INTUITION
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Exiting the Covid Recession

Normally, recovery from recession is a gradual process. Economies take time to heal. But there was nothing normal about the Covid recession – not the way it was entered, and neither the expected exit. This year could mark one of the strongest periods of global growth in recent memory. That should be supportive for markets, but it's not without its risks.

Michael Porter

A typical recession unfolds after years of growth, which in turn fuels excesses and inflation within an economy. As growth accelerates, so does inflation, which in turn forces interest rates to rise, thereby cooling the economy. Often there is a trigger for a deeper contraction – a recession - which is characterized by job losses, business closures, a drawdown on savings, and depressed confidence. Lower interest rates eventually feed through to a turn in activity, and a gradual recovery. But that recovery can take time because consumer confidence is fragile and savings have been depleted.

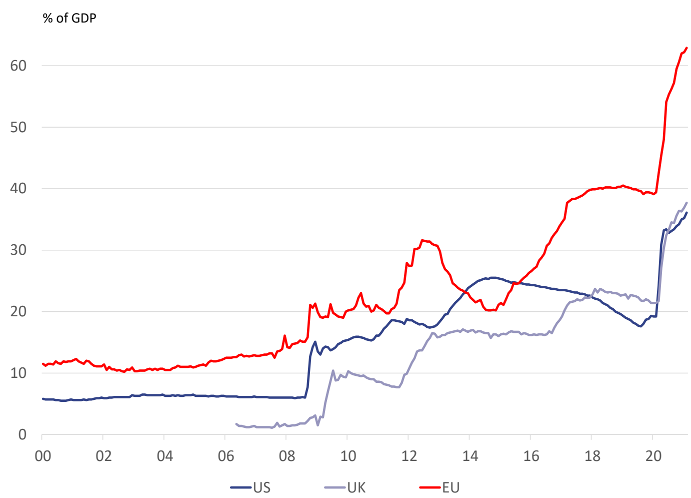
2020 saw one of the most severe recessions in history, but there was nothing normal about it. As we all know, it was induced by stringent lockdowns rather than financial excesses or rampant inflation. There was another important difference as well. Because the recession was induced by government policy, governments unleashed their full arsenal to limit the damage. Whether it was slashing interest rates to record lows, or furlough schemes in the UK and Europe, or "helicopter" money in the US, governments almost literally threw money – and billions of it – at the problem. The concept of "quantitative easing" was first introduced after the Global Financial Crisis – central banks printing money to flood an economy with liquidity to prevent a cascading collapse. In the three years post the GFC, the central banks in the US and UK injected $1.6 trillion and £24 billion respectively into their economies. Fast forward to the Covid Recession. Within the space of a few months, those same central banks injected $3.4 trillion and £86 billion respectively into their economies – unprecedented, even by GFC standards. This was also coupled with zero interest rates and generous government handouts.

In unleashing all the stimulus, governments have softened the blow. But there has been another significant difference. Globally there has been very little demand destruction due to minimal job losses (furlough schemes – now extended to September in the UK) and handouts. Furthermore, due

SPEED READ

- **Normally recessions result in demand destruction, as liquidations and insolvencies take their toll on jobs and savings.**
- **Covid was different. It was government-enforced, but that unleashed some of the largest stimulus packages in history.**
- **Savings rates have ballooned across the world. A tsunami of pent-up demand is waiting to be unleashed as vaccinations encourage greater mobility.**

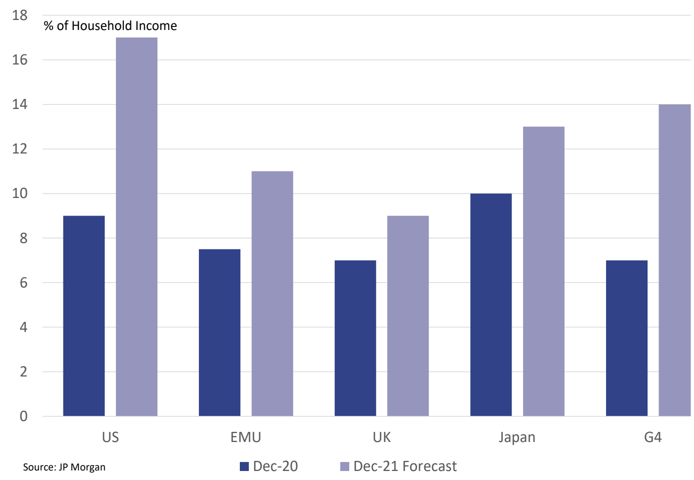
CENTRAL BANK BALANCE SHEETS



Central banks have injected unprecedented amounts of money into the financial system within a very short space of time.

to restrictions on mobility, consumers have been forced to delay spending – not by choice. The net result has been a significant rise in savings around the world. Consumers have been showered with stimulus money and largely been prevented from spending it. The chart below highlights the magnitude of these extra savings. This chart measures the excess savings (ie, the extra savings over and above a normal rate). Savings rates climbed in 2020, but they are forecast to climb even higher over 2021.

