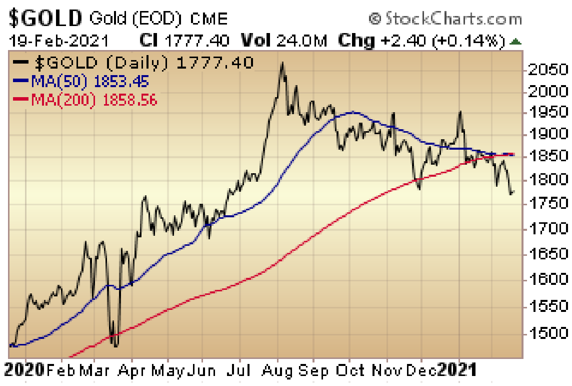
GLOBAL
ECONOMIC AND INVESTMENT NEWSLETTER

22nd February 2021 Issue No.242

Introduction

The price of gold continues to fall, as shown in the adjacent futures chart of the spot price. It reflects a recovering US dollar, rising interest rates and more risk-taking by investors, as they can see the end of the pandemic, with vaccines being widely distributed. Economies are improving and the flight to safe haven assets is reducing.



The adjacent chart shows the 200-day moving average (red) moving above the 50-day moving average (blue), which in technical terms is known as the "death cross" (by followers of the dark art of trend analysis).

This is generally thought to represent the crossroads where a short-term trend becomes a more permanent longer-term direction.

Equities

- In our previous newsletter, we said that the share market was overdue for a short-term correction. In the last week the global equities market has become jittery, sending markets down, as investors become concerned about the possibility of rising inflation - which has sent bond yields higher. The yield on the 10-year New Zealand government bond started the year at around 1%... and has now climbed above 1.5%.

  The problem for the share market is not rising inflation or interest rates, but strong policy moves by the central banks - or indications that this could occur. For the share market, moderate inflation is usually a good thing, as long as central banks do not become aggressive. Studies indicate that US equities tend to outperform for 90% of the time when inflation is low but rising - as it indicates that investors are becoming more confident in the economy.

  The magic number to watch on the US 10-year Treasury yield chart is 1.75%, after which equities could well be affected. This is currently around 1.34%.

Investment Strategies

- Renewables are the flavour of the month in the energy sector, with a range of major oil companies paying what has been described as "staggering" prices for leases of offshore wind projects assets in the UK.

The oil companies rely on traditional fossil fuel-based sources for their cash flow, but appreciate that the game is up in the industry and that they need to secure renewable energy sources. BP has plans to shrink its hydrocarbon production by 40%.

- The share prices of marijuana companies supplying product in the US are booming. It is been legalised for recreational use in 15 states in America, as well as Washington DC. However, overall, at a federal level, it remains illegal. This creates a conflict.

  Canada is a prominent supplier, with its largest five companies listed in America, on the New York Stock Exchange or the NASDAQ.

  However, the four largest US companies are not listed, as their activities are illegal countrywide. Valuations of listed companies are through the roof and many investors are investing through Exchange Traded Funds (ETF's).

- Special purpose acquisition companies (or SPACs) have become popular in the US and their share prices are surging. These are companies with no existing businesses that raise funds through an IPO with the intention of merging with private enterprises down the track - which are therefore provided with a low-priced backdoor listing. They are usually associated with a business person with a successful background in the sector being targeted. The SPAC promoter typically receives around 8% of the shares, for little cost, as remuneration for the exercise.

  Around 250 SPACs were launched last year in the US, raising $83 billion. This rate has accelerated - in January 2021, an average of five new SPACs were created each working day, totaling $26 billion in capital for the month.

  Investors usually pay about $10 a share and also receive warrants giving them the right to buy more shares if the SPAC is successful. The company then searches for an acquisition target in order to complete the exercise. However, studies indicate that on average companies that go public via this route are unsuccessful, lagging behind the wider market in share price accretion. Furthermore, 75% of SPACs launched last year are yet to find an acquisition.

- The price of Bitcoin during 2021 has surged by over 85% and the total market capitalisation has now reached in excess of US $1 trillion. A mysterious and anonymous person known as Satoshi Nakamoto created the digital asset just 12 years ago.

Debt, Inflation and Interest Rates

- Most economists are saying that inflation will not be an issue for the foreseeable future. The IMF, for example, anticipates that global inflation will remain muted until 2025, due to the deflationary effects of Covid-19.

  This is important, as a sharp rise in inflation would cause central banks to consider raising interest rates, resulting in a detrimental effect on equities, commodities and the real estate market.

  However, investment bank UBS has predicted that annual inflation will increase to over 3% in the US and approach 2% in the Eurozone in the first half of 2020, as prices move upwards from a low base. Inflation in Europe has shifted from services (generally requiring person-to-person contact) to goods, with consumers switching from service items such as restaurants and travel, to assets like computers and cell phones. Manufacturers had not anticipated increased demand in this area, creating bottlenecks in the supply of many consumer goods.

