying to tackle the virus by implementing national and regional lockdowns, supporting the development of vaccines, and offering financial support on a record scale. Even though 80% of UK adults have received both doses the new case infection numbers remain high as children return to school after the summer holidays. Ongoing discussions have taken place about a booster injection in the autumn to help against resistance to the Delta variant of the virus. Future threats exist especially on how long vaccines offer immunity for as this is still unknown.

Whilst the infection rates have continued stay above 30,000 a day, the correlation between this data and the number of hospital admissions and deaths related to the virus has changed markedly since the dark days of January, when almost 40,000 were in hospital and 4,000 were on ventilation resulting at one point in nearly 1,000 deaths per day. Those currently in hospital total around 7,000 for the last two weeks, with the number being admitted still quite high, but many only visiting hospital for a short period and not requiring critical care.

Although being double vaccinated does not avoid contracting COVID-19, it would appear based on the data thus far, it does decrease the likelihood of serious illness and the need to stay in hospital. The government both in the UK and elsewhere will be hoping this trend continues to ensure future restrictions or lockdowns can be avoided. Clearly countries around the world are at different stages in tackling the virus but as vaccination rates rise central government confidence grows in operating an open economy without limits, pointing to a more normal future living alongside the virus that has had such a dramatic impact on our lives.

Financial factors and considerations

The financial impact of the pandemic is hard to quantify as the far-reaching consequences of shutting the global economy initiated central government responses which haven't been seen since the world wars. The financial response and support packages required to help individuals and businesses through the worst of the lockdowns required record breaking stimulus, much of which was borrowed adding to the enormous debts already held by most countries around the world. In addition to cutting interest rates to zero or near zero, central banks printed money through the process of quantitative easing thus making it easier for banks to lend and businesses to borrow.

Now, as the economies reopen the built-up demand continues to put pressure on supply lines often delaying subsequent purchases and therefore pushing up prices as built-up savings chases too few goods. Thus far central banks have talked with confidence that the rise in inflation is temporary and not more permanent. Initially investment markets reacted suspiciously to these comments pushing up bond yields in the expectation that more sustained inflation may force central banks to concede and raise interest rates in response to cool overheating economies. Based on the recent data, the latest third wave in the US has stunted economic growth during August. Will this be just a short-term blip to be followed by further rapid growth? Clearly nobody can be certain about what will happen next, but other data raises the prospect of future demand pushing up prices. Let's explore what these contributing factors might be.

Inflation threats

Since the start of this year the biggest factor influencing markets has been inflation. There are multiple reasons why. If inflation shoots above expectations for a sustained period, the first impact is on the future expected path of interest rates. If central banks need to act quicker and implement bigger rises than first thought, markets might re-evaluate all asset classes and the economic outlook. Bond yields normally rise reducing the capital value of the loans in circulation and new issuant loans, both government and companies, usually pay more to borrow. The more that companies are forced to pay for future debt payments the less profit and earnings they make, thus bringing about a change in the valuation of their share price. If governments pay more interest on debt, they have less to invest in the economy perhaps leading to slower growth or future recessions.

Inflation is mainly driven by the balance and relationship between demand and supply. Demand has been exacerbated by several ongoing components. Firstly, during lockdowns much of the workforce either went into furlough arrangements or, where able, worked from home. Many saved enormous amounts on avoiding the daily commute in addition to being unable to spend money on goods and services like cinemas, restaurants, gyms, and foreign holidays. Billions were saved waiting for restrictions to be lifted with many putting off purchases to a later date.

Once the restrictions were lifted spending restarted putting enormous pressure on the manufacture and supply of goods. Supply challenges continued to be driven by travel and trade restrictions as different countries were only able to reopen according to their own pandemic status - often at different times to the country ordering either the raw materials or the finished product. This is best demonstrated by the car industry. Shortages of raw materials caused a slowdown in the availability of chip components causing long delays in the manufacture times. This has forced many to buy a nearly new car, rather than brand new, forcing up prices of used cars and new cars alike. In addition, something as simple as the availability of enough lorry drivers to transport either materials or finished goods has caused delays in delivery. Commodity prices have also responded in line with economic activity. As economies reopened for example, oil prices rose from the lows of last year with prices regaining their pre-pandemic level more recently.

