Quarterly investment outlook

Inflation: What is it good for?

Q2 2021

mazars

Contents

Foreword

Rising concerns for the prospects of inflation dominated the first quarter of 2021 and caused bond market yields to rise in both the US and the UK. As a result, US treasuries lost over -5% of their value (in Sterling terms) during the period, whilst the loss on gilts was even greater at just shy of -7%. Though some had feared that rising bond yields might undermine the lofty valuations on equities, stock markets continued to rely on the gradual emergence from lockdowns in some parts of the world to support optimism resulting in global equity returns of over +4.6%, again in Sterling terms. The US again led the way with returns over +6%, with the UK not too far behind at +5.4%. Gold, which had offered considerable protection during the sell-off a year ago, continued to struggle even in the face of rising inflation expectations, losing over -10% in the quarter.

The case for rising inflation has solid foundations, and perhaps the bigger question is whether the world sees a short-term bout of transitory inflation or a more established pattern of price rises extending into the medium term. Inflationary pressures can broadly be sorted into three areas. Firstly, the frictional effects of the Covid-19 pandemic and the associated disruption to global supply chains. Secondly, an expectation that (some) consumers have cash burning a hole in their pockets and will want to spend it once lockdowns ease. And finally, that in addition to well established loose monetary policy, fiscal expansion is now a significant force, at least in the US. Companies are already reporting an increase in the prices they are having to pay across their supply chains, and we suspect that consumer psychology and willingness of governments to continue spending beyond the pandemic will be crucial to determining what type of inflation the world sees, and for how long.

Support for the economy in both monetary and fiscal forms remains necessary to prop up the economy which is still hampered by the effects of the pandemic, and we think that the danger of stimulus being withdrawn too quickly is an unlikely risk. We do though expect to see differing approaches to government spending around the world and don't necessarily expect President Biden's recent stimulus package to be imitated in other countries, particularly in the EU where fiscal prudence is at least theoretically written into the rule book.

Similarly, divergences in monetary policy are starting to become evident with the US Federal Reserve and the Bank of England seemingly unconcerned with the recent rises in yields, whereas by contrast the European Central Bank will look to increase quantitative easing to ward off tighter financial conditions.

Underpinning all other considerations is the market's continued optimism for the reinvigoration of the global economy as the worst of the pandemic passes. This is of course a brave assumption, particularly given the difficulties of vaccine supplies, the scale of the global vaccination program required, and the possibility of virus mutations which might leave science on the back foot once more. Challenges in this area might give markets cause to question current valuations.

At our April meeting the Investment Committee voted to make changes to our portfolios which move closer to our new strategic asset allocation. These changes include a greater weighting to overseas equities (with some currency hedging) and a move away Sterling denominated debt towards a more diverse range of bond investments. Within our tactical positioning we hold the view that what worked well last year may not do so this year, and therefore favour the UK geographically, and have increased our weighting to 'value' stocks.

David Baker
Chief Investment Officer,UK

Inflation: What is it good for?

Inflation: What is it good for?

Overview

There are two kinds of people in the market: those who remember what inflation looks like – and those who don't.

Inflation dominated investment discussions in the first quarter of 2021, and for good reason. It is the only real factor that can deter central banks from pumping the financial markets with cash and disrupt a 12-year old monetary regime which has seen global equity and bond prices reach historical highs, as investment risk was suppressed. Since 2008, the US Federal Reserve alone has expanded its balance sheet by $7tn. That is equivalent to 66% of GDP each year. In total, more than $16tn have been added to the global economy, or 20% of a year's global output. In theory, money printed in excess of GDP growth should be inflationary. It does little to the economy since the increase in money is accompanied by a commensurate rise in prices. However, in the observed absence of inflation, this money became real wealth, making up for the shortfall in demand after the Global Financial Crisis, at least as far as the financial economy (stocks, bonds, and other risk assets) is concerned.

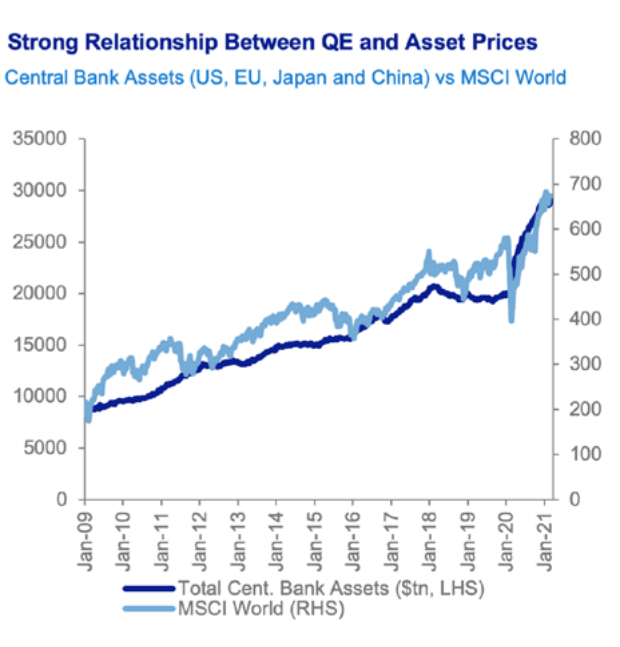
Inflation, in its most taxing form, has been absent for more than 20 years, except for a couple of periods where such a rise proved transitory. If long term inflation returned, central banks would need to drastically change their tactics, and the current financial paradigm would be upended. Managers of risk assets who have been 'Pavlovianly' conditioned to depend on central banks would probably see a massive rerating of their holdings. With the entire system of risk assets restructured and reorganised before seeking a new modus operandi.

During this quarter, supply side inflationary pressures became all too obvious. As the global economy desynchronised, due to differentiated local responses to Covid-19, value chains suffered.

George Lagarias
Chief Economist, UK

Restocking cycles were disrupted and so too was production. China's restart of its economy in the second half of last year, after strict lockdowns, caused a surge in demand for raw materials.

