Quarterly investment outlook

Will the Post-Covid labour market ever be the same?

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mazars

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Foreword

Much as we had expected at the start of the Summer, equity markets in the developed world traded pretty much sideways for the past three months as corporate earnings rose to justify somewhat the high stock market valuations. Returns for global equities in local currency terms were around 0.7% for the quarter, though UK based investors returned over 2.5% thanks to a sell off in Sterling (mainly against the US Dollar) late in September. Japan was an outlier as a change in prime minister drove sentiment and returns of over 7% in local terms. Emerging markets were more challenged with the index being mainly driven by issues in the Chinese property development sector, as well as continuing Covid-19 issues. Gilts fell by nearly 2% as inflationary pressures persisted, driving yields higher.

Covid-19 factors continue to dominate global economics, either directly in those parts of the world where vaccination programmes are yet to reach the majority of at risk populations, or via the legacy effects of global lockdowns in those economies which have largely now reopened. Pictures of container ships queued outside ports worldwide give a visual insight into the dislocations in global supply chains, while the cost of transporting goods has increased substantially. Frictions also exist in labour markets as countries attempt a return to normality and find transitioning from emergency fiscal support measures to regular employment conditions a challenge. Job openings might be as high as the unemployment rates, but a seamless matching of people to jobs is unlikely particularly in the service sector. Psychological factors are also at play as the pandemic has caused many in the workforce to rethink their work and life priorities. Climatic effects have stoked energy prices, adding to concerns that inflation pressures may be 'transitory' for a longer period than first expected.

There are brighter points in the economy. Corporate earnings have improved above market expectations despite GDP numbers not yet recovering to Q4 2019 levels in many parts of the world. While Purchasing Manager Indices (seen to be one of the better leading indicators or future economic growth) are falling, they remain firmly in expansionary territory and the rate of decline is not dramatic. It is reasonable to assume that consumer demand will remain buoyant as the unemployment rate falls and those households which stored cash during the pandemic are freed up to resume consumption in the service sector. Similarly, corporate cash levels are at very high levels, a factor which usually indicates an increase in capital expenditure to come.

Thus markets are confused and jumpy. The link between extraordinary monetary policy (principally Quantitative Easing (QE)) and stock market growth is undeniable, so we revert to a position where good economic news is bad for markets, and bad news is good due to the impact on the probable path for QE and interest rates. The complicating factor now is that much of the bad economic news is inflationary in nature, testing central bankers' resolve to allow price rises to run unopposed for a period of time. Indeed, the US Federal Reserve has become more hawkish in recent weeks, a position mirrored in the UK if not yet in Europe. Add in issues such as the US debt ceiling, a change in leadership in Germany, and waning equity momentum, and we find reasons to exercise caution even though the economy may be in 'mid-cycle'.

At our September meeting the Investment Committee voted to reduce any overweight equity positions within our portfolios to neutral. We acknowledge that bond markets continue to look unattractive on a real return basis (after inflation) and therefore allocate the proceeds of equity sales to gold and short dated corporate bonds. We continue to hold a balance between value and growth stocks, and favour the UK on a valuation basis.

David Baker
Chief Investment Officer,UK

Will the Post-Covid labour market ever be the same?

Introduction

The 80s were probably best encapsulated in Gordon Gekko's 'Greed is Good' speech. **"Greed works"**, he exclaimed. **"Greed clarifies. Cuts through and captures the essence of the economic spirit"**. Oliver Stone's not-so-fictional investment icon equated the individual pursuit of happiness with the unbridled acquisition of wealth and made a compelling argument about how this leads to a better society. Arguably he's unsurpassed in capturing the essence of that time. The '80s looked like a decade-long consumerist party bought and paid for by lower taxes and the unleashing of unfettered bank lending. The culmination came with the loud bang of the Berlin Wall collapsing, providing assurance to western workers and consumers that their way, the way of Greed, was the right way.

