RATHBONES | Incorporating Investec Wealth & Investment (UK)

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Overstimulated

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Last week the Research team moved to a different floor while various pre-integration renovations are taking place. The new location has a fancy hot beverage machine which looks identical to the one we used to use. However, it turns out that some of the control panel buttons are set up differently. Whereas one used to press a side-button with a coffee bean on to select a decaffeinated coffee, now it's a choice on the main panel. How was I to know? Loyal readers might recall that I have generally eschewed caffeine for more than a decade. Unsurprisingly, two fully caffeinated cappuccinos meant that I was still bouncing off the walls like Tigger at 11pm and had virtually no sleep throughout the night. It turned out to be much worse than jet lag!

I am no neurobiologist, but as I understand it, coffee keeps you awake by blocking receptors in your brain that are sensitive to the hormone adenosine. Adenosine is what tells your body to go to sleep. But even if you do feel wide awake, your brain and body are in fact getting more and more tired in the usual way, which is why people often experience a “crash” when the effects wear off. I certainly did. Although caffeine is widely referred to as a “stimulant”, one should, perhaps, think of it more as a “masking agent”.

Stimulus is a popular concept in politics and economics at the moment. Fiscal and monetary stimulus were key policies during the pandemic. In the UK and Europe, furlough-type schemes were used to support employees who were unable to work under lockdown conditions. In the United States, the government sent “stimmie” checks to everyone regardless of their employment status. Interest rates were cut to zero or lower and central banks stepped in to buy financial assets – mainly government bonds.

The distortions caused by monetary policy during the pandemic

These actions created a number of distortions. It's becoming clearer in retrospect that one of the key reasons for the big spike in inflation was this fiscal generosity. Goods were in short supply owing to manufacturing and transport disruptions, just as extra demand was being created. Quite a lot of this “free” money, especially in the US, was channelled into speculative investments, the hangover from which is still visible in the performance of less profitable technology company shares, for example, or in some areas of the Renewable Energy sector. These sub-sectors also benefitted from a very cheap cost of capital – a factor that has since been reversed, with predictable consequences.

One reason for the persistence of strong household consumption in the US (and its relative resilience in the UK and Europe) is the “excess savings” which were built up during the pandemic. Yes, some of it was the result of not being able to spend, especially on services and experiences, but it was also accrued from the handouts. Excess savings is a slippery concept at the best of times and the calculation of the US version was further complicated by a big revision to historical data last year. The result was that US consumers appeared to have even more money up their sleeves than previously thought and therefore have been able to keep partying longer and harder. It helps to explain why the much-anticipated recession has still not arrived.

But if money has been put into consumers’ hands, it has to come from somewhere, and the balancing item (in the absence of strong productivity growth) has been government debt. The debt-to-GDP ratio in the US has risen to more than 120% and it’s around 100% in the UK. Rising government debts caused little alarm when interest rates and bond yields were trending lower. But now that they have risen, the bill is rising rapidly. Furthermore, the supply of new debt is no longer being hoovered up by central banks, which have switched from Quantitative Easing (buying bonds) to Quantitative Tightening (selling them or at least not reinvesting proceeds as they mature).

This means that the private sector has had to take up the slack and there have been moments when it has revolted at the prospect. The major incident in the UK was the period following the Truss/Kwarteng “mini” budget in September 2022, which set off a cascade of negative events in the Gilts market threatening the viability of pension funds which had engaged in Liability Driven Investment strategies. It required the Bank of England to step in to calm the market.

In the US, we saw a big sell-off in the Treasury market in September and October last year as investors anticipated a wall of supply. This did not necessitate central bank intervention to correct, as the 10-year yield rising to 5% provided some valuation support (and a prospective real 10-year yield of 2.5% looked especially attractive).

But there was also a bit of shenanigans going on. When the Treasury announced its fourth quarter funding programme, it pledged to issue a much greater percentage of short-term bills as opposed to longer term bonds. The buyers of bills tend to differ from buyers of bonds, in that they are managing short-term cash balances as opposed to long-term assets and/or liabilities. The bills attracted funds from the Federal Reserve's Reverse Repo Programme owing to a higher interest rate, and money market funds also flocked to them.

This all sounds very technical, I know, but it's at the heart of current liquidity flows and valuation drivers. The rebound in the bond market (with yields falling sharply) took a lot of pressure off the equity market, triggering the strong rally in November and December.

However, those debts are still there and still have to be funded and, one would like to think, paid back one day. The Treasury cannot keep rolling over Treasury bills ad infinitum. It's going to have to issue more "coupon" debt soon. Indeed, we have already seen the market acknowledge this to some degree as bond yields have risen again in early 2024.