As the western world entered renewed lockdowns, while China was ramping up production, the world further decoupled. This caused a surge in input prices evident in various Purchase Manager Index reports as well as producer price indices. In early February, markets began to price in the probability of higher inflation. The long end of yield curves (where inflation lives) rose, while the short end (affected more by interest rates) remained at the same levels.



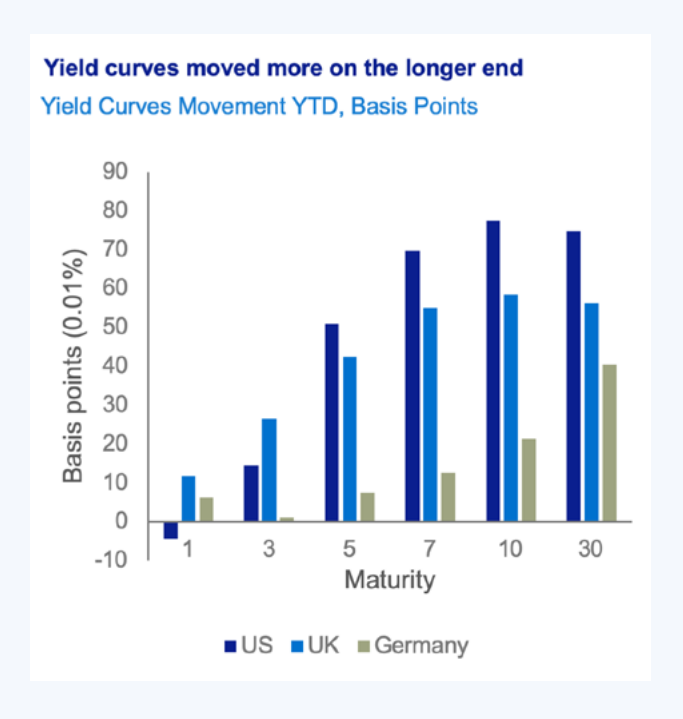
Source: Refinitiv, Mazars Calculations

However, at this point we have to say that rising inflation expectations are mostly a US phenomenon. This is due to the fact that the US is projected to vastly outspend the rest of the world in terms of fiscal easing. While there may be technical factors behind the rise in market "expectations" (the difference in yield between an inflation-linked and its nominal equivalent bond), including increased demand by the Fed for inflation protected securities, there is also solid economic reasoning. The narrative goes: authorities are willing to risk an overheating the economy rather than risk a post-pandemic slump which could further hurt already sluggish economic growth.

The US's projected $3tn infrastructure project was the piece of news that launched the "inflation trade". The US central bank was quick to endorse those hopes, changing its framework to target "average" inflation and reiterating that it would tolerate a modicum of higher inflation over a short period of time, especially if this improved growth conditions and helped it achieve its other mandate, full employment.

As a result, US 10y bond yields have risen by almost a full percentage point to 1.71%, at the time of writing, since November, and the market quickly saw the biggest yield curve steepening in the past five years.

The move was remarkable for asset allocators who, for the first time in years, appear to be able to consider the possibility of increasing their bond exposure to ensure some non-equity income for their portfolios.



Source: Refinitiv, Mazars Calculations

The four conundrums

There are three questions we need to answer which will be very important for our portfolio positioning:

a. Will long term inflation stage a comeback?

b. If it does, what does this mean for a market that has become dependent on central bank accommodation?

c. Will the bond yield rally continue?

d. What about the debt?

Inflation: What is it good for?
Overview

Q: Will inflation stage a comeback?

A: It largely depends on the age of the person you ask.

Inflation can be categorised in three distinct eras. In the 70s, right after the change in monetary regime from the Gold Standard to Monetarism, US inflation peaked slightly below 15% per annum. That would mean that an average worker would need to see their compensation rise every year by 10%-15% just to maintain real income. This was an era of despair, a "lost decade" until 1984. The second era, from the mid-80s until 2008, average inflation dropped to a 5-year average of between 3.5% to 5% and only twice, very briefly, crossing the 5% threshold. This ushered an era of high growth, improving living standards and unfettered consumerism. The third era, following the Global Financial Crisis, is characterised by even lower inflation (a five-year average down to 1.5%, stubbornly below the central bank threshold of 2% and even lower global growth). This was an era of stagnation.

To remember anything about high inflation, one probably needs to have been in their twenties by 1984, and thus in their sixties now. As that generation approaches retirement, the market is quickly losing institutional memory of a key determinant of both the economy and the course of risk assets.

The second cohort, those between forty and sixty remember inflation not as a threatening macroeconomic variable, but as a flashing number on their Bloomberg terminal. This was a generation hooked on watching the US jobs number every first Friday of each month as a key indication. The higher the number of jobs, the higher the probability towards increasing interest rates and the lower the accommodation. Still, it was an era of real growth and relatively low cost of money.

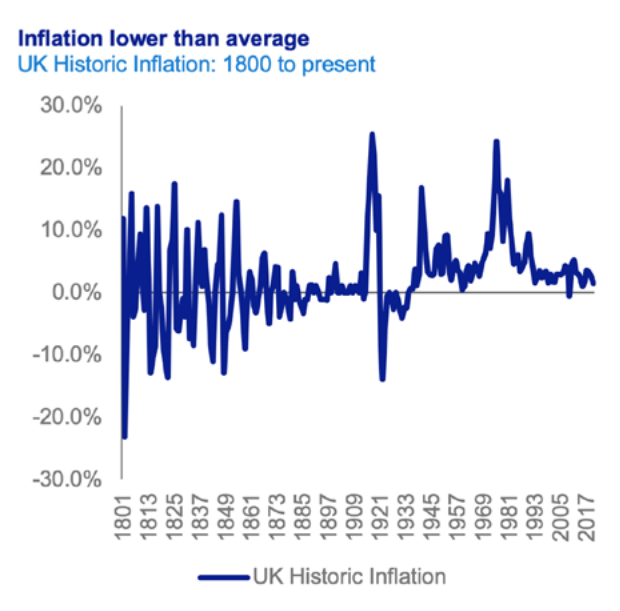
Source: Refinitiv, Mazars Calculations

Inflation: What is it good for?