In the '90s, under the auspices of Bill Clinton, banks shed the last fig leaves of Glass-Steagall, an antiquated piece of legislation preventing them from leveraging their clients' deposits into other investments. The distinctions between 'normal' and investment banks were gone and the system created debt (a form of money) out of thin air. For consumers, everything and anything was possible. To the point that by the end of the decade, they started wondering: **"how much stuff do we really need"**, as Tom Cruise's reluctant-but-affluent 'Jerry Maguire' took over from Gekko.

At the turn of the Millennium the world was set to become more colourful, more diverse and inclusive, as idealistic 'Millennials' entered the stage. Behind them, silently working in the backstage for a decade already, the Chinese giant was ascending. But the party was violently interrupted. First, by the 'dot.com' bust, a major stock market crisis, and just after it, the tragedy of 9/11. Alan Greenspan was forced to floor interest rates to keep capitalism going. Businesses felt something was amiss. They took production to Asia and started slicing costs. Western incomes stagnated, but that was okay. What was lost in terms of income was gained in terms of disinflation which brought cheap 'luxuries for the masses[1]' and cool iPod tunes. Sensitive Jerry Maguire was replaced by futurist turtleneck Steve Jobs, a new-age Carnegie for business and millennial guru.

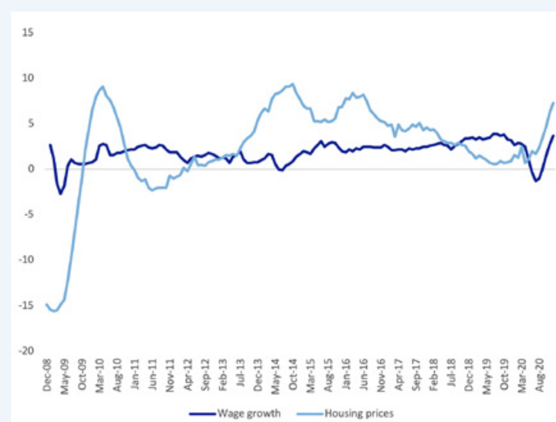
Just before that decade ended, another bang, as banks could no longer solely bear the weight of global consumerism on their shoulders. The Fed's Quantitative Easing may have saved markets and investment portfolios but exacerbated inequalities, now laid bare on social media. The more people felt pressure to pay their bills and mortgages, the more they were exposed to targeted advertisements and the 'Rich Kids on Instagram'. The idea that each generation was destined to live better than the previous one collapsed. To be sure, there were enough jobs to go around, but increasingly less attractive. High paid manufacturing jobs were a thing of the distant past for the west. And white-collar jobs saw stiff competition, without nearly as much reward as in previous decades. Sounds got angrier and sadder. They now speak not of parties but revolution. So did votes. And movies. The 'Wolf of Wall Street' is no longer a secretly envied sleek-haired cultural icon, but a cartoonish cocaine addict whose downfall is all but certain, a cautionary tale that good times don't roll forever.

Meanwhile, in real life, the turn of yet another decade found us holed up in our homes, hapless before an

George Lagarias
Chief Economist, UK

UK House prices vs wage growth since average millennials entered the workforce in 2008

YoY indices



Source: ONS

[1] HBR Luxury for the masses

[2] Investopedia.com: The real Reasons millennials aren't buying homes

Introduction

invisible miniscule viral enemy. The millennial is now a 40-year-old mid-level executive who can't afford to buy their own house[2], and may never do.

Gekko, the millionaire seeking to become a billionaire also was my father-in-law's icon. A successful building contractor and auto dealership owner, he had had three children and four grandchildren and at 85 he's proud he's never had to change a nappy. Generation X, my generation, has been buried knee deep into the contents of those nappies, almost as much as in household debt. Millennials, meanwhile, are wondering whether they can afford to procreate at all. Their first debts came before they were twenty and their purchasing power is much lower.

When economists say 'consumer' they mean a being uniform across the ages, who according to Adam Smith will perpetually seek to maximise utility, and by utility we mean the ability to make purchases. A consumer will be cool during crises, accepting cyclicality and remain patient for the 'invisible hand' to show up and correct exaggerations. Of course, this person doesn't exist.