GLOBAL EXCESS SAVINGS RATE



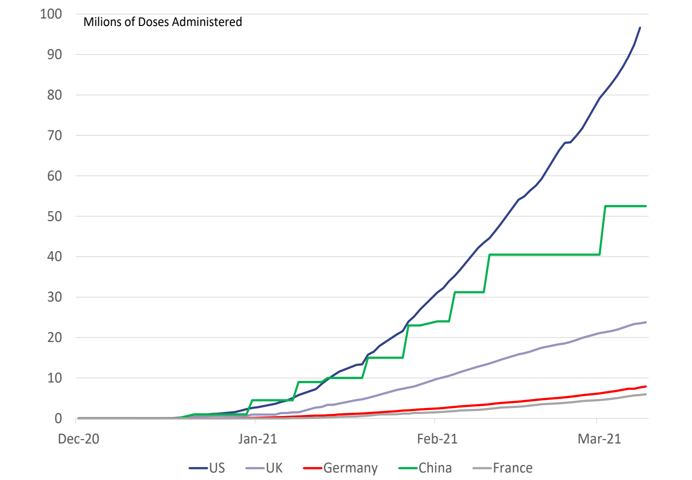
Thanks to numerous government policies, consumers have built up a significant amount of excess savings. At some point, it is going to burn a hole in their wallets.

As we all know, excess cash soon burns a "hole in your pocket". My young children can't resist the temptation to spend their pocket money at the first opportunity. Imagine the temptation for adults with thousands of extra dollars (or pounds or euros) in their account – money for which they haven't even had to work! Consequently, economists are expecting a surge in consumption expenditure over the remainder of this year. This surge is based on three factors:

> "Consequently, economists are expecting a surge in consumption expenditure over the remainder of this year."

1. Pent up demand from restricted mobility. Both the US and Europe have been hard hit by the second wave of Covid. Lockdowns have been intense, not much different from March and April last year. As vaccinations gain pace and restrictions ease, there is significant pent-up demand for both goods and equally importantly, services.
2. A recovery in labour income (wages). As restrictions ease, people will get back to work. In the US, JP Morgan expects 8 million jobs to be created this year. In Europe, it will be less dramatic because of the extensive furlough schemes in place. But strong growth in itself will fuel a virtuous cycle of job creation. On top of already healthy bank balances, consumers will benefit from strong wages, which will add further fuel to the consumption fire.
3. Finally, despite the recovery underway, governments are still committed to unleashing extra stimulus – the (very juicy) cherry on top.

PACE OF VACCINATIONS



Developed countries have hit the road running. Vaccinations are proceeding apace, which should ensure that life returns to "normal" sooner rather than later.

Consumption expenditure is just one leg of any economy, but it is an important one. Strong demand in turn fuels higher manufacturing and higher demand for raw materials. It also spills over into services – leisure activities, travel, and hospitality to name but a few. When combined, this is forecast to lead to one of the strongest periods of global growth in recent memory. The table below highlights the rate of GDP growth for major developed markets over the past six years – as well as what is expected over the next two years. The rate of growth to come dwarves the rate achieved in the recent past. Furthermore, the depth of the recession in 2020 hs turned out to be less severe than expected.

Crazy as this seems, what it implies is that the US economy will be bigger at the end of 2021 than it was at the end of 2019. Europe and the UK will achieve this by the end of 2022, whilst China escaped a decline in GDP last year altogether. These statistics are at complete odds with expectations just a few short months ago – and certainly contrary to one's gut feel given the scale of the second-wave lockdowns.

Global GDP Growth (% Rates)				
	Average Growth Rate	Actual Growth	Forecast Growth	
	2015 - 2019	2020	2021	2022
US	2.5	-3.5	6.2	4.0
UK	1.7	-9.9	6.0	6.7
Europe	1.9	-6.8	5.7	4.8
China	6.6	2.3	9.5	5.6

The above scenario is certainly a perfect environment for shares. Strong GDP growth should fuel both earnings and dividend growth, providing investors with substantially higher returns than what can be earned on government bonds or cash. Indeed, that is partly the reason why shares have started the year in such an ebullient mood.

Unfortunately, there is always a catch. Those clients who keep an eye on the daily movements across markets will have noted an increasing level of volatility recently. If the outlook is so bullish, why the jitters? Ironically, the outlook is too good! Strong growth coupled with excessive amounts of cash have always led to inflation in the past, and inflation leads to higher interest rates – the one factor that could bring the party to an abrupt end.

There are already plenty of signs that higher inflation could be imminent. Commodity prices are soaring – many at record highs, and data out of the US last Friday pointed to accelerating wage inflation, despite a still-elevated unemployment rate of 6.2%. Sensing the rising concern amongst investors, the US Federal Reserve has been at pains to explain that it is no hurry to stop the music (raise interest rates), understanding that doing could cause a destructive feedback loop – higher rates result in falling markets, which dents confidence and in turn stalls the recovery in its tracks. But low interest rates can't last forever. Investors must be prepared for a change. Those sectors most vulnerable to a change in rates are ones with sky-high valuations (technology and "green technology" for example) – pushed to extreme levels over the past 12 months. Solid, traditional businesses should fare far better, and valuations in these sectors are far more palatable as well. That will be our focus area when building portfolios.

This theme will be explored in more detail in our forthcoming seminar. Watch your email / social media for more detail.

Vacciness are rolling out at pace across the developed world.

Given the uncertainty over a second wave of Covid, we cannot predict with any certainty when we will be allowed to resume our seminars. Until we have clarity, we will continue with our online videos and presentations. Please ensure that you subscribe to our Facebook page and YouTube channel to be kept up to date.

Please RSVP to Clare Mitchell on 033 3302164 or clarem@hhgroup.co.za.

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Topic: **N/A**

Natal Midlands	
Date:	N/A
Venue:	Fernhill Hotel Midmar / Tweedie Road (almost opposite entrance to Midmar
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm

Johannesburg	
Date:	N/A
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Time:	7am for 7.30am

CONTACT DETAILS:

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