Overview

The third generation, those below forty, know of inflation only from the history books. In an era of continuous monetary easing, where central bank accommodation has been the only game in town, 'good news' about the economy is often treated as 'bad news' for accommodation. Monetary easing was the only way for financial assets to grow and for the real economy to add value. This generation has known very little apart from central bank underwriting of risk (some could call this market manipulation). More importantly, for this generation this 'new normal' is simply the 'normal'.

History teaches us that inflation can be absent for a long time and still stage a comeback. In the UK, the dominant financial power in the 1800s, for almost half a century, from 1852 to 1914, inflation barely rose above 5% a few times, and was very near zero until the start of the first world war. But return it did. History also teaches us that monetary regimes, those where money velocity and interest rates are not based on a fixed asset, like gold, eventually collapse every time since the Tang dynasty first used paper money in 7th century China. And when they do, inflation occurs.



Source: ONS

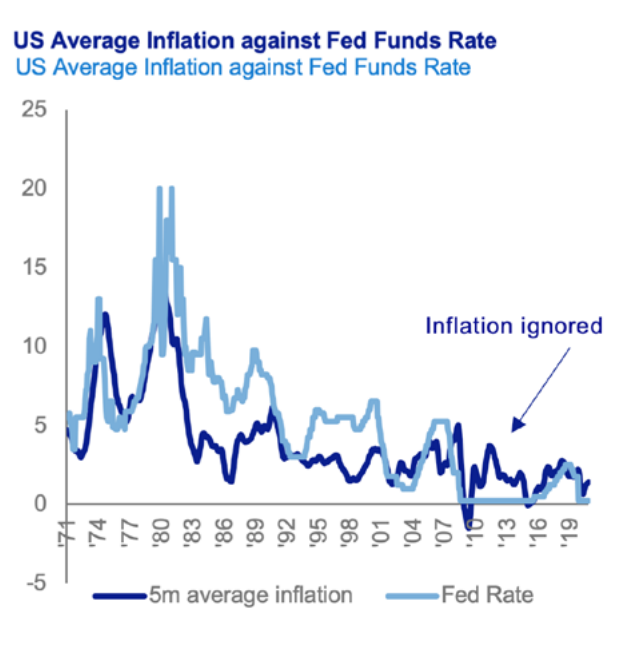
Inflation: What is it good for?

Overview

"'Beware', warns the older generation, a step away from retirement but scared from high inflation just as they were entering the market. 'Inflation is always present, it's only a monetary game' says the second generation, in its prime and holding most key positions in the financial industry. 'This time is different', gloats the third generation, who have never experienced the invisible hand of the market but the heavier and quite more visible hand of the central banks on the scale.

The arguments for and against long term inflation are many.

The key issue focuses around fiscal easing. For the past twelve years, governments experienced fear with regards to rising debt, mostly stemming from the 2011-12 Eurozone crisis and the repercussions in peripheral Eurozone countries. While Eurozone countries are uniquely constrained in a monetary world (they can't just devalue their currency to pay their debts), policy makers of other countries, with significantly more monetary independence didn't dare challenge the so-called 'Bond Vigilantes'. Instead, they relied on central banks to re-stabilise the global financial system and to foster whatever growth they could. However, Quantitative Easing stayed largely within the confines of the financial economy. Asset prices were inflated, even those of real assets like houses or commodities, but not consumer prices. As a result of the credit-fuelled boom and subsequent crash in their balance sheets after 2008, consumers restrained their purchases, ushering in a 12-year period known as 'secular stagnation'. This is what is known in economics as the 'paradox of thrift'. The more one saves, the worst it is for the economy, as it is spending that drives business investment. Less spending by consumers means less hiring, lower wages and overall, less business expansion. Twelve years of Quantitative Easing failed to move the consumer inflation needle materially. Fiscal initiatives were muted, and Quantitative Easing helped push up the savings rate (which also includes pension money).



Source: Refinitiv, Mazars Calculations

Inflation: What is it good for?
Overview

The difference this time around is that fiscal easing not only augments the potency of monetary easing, but it results in actions which more directly target consumers. From cheques sent straight in the mail, to infrastructure projects in the US, to the super-deduction in the UK, incentives to spend and invest are the largest they have been in almost a generation. In other words, monetary easing creates conditions for growth, but it is fiscal easing that can spur the consumer into using the extra money. Nevertheless, the question remains: will it be enough to generate long term inflation above the 2%-2.5% threshold which would put central bankers on alert?

Our basic thesis follows that of the Federal Reserve: we don't believe so.

Milton Friedman famously said that "inflation is always and everywhere a monetary phenomenon". With all due respect to the Nobel Laureate, he was dead wrong. Like most economists of the time, he assumed that extra money would mean extra demand for goods and services. Since his time, three other Nobel Laureates (Shiller, Kahneman and Thaler) proved with their work that consumers don't think in the linear terms economic theory wants them too, and that they may regularly overestimate or underestimate risks. The decade preceding the pandemic made that point. The world went into the pandemic crisis with a cohort of consumers too timid to overspend on their credit cards or buy a house they might not afford if another crisis erupted. There was little demand for consumer credit and little supply as well, as banks, the primary creator of credit money, found themselves in a much stricter regulatory regime than in the previous years. One of the more surprising findings from the pandemic is that banks were reluctant to risk lending money to consumers and troubled businesses, even if the government picked up most of the tab. We simply don't have enough evidence to credibly claim that conditions (pessimistic consumers, low credit expansion) will change in a way that is meaningful for companies to invest more post the pandemic.

Source: Refinitiv, Mazars Calculations

Inflation: What is it good for?
Overview

It is not just central banks that believe inflation to be transitory. Companies, which have experienced higher input prices are not passing on these increases to the consumer and prefer to reduce their margins rather than risk losing market share.

Having said that, we can't overlook the opinion of a generation that has actually seen inflation. The truth of the matter is that we have little insight as to how consumers will react after a life-changing yearlong lockdown. So, while we believe there's a solid case for inflation to disappoint on the downside, we are willing to leave ample room to the opposite side of the argument.

