Psigma
Investment Management

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View from Psigma

The Global Economy: Are We Living in a Suspended Reality?

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Introduction

We have written in recent Views that we believed that after an initially strong economic improvement (a classic "V" shaped recovery), progress had slowed (the "V" morphed into a "U" shaped recovery) and that the global economy had recently reached a plateau from which a further climb towards "normality" would be challenging. The economic outcome observed over the last six months has been in line with the expectations that we have outlined since the beginning of this crisis, and this reality has been reflected in many indicators across all the main consumer, corporate and industrial sectors. However, in light of the latest political and medical developments, we thought it would be useful to use our final View of this "mini-series" to update you on our refreshed economic views, and to answer the regularly asked question of whether we are living in a "suspended economic reality".

The recovery so far

In very simple terms, we would estimate that overall global economic activity fell by roughly 40% at the nadir of the crisis and "peak lockdown", before gradually recovering to now "only" being down between 10-20%, depending on the specific country that one analyses. The economic slumps and subsequent recoveries across the world have occurred at different times, with China now closest to a full recovery and, sadly, the UK lagging behind many other parts of the world. The question we must now ask is whether we have achieved, on a global scale, all that we can without a lasting solution to the COVID crisis, such as a vaccine (which appears to be a possible scenario for the early months of 2021), or a major improvement in corporate and consumer confidence.

The economy recovers by 2022

It is worth noting that most economists' projections for the global economy in the coming years are reassuring, with analysts still upgrading their estimates for future growth. The consensus expects that within a few years we will have seen economic progress from levels that we saw at the end of 2019. The latest Consensus Economics forecasts show a continuation of the "V shaped" recovery, easily surpassing the recovery that the world experienced in the post financial crisis years after 2008. According to the latest reports from the OECD, this would take global economic growth in 2022 to levels about 4 percent higher than those we last saw at the end of 2019. Such scenarios assume that there is the successful development and distribution of a vaccine and that a large proportion of the global population takes up the vaccine. Our own forecasts, as you know, have been built upon the premise that global economic growth would not get back to the levels that we saw pre-COVID until we "rang the bell" on 2021 and progressed in to 2022, even if there is the "solution" that a vaccine could supposedly provide. Therefore, we would appear to be a little less optimistic than most, reflecting the fact that we feel the recovery from here will be more "U shaped" than "V shaped".

The future is uncertain

Given the lack of any historical observations to analyse to guide us to the future, there are obviously many upside and downside risks to any forecast we can currently make, not least with the "vaccine factor" still unknown. However, the reason that we are perhaps more cautious than most is that, in our opinion, there are three major concerns that we have with the view that the economy will continue to recover in the short to medium term.

New "lockdowns" will hinder the recovery

The first troublesome factor is that it is quite clear in many countries, most notably in the UK and Western Europe, governments have deemed it necessary to resort to further lockdowns, which will cripple parts of the economy and deliver a potentially fatal blow to some of those businesses that were just starting to clamber off the canvas. In economic terms, the unveiling of further restrictions on citizens' social and working lives is a dangerous step for the economies where such measures are being implemented. Even in an economy that has nearly fully recovered (it is ironic that I am talking here about China, given this is where the COVID crisis originated), it is obvious that the parts of the economy that continue to lag the recoveries of the industrial, manufacturing and property sectors are linked to the consumer economy. In simple terms, citizens can be forced by their governments or employers to work, but they can't be mandated to take an evening drink at the local pub. This lead indicator from China and other economies in the later stages of their recoveries are important guides for what we are seeing in the western economies.

Lockdowns appear to be popular

Interestingly, the sorts of measures that we have seen announced by the UK government in the last week appear to be very popular with voters, with polls suggesting that citizens in the UK want harsher rather than looser restrictions on how we go about our daily lives. The latest poll from Ipsos Mori showed that a net 57% of people want all travel in to and out of the UK banned and a net 10% (44% of all respondents) wanted a second total national lockdown. Such actions will obviously blunt further economic progress, and we have to confess to being particularly concerned about the economic outlook for the UK economy.

How confident can we be?

The evidence from such polls leads us neatly on to our second fear, which is admittedly an unmeasurable dynamic: namely, the impact from the deep psychological scars left upon consumers and companies alike. We must question whether consumers and businesses will want to spend and invest like they did before the onset of the COVID crisis, or whether the damage wrought upon all of our lives and finances earlier this year will lead to reduced appetite in the future. In very simple terms, we have to ask whether the lost economic activity from earlier this year (I couldn't take the long-suffering Mrs Becket out for a steak dinner last April) will be replaced by pent up demand going forwards (will I take her twice in October?). Will companies really be in a hurry to employ new staff, pay existing staff higher wages or build a new factory? To answer such challenging questions, we need to think about how secure the current economic scenario really is. First and foremost in the developed world, given the reliance upon the consumption and services, we have to worry that many consumers will continue to be apprehensive about their job prospects, particularly as the "suspended reality" of the various support measures and furlough schemes start to end. If consumers are reticent to spend money, then demand will falter, and businesses will not invest. This is why we believe that predicting the future is currently particularly complicated and why we are erring on the side of caution. The truth is that we just don't know what the impact upon confidence will be until we learn how strong the economy is beneath the "comfort blanket" of government support.

The help is here to stay

A key factor behind other commentators' optimism appears to be that the unprecedented support of both the central banks, through massive liquidity injections and financial market interventions, and governments, with their stimulus measures and unemployment provisions, will stay with us long into the future and could actually accelerate if needs be. We don't disagree; this is accounted for in the "You Ain't Seen Nothing Yet" framework that we have previously outlined for the "Turbulent Twenties" ahead. However, there are obvious limitations to what these actions can achieve. Central banks can of course manipulate economies with the tidal wave of money they have flooded the financial system with, but this will predominantly be a support for asset prices, such as we are seeing in stock markets and the housing market, and not provide the money or the confidence for the "average person" to go for that drink in the pub or take their partner out for that steak dinner. The optimists would then chime in that the governments will take care of that with cash handouts to those who need it, but as we have seen in the UK through the success of the "Eat Out to Help Out" scheme, many people are willing to eat out if there is a "perceived bargain" on offer, but do not currently feel financially secure enough to go out normally. Would cash-strapped consumers rather save any government handouts to cover their uncertain futures? It is therefore not obvious to us that this present reality will improve in the immediate future, particularly in the UK where we are going backwards with regards to our "economic reopening" and, of course, where the government is already financially stretched.

Conclusion

In answer to our original question, we currently are seemingly more worried than most about the economic outlook, believing that we are indeed existing in a "suspended economic reality", where the distortive supports of governments and central banks are masking how challenging the present economic situation is and how long it will take the global economy to fully recover. This is reflected in the present biases that we have across our investment strategies. We feel that the actions taken so far by governments and central banks will limit "default risk" but will not spur further economic growth, which leads us to a "fixed interest" over "equity" stance in our clients' portfolios. This view has been recently strengthened by the decisions of governments across Europe to resort back to lockdowns. This backward economic step does not mean that investors should panic, but rather recognise that the path ahead is complicated. Of course, there are always opportunities for investors, and despite the economic uncertainty we can find lots of attractive long-term investments: we are deliberately seeking out pockets of opportunity around the world, where we feel that future growth prospects are attractive or underestimated by other investors. This continues to give us comfort and confidence in a world where such sensations are in short supply.

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