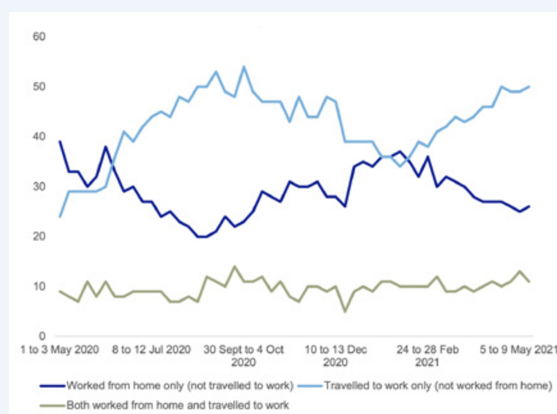
Times change fast, and with them habits. Linking happiness solely to wealth was a feature of the previous decades that doesn't apply wholesale to the present. To understand employees we have to understand that as consumers, they have been cooling on the idea of chasing wealth for over two decades, since their incomes started stagnating. They didn't fight, they did what human beings do best, they adapted. Younger employees, who have never experienced sharp increases in income, have few scruples tilting the work/life balance towards the 'life' element. A common feature of every crisis since 2000 is that many have been, ostensibly inexplicably, dropping from the workforce. If people don't prioritise wealth anymore, modern economic theory, from Smith to Milton Friedman, goes out of the window. Trying to understand why someone who can work to make money, versus not working and not making money would choose the latter may seem inexplicable. But just as the ages, role models and culture change, so does the labour force.

The pandemic mass-forced millions of people to work from home, ripping consumer and labour norms through generations. Some were put on furlough or unemployment benefits and were left without work for a long time. Roles were redefined, as the person who would stay at home and take care of the children was decided not on the basis of entrenched social norms but availability. Managers, who in 2014 pressured workers to commute through massive London Tube strikes were now relaxed about their reports working from home five days a week. Working from home and/or the disruption of work cycles (a waiter at a restaurant forced on to furlough) is changing the work environment in such a massive scale it is bound to have massive effects. Until the necessary reshuffling is completed, demand for skill outstripping supply is pushing wages higher, exacerbating supply-side inflationary pressures around the world. Accommodative central banks have been the keystone to economic recovery for the past twelve years. Demand-side wage inflation could upend this.

This report looks at the trends behind labour during and post-covid, and tries to answer the most important question of all: Will those who left the workforce ever return? What are the effects of the 'new normal' on businesses, the wider economy, and investments?

Attitudes towards working form home

ONS – Opinions and lifestyle survey



Source: ONS

[2] Investopedia.com: The real Reasons millennials aren't buying homes

Shorter term effects – and life after furlough

To counter the economic effects of Covid-19, governments took emergency measures which have caused significant distortions in the labour markets. As Covid-related unemployment benefits in the US and furlough in the UK stopped in September/ October 2021, we are already experiencing a very tight labour market where companies compete for talent and negotiating power has, temporarily at least, passed to workers.

Some of the characteristics of this market are:

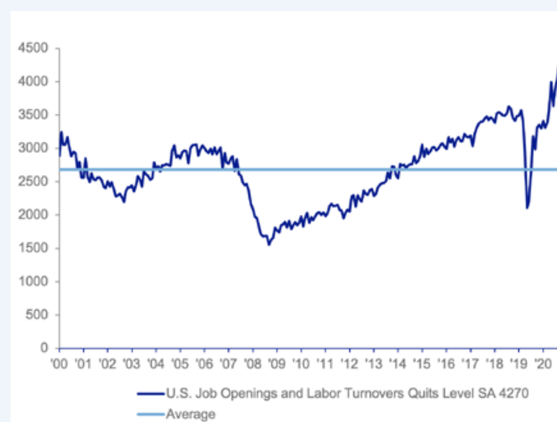
- Significant job shifting for mid-career individuals
- An increase in temporary and permanent job placements at record levels
- Upward wage pressures
- Certain groups more disadvantaged than others

We believe these effects will be, by and large, temporary.

