FPWM
TAILORED FINANCIAL SOLUTIONS

QUARTER 3 2020

# Investment Strategy Committee Tactical Asset Allocation Views & Commentary

Tactical positions relate to the strategic allocations for our five risk rated portfolio benchmarks which power our investment process. They are expressed as in the key below.

| - - Strong Underweight | - Underweight | N Neutral | + Overweight | + + Strong Overweight |
|---|---|---|---|---|

Please contact us if you require further information.

| ASSET CLASS | TACTICAL POSITION | COMMENTARY |
|---|---|---|
| **Global Government Bond** | + | Valuations remain very expensive with yields at historical lows and we wonder how much further yields can fall. However, the global recession is likely to keep monetary policy ultra-loose for an extended period and we value the ultimate risk off protection of the asset class as a portfolio hedge |
| **Investment Grade Bond** | N | We move to neutral following the recent tightening in spread levels. The Fed's liquidity support measures continue to benefit the market, but much may be in the price and long-term value may lie further down the credit scale. We are wary of credit downgrades disturbing the market equilibrium |
| **High Yield Bond** | N | We increase to neutral as US monetary policy initiatives continue to support the sector and valuations suggest better long-term returns than IG. In Europe, a larger the Pandemic Emergency Purchase Programme is positive for this market. In depth analysis and selection key to avoid defaults |
| **Emerging Market Bonds** | - - | We maintain our underweight as we are concerned re effect of recession and also potential for a virus spike in heavily populated or poor areas. Strong USD is a continuing headwind for this asset class. The likelihood of US/China trade war escalation would be a negative for the Asian EM |
| **UK Equity** | + | Valuations and monetary policy are supportive, economic weakness caused by slower re-opening of the UK economy vs others is a concern. With little progress on a EU trade deal, and with a 'real deadline' of 31 October, tensions are likely to grow as the two parties seek to break the deadlock. |
| **Developed Market Equity** | + | US markets levels have rebounded close to all-time highs and we maintain exposure despite narrow tech leadership and high valuations. Other developed markets may play catch up. We favour tech-heavy markets as beneficiaries of lockdowns and quality co's with balance sheet strength |
| **Emerging Market Equity** | N | EM equities offer attractive valuations, but we stay neutral. Whilst activity in China is rebounding, so too is geopolitical risks. Increased US/China trade tension is a headwind. China has outperformed but we expect leadership to come from cyclical and tech-heavy markets of Korea and Taiwan. |
| **Commodities** | N | We upgrade commodities to neutral. Prices may have bottomed out and started to recover, led by the energy sector. There has been a strong rebound in demand from China for metals, but this has started to slow. Agriculture may have bottomed, and Gold is still a good portfolio hedge |
| **UK Commercial Property** | N | We move to neutral on uncertainty regarding the long-term effect of the crisis on property sector. Whilst continuing fund suspensions are a concern, they will reopen in good time and the closures do not impinge on day to day management. Logistics warehousing likely beneficiaries of online boom |
| **Absolute Return** | + + | The current market dynamics continue to place focus on this basket to provide diversification, reduce portfolio volatility and provide downside protection. We stay with a combination of market neutral and macro strategies to help diversify risk exposure, despite challenging sector dynamics |
| **Cash** | + | No change to cash weighting as we feel the market has come a long way very fast feeding on government and central bank stimulus and liquidity. Hereon this is more challenging as lockdown eases with fears of a second spike and the consequent economic challenges very much in focus |

**Please Note:** The views expressed are those of the Investment Strategy Committee. They should not be taken as a personal recommendation to invest or refrain from investing.
Past performance is not a guide to future performance. The value of investments and the income from them is not guaranteed and can fall as well as rise due to stock market and currency movements.

## LOOKING BACK…

After a savage first quarter, Q2 2020 has seen an indecently strong rebound for equities and credit as governments and central banks provided massive stimulus and economies started to reopen. The **FTSE World Index** rose **+17.86%** and despite the strong recovery in risk assets, traditional risk-off assets such as government bonds and gold have also held up well. US Treasuries are up about 9% year to date, while gold is up close to 18%.