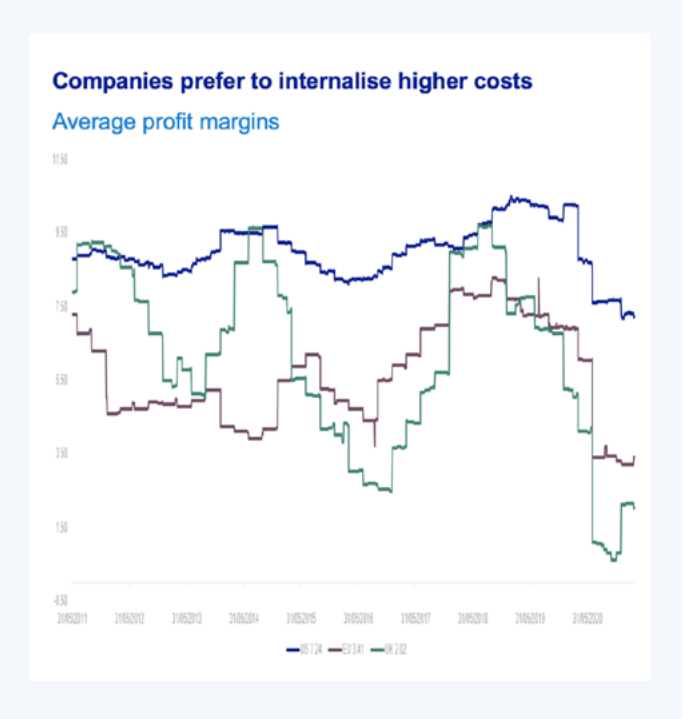
Which brings us to the second question, and the one less pertinent to economists and more relevant to asset allocators.

Q: If inflation does indeed come back, what does this mean for a market that has become dependent on central bank accommodation?

A: Repeat after me: the Central Bank is your friend.

From an investment standpoint, it is entirely possible that the inflation debate may prove to be a red herring. Let us assume that governments, encouraged by low rates and assured that central banks will help, risk higher fiscal deficits. As a result, long term inflation will defy expectations and stage an impressive comeback. Is that something to fear? What will it look like and what repercussions will it have for money managers?

First of all, for any sort of long-term inflation to stage a comeback, bar a commodity or monetary shock like in the 70's, consumer demand would need to drive it. The gift of globalisation was that competition on a global scale ensures that supply-driven inflation won't be able to last for long. Even if trade wars reduce trade mobility, global supply chains have become too sophisticated over the past decades to allow slacks in production and distribution which would drive prices up permanently.



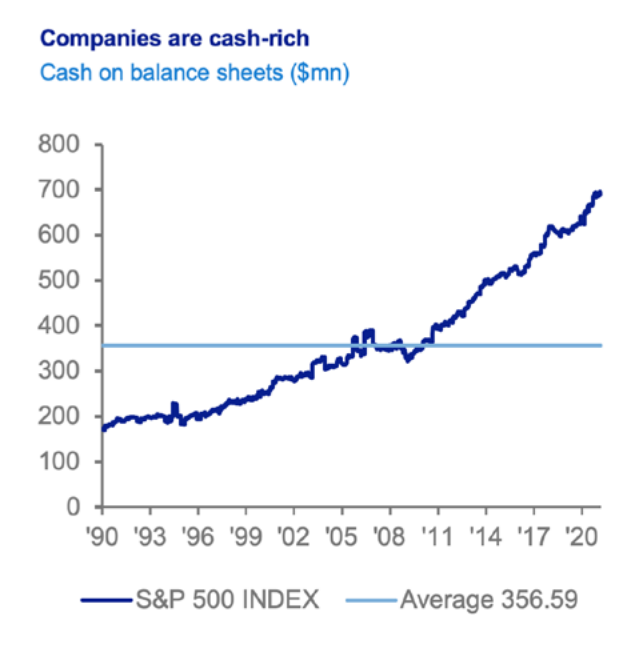
Source: Refinitiv, Mazars Calculations

Inflation: What is it good for?
Overview

So, a British car manufacturer might have problems procuring parts from Europe, due to Brexit, but they wouldn't allow such a thing to force them out of business. They would source the parts from somewhere else, even at a higher cost, and over time they would find a way to compete again for a good profit which would entail not allowing their prices to rise materially. Even companies with significant pricing power are often reluctant to raise prices too high, for fear of encouraging competition.

Higher demand for goods, to the point that supply can't keep up resulting in higher end prices, would be welcome news for businesses, stakeholders, and shareholders alike. Wages would have to go up, which is why the Federal Reserve focuses a lot on consumer expenditures and average compensation, as opposed to the traditional CPI basket. People would live better. CEOs would finally spend their cash to expand organically, creating even more jobs and improve the pay of their current staff. They would also be able to increase dividends on an absolute basis, and still leave a lot of retained earnings to expand. Employees, consumers themselves, could feel more comfortable taking a few more risks, by buying a slightly more expensive car or a house.

That we should be afraid of such an outcome in and of itself is ludicrous. Everything may be in flux, but one constant throughout history across continents and civilisations has been the relentless human "pursuit of happiness". If Capitalism were afraid of thriving businesses and happy consumers then capitalism would inescapably be consigned to the same history bin as Soviet communism or any other system that put its own needs of survival above those of the people it purports to serve. Thankfully, it is not.