In July, the US registered a near-record 4 million resignations. Research showed this was driven by mid-career individuals[3], 30-45 years old. Conversely, the 20-25 year cohort which usually has the highest turnover rate actually saw decreased resignations. The reason is probably post-lockdown pent-up career shifts. Employees were waiting to see how the situation on the ground would develop and, emboldened by the end of lockdown measures, they decided to make long-awaited career moves. The dropout was largest in Technology and Healthcare, two sectors where employees came under a lot of pressure to perform during the pandemic, but also exhibit a lot of labour demand. This jump follows a period of very low turnover, so we feel it was merely scheduled career moves that were delayed because of Covid-19, and the tidal wave of resignations should abate.

Pent-up job changes happening

US Labour Turnovers Quits level



Source: BLS

Meanwhile, permanent placement growth hit a record high in the UK, but candidate supply dropped, driving sharper increases in pay. Vacancies have been growing to an all-time high.[4] However, these numbers feel temporary also, and we would expect the candidate pool to be filled quickly when cessation of furlough takes effect.

According to a study by Renovo[5], a software company, 69% of all UK employers anticipate job losses in the next year, with 46% expecting to make redundancies within the next six months. Most have cited the financial impact of the pandemic, with some (28%) citing technology as the main drivers for the upcoming job losses. One in eight also felt certain roles were no longer necessary due to the move to hybrid working. It is very interesting that of the employers expecting redundancies, 84% had employees on furlough. This shows the labour distortion caused by the pandemic.

People who have not worked for more than a year have had a chance to re-assess their careers, while in some cases their employers have learned to do business without them.

Workers in manual industries are also impacted. Despite a rise in wages which had already been taking place from 2014, manual workers come from lower socioeconomic statuses as University graduates opt for more desk-jobs.

Disadvantaged groups

A group that was primarily disadvantaged by the pandemic was young parents, especially women. Research by McKinsey , a consulting company, shows that women with children under 10 years old were considering downshifting their career (17%) or leaving the workforce altogether (23%). The respective number for men was 13% on both categories. The research shows that the groups most challenged

[3] HBR: Who is driving the great resignation, 15 Sep 2021

[4] KPMG and REC, UK Report on Jobs, Sep 2021

[5] City AM: Wave of Redunduncies Looming

[6] CNBC: Why the biggest job wage boom is blue collar

[7] McKinsey: Seven charts that show Covid-19's impact on women's employment

Shorter term effects – and life after furlough

were "working mothers, women in senior management positions and Black women". This was confirmed in the September 2021 US Labour report which saw 0.5%, a relatively large number, of women dropping out from the workforce almost completely. The findings showed that women felt more pressure at work than men, with over 55% of senior level women feeling exhausted, as opposed to just 40% of men. The effects have been worst in emerging economies, with job insecurity creeping in for countries where the labour market only recently made strides towards inclusiveness.

The impact was not just a matter of gender or race. Research by the OECD[8] suggested that other groups were also severely affected

- Lower wage employees as opposed to higher and middle wages
- Young professionals entering the workforce
- Those working in leisure and mining as opposed to those working in financial activities

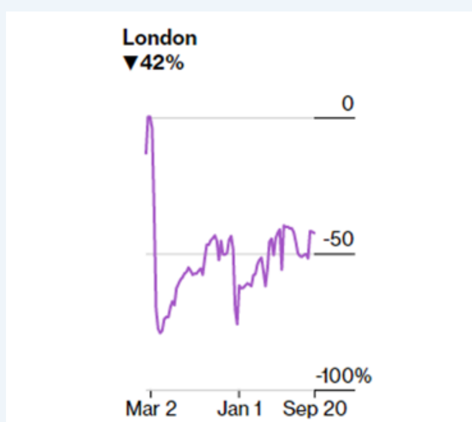
How short-lived?