US equities rebounded strongly **(S&P 500 + 19.95%)** and outperformed other major equity markets. Despite data confirming the severe economic impact of lockdown measures, subsequent easing of restrictions, ongoing loose monetary policy from the Federal Reserve (Fed) and early indications of a recovery led to widespread equity market gains. Weekly claims for unemployment insurance slowed substantially and retail sales rebounded strongly from April to May. Federal Reserve Chairman Jerome Powell is "…not even thinking about thinking about raising rates". Investor optimism was tempered by a recent rise in Covid-19 cases prompting some states to reconsider the easing of lockdown measures. Across the US the trend of new cases accelerated toward the end of June with Texas, Florida, California and Arizona seeing notable increases in cases. The rebound in retail sales led to outperformance of consumer discretionary stocks and information technology, which has been consistently resilient through the crisis. Energy and materials also made strong gains. More defensive areas such as utilities and consumer staples lagged behind.

Eurozone equities posted strong gains **(FTSE Europe ex UK +18.33%)**, as the less hard hit Baltic countries and Austria relaxed their lockdowns in April, while Spain, France and Italy waited until later in the quarter before loosening measures. Markets were buoyed by the EU's Covid-19 recovery plans as EU president Ursula von der Leyen called for a €750 billion recovery fund for the worst affected EU regions in addition to a €540 billion rescue package agreed in April. The European Central Bank (ECB) also expanded the pandemic emergency purchase programme to €1.35 trillion. The eurozone economy shrank by 3.6% in the first quarter, however, economic activity data showed marked improvement through the spring - the flash eurozone composite purchasing managers' index (PMI) for June rose to 47.5, from 31.9 in May and 13.6 in April. (above 50 illustrates expansion below 50 contraction). All sectors posted a positive return in the quarter with information technology, industrials, materials and financials, showing the strongest gains as lockdowns lifting buoyed economically sensitive sectors.

UK equities rose over the period **(FTSE All Share +9.77%)** as national lockdown measures were eased and, economic indicators suggested the downturn was past its worst. Economically sensitive areas of the market outperformed amid a general improvement in investor sentiment, largely driven by global considerations. The mining sector outperformed partly due to the recovery in Chinese economic activity and new stimulus measures. The UK economy contracted by 20.4% in April - the first full month of UK lockdown – but Google mobility data suggests that the fall in travel to work also bottomed out that month, supporting the view that GDP could have returned to positive growth in May. The government confirmed a phased end to the furlough scheme and the Bank of England (BoE) expanded its quantitative easing programme. The BoE's governor told parliament that negative rates were under "active review" while the Debt Management Office reported it had sold negative yielding gilts for the first time. Brexit returned to the agenda as the deadline passed for an extension of the transition period, which expires on 31 December 2020.

After weakness in early April, the Japanese equity market recovered well **(TOPIX +11.10%)** and after some short-term currency volatility in June, the yen remained in a fairly stable range throughout the quarter. As the quarter unfolded, investors reacted positively to signs of a peak in virus cases globally, rather than specific news on Japan itself. As a result, economically sensitive and global stocks, together with pharmaceuticals, tended to lead the market recovery. Domestic-focused stocks such as transportation, insurance and utilities typically lagged. Japan had a rather different trajectory of recorded virus cases and mortality over the last three months. A state of emergency was declared by the central government across seven prefectures, including Tokyo, on 7 April - later extended nationwide. However, the practical restrictions on social and business activities remained far less restrictive than those seen in Europe. Prime Minister Abe was then able to announce a staged lifting of the state of emergency, starting from 14 May for some prefectures and culminating on 25 May for Tokyo. The Japanese government stepped up its fiscal response to the crisis and drew up a second supplementary budget, as expected, in May. Following the increase in its pace of exchange-traded fund (ETF) purchases from March onwards, the Bank of Japan also announced additional monetary policy initiatives.