Source: Refinitiv, Mazars Calculations

Inflation: What is it good for?
Overview

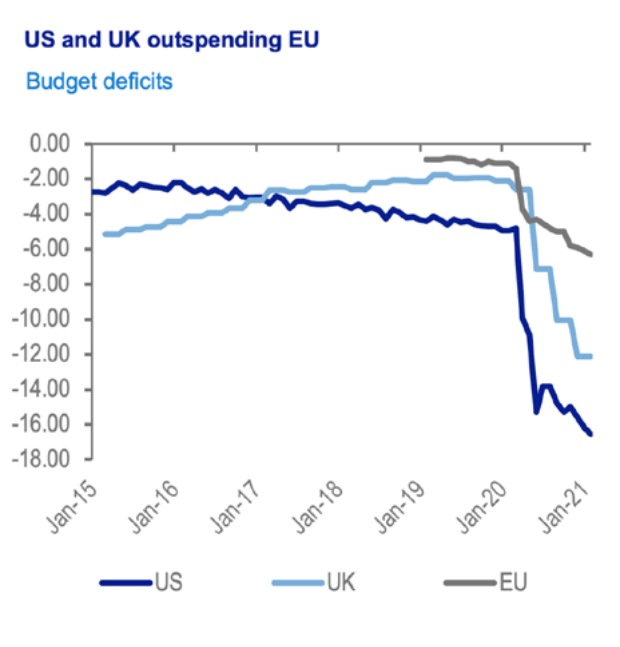
Thus, the lesson from the last twelve years is not that we should espouse monetarism as religion, afraid that one day it will prove to be a false God. It is rather much simpler: In a monetary world, the power lies to those with the printing presses. Mayer Amschel Rothschild has often been misattributed with this anonymous aphorism, 'Permit me to issue and control the money of a nation, and I care not who makes its laws!' Central Banks have been proven to be very powerful and very adaptive. Rational investors would follow them even if they changed direction, sooner than fight them.

Our base case view is that any inflation will not throw the current paradigm. Not the paradigm where central banks pump money into financial assets to foster high returns, but the paradigm where central banks foster the best conditions they can towards avoiding market panics.

We share the markets' concerns that the return of long-term inflation could upend the current paradigm. However, we have learned to trust central banks post-2008. While one cannot avoid a massive re-rating of risk assets in that scenario, one also should not predetermine that this will happen in a disorderly fashion. i.e. it is difficult to fathom that one day central bankers would just decide to surprise all of the investment world and suddenly tighten monetary conditions, without ample pre-warning and communication for portfolio managers to adjust. In fact, we feel that due to the large debt overhang, surprises would probably not even be in their playbook, unless they are faced with true runaway inflation, usually a result of massive currency depreciation, a rarity especially for owners of global reserve currencies like the US Dollar, British Sterling and the Euro.

There's no way to tell when this financial cycle, that has lasted over 13 years, will finally break. But when it does, we feel that the system is more fortified than in 2008 to withstand systemic losses which would exacerbate the fall. The re-rating could very well happen quickly and a new regime, based on fundamental consumer demand would probably be a lot more robust and dependable than the current one which has led to a decade inequality exacerbation and commensurate political tensions across the globe.

However, this scenario has a caveat. There's no such thing as global inflation. Inflation is a very local phenomenon.



Source: Refinitiv, Mazars Calculations

Inflation: What is it good for?
Overview

Increased consumer appetite is inextricably linked with enough fiscal easing to change the 'secular stagnation' motif, along with concomitant tolerance for high debt to pay for the stimulation. In essence it assumes that governments will borrow large sums of money to invest in future growth. Assuming that borrowing costs remain low and fiscal targeting is successful; this would still leave the world with a problem: not every country is willing to go down that road.

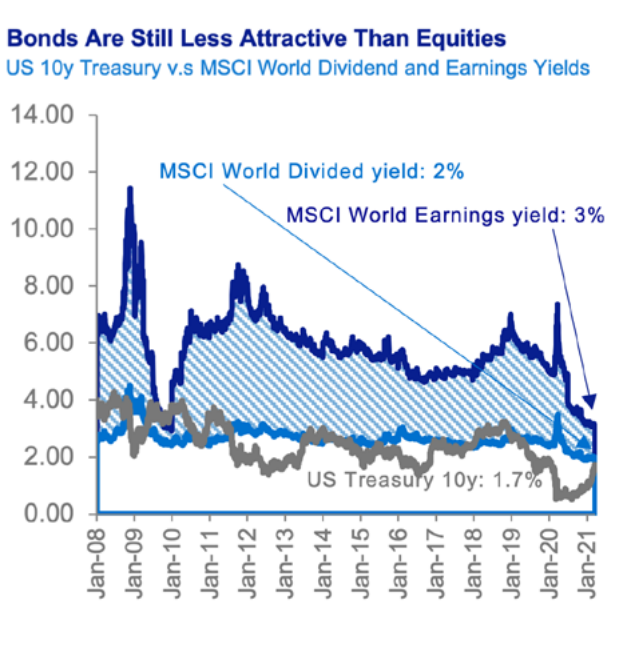
The US has seen its yield curve steepen precisely because markets believe it will pay a lot to stimulate its economy. Thus, it may experience both high growth and high inflation. The UK presented a generous budget now and a promise for higher taxation down the road (which may or may not be fulfilled) and is also down the same, albeit slightly more conservative, fiscal path. It is natural, after all, as fiscal spending might not hurt demand for the world's major reserve currency, the USD, but it could cause significant pressures on GBP. The EU on the other hand has shown no intention to take that path. It remains fiscally conservative at its core as countries are constrained from incurring large deficits for too long. The constitutional court in Germany is still debating the legitimacy of the €750bn Recovery Fund some of which is to be funded with mutualised debt.

In this world, the US would experience high growth and relatively high inflation, the UK slightly less on both and the EU would decouple, hoping the American consumer would also increase demand for its goods and services as opposed to local offerings. In this world central banks would have less common ground for cooperation and tensions between governments could re-emerge.

Q: Will bond yields continue to rise?

A: It is possible, within limitations.

At the time of writing the US 10-year bond was trading at 1.71%, in a small sideways range for two weeks. Evidence shows that the market still hasn't seen massive influx of capital.