Some of those effects appear to be short-lived. A study showed that 32% of organizations are replacing full-time employees with contingent workers as a cost-saving measure. However, when those cost savings are achieved, equilibrium should be restored.

Childcare issues are also slowly being resolved. Despite a spike in new Covid-19 cases, especially in school children and young adults, vaccination levels are prompting a paced return to working from the office. Covid medication in the pipeline could speed up this return. Globally, around half of pre-Covid workplace activity has returned. Given the realities of hybrid working, we don't feel we would see more than an 80% return to pre-Covid activity.

Return to the workplace is still sluggish

London is back to 58% of its pre-Covid activity



Source: Bloomberg.com

Young professionals and lower wage workers that were displaced should be absorbed back into the workplace relatively quickly as offices, shops, and cafeterias are re-opening, especially in western economies. Parents who have felt burned out from constant childcare (something no econometric model can possibly measure), may feel better when a work routine sets in.

Friction due to workplace movement dominoes (one movement could cause at least a three-month-vacancy) should settle, as lock-down pent-up demand for changing jobs will naturally lose steam. And as emergency economic measures end, vaccination proceeds and supply chains are restored, so should some of the more extreme dislocations in the labour market address themselves.

The work 'new normal'

However, we don't believe that returning to pre-2020 'normality' is now an option. Disruption has lasted for a long time, giving business leaders and governments time to reflect on how things can be done better. The challenge ahead is not how we restore what was lost, but how we can effectively and efficiently transition towards a 'new normal' with distinctive features

- The rise of hybrid working
- De-globalisation and re-onshoring of supply chains

Hybrid working

First, let's look at the realities of hybrid working. In 2013 Yahoo! famously banned working from home, only to relent after a public pressure build up. Even before the pandemic, agile working and hot-desking were leading the way towards some form of hybrid work. People were happy to sacrifice part of their salaries to avoid long commutes. Technology developed around tele-commuting was available during lockdowns, suggesting to many business bosses that

[8] OECD economic outlook December 2020 March and June 2021

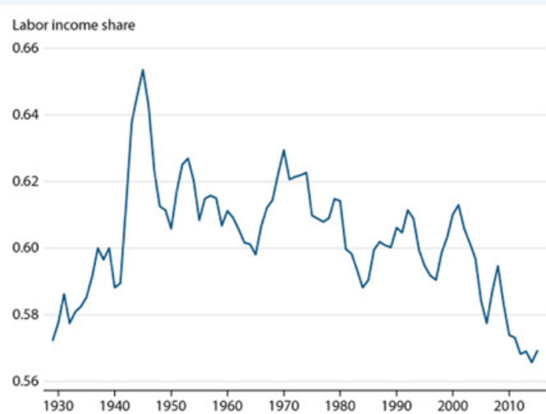
their operational models might be successful even with remote working, for those activities that don't absolutely require physical presence. A recent poll by Gartner suggested that half of employees would likely work remotely at least part time, up from 30% pre-pandemic. According to a survey[9] conducted by Harvard Business Review, three of four workers want to work from home at least part of the week, and one in three wants to work from home full-time. Demand for full-time work from home was more pronounced amongst young mothers. Around forty percent suggested that they would likely change jobs if a hybrid model wasn't offered. Employers responded to this, and roughly only 16% are considering a full return to the office, while another 20% is still unclear about their strategy. Around 50% consider offering 3-5 days working from home. This represents a four-fold increase of remote working since pre-pandemic.

According to a survey conducted by McKinsey[10], "the pandemic accelerated existing trends in remote work, e-commerce, and automation, with up to 25% more workers than previously estimated potentially needing to switch occupations".

The same survey suggests that the longer-term challenges are concentrated around jobs that require high levels of proximity: leisure and travel venues (including restaurants and hotels), retail and hospitality, computer-based office work and production and warehousing. In less dense work arenas such as outdoor production sites, the pandemic's effects may fade quickly; "Depending on how extensively these trends stick, our scenarios suggest that more than 100 million workers in the eight countries may need to switch occupations by 2030, a 12 percent increase from before the virus overall and as much as 25 percent more in advanced economies.