But it doesn't look as though the politicians who accumulate the debts are going to change their stripes soon. It's election year in the US and UK, and all parties are committed to more spending in some shape or form. The truth is that electorates continue to demand even more spending, possibly not fully aware of the potential negative consequences. Austerity is a dirty word these days.

The nice thing about deficit spending is that it increases GDP growth. Historically, it has been used as a tool to rescue the economy during a period when the private sector has been in trouble. This was, no doubt, the rationale behind increasing spending during the pandemic, but it clearly went on for too long and, especially in the US, was far too generous. It is extraordinary to think that the US government is still running a budget deficit of around 6% of GDP when the economy is growing in real terms at more than 2% (which is around trend growth) and unemployment is still as low as 3.7%.

In the end, the only sustainable solution to growth is to increase productivity. Growing working age populations also help, but demographics are poor in the West (and, notably, China) and there is an increasing intolerance of immigration which could otherwise alleviate labour shortages.

And so various bouts of "stimulus" are all well and good in their appropriate place, but they don't solve long term structural problems - they only mask them, a bit like the caffeine does with fatigue.

This scenario is currently playing out with a vengeance in China, where the (necessary and long overdue) deleveraging of its real estate sector is acting as a lead weight on general economic activity and animal spirits. I don't doubt that at some point the government will hit the stimulus button, but if they don't enact structural reform at the same time, it won't be long before they are back at square one.

China and Hong Kong are the biggest sore thumbs that are sticking out so far this year in equity markets. As at last Friday's close, their main equity indices were down around 5% and 10% respectively, and they have carried on in that vein this week. A year ago, China was touted as the great recovery play, but the CSI 300 index is down 25% from last year's January peak (and that's before accounting for a weaker yuan). There is a raft of reasons for this, ranging from geopolitical worries (who would want to risk owning anything listed there if China invaded Taiwan) to demographics (a second consecutive annual fall in population has just been reported for 2023), on top of the afore-mentioned real estate problems and ongoing government interference in various sectors of the economy.

We are learning that low nominal growth in China is not helpful. Deutsche Bank has published some interesting data looking back over several decades. In the 1980s, nominal GDP growth averaged 15.5%; in the 1990s it was 18.5%; in the 2000s it was 14.5%; in the teens it was still 11%. In 2023 it was just 4.2%, with the 2020s average running at 6.2% so far. We know that low nominal growth makes it difficult to outrun debts. If there is a recovery out there somewhere, maybe rising inflation rates will be the catalyst. It is currently running at -0.3% (which is too low for comfort even if one allows for the beneficial effects of sharply lower pork prices).

As chance would have it, after I started writing this piece, I spotted a quote from Germany's finance minister. He claims that Germany is the "tired man of Europe" and just needs "a good cup of coffee, which means structural reforms, and then we will be continuing to succeed economically". To expand the metaphor, I would say that structural reforms demand a better diet, a comprehensive exercise programme and attention to one's sleeping habits (to name the most important ones). A cup of coffee is only going to keep you going for the next few hours, not the long term.

Question of the week:

Last week's question: Which member of the Cabinet is currently MP for Chichester?
Gillian Keegan

This week's question: Which club did footballer Kevin Keegan join from Liverpool in 1977?

Economic Commentary

This Week's Forthcoming Events

US	Leading Indicators SA M/M
US	Markit PMI Manufacturing SA (Preliminary)
US	Markit PMI Services SA (Prelimanary)
US	GDP Chain Price SAAR Q/Q (First Preliminary)
US	Initial Claims SA
US	GDP SAAR Q/Q (First Preliminary)
US	Personal Consumption Expenditure SA M/M
UK	CIPS Manufacturing PMI SA (Preliminary)
UK	CIPS Services PMI SA (Preliminary)
UK	CBI Distributive Trades Survy Realized NSA
EU	Consumer Confidence Indicator (Flash)
EU	Markit PMI Composite SA (Preliminary)

UK – Last week illustrated the difficulties of negotiating a possible turning point in the economic and interest rate cycle. Tuesday's employment data was greeted with euphoria when average annual wage growth dropped from 7.2% in October to 6.5% in November versus an expected 6.8%. Excessive wage growth has been an inflationary threat in the Bank of England's eyes, keeping it hawkish on interest rate policy. However, Thursday's inflation report saw headline CPI in December rising back to 4% versus 3.9% and an expected 3.8%. Core CPI was stuck at 5.1%, still too high for comfort. But on Friday, December Retail Sales came in at -3.3% from November, a surprisingly weak print. Maybe there was some giveback from discounted Black Friday sales, but it was still poor. Thus, interest rate expectations were buffeted around. The net effect is that interest rate futures now expect the first rate cut to arrive in May (it had been as early as March) with the Base Rate potentially falling to 4% by year end. We are not so certain but would certainly acknowledge at least that the next rate move will be down, not up.