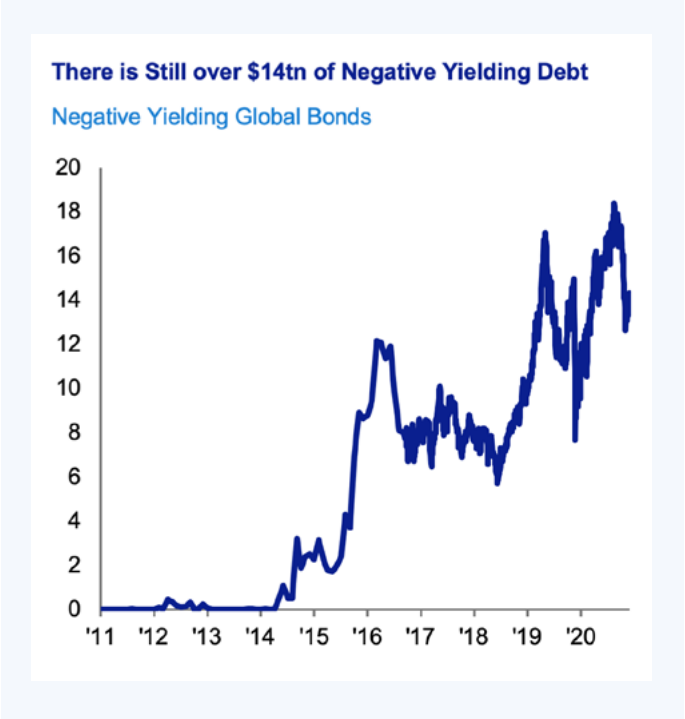
Source: Refinitiv, Mazars Calculations

We believe that at this range bonds are still too expensive versus equities to make a difference within the context of a diversified portfolio. The MSCI World's Dividend Yield is at 2% and the MSCI World's Earnings Yield (Earnings/Price) is at 3%. Currently, fund managers have very low allocations towards cash, which means that for bond yields to see inflows, it would need to be between the 2-3% range. Thus, above 2% bonds start becoming interesting and near 3% they would start to become attractive and offer pension funds and other income-seeking vehicle a good risk-free yield. Various manager surveys also corroborate these levels. We feel, however, that the global appetite for yield is so large that demand would soon bring yields down again. Also, we should note that credit spreads (the difference between a sovereign and a similar maturity corporate bond) are persistently low, which means that corporate exposure offers only slightly better returns than sovereign.

Thus, our view on the matter is simple and in line with consensus: We feel that lack of free cash and unattractive valuations versus equities could allow the bond selloff to continue for a little while. After all, there are still $14tn worth of global bonds still in negative yield territory.

However, much of the market also believes that inflation will eventually underwhelm, which is why the selloff seems to have paused at current levels.

We would not add to our allocation at the current yield levels and would consider expanding our bond holdings only if the US 10-year yield found itself sustainably within the 2-3% range.



Source: Refinitiv, Mazars Calculations

Q: What about the debt?

A: What about it?

We devoted our final quarterly of 2019, 'Ghosts of Japan', to the subject of debt. In the absence of a ground-breaking technological innovation or another breakthrough which would improve productivity, inflation-driven growth will come from debt. According to the institute of International Finance and Axios, global Debt to GDP as at the end of 2020 jumped to a record 356% ($281b), up from 322% just a year ago.

Inflation: What is it good for?

Overview

The IMF estimates US government debt to GDP at 127% and 134% by 2026. For the UK, projections are for 103% and 113% respectively.

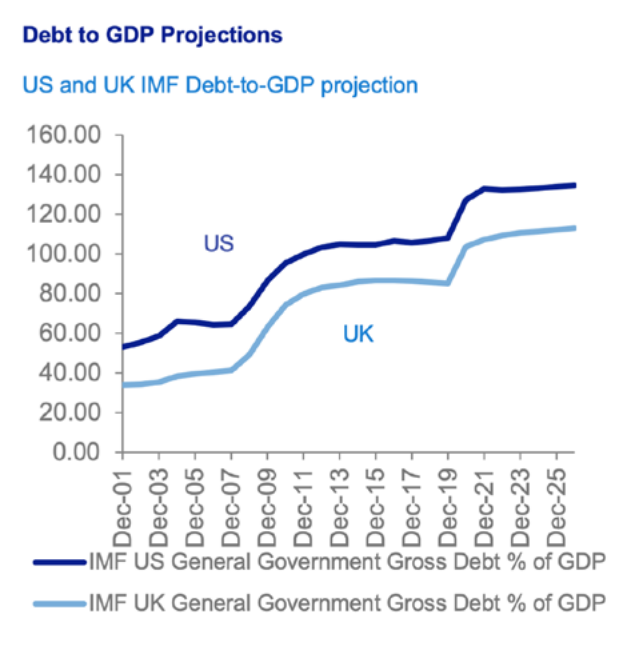
Theory suggests that over 90% of debt to GDP, debt becomes a drag on growth. However, this framework by Carmen Reinhart and Kenneth Rogoff has specific limitations. The most important is interest payments. From 2000 to 2011, US average interest payments on its debt topped 3% as a percentage of GDP. The number fell to slightly above 2.5% after the Global Financial Crisis crashed interest rates. The OECD now projects interest payments at 1.17% of GDP, despite a 20% climb in debt. In other words, governments can sustain more debt for now, because they are not paying too much for it.

Higher inflation would bring about higher rates when that debt was to be refinanced. However, at the same time it would reduce the nominal cost of debt. In fact, in a high debt situation, inflation is a welcome development.

Fear over high debt stems from lack of trust in monetarism and the power of reserve currencies. In theory, a country can print as much money as it wants to pay off its debt, at the price the relative value of its currency. However, in theory, if all major countries and owners of reserve currencies print more money simultaneously to finance government spending, then currency valuations should maintain the balance between them.

The winners would be currencies outside this arrangement (countries which haven't borrowed and printed as much), and real assets (real estate, gold etc). But also, the states that borrowed, assuming they managed to invest wisely and rekindled consumer demand.

In this writer's humble opinion investors should learn to be comfortable with more "fluid" notions of money, and the fundamental idea that the creation of money can equal the creation of wealth. Inflation is an inaccurate and unpredictable arbiter of how much wealth central banks can create.