US labour share of income is declining

US Labour Share of Income



Source: St. Louis Fed

Workers without a college degree, women, ethnic minorities, and young people may be most affected."

De-Globalisation

A larger trend that has been at play even before the pandemic was de-globalisation. For the past decade, stagnating incomes in the West have alerted policy makers to the dangers of dependence on China for manufactured goods. Globalisation has been a purveyor of low inflation. Additionally, for the US it has provided a way for Chinese savers to fund American debt. The downside was the migration of high-paid jobs to the East which has been often deemed a primary culprit for the dramatic reduction of labour's share of income (the labour earnings proportion of Gross Income) dropping in the US and other large economies. In the US alone it has dropped from 65.4% in 1947 to a historic low of 56.7% in 2016[11].

As a result, policy response was initially focused on China. However, as industrial towns in the western world came under increasing pressures, citizens demanded a wider deceleration of globalisation and, where possible, re-onshoring of key operations. Brexit was one such instance. Another was Ms Merkel's call to re-onshore important operations to the EU, after India stopped exporting vaccines to Europe, following its own outbreak.

The reality is that globalisation has two underlying components: technology and optimism. The technological element remains intact. In fact, remote working is making it even easier to conduct regular cross-border operations. The latter element, though, is in short supply. The pandemic saw closed borders and disrupted trade, let a lone a build up of tensions at home. It featured western countries hoarding vaccines at the expense of developing economies and a

[9] HBR: Don't force people to come back to the office full time

[10] McKinsey, "The Future of Work after Covid-19"

[11] McKinsey, a new look at the declining labor share of income in the United States

Shorter term effects – and life after furlough

rise in Euro-sceptisicm even amongst key European countries.

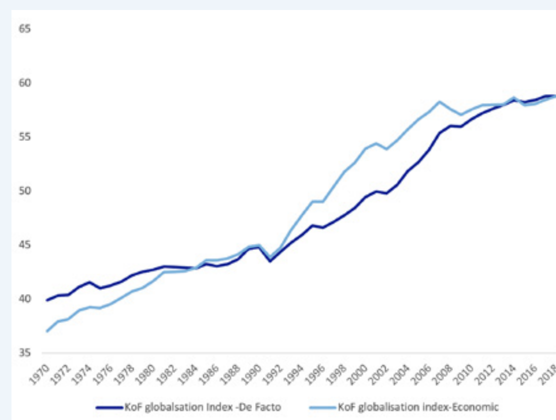
We don't yet have any solid evidence of accelerating de-globalisation. The Kof Globalisation index[12] does appear to slow down, hamstrung mainly by slower rates of trade globalisation, a trend that already began in 2008, when China had reached a stage of manufacturing maturity. And overall the index is still tending towards more globalisation. However, we feel that extending pressures towards China and strained global relationships post-Covid could threaten that picture.

The impact on labour could be momentous. De-globalisation would mean a reduction in labour mobility, which could push wages higher. It would also mean a material slowdown of technology and know-how, leading to the rise in local versus global standards. The effect, meanwhile, on blue-collar labour would probably be less than anticipated. According to the abovementioned McKinsey survey9 only one-tenth of the falling share of labour income can be attributed to globalisation and labour bargaining power. A lot more has to do with the boom and bust of super-cycles in mining, construction, real estate and energy as well as faster depreciation (electronics increase the share of assets from intellectual property products and with it faster depreciation).

Thus de-globalisation may become a trend going forward (no matter how right or wrong the reasons), and could disrupt labour mobility without compensating with the return of manufacturing jobs on-shore. In fact, 'on-shoring' has now been substituted with 'Friend-shoring'[13], a return to the Cold War dogma of keeping key production within key allies.

Globalisation is stalling – will it press on?

KoF Globalisation Index



Source: KOF Swiss Economic Institute

[12] KoF Globalisation Index

[13] 'Onshoring' is so last year. The new ling is 'Friend Shoring'.