Asia ex Japan equities lagged the World Index **(FTSE Asia Pacific ex Japan +15.22%)** but recovered strongly buoyed by fresh stimulus from major central banks, normalisation within the region and the reopening of economies across the world. As a result, export-oriented markets - Indonesia, Thailand and Taiwan - outperformed on hopes of a recovery in global demand in the second half of 2020. India's central bank provided additional support in April and a major fiscal stimulus package in May. By contrast, Hong Kong underperformed amid increased geopolitical tensions. China announced the imposition of a national security law in Hong Kong, which came into effect on 30 June. China slightly underperformed, after strong outperformance in Q1. During the second quarter, economic activity continued to recover, with manufacturing PMI improved to 51.2 in June. The Chinese government announced further fiscal support at the National People's Congress in May, but, geopolitical concerns increased as the US-China confrontation expanded beyond trade and technology issues.

Emerging market (EM) equities rallied **(FTSE Emerging +16.60%)**, recording their strongest quarterly return in over a decade, with US dollar weakness amplifying returns. This was despite an acceleration in the number of new daily cases of Covid-19 in some EM countries. EM countries with high foreign financing needs outperformed, notably Argentina, South Africa and Indonesia. In South Africa, after initially announcing a strict lockdown, the government started to reopen the economy, and economic activity started to recover, as evidenced by June manufacturing PMI which showed marked improvement. Mexico underperformed as the government remained reluctant to provide more meaningful fiscal support. China also underperformed, following Q1's outperformance, despite economic activity continuing to normalise and additional stimulus. While focus was on increasing US-China tensions, relations with India were strained, amid skirmishes on the disputed Himalayan border.

Government bond yields saw some divergence over the quarter **(FTSE WorldBIG Domestic Sovereign +0.95%)** with US and Germany's 10-year yields little changed, but those more sensitive to risk sentiment declined (prices rose). The US 10-year yield remained in a narrow range, and finished one basis point lower, having sold off in early June after stronger-than-expected US labour market data and reversing the move later in the month. In Europe, Italian 10-year yields fell more than 22 basis points (bps) to 1.26% amid hopes for more coordinated support measures in the eurozone. With Brexit back in focus,

the UK 10-year bond yield was 18bps lower at 0.17%. The UK two-year yield dropped below zero for the first time, finishing at -0.08%, as the central bank discussed the possibility of negative interest rates.

Corporate bonds performed strongly **(Barclays Global Aggregate Corporate +8.55%)** outpacing government bonds benefitting from the stronger risk appetite. High yield performed particularly well **(Barclays Global High Yield +11.36%)**, led by the European market. The US energy sector performed well across investment grade and high yield. Emerging market (EM) bonds also rebounded to produce strong gains **(JPM GBI EM Global Diversified +9.82%)**. Emerging market currency performance was mixed, broadly lagging behind other risk assets, as concerns over Covid-19 remained heightened, notably in Brazil.

Commodities rallied strongly in Q2 **(Bloomberg Commodity +5.08%)** recovering some of the ground lost in Q1 and aided by US dollar weakness. The energy component posted a sharp gain, as OPEC (the Organisation of Petroleum-Exporting Countries) and Russia agreed to make temporary production cuts. This masked volatility in April caused by oversupply and storage concerns. The industrial metals component recorded a positive return, led by iron ore and copper. Precious metals advanced too, with silver the standout performer. The agriculture sector posted a negative return, with coffee and wheat prices notably weak.

Commercial Property weakened **(FE UK Property -2.28%)** amid fears for the UK economy and retail particularly suffered as shops were closed and fears increased for the retail sector.