Lastly, wage increases have risen sharply in recent months as companies who are starting to re-hire are finding it increasingly difficult to find the right candidate. According to the Office for National Statistics in May to July 2021 there were an estimated 953,000 job vacancies, a record high, having grown by 43.8% (290,000) compared with the previous quarter. A combination of Brexit impacts limiting the supply of foreign workers and many part time workers who were at or close to retirement realising throughout the lockdowns that they can live very happily without the additional income has restricted the supply of suitable individuals to fill the growing vacancies. Certain sectors have an acute shortage of skilled workers which has prompted some employers to offer much improved contracts, some with a signing on bonus and the obvious consequences this has when existing employees uncover that their new colleague is being paid better than them. Much of this wage increase can be absorbed by businesses but what is not clear yet is how much will be passed on in higher prices for goods and services they provide. Only time will tell whether central banks are right and this spike in inflation is actually transitory or if the markets suspicion is justified.

Change in behaviours and working practices

Importantly different sectors have been affected in different ways during this crisis. Much of this is being driven by a change in behaviours which has been accelerated by lockdowns and restrictions. The switch to online shopping in certain age groups, like the elderly, was extraordinary. Trapped indoors shielding to lower the risk of infection, many went through a crash course in online shopping and zoom calls with relatives and experienced the novelty of board games on a screen, not on a board. The impact of this behavioural change has meant that those companies who were either built around an online model or had already embraced the changing world prior to the pandemic have outperformed whilst many traditional companies, especially in the retail sector have gone into administration. Will this trend reverse or is it likely to remain? Whilst there is little certainty at this early stage of returning to normality, some experts agree that most of the accelerated change in shopping and retail habits is irreversible.

As with shopping online, many of us experienced working from home for the first-time last year. Millions of businesses delivered laptops, screens and kit to allow their employees to work from home. The consequences have been enormous. Putting aside the millions of parents having to become a part time teacher for the home-schooled children as their schools closed for long periods, many had to adapt to new way of working, meeting and communicating with colleagues prompting the most commonly used new phrase – 'you're on mute!'. A genuine re-evaluation of work-life balance has been carried out by both individuals and businesses. The potential consequences of this accelerated evolution adapting to the impact of the virus may mean a new way of working for many individuals.

Some business leaders were initially concerned that employees working from home unsupervised would mean a drop in productivity and a reduction in business output. Initial data collected thus far by those companies who specialise in this type of analysis have concluded the complete opposite. Buoyed by the flexibility working from home offers, many workers have excelled in a way probably not possible if faced with the normal two hour commute to and from work, on top of the collection of children from the child minder and fixed specific hours dictating and limiting their output. Now many individuals can plan their workday around their families and other commitments in agreement with their employer - often leading to working more hours than they did when five days a week in the office. The gradual return to the office has begun for many of us with weeks split into part-home/part-office subject to review in a few months' time once companies have time to assess the impact or benefits. This dramatic shift in working patterns will likely have long-term ramifications for both commercial office space and employee contracts as companies adapt to a new way of recruiting people and the terms under which jobs are agreed.

Migration from the city to the country

Once again according to the Halifax House Price Index, August saw a small rise in house prices even after the incentives on stamp duty finished in June (which fully taper off this Autumn). As previous updates have mentioned, when you peel back the data on house transactions over the last 12 months, an interesting shift in mobility arises. Having had the opportunity to see a different, and in many cases a better quality of life working mainly from home, many families have decided to sell-up their city or suburb home and move further out into the country now that the five day commute is no longer mandatory. The prospect of a better quality of environment is a big attraction and this has seen a big dispersion in house price rises. Usually London is way ahead of the rest of the UK in house price rises, but it's growth has been lagging near the bottom reflecting this great shift. The big question now is whether this trend will continue or is it just a temporary factor. One factor may be how housebuilders plan their next developments and whether they spot this trend and respond accordingly.

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 August.

Note: Data as at 7 September 2021.

Important Information