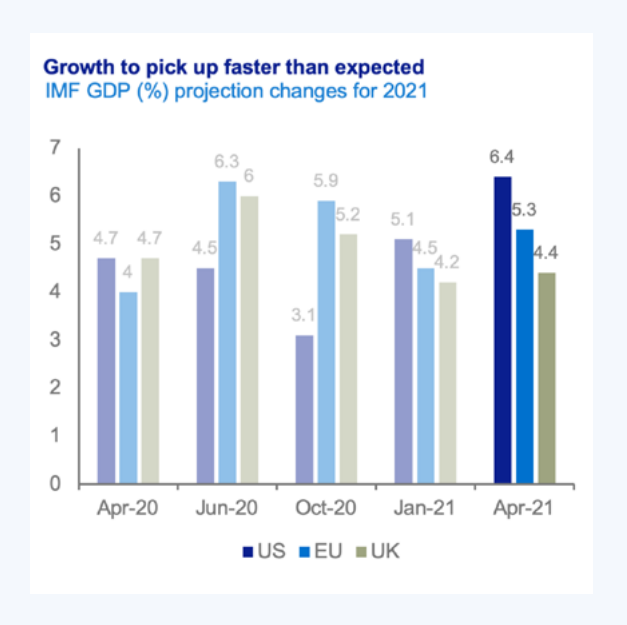
Source: IMF

A divergent recovery

2021 is projected to be the year of recovery. It is also projected to be a year of economic divergence. The global economy is at a turning point with Covid-19 continuing to be the primary driver of economic activity. G7 countries, the most important economies bar China and those most hit by the pandemic, are also leading the recovery. As of 6 April 2021, the UK had vaccinated roughly 46% of population with at least one dose. The US is swiftly catching up with 32%. The EU is lagging significantly with 13% on average.

The IMF has upgraded its outlook, expecting the global economy to grow by 6% in 2021 and 4.4% next year. However, economic divergence is set to persist, with long-lasting output gaps and considerable slack in major economies. We believe that the recovery will be out of sync, and uneven in shape. We expect a swift initial recovery as lockdowns are lifted, and thereafter a slow, bumpy return to (a modicum of) normality. That normality's most important aspect is 'desynchronisation'. Lacking central coordination, economies, from a national to a local level, adopted different responses towards the pandemic. Currently, vast stimulus is masking disconnects. We feel that when the stimulus is lifted, it will reveal that the global economy is, on many levels, out of sync. Nations have de-synced with each other, towns between them and sectors as well, with manufacturing suffering less than services, but also featuring less rebound potential.

Due to its massive stimulus programme, the US is expected to grow by 6.4% in 2021 and 3.5% in 2022. The UK is expected to see the recovery carried into the next year, with growth rates of 5.3% and 5.1% respectively. The EU, which has followed a considerably more conservative fiscal approach is expected to follow with only 4.4% growth this year and 3.8% in the next. Overall, emerging economies are expected to see a rebound in their output by 6.7% in 2021 and 5% in 2022.



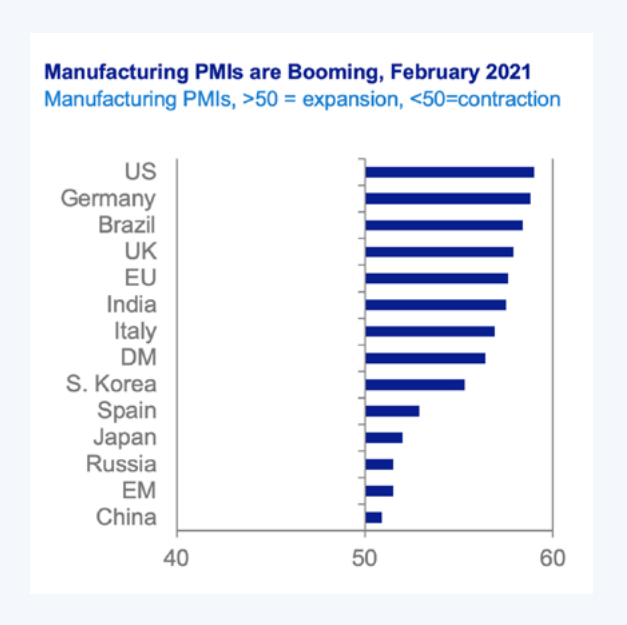
Source: IMF

Inflation: What is it good for?
The state of the global economy and risk assets

Normality not restored yet. As vaccination rates progress, economies are already planning to reopen. However, due to (not entirely unexpected) impediments in the rollout, especially in Europe, we don't see a return to a 90-95% of 'normal' economic activity until later in 2021. Already, economists are changing their projections for a 2021 recovery, spilling into 2022.

For the time being, manufacturing is outperforming services. We expect the situation to reverse when economies exit their lockdowns. Manufacturing (20-30% of GDP in developed economies) is currently holding up better than services (70-80% of activity), especially due to a bout of global re-stocking of inventories. However, over the long term we expect services, primarily driven by a rebound in domestic consumption (50-70% of GDP), to recover quicker as manufacturing will have to grapple with damaged and out-of-sync supply chains.

Once lockdowns are exited, the key driver of global economic activity will be extended fiscal and monetary stimulus, which is widely expected to outlive the pandemic. We expect these extraordinary measures to be withdrawn only after governments and central banks are comfortable that the recovery has sufficient impetus. This means generous budget giveaways and low tolerance for financial risk until the recovery is well under way and the scars of the pandemic have sufficiently healed, and maybe even extended towards a time when long term inflation will be considered to have made a realistic comeback.



Source: Markit

Inflation: What is it good for?
The state of the British economy

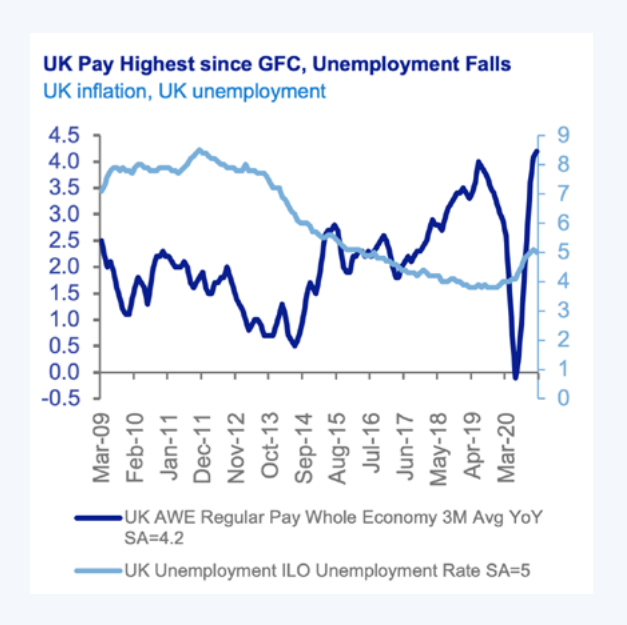
Vaccination rates suggest that the UK will the first G7 country to turn the corner, closely followed by the US. British economic and business sentiment is at its highest levels in seven years. However, as two thirds of British trade happens with Europe, and the continent is lagging the recovery by more than two months, British economic recovery will probably be mostly limited to the rebound in internal consumption.