Sterling weakened against **EUR (-2.62%)** and was broadly stable against **USD (-0.15%)** and **JPY (-0.10%).**

**Please Note: All quoted returns are on a price basis in local currency terms.**

## LOOKING FORWARD…

*Several things go together for those who view the world as an uncertain place: healthy respect for risk; awareness that we don't know what the future holds; an understanding that the best we can do is view the future as a probability distribution and invest accordingly; insistence on defensive investing; and emphasis on avoiding pitfalls. To me that is what thoughtful investing is all about. – Howard Marks*

The pandemic has given us some extreme swings in stock markets. The longest bull-run in history, which started in March 2009, came to an abrupt end in early February when markets crashed in equally record-breaking fashion. Measured from its 2020 peak in February, the S&P 500 bottomed at close on 23rd March down 1,148 points or -33.9%. The falls in equities were the shortest, sharpest correction in history, even quicker than the crash in 1929, which preceded the Great Depression and much faster and sharper than the 2008 financial crisis. For credit markets the corrections were the worst since the collapse of Lehmann Brothers. As central banks and governments announced ever more extraordinary measures to protect jobs and the economy, stocks rebounded and by the end of June the S&P 500 was down 8.44% from its peak on 19th February and 4.45% year to date (YTD), having flirted with YTD parity on 8th June.

Within those numbers are some interesting elements that are noteworthy: European stocks outperformed US stocks in mid-March, US small companies outperformed large caps in mid-April, and value outperformed growth in mid-May in the US. However, these notable trend reversals were brief in their duration and the big picture trends have remained intact. Growth stocks have outperformed, and the degree of underperformance of value and smaller stocks has been quite historic over the last year and a half. In statistical terms the degree of under/outperformance has been enormous measured in terms of Standard Deviations from the normal distribution of returns. In March, US value stocks underperformed by about 4.5 SDs and US small stocks underperformed by about 6.5 SDs. To put that into statistical context, a 2 SD move is something that you should expect to see once every five or ten years the likelihood of seeing a 3 SD move in a career is slight and a 4 or 5 SD move is so unlikely that you would be better advised to bet on a Donkey winning the Grand National. Advocates of value investing will no doubt suggest strongly that this is a compelling reason to seek out value stocks, but it is worth considering why growth has outperformed value for so long and whether that dynamic is likely to change in the short term.

Relative to other periods of recovery, economic growth since the global financial crisis 10 years ago has been muted. In this environment growth has been scarce and the market has been happy to pay a premium for quality and for growth. In the past few years this has been concentrated further still on a very narrow subsector of the market - the tech giants, while more traditional companies have tended to lag. COVID-19 has further benefitted many of these Tech Leaders as the stay at home environment played to their business strengths. The economic impact of the COVID Crisis may well exacerbate the scarcity of growth and particularly cash generation and balance sheet strength. With many Corporates highly indebted and lacking the means and confidence to reinvest in themselves, consumers wary of job security, rising savings rates and highly indebted governments it is easy to see a scenario where growth stays a rare commodity and this narrow market leadership can persist. If we do experience a V-shaped recovery, there could be a period where aggressive monetary and fiscal policies will favour some of the more traditional industries and lift those businesses for a moment in time. However, once the sugar rush is over, we would expect to see a premium placed on balance sheet strength, earnings and cash generation and those companies that show a good return on the cash generated and reinvested to fund growth.

Of particular interest and concern at this point is the extremely narrow concentration of the market return drivers in the US market. The FAANGs (Facebook, Amazon, Apple, Netflix, Google/Alphabet) plus Microsoft represent 25% of the S&P 500 index by value and 8% of its revenues. Tesla is now valued higher than Daimler, BMW and VW combined, and YTD has added the equivalent market cap of 1.2 Toyotas, 5.6 General Motors or 27.5 Renaults. Whilst neither of these is an accepted unit of measurement, it is worth noting that Toyota was the world's most highly valued car manufacturer and though we appreciate Tesla's first mover advantage, the growth its valuation is staggering and reminds us of the Tech Bubble of the late 90's. No doubt this time will be different……….

Looking further into the valuation of markets, the traditional Price/Earnings (P/E) ratios on global developed markets are above 30-year averages in the majority of markets. if we consider that the E of the P/E is very much in the wind then perhaps we can appreciate the bubble-like valuations of markets. The US is worst, reflecting the narrow Tech leadership as above and the domination of Tech of the US market. The next most Tech heavy market is EM. The UK is Tech-Lite.