What are the effects on businesses

A number of factors mean that the UK labour market may remain tight for several years to come. Demographics, Brexit, sector realignment all play a role. The challenge is well beyond one of turning offices into business and meeting hubs. What will business leaders need to do to make sure the labour force remains productive is:

a. Reskilling especially after the furlough. The post-Covid world will be different for retail and hospitality. New skills will be needed either in the same sector, or in some cases, reskilling will be about different sectors altogether.

b. Retail, in particular will have to adjust quickly, and speed up transition to e-commerce and the 'delivery economy'.

c. Career paths for work from home. The existing business mindset places workers from home at a 'lower tier' in terms of career paths. It is very difficult to imagine a top executive working from home 3-4 days a week. But it is the new reality. For workers to remain engaged they will need succinct and well-defined career paths. Management systems should be developed to reflect the new way of working.

d. Prepare for complexity. Supply chains will be reconfigured across the board. And it is only a matter of time before an employee working five times a week from home, request that they do so from another country. Organisation management across regions, or even time zones and countries may become a lot more complex. Many companies are already enlisting AI to help with these difficult transitions.

What are the effects on the economy and investments

The question in investors' minds is whether this new era will be able to address key economic challenges such as

- The falling share of labour income
- Secular stagnation
- Lower labour participation rates

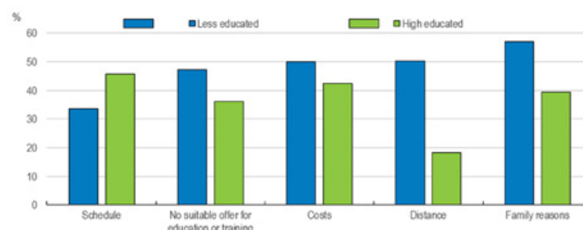
In the previous section we discussed how de-globalisation will not affect the falling share of labour income. This has more to do with where the Capital lies, (i.e. rise in intellectual property goods) than with what labour gets out of it. In fact, another study[14] suggests that the net labour share income (excluding taxes and depreciation) is only 2-3% below a 1969 historical high.

The conclusion is that this particular metric has a lot more political than economic value. It does not signify income inequality. Instead, it suggests that balance sheets are swollen by the high value of intellectual property goods, to the development of which labour input is minimal. While the few tech savants behind them might see significant pay offs, the large majority of labour associated with the production of a smartphone is deemed to be more replaceable. If the value of technology-related intellectual property falls relative to other sectors, and mining and energy super-cycles subside, we could see a meaningful rise in the share of labour income, without still a material improvement in people's lives.

Instead, could focus on two other key issues: secular stagnation, and lower labour participation rates. Secular stagnation was covered in our previous quarterly publication5.

Key challenge- reskilling in the face of family obligations

Eurostat survey



Source: Eurostat

[14] Tax Foundation: Labor share net income within historical range

What are the effects on businesses

We feel that it would take a combination of significant fiscal stimulus and the relaxing of bank lending rules to change and sustain the post-GFC conservative consumer mindset. And while we may see increased fiscal stimulus in the next few years, it would take a significant leadership upgrade to unshackle banks from the current regulatory framework. Thus, by and large, we expect consumers, who are also labour, to remain conservative.

The big question for us is really whether the labour participation rates will return in pre-covid levels. This is important from many perspectives:

- It would reduce pressures on businesses to increase costs to attract new talent
- It would help create more jobs in the long run, as companies wouldn't consider automation if labour costs were manageable
- It would reduce wage pressures on inflation, which in turn would relieve pressure on central banks to raise the cost of money and allow them to keep underwriting stock and bond market risk

From the outset, we should say that why people of working age drop out of the labour force is very difficult to gauge and no research exists that can positively ascertain the source of reduced labour participation.