Forward-looking PMI data suggest that the rebound in manufacturing is gaining momentum, on the back of strong new orders and restocking in preparation for the loosening in lockdown restrictions. However, disruptions in supply chains remain a significant constraint on economic activity. Overall employment conditions remain benign, with unemployment near 5%, only slightly up from the 3.8% pre-pandemic level. Having said that, we would expect it to grow once the furlough schemes are withdrawn, with the most pessimistic estimates assuming as much as 4m more unemployed, i.e. headline unemployment around 13%. In this uncertain environment the Bank of England remains very accommodative assuming, much like the US Federal Reserve, that any bout of inflation will be temporary.

Additionally, Brexit is causing notable trade friction. Exports of UK goods to the EU fell 40.7% in January from the preceding month while imports from Europe fell by 28.8%. As the lockdown regime hasn't differentiated much on a monthly basis, it is logical to assume that Brexit-related trade friction, as well as excessive stocking prior to the Brexit deadline on 1 January may be the primary culprit for reduced activity. Over the shorter term we would expect Brexit to be an impediment to the economic rebound.

The real game-changer could very well be fiscal stimulus. In 2019, the UK borrowed £55bn on a net basis.

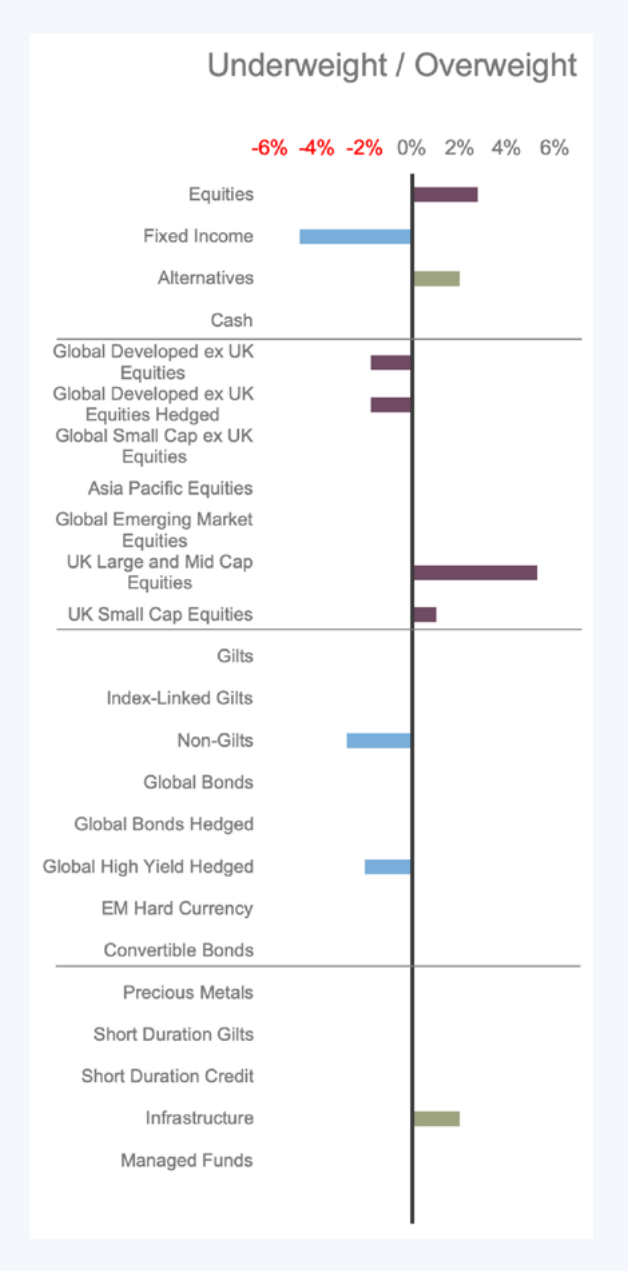
In 2020, the figure was close to £300bn. Despite the rebound, the government decided to borrow another £230bn, at least, in 2021 in order to shore up the economy post the pandemic, but also to help key sectors restructure post-Brexit. The bold goals set out in the budget (decentralisation, capital expenditure) could certainly help towards the goal of making the necessary changes to the British economy after Brexit. The budget suggested that fiscal stimulus is set to be withdrawn near the latter part of the year, and possibly not until 2022, although we wouldn't be too surprised to see heightened government spending protracted beyond that period.



Source: ONS

We remain slightly overweight equities and risk, in the belief that even a central bank-guided market can still deliver returns.

The Investment Committee decided to make no headline asset allocation changes, as we saw little value in adding to our bond positions at current valuations. The changes made this quarter are in line with moving towards our new Strategic Asset Allocation We also intend to shift some weight towards value to better balance our value-growth exposure. We remain slightly overweight equities and risk, in the belief that even a central bank-guided market can still deliver returns. In terms of geographical allocation, we remain overweight to the UK which we feel is still sitting at a significant discount to other markets. Our underweight in fixed income continues as a result of structurally low yields. In relation to Sterling, we keep close to the benchmark. We maintain a healthy exposure to gold, as the asset class remains uncorrelated with equity markets and would tend to gain in times of aggressive monetary accommodation. In terms of alternatives, we maintain exposure to infrastructure, which we believe might be a beneficiary of increased fiscal spending in the next few years.



Mazars balanced portfolio as of 6 April 2021

Contacts

David Baker, Chief Investment Officer
T: +44 (0)7580 999 021
E: david.baker@mazars.co.uk

George Lagarias, Chief Economist
T: +44 (0)20 7063 4721
E: george.lagarias@mazars.co.uk

mazars