While Global equities have stormed higher since their March low, they are now showing some signs of fatigue. The unprecedented and deep economic fallout has been matched with equally unprecedented and forceful policy reflation. Central banks have pulled out all stops to crush the cost of borrowing and

ease credit strains, while fiscal authorities have attempted to provide a bridge to cross the deep hole in both personal and corporate incomes. The combination of a powerful policy backstop, a flatter global COVID-19 curve, excitement over the prospects for economic reopening, and lack of fixed-income alternatives, have all helped fuel equity market gains in recent weeks. That said, global equities are now well ahead of improving economic fundamentals. Indeed, there has been an abnormal divergence between equity prices and the collapse in earnings and economic activity, causing an air pocket in stocks that is much larger than the one that developed at the start of 2020. Equity investors are now betting on a rapid and smooth rebound in earnings back to where they started the year.

Although we are generally constructive on the prospects for an economic and earnings recovery, there is ample room for near-term disappointment among investors given current elevated expectations embedded in equity prices. Broadly speaking forecasts suggest that we will start 2023 exactly where we would have been if COVID-19 had never happened. That seems a very aggressive forecast which ignores a lot of potential bad news and concentrates on the power of the Fed and government support. Whilst we are told that we shouldn't fight the Fed the market seems to be very much travelling in hope and with unreasonable or untested expectations.

In the near term, investors must make a judgement call on whether the disturbing data on COVID-19 in the USA, India, Brazil and elsewhere represents a threat to markets. In California, Texas and Florida (more than 27% of US population) there is clear evidence of an increase in the infection rate. While Trump is correct that testing has increased significantly (+41%), the rate of increase in positive tests (+106%), daily hospitalisations and deaths all point towards a significant second US outbreak. Further, and more from an economic standpoint, high frequency data is showing that activity levels are slowing and dropping off, suggesting that as infection rates rise, the populace are less happy to get out and about which has to impact the pace of economic recovery.

Regular readers will be used to discussions on liquidity in the financial system and in the very near term, post the initial shock and awe, we note that the flow of US liquidity is actually quite weak, but the stock of liquidity is high. The Fed is now buying less debt than it is issuing and the excess money seems to be starting to get into the hands of US households who data suggests are speculating in the markets or paying off debt, whilst this "Paradox of Thrift" effect is a negative, at least QE is getting into the hands of the consumer, something that conspicuously failed to happen in the GFC. The US Treasury General Account (TGA) is again awash with funds just as it was at the beginning of the Trump administration. The usual account balance is around $200bn and at the end of Q2 was in excess of $1.2 trn, so we can expect a further wave of liquidity as the Treasury spends its cash balances over the Summer as Trump tries to sustain the US equity market to support his re-election bid. A re-boot of 2017's Trump Trade?

In China liquidity has improved enormously as they have been an unintended recipient of the US largesse, mostly through lending from Japanese banks. This has funded the Chinese economy as it emerged from lockdown and has eased its Balance of Payments (BoP) constraints through a massive USD injection. The shortage of USD had been a serious barrier to the growth in the Chinese economy and a continuing issue that they were struggling to overcome. The result of the flow of money through the global financial system and via Japanese bank lending to China, has been an easing of economic policy which in turn has meant that they have reported very strong credit data and recoveries in domestic production, construction and Local Government sectors. However, domestic demand has not recovered as China is still reducing imports and tourist spending abroad has collapsed. China's trade and current account surpluses are most likely surging again (as it sells more than it spends) repairing the damaging BoP imbalance which means that instead of reflating the World, China's response has actually been deflationary as it has released further cheap goods into the market suppressing goods price inflation. We wonder whether the consensus fully appreciates this dynamic.