- Some pundits believe that inflation is in a “goldilocks” zone – rising, but not enough to force the hands of central banks. In this situation equities generally do well, as long as the fulcrum does not tip too heavily towards rising prices, and as long as investors – looking ahead – do not over-anticipate the trend. As such, they are tricky times.

  Central banks, particularly the all-important US Federal Reserve, are saying that interest rates will stay near zero for some years – but they would say that, keen not to spook the markets.

  However, an over-extended period of ultra-low monetary policy tends to sow the seeds for a subsequent bout of higher inflation and late reacting reversals of central bank policies.

- Inflation is rising in the UK with the price of consumer goods rising at an annualised rate of 0.7% in the year to January 2021. Analysts are now predicting that inflation in Britain could pass the target of 2%, set by the Bank of England, before the end of the year. This is despite reaching a four-year low of 0.2% in August 2020.

  Almost every sector saw an increase, despite the lockdown in January.

  In the US, the University of Michigan survey of consumer inflation expectations show that they believe inflation will reach 3.3% over the next 12 months. This is the highest reading since 2014.

- Bond prices have been falling and their counterparts, interest yields, rising - with the yield on the benchmark US 10-year Treasury note trading at its highest level since before the pandemic. Concern about inflation has been the main driver.

  The steep rise is shown in the adjacent chart of the benchmark US 10-year Treasury yield (divide by 10 to get the interest rate). The interest yield has risen from 0.9% to just under 1.4%, since the start of the year (and was just 0.7% in September 2020).

  The damage is particularly prevalent in ultra-along Treasury bonds. The 100-year Austrian bond, for example, has recorded a loss of nearly 30% for the year-to-date.

- In spite of obvious signs of recovery in the major economies, most are not expected to fully recover to pre-pandemic levels for some time. The IMF has forecast that the US and Japan will not return to pre-Covid levels until the second half of this year, while the weak Eurozone and UK economies will not reach this level until well into 2022. The Eurozone economy contracted by more than twice that of the US in 2020 and accordingly will recover at a slower pace.

Catalysts include the reopening of economies and an anticipated surge in consumer demand after that.

China is a different case, with its economy expected to be 10% larger than 2019 by the end of 2021.

- With global rates now between 80 and 120 basis points (0.8% to 1.2%) above November 2020 figures, investors and new property owners in New Zealand are now looking to lock in longer term mortgage rates to protect against inflation… and possible moves by the central bank.

Economies

- Defying gravity, UK business confidence has leapt to its highest level in five years, according to a survey of 1000 corporates from the ICAEW accounting body. The index increased from -19 in the fourth quarter of last year to +10 in the first quarter of 2021. With vaccines being widely distributed, firms are looking to the end of the pandemic, with an associated increase in revenue.

  This is despite forecasts of weaker economic conditions down the track. The British Retail Consortium and Barclaycard said spending in January was at its weakest level since May, 2020, amidst an increasing number of physical stores being shuttered. The UK suffered its largest annual contraction in GDP for 300 years in 2020.

Coronavirus Solutions

- The Wall Street Journal has said (18/2/21) that the US will "have herd immunity by April". Cases are down by 77% over the last six weeks, which is a faster decline than experts had predicted. The herd immunity prediction is because natural immunity from prior infections is more common than previously believed. Testing has only been capturing between 10 and 25% of infections - meaning that there are more people than previously thought in the community with natural immunity from previously contracting the virus (but have been asymptomatic).

  Added to this, vaccinations are progressing at a rapid rate, with 15% of US citizens receiving the jab to date. It is estimated that about 250 million doses will have been delivered to around 150 million people by the end of March. The population of America is 330 million.

  If more data was available on natural immunity, then the vaccination process could be more selective. Reinfection after contracting Covid has occurred in less than 1% of the population, and these have been mild.

- The World Health Organisation (WHO) has been searching for animals in China that could have spread the coronavirus to humans. Pangolins, small scaly animals considered the most trafficked animals in the world (particularly to China and Vietnam), were originally thought to be the perpetrators, but the WHO is also looking seriously at ferret badgers and rabbits, which have been found to be susceptible to the Covid virus and are sold in Chinese markets.

The closest relatives of the virus have been found in bats (the original reservoir), but the search is on for an animal intermediary. They are investigating legal and illegal animals sold in markets in Wuhan, but also testing mink farms, after virus variants were found in mink farms in Denmark. Most scientists are suggesting that the virus was spread via China's illegal wildlife trade.

Suggestions from China that the virus could have been introduced into the country via frozen products has been discounted, but other countries in Southeast Asia are also being considered, including Cambodia and Thailand.

Business

- Semiconductors have been in serious global short supply, due to trade issues and the Covid-19 pandemic. As consumers shifted from spending on services to products, the demand for items such as cell phones and computers has escalated. This has been particularly obvious with items that assisted people to work remotely.

  A shift of emphasis in the automobile industry also contributed to the problem, with hybrid cars requiring about twice the number of semiconductors as traditional vehicles.