US – A very different story on the other side of the Atlantic, where December retail sales rose 0.8% month-on month. The US consumer appears to be in good shape. Excess savings have not yet been run down, wages are growing in real terms, and US investors are more exposed to a stock market that his just hit a new all-time high. Mortgage holders have locked in rates at around half the prevailing 7% and house prices are resilient. Both of the leading prospective Presidential candidates are promising to be generous even while unemployment remains close to a cycle low at 3.7%. But if things carry on like this, the 1.5% of interest rate cuts priced into futures this year will not happen.

Europe – Ahead of this week's meeting, the European Central Bank (ECB) lowered its inflation forecasts. These now stand at 3.2% versus 4% previously one year ahead and 2.2% versus 2.5% three years ahead. Even so, there remains a general reluctance at the ECB to agree with the market's assessment that interest rates will fall rapidly to around 2.5% by the end of this year. We await more guidance from the meeting.

China – China reported GDP growth of 5.2% year-on-year in Q4 2023. Not that many believe the number. One independent research house put the real number at 1.5%. Other data released showed Retail Sales growing at 7.5% year-on-year in December, but that was down from 10.1% in November. There might be some mitigation in the fact that the ending of the zero-Covid policy is playing havoc with comparable data, and this effect could well persist past the Chinese New Year holiday in February. The figures for Industrial Production and Fixed Asset Investment were 6.8% and 3% respectively, neither of which blew the lights out. Property Investment specifically was down 9.6%, a reflection of the ongoing deleveraging of the sector, with residential property sales -6%. There is still no sign of any "big bang" stimulus from the government or central banks and equity markets continue to display deep disillusionment.

Economic Commentary

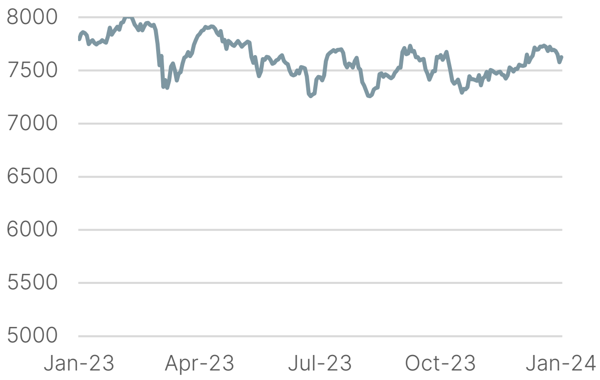
FTSE 100 weekly winners

Flutter Entertainment Plc	22.7%
Abrdn plc	5.9%
InterContinental Hotels Group PLC	2.7%
Smith & Nephew plc	2.1%
RELX PLC	1.6%
Ferguson Plc	1.5%
Auto Trader Group PLC	1.2%

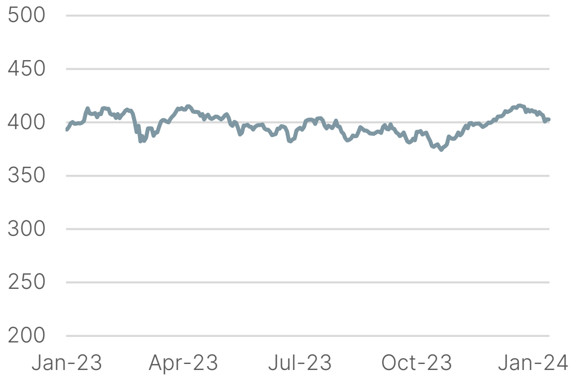
FTSE 100 weekly losers

Ocado Group PLC	-15.4%
Fresnillo PLC	-10.6%
B&M European Value Retail SA	-8.6%
Glencore plc	-8.0%
British Land Company PLC	-6.7%
Land Securities Group PLC	-6.5%
Standard Chartered PLC	-6.1%

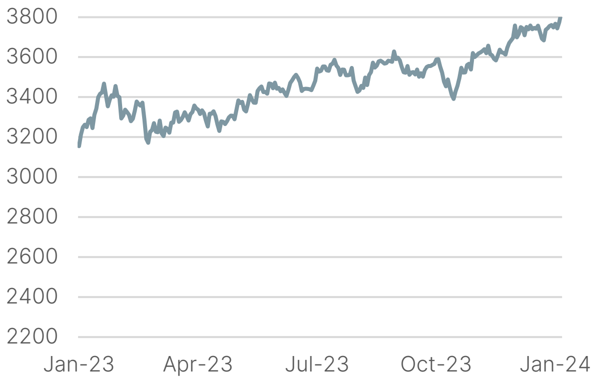
FTSE 100 index, past 12 months



EuroStoxx 600 index, past 12 months



S&P 500 index, past 12 months



All data shown in GBP.

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