In the USA, the monetary and fiscal easing has also been immense, but as consumers have not been able to get out and spend, the implied savings rate has increased significantly. Whether measured by savings or money balances, US consumers have a large amount of firepower to spend Post Lock Down – whenever that might be. It is expected that there will be a release of pent up spending at some point and it appears from inventory data that there is cheap supply out there. However, we wonder what will happen after this traditional "post war" boom in spending is finished. Will it collide with a changed labour market where arguably, the first signs of higher inflation in the US service sectors are emerging? Also, while corporates have gained from the fiscal easing, small companies need to repair their finances, perhaps by higher prices? It seems to us that the risk to service sector inflation is that it moves higher in the near term as the "War" ends'

Global freight markets have started to improve, and based on traffic data, the shipping industry may have returned to around 95% of its pre-Covid volumes, so Global trade does seem to be recovering. Global inventory ratios deteriorated massively in April as the global economy went into lockdown and whilst data is slow to emerge, we suspect that the Asian Inventories ratio will have fallen back towards January's levels over recent weeks, stabilised in the Euro Zone as a whole and are neutral in the US.

The rebound in China's GDP data (calculated on output rather than actual demand/sales of goods as it is a planned economy) and its industrial production has been driven by credit and probably government decree, however is there demand for what is being produced? The tale of weak imports, rising exports, and the high levels of inventories within the global system suggest that the production may not have many willing buyers as demand is weak. Any deflation in global goods price trends will ensure that headline Consumer Price Indices stay suppressed. This is supported by indices for Asian export prices which declined during the second quarter and were recently actually weaker than in February – April. This raises the possibility that the recovery in trade volumes may have been due to some suppliers/countries seeking to reduce their inventories or dump current production via the use of heavy price discounting.

It may be that in the very short term the Developed World has moved back towards a period where service sector inflation is offset by goods price deflation, again creating a form of 'Goldilocks' economy, which has usually proved to be supportive of equity prices. There is clearly the potential for further 'Goldilocks' gains in risk markets in the near term, if inflation remains tame and the US Treasury runs down its cash balances in the Treasury General Account, without issuing Treasury bonds. It will then be giving money to the real sector, while at the same time NOT removing money from the markets by issuing bonds to investors. Broadly, this is a kind of QE policy, although the flow of funds would be more to the real economy/retail investors and less to institutional investors – exactly what we have previously suggested is essential to emerge from this economic crisis. The Treasury's daily reports suggest that this has not yet started but it is probably significant that the TGA is no longer rising, and quite possible that we are on the cusp of a new surge in liquidity. The last time this happened it was behind the post-election market rise or Trump Trade.

It would be easy to run with the herd and be quite bullish on risk assets, even from these elevated levels. However, we must also balance the more positive aspects with the fact that it is probable that the US economy is slowing following the latest surge in case numbers, and also consider the recent intensification in the Sino-US 'Cold War' perhaps returning to a trade war through the US capital account.

It is rare that a book creates economic consequence for the world, but John Bolton's book on life in the Trump administration may have done just that. Revelations that Trump's supposed hard stance vs China was all smoke and mirrors has come at a very bad time for a President behind in the polls and heavily criticised for mishandling the crisis. Trump has traded heavily on his tough negotiation skills and hard man of business reputation, which has been damaged by suggestions that he has buddied up to President Xi and even perhaps is somewhat in awe of the Chinese Premier. When you add to the mix the recent "declaration of war" from the FBI Director Wray who said that acts of espionage and theft from China's government pose the greatest long term threat to the future of the US, then you can see why it seems like the China hawks are seizing their moment.

We have previously mentioned the effectiveness of the US waging economic war through their capital account – restricting the flow of US dollars to China – and this is very much back in focus. The anti-China group are keen to break the flow of money into China and especially their supply of USD. If they are successful, this will slow the Chinese economy and also halt the ongoing development of the Belt and Road strategy which has largely been funded through USD borrowing over recent years. China has an estimated $6.5-7 trn in USD denominated debt and around half of that has a term of 90 days or less, placing huge reliance on wholesale USD money markets to recycle the debt when it matures. If you can slow this flow, you can slow the Chinese economy, blunting their attempts to gain economic hegemony.

This week, the President Trump signed into law an Executive order that makes it extremely difficult for US-regulated lenders to conduct business with many Hong Kong counterparties. This move, on top of the OECD's recent downgrade of Hong Kong's effective credit rating below that of Botswana, seems a threat to China's balance of payments by reducing the ease of getting dollar funding, and as a consequence, the ability of the Chinese banking system to continue to provide the rates of credit growth that the economy needs to sustain its growth and its current economic model. China would be forced to reduce imports and increase exports to gain USD to pay its outstanding dollar debt burden.

