BACK TO THE FUTURE

MULTI ASSET – SUMMARY

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BACK TO THE FUTURE

BY DAVID MCINTYRE

The Covid-19 pandemic has produced huge social and economic impacts: at the time of writing, 28 million cases worldwide; 900,000 deaths; quarantine and lockdown affecting more than half the global population; and (according to IMF projections) a likely 5 per cent decline in global GDP for 2020, much worse than during the 2008 crisis. These have been met by unprecedented fiscal and monetary stimulus.

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Over recent months, Baillie Gifford's Multi Asset Team has been debating what the post-Covid world might look like. Clearly, there are considerable uncertainties. Successful implementation of testing and tracking programmes; continued improvements in treatment; and, in time, the discovery and deployment of a vaccine could all help ensure a rapid return to normal levels of activity and perhaps limit any long-term impact. By contrast, further waves of infections followed by repeated and widespread lockdowns could lead to more significant economic damage and much more enduring effects.

Nonetheless, we think the contours of a post-Covid world are becoming clearer, at least in some important respects. In particular, we believe the Covid outbreak will mark the point at which economic orthodoxy begins to shift in a meaningful way: that the primacy of monetary policy will give way to fiscal. This would not, in fact, be new – it is precisely what happened in many countries during much of the 1930–1970 period. However, it would mark a significant departure from the post-financial crisis era in which the need for 'austerity' dominated economic and political discourse.

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Over recent decades, prevailing economic orthodoxy in most developed countries has emphasised a distinction between the roles of central banks and governments. Central banks, in this view, are responsible for managing aggregate demand – deploying monetary tools to maintain economic activity at a level consistent with a given inflation target. Governments, it is generally held, should work to ensure the efficient functioning of markets and enact 'supply side' reforms (to labour markets, education and regulation, for example) with the aim of improving potential growth.

We believe these roles will change in the post-Covid era. In time we will move to a world in which governments will become a structural source of aggregate demand, with fiscal policy a much more central tool of economic management. Central banks, rather than managing demand, will commit (implicitly or explicitly) to absorbing public debt issuance and hold down yields for an extended period.

There are several reasons for this. We think one legacy of the crisis is likely to be a rise in private sector saving, as households, scarred by the recent experience or fear of unemployment, seek to build protective buffers against a future downturn; and as highly leveraged companies pay down debt. At the same time, greater uncertainty may lead (as it did in the aftermath of the 2008 crisis) to lower corporate investment. This combination of lower consumption and investment will weigh on growth.

In the orthodox economic approach, this should be addressed by monetary policy: interest rate cuts to encourage consumers to save less and companies to invest more. The obvious problem with this is that the developed world is now rapidly approaching the effective limits of conventional monetary policy. Real interest rates are close to all-time lows and may be difficult to cut further without adverse consequences (for example, on the profitability of the banking sector). And, in any case, if fear and uncertainty are the causes of high savings and low investment it is not obvious that a further reduction in the cost of borrowing will make any meaningful difference.

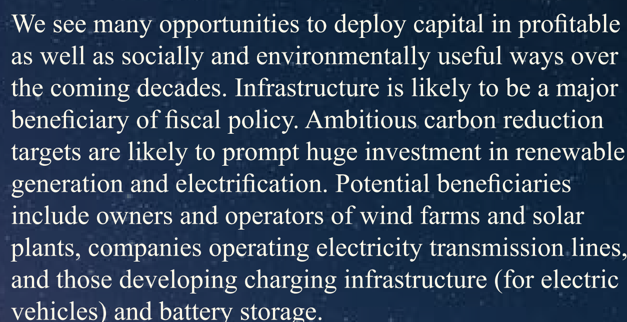
We think a new economic orthodoxy brings many winners, and some losers. It creates significant opportunities for a multi asset portfolio, but also some risks to be avoided or hedged.

That is why the baton is now in the hands of fiscal policy setters. If their efforts can be directed towards much-needed infrastructure investment, it might help to reverse many recent economic trends. For example, it could improve stagnating productivity; absorb some of the excess savings that have pushed down on interest rates and deal with the increasingly pressing issue of climate change. The alternative, a return to austerity, is unthinkable. In contrast to a decade ago, most survey evidence suggests it is deeply unpopular; and academic evidence increasingly points to fiscal consolidation in the post-crisis era being at best ineffective and at worst counterproductive.

We think a new economic orthodoxy brings many winners, and some losers. It creates significant opportunities for a multi asset portfolio, but also some risks to be avoided or hedged. Baillie Gifford has produced a good deal of commentary on the implications for equities in a post-Covid world, and we strongly recommend recent work, for example, by Dave Bujnowski on the opportunity for technology companies. Here I consider other asset classes such as government bonds, infrastructure, and commodities.

The crisis almost certainly means the equilibrium level of developed market government bond yields has dropped sharply, but even if yields are lower for longer we see few attractions in developed market government bonds: the likelihood that yields remain low is already more than reflected in market pricing. Over the longer term, possible outcomes for government bonds

become increasingly unfavourable because one potential consequence of a shift to fiscal primacy is, ultimately, higher inflation. Entering a period of fiscal dominance is much easier than leaving it. A clear exit strategy is needed if and when economies return to full capacity, otherwise demand management becomes highly politicised and the temptation to engage in excessive, inflationary stimulus may prove hard to resist: precisely the scenario independent central banks were established to avoid. We think this is a good time to add inflation protection, such as index-linked bonds, real assets and gold to portfolios.



We see many opportunities to deploy capital in profitable as well as socially and environmentally useful ways over the coming decades. Infrastructure is likely to be a major beneficiary of fiscal policy. Ambitious carbon reduction targets are likely to prompt huge investment in renewable generation and electrification. Potential beneficiaries include owners and operators of wind farms and solar plants, companies operating electricity transmission lines, and those developing charging infrastructure (for electric vehicles) and battery storage.

An increase in green investment could also bring opportunities in commodities such as nickel, which is used in electric car batteries. Despite a fall in demand this year, in the medium-term requirement for high-quality nickel is likely to exceed available supply.

Persistently low real yields, significantly expanding central bank balance sheets and rising fear of higher inflation are supportive for gold. We also believe that silver will be boosted by demand from electronics, driven by electric vehicles and solar panels.

In summary, we believe the Covid-19 pandemic has exposed the limitations of monetary policy. As a result, the focus in the short to medium term will be on fiscal spending, with central banks playing a supporting role, rather than a leading one. Although that comes with risks, such as possible sharp rises in inflation over the longer term, it also creates attractive investment opportunities.

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