  Almost every business that is dependent on semiconductors has been affected by the shortage, which has been described as a "perfect storm". Demand in areas such as the Cloud, artificial intelligence and electric vehicles is unlikely to abate in future years.

- Freight rates are currently high, increasing the cost of imported goods and raising inflation. As an example, costs for 40-foot containers between East Asia and Europe are up six-fold since April last year. Rates between Asia and the West Coast of America are up four-fold since March 2020.

  Part of the reason is a shortage of shipping containers. Health precautions, relating to the pandemic, have slowed the flow of containers through the ports. Costs are likely to remain elevated for some time.

- The essential feature behind the conflict between Australia and Facebook, and Facebook's decision to block people from sharing news in that country, is the question of whether large corporates or nations should control the Internet and in particular social media platforms. Big business threatening to bring a country to its knees is considered by many to be unacceptable. The issue relates to whether or not social media companies should pay for access to news.

  Initially Facebook's motto was "move fast and break things", then this morphed into "move fast" - and perhaps will now be changed to "break things" … now that it has "unfriended" Australia. Nearly 40% of Australians use Facebook for general news.

  Canada has branded Facebook's actions as "highly irresponsible" and is likely to follow suit. Nations are moving to curb the power of social media and new laws in the European Union have led Google to agree to pay French news publishers for their content. Google has signed deals with more than 500 publications worldwide.

Politics

- Among the parties taking legal action against Donald Trump are Dominion Voting Systems and Smartmatic, companies that provide voting technology. Dominion is also launching a $1.3 billion claim against Rudy Giuliani, Trump's legal advisor. The claims relate to defamatory statements over the accuracy of voting technology used during the election.

  However, it is not easy to successfully establish libel cases in the US. The First Amendment offers protection for "freedom of speech" and it is up to the plaintiffs to provide burden of proof. In comparison, the UK system requires that defendants have to establish that their comments were true.

  US courts have a natural bias against defamation claims.

Commodities

- Dairy prices are strong, with Westpac forecasting $7.50 per KG MS (and ASB $7.40). This is the highest price for the last six years.

  Buying is being led by China, which has increased its consumption by 16% from 2020.

- Copper prices are still on a roll, last week rising to their highest levels since 2011 as the metal benefits from a shift away from fossil fuels to electricity (it is used in wiring). The demand for copper in renewables and electric vehicles is expected to grow more than seven-fold by 2050, if the world is to make significant advances towards zero greenhouse gas emissions. Overall, the demand for copper should double during that period of time.

  However, there are very few new large copper mines coming into production over the next decade. Copper also benefits from a fall in the US dollar and rising inflation.

- China has lifted its ban on scrap metal imports, reducing its dependence on Australia for iron ore - another stroke in its discriminatory moves against the Aussies. Around 60% of iron ore use in China comes from Australia and China accounts for over 50% of global steel production.

  The China Iron Ore and Steel Association reported that 3000 tons of recycled steel was imported from Japan in January, the first import of scrap metal in the last two years.

  China says that by importing recycled metal it is reducing the carbon emissions created by making steel. They plan to achieve a net zero emissions overall by 2060 and to cut steel manufacturing emissions by 20% over the next five years.

Real Estate

- In New Zealand, the Reserve Bank is to introduce higher deposit requirements for residential real estate, which is causing a rush by investors to purchase before the date of implementation. The RBNZ estimates the new restrictions will lower house price increases over the next year by between one and four percent. From March, at least 80% of new bank lending to owner-occupiers must be with deposits of at least 20%, while 95% of investors require a deposit of at least 30%. From May the deposit amount for investors will increase to 40%.

To a large extent, the horse has bolted as banks like ASB have already increased their deposit requirements from 30% to 40%. Investors are now likely to shift their purchasing power to lower priced cities with employment opportunities, like Christchurch.

ANZ believes that the New Zealand housing boom is an outlier in the global market, and it will not last.

- As in New Zealand, Australia, and America, the UK real estate market is surging, in spite of pandemic and Brexit issues. UK residential real estate prices increased by 8.5% during 2020, the highest annual growth rate since 2014.

  The surge reflects the effect of a stamp duty holiday, which ends in March. Buyers, isolated in their homes for nearly a year, are also seeking more appropriate and larger spaces.

  The average house price in the UK reached £252,000 in December, a record high.

- The shift in emphasis in Australia for residential real estate buyers to avoid CBD property was reflected in a 11.2% drop in housing rents for Melbourne city, and a 10.8% decline in Sydney city rents, in the year to February 2021.

  It's reflects a shift in emphasis from working in the city to relocating to home.

  However, smaller cities like Perth and Darwin saw rents rising at a rapid rate.

- Americans have been ramping up mortgage arrangements, taking out a record $1.2 trillion worth in the final quarter of 2020 – seeking to take advantage of record low rates. Over $180 billion of mortgages were arranged during this period.

  It was the largest quarterly expansion of mortgages in the US since records began in 2000.

John Ryder and Devon Ashby