However, we can't help but notice that each of the previous crises, in 2000 and 2008 has resulted in a reduction of those who are of employable age and are either employed or seek work altogether. For the US, the rate peaked at 67% in 2000, fell to 66% until just before the global financial crisis and subsequently settled around 63%. After the pandemic it fell briefly to 60%, before rebounding to just below 62%. The inflationary implications for even a 1% shift in this index can be significant. In the UK the numbers are different. Labour participation peaked at 80% just before the pandemic, then dropping also by two percentage points to 78%. Differences between social systems and statistics can explain the disparities in headline numbers amongst similar, but not the same, economies. For the UK, we are fairly positive that once schools are running Covid-free, labour participation rates should increase near previous highs. Having said that, this does not necessarily mean easing wage pressures. The combination of Brexit and the pandemic has forced a large number of low-wage Europeans out of the workforce, and the country altogether. This factor alone should keep the UK labour force tight for years, after the first wave of post-furlough layoffs has subsided. High participation rates also mean that there isn't much room for more people to come (or return) to the workforce, so wage pressures should remain high.

Surveys suggest that the impact is higher on manual workers who can't return to work due to inaccessibility to child care and continued unemployment benefits5. However, only the former (childcare) explains why someone would not be looking for work. Inasmuch as childcare is the issue, we would expect to see a gradual return of labour and an easing of wage pressures.

Can we bring people back to the labour force?

US Labour Force participation rate

Source: Mazars Calculations, Refinitiv

In the US, the picture is different. According to the Census Bureau[15], the problem is one of demographics. As baby boomers enter retirement age but continue working they are not only taking jobs from those within the measured labour force but also forcing lower wages outside their own bracket. 27% of those between 65 and 74 and 7.2% of those 75 and older (up from 25% and 5.7% respectively from a decade ago) are still employed, but not

[15] Census Bureau: Why did the labour participation rate decline when the economy was good

considered to be part of the labour force. If this is the whole story, then it is one of counting. If we included those over 65 and working to the labour force, we would probably see higher rates. As such, we expect that the pandemic could see the usual post-crisis employment friction, but by and large a sufficient number of workers should return to ease wage pressures all other things being equal.

What it all means for investment portfolios

Our research suggests that as vaccinations increase and childcare concerns fade, a large portion of workers should return to the workplace easing wage pressures across the board. The UK may be an exception due to the complexities caused by Brexit. Thus, we continue to feel that sustainable demand-driven inflation may be a product of game-changing fiscal stimulus and easing in bank lending, both of which are, at this point question marks.

From a bird's eye view, the Covid-19 Crisis had a rather unique element. It was exogenous to the financial system. Endogenous crises were addressed in wholesale, top down fashion. Inflation was dealt with high interest rates in the 80s. Problematic banks were helped in the 90s. The Sarbanes-Oxley Act fixed financial reporting and governance issue which led to the Enron collapse in the 00's. The Fed and the Dodd-Frank Bill saved and secured the financial system in 2008. In any one of these instances, the dislocation was internal to the system and the system self-corrected.

Conversely, an exogenous crisis can't necessarily be addressed by policy, never mind a single policy. Let alone a crisis that is ongoing and mutating, not a one-off event. The pandemic has already had a profound impact on businesses and labour and challenged some sectors a lot more than others. **To find answers for the world that is to follow, we should look from the bottom up, not the top down.**

Investors may be misled if they follow the red herrings of de-globalisation, labour force participation rates and labour shares. **For all the political baggage these concepts carry, ultimately labour conditions are a product of technology and sector composition.**

Instead, portfolio managers should turn their sights towards sector adjustments. Some sectors will transition to a new type of economy easier and faster than others. The course won't be deterministic, but rather the product of executive decisions by sector leaders.

The key word here is 'management'. If management of a company is procedural, you should expect more difficulties in adjustment. Even pricing power may not be enough to protect companies from tardiness in adapting to new labour conditions. These companies may face challenges to their status quo faster than the market currently anticipates. Instead, where management is adaptive (not necessary visionary) and quick to move, you should expect competitive advantages to be built. If those companies are already leaders, then investment managers should expect their sectors to outperform.

Global economic arrythmia

