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Macro issues dominate investor sentiment

Some basics for investors

By Keith Hiscock, CEO, Hardman & Co

Table of contents

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Executive summary

Macroeconomics – the big topic in investment world currently

The big topics in the investment world at the moment seem to be macroeconomic. With that in mind, we thought it would be useful to revisit some of the basics of the terms being used in the current environment, and to remind investors of the things to look out for (indeed, many younger investors may not have come across some of these influences in their investing lifetime):

- Recession does not affect all sectors and companies equally.
- The depth of a recession will vary among sectors, as will the timing of the impact.
- Gross Domestic Product (GDP) is the standard way to measure economic success, but some have promoted a "happiness index".
- The full impact of higher interest rates takes time, perhaps years, to show.
- The devaluation of growth stocks is due to more than just a change in the zeitgeist.
- Inflation favours equities over bonds, particularly for companies that are price-setters, rather than price-takers.

The Bank of England (BoE) will struggle to get inflation down as fast as it hopes.

Recession

Conventional economists' definition of recession: period of two or more consecutive quarters in which GDP declines

The mention of the word "recession" creates blind panic across the media and great foreboding among swathes of the population. What does recession mean, and should we panic?

Recession is the term used by economists to describe a period when an economy goes backwards. This is normally measured in terms of GDP. Most economies move in cycles, and the recession is the period of the downcycle.

The conventional economists' definition of recession is a period of two or more consecutive quarters in which GDP declines. GDP is a measure of the wealth creation of an economy during a time period. It is not a measure of total wealth at any one time point. GDP is akin to the amount an individual saves during the year, rather than a measure of his/her total savings at the year-end.

Of course, there is nothing magic about this definition; it could just as easily be defined as a down period lasting three quarters, but, nevertheless, two is a good yardstick.

Should we run for the hills the moment recession is mentioned? Well, not necessarily. Imagine a recession lasting just two quarters, with a GDP decline of 0.1% in each quarter[1]. Frankly, most people would struggle to discern this setback,

[1] The percentage declines quoted are always derived from comparing the current period with the equivalent period 12 months ago. They are not this quarter compared with the previous one.

although you could argue that, with the long-term growth rate in mature economies probably around 2.5% per annum, the economy has missed out on 1.25% growth.

Investors should also bear in mind that recessions have unequal impacts across industry and society. Broadly, there are two parts to these differences: the first is the depth of the downturn, and the second is the timing of the downturn.

Investors should recognise that effects of recession are not universal in terms of depth of impact by sector…

- Different sectors of the economy will experience different degrees of setbacks in conditions. Indeed, some sectors may miss out on the recession completely. During the worst recession in "modern times", in the 1930s (so bad it was called a depression), some industries saw no decline. Indeed, the radio and car sectors continued to grow, because the strong demand for these new products overwhelmed any recessionary impact. And today, despite a global recession staring us in the face, demand for luxury cars is booming. Some industries will see a light recession, while others will see a deeper one than the average story tells.

…and timing

- Timing will differ too. Even if all sectors were to see the same depth of recession, the timing of their cycles would not coincide. Hence, it is perfectly possible for one sector to be heading into a recession, while another comes off the bottom at exactly the same time (remember this when extrapolating news, such as company results). For example, retailers of consumer durables, such as washing machines, are likely to see a slowdown before food retailers (as well as seeing a bigger setback).

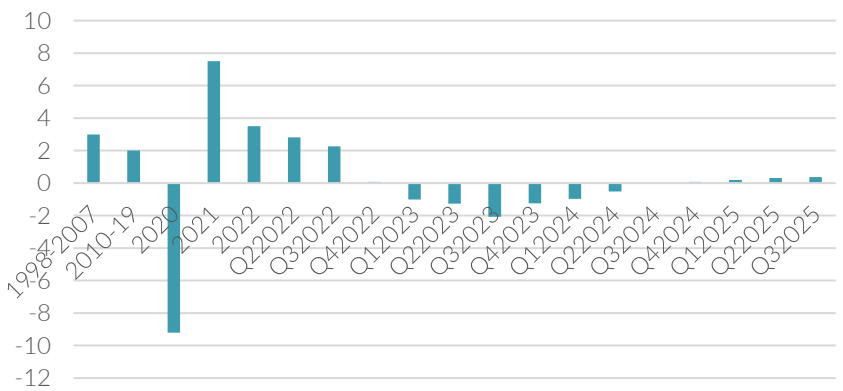
Why does recession matter?