Whilst this dynamic is deflationary in the short term, if China's economy were to stumble as a result of a weaker BoP, then this, on top of the impact of the virus, might prove too much for even today's Teflon markets to cope with. Clearly, the next few weeks will see pressures on markets to melt up, and also for them to fall. It seems that we are facing an increasing test of liquidity versus fundamentals in markets.

Investors also need to keep an eye on domestic political developments in the USA, and particularly two economic policy areas going forward. Firstly, the ability of Congress to pass a balanced fiscal package and secondly, tax policy after the US presidential elections in November. The first is key for the US economic outlook, while the second could undermine future earnings trends and equity valuations. An increase of corporate taxes in particular would have a meaningful negative effect on earnings and profitability, leading to less optimism on the US equity market. Investors need to watch how the outcome of the upcoming US elections is shaped by events and economic developments in the coming months, as numerous factors can influence the outcome between now and November, developing a view on the result of the US elections will most likely prove challenging until they go to the polls.

Of particular importance to the economic picture is the increase in money growth, which has been driven by credit expansion and fiscal spending. This very strong money and credit growth is a direct result of the expansive monetary policy seen around the world and evidence that the transmission mechanism is actually functioning. In the Eurozone, we estimate that money supply growth will be 15% YoY by the end of 2020, the fastest in the Eurozone's existence. This should help to kick-start the Eurozone economy and perhaps to normalise inflation and eventually bond yields.

The collapse in economic activity caused by COVID-19-related lockdowns is pushing inflation down. Lower oil prices and weak (or non-existent) demand for many goods and services are dampening inflation. Headline and core inflation rates have fallen sharply in the USA and Europe, and inflation should remain low until economic activity has fully recovered - perhaps late next year or in early 2022? Beyond that horizon, we think inflation could pick up significantly due to the policies deployed to contain the economic damage from this crisis ‑ large fiscal stimulus packages and massive central bank quantitative easing programs. Where previously the symbiotic inverse relationship between goods prices and service prices kept headline inflation muted perhaps this time it will be different?

Commentators can point to the failure of past quantitative easing programs to generate higher inflation as evidence that these programs will also fail. However, now the stimulus is producing a sharp increase in money supply growth - something it failed to do after the global financial crisis when banks and governments were consolidating their balance sheets. With broad money supply growth in the USA and Europe having risen sharply in recent months and the fastest for well over a decade it looks like the transmission mechanism into the wider economy is functioning, at least for now. It can take time for money supply inflation to pass through to higher consumer price inflation, especially during lockdown, but this big increase in the money supply may signal strong pent-up demand in the future, switch around the supply/demand dynamic and lead to a surge in prices.

The extent to which inflation stays high will depend on policymakers. If governments and central banks reverse their COVID-19 policies quickly after normality returns, then any rise in inflation could be limited. But we think that both governments and central banks will be comfortable accommodating somewhat higher inflation, having failed to generate it for over a decade. That would help them reduce the considerable government debt burden accumulated during this crisis. This stagflation environment is a very uncomfortable one for investors, but an interesting one for the talented stock picker.

Whist short term we may see the return of Goldilocks – liquidity, stable headline inflation and improving economics we must be wary of the risks:

- The virus is returning to the USA, which could spook markets, delaying the 'end of the war'.
- Credit defaults/downgrades end the credit boom if government support reduces
- US Domestic Politics – a Biden win would change the market dynamics
- International Politics - The cold war between the USA and China heats up and the US uses capital account sanctions. Tariffs may also prevent Chinese deflation offsetting US inflation.

While the wall of money on the sidelines suggest any market fall will be short, at the time of writing we would not increase risk, preferring to maintain what dry powder we have for the time being, whilst watching carefully to see how the risks play out. We remember that sometimes it pays to sit on your hands and that superior returns are often made through avoiding losses rather than chasing markets up.