In a recession, the economy's wealth creation shrinks. In aggregate, people have a little less to spend, and tax revenues go down. Governments may choose to adjust to this by cutting public expenditure, raising taxes or postponing the problem by borrowing more. Companies' fortunes wane, and they cut back on investment and payouts to shareholders.

How serious is this recession going to be in the UK?

Based on BoE forecasts, this will be a deep and long recession.

UK GDP growth[2], 1998-3Q'25E (%)



Source: Bank of England Monetary Policy Report, August 2022, Hardman & Co

[2] GDP growth projections based on market interest rate expectations (mean)

UK GDP growth based on market interest rate expectations[3], 1998-3Q'25E (%)	
1998-2007	3
2010-19	2
2020	-9.2
2021	7.5
2022	3.5
2022Q2	2.81
2022Q3	2.26
2022Q4	0.07
2023Q1	-1.01
2023Q2	-1.26
2023Q3	-2.07
2023Q4	-1.24
2024Q1	-0.97
2024Q2	-0.52
2024Q3	-0.04
2024Q4	0.07
2025Q1	0.19
2025Q2	0.32
2025Q3	0.38

Source: Bank of England Monetary Policy Report, August 2022, Hardman & Co

The chart and table above use data from the BoE's latest Monetary Policy Report. The data are the same in both, but are shown in two ways for ease of understanding. The BoE publishes many forecasts for GDP using different assumptions. We have used its central, mean forecast.

On average, the UK grew GDP by 3% each year from 1998 to 2007 and by 2% from 2010 to 2019. The deep impact of the pandemic is captured by the 9.2% decline in 2020, with a 7.5% bounce-back in 2021.

BoE forecasts show a recession lasting seven quarters

The BoE forecasts show a recession that looks quite deep and long by historical standards, and that will last seven quarters. For comparison, the recession in 2008/09 lasted six quarters.

[3] These percentage figures show the change in GDP compared with the figure 12 months before

GDP

GDP is the most commonly used measure of an economy's output or wealth generation. It is calculated by the following formula:

aggregate consumption + government expenditure + investment (by which economists mean new plant and machinery, not savings accounts) + exports - imports

GDP still most common way to measure economic progress...

In the UK, GDP is calculated quarterly by adding monetary values for these components. There are some activities to which it might be difficult to assign a monetary value. For example, do you measure nurses' output by how much they are paid? In this case, a pay rise would automatically increase GDP! On the whole, GDP can be calculated without having to make value judgements, unlike a "happiness index".

...but some prefer to use measure of happiness, despite difficulties in its calculation

In recent decades, there has been a move by some economists to create another measure of economic success. They argue that what a government should seek to do is to maximise the happiness of its citizens, rather than monetary wealth. They would prefer to use a happiness index to measure economic success. Proponents would argue, for instance, that GDP takes no account of the harm that greater output does to the world's climate, which will affect future generations. Understandably, those for whom green issues are particularly important tend to support a move away from GDP.

On the face of it, there are strong arguments to move away from GDP as the benchmark of economic success. However, calculating a happiness index is fraught with problems: which factors should be taken into account, how do you measure them, and how do you weight them? For example, you could argue that more leisure time equals more happiness. Creating a greener landscape could be another factor that should be considered. But how do you measure each, and how do you add them together? Is an hour of our time watching football on the television worth the same as an hour watching a match at the stadium? How does it compare with an hour playing with your children? Or is one worth more than the other? How do you add together leisure time and a better environment to get one figure?

Measuring happiness has a lot in common with utilitarianism

In many ways, the happiness approach strays into the "Utilitarianism"[4] of the philosopher John Stuart Mill. This ethical theory sought to maximise the happiness of society as a whole. Mill got into all sorts of contortions as the theory developed, such as "it is better to be a human being dissatisfied than a pig satisfied; better to be Socrates dissatisfied than a fool satisfied".

A lot of effort has been expended into developing a happiness index, and the first "World Happiness Report" was published on 1 April 2012 by the United Nations.

[4] Utilitarianism, John Stuart Mill, 1861

Impact of interest rates over time

It will take some time, perhaps years, for the full effect of the latest rises to work through

Investors are rightly concerned about rising interest rates just now. They should remember that, even if interest rates don't rise further from here, it will take some time for the full impact to be seen. This is a screw that gradually tightens.

This is because many individuals have fixed-rate mortgages (or car deals where the implied interest rate is fixed), while companies have fixed-term, fixed-rate debt. In these cases, there is a financial impact only when those deals run out. In the theoretical world of economics, we used to believe that consumers would anticipate higher debt costs by immediately adjusting their lifestyle, so that there would not be a shock down the road. The reality is that most people carry on as before until the new, higher bill drops through the letter box.

Why growth stocks have been devalued

Investors have fallen out of love with growth stocks

Markets veer between hope and fear, and, right now, we're heading deep into the fear territory. Growth stocks prosper in times of hope. Investors have fallen out of love with growth stocks, particularly if they don't pay a dividend. But these changes in sentiment are not due entirely to mood swings. There are practical reasons too.

Rising interest rates mean consumers think twice before taking on new commitments. The cost of building new factories goes up. And, most importantly, the value of future revenues and profits falls, because a higher discount factor is applied to them. A pound tomorrow in today's terms becomes worth less than it was yesterday.

Inflation

Inflation is a measure of changing prices. That means that, if inflation falls to zero next year, prices won't go back to where they were – they just won't rise further. As with recession, every economic party has its own inflation rate, depending on where its money is spent. The published rate for the CPI (Consumer Price Index) is designed to reflect the change in prices faced by the average consumer. There is also a Producers Price Index (PPI).

The general assumption is that inflation favours equities over bonds in the long term. Company revenues should broadly move with inflation, as should profits and dividends. In contrast, most bonds pay a fixed coupon each year, and the maturity value is set in stone when the bond is issued; of course, some bonds are inflation-linked.

Price-setters in stronger position than price-takers

While the general idea that equities are a hedge against inflation is right, not all equities are equal in the face of inflation. Price-setters, such as natural monopolies, are in a stronger position than price-takers. Then there are timing effects; for example, packaging companies typically suffer a rise in the cost of raw paper before they can recover the increased cost from customers, and profits dive during the transition.

The general view of economists is that a little inflation is good. Deflation is bad because consumers will hold off buying as long as they can – as they keep getting more for their money. On the other hand, high inflation disproportionately affects people on fixed incomes (pensioners are always given as the example) or with savings. A couple of per cent per annum is where most governments and central banks would like inflation to be.

It is not being said openly, but the government could be the largest beneficiary of higher inflation (particularly helpful when it has accumulated such debt during the pandemic). There are two key reasons for this.

Largest beneficiary of high inflation will probably be the government

- First, in aggregate terms, if inflation runs at, say, 10%, everybody is 10% worse off, apart from the government, which has just printed 10% more money for itself (it's a lot more complicated than that, but this is a simple way to think of inflation). Most government debt has coupon and maturity payments set when the bond is issued, and these do not rise in line with inflation; in effect, every 1% of inflation saves the government 1%.

- Secondly, there is a whole raft of taxes where the thresholds and allowances are set in fixed amounts, and these do not rise automatically with inflation. For example, the Higher Rate (40%) of Income Tax in the UK is charged on incomes over £50,270. Inflation means that more people will start to pay this rate, and the government will collect more revenue unless the threshold is adjusted.

Economists call this "fiscal drag", and it could be worth £30bn in extra tax revenues next year.

UK inflation (H2)

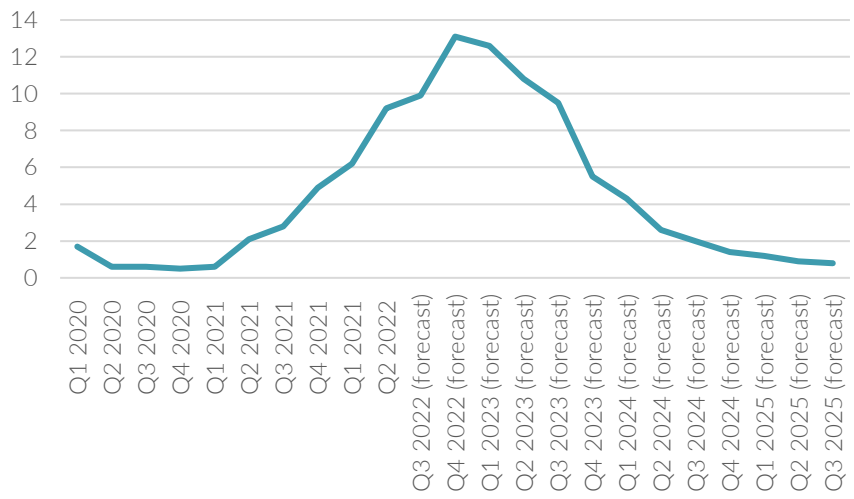
The BoE is tasked with keeping inflation close to 2%. The measure used is the CPI. There are many other measures, and, in the past, the default rate was typically the Retail Price Index (RPI) – the main difference with CPI is that RPI includes housing costs and has been consistently higher than CPI.

The BoE has had an impossible task in the last two years, worrying about an economy that could have imploded during the pandemic. It is easy to see now that it should have been more aggressive about inflation earlier by raising the base rate sooner (essentially, its only weapon to curb excessive inflation).

It is going to struggle to put this tiger back in the bottle. Looking at the causes for higher inflation this time around, it has little control over some elements. For example, commodity prices are set by world markets, have been affected by the war in Ukraine and are mostly priced in US dollars. The BoE fears that, if pay settlements match inflation, a vicious cycle could be created.

The forecast for inflation is set out in the graph below. In our view, the greatest risk is in the down trajectory taking longer than the peak rate – a period of strikes and aggressive wage demands could quickly undo the BoE's optimism.

CPI inflation rate, 1Q'20-3Q'25E (%)



Source: Bank of England Monetary Policy Report, August 2022, Hardman & Co

Conclusion

Macro themes seem to be dominating investment discussion at the moment. We have covered some in this article. There could be others – these could include stagflation (the dreadful combination of economic stagnation with high inflation, which we had in the UK in the 1970s), more war stories (Taiwan?), and elections in the UK and the US. It seems likely that it will be some time before micro issues return to the front of investors' minds.

About the author

Keith Hiscock

Keith Hiscock is the Chief Executive of Hardman & Co

He is personally responsible for the firm's relationships with its corporate clients and also for corporate finance. In addition, he is the author of several articles tackling the issues facing companies in today's climate. Keith has 40 years' stockbroking experience, and has developed long-standing relationships with many major institutional investors, including Private Client Brokers and Wealth Managers. He started his career at James Capel, at the time the top-ranked research house in London. He was a founding member of Schroder Securities and of Agency Partners, a leading research boutique house, and was a member of the five-man securities board at Evolution. Keith has also advised companies, large and small, on their relationships with the capital markets.

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research@hardmanandco.com

1 Frederick's Place
London
EC2R 8AE

+44 (0)203 693 7075

www.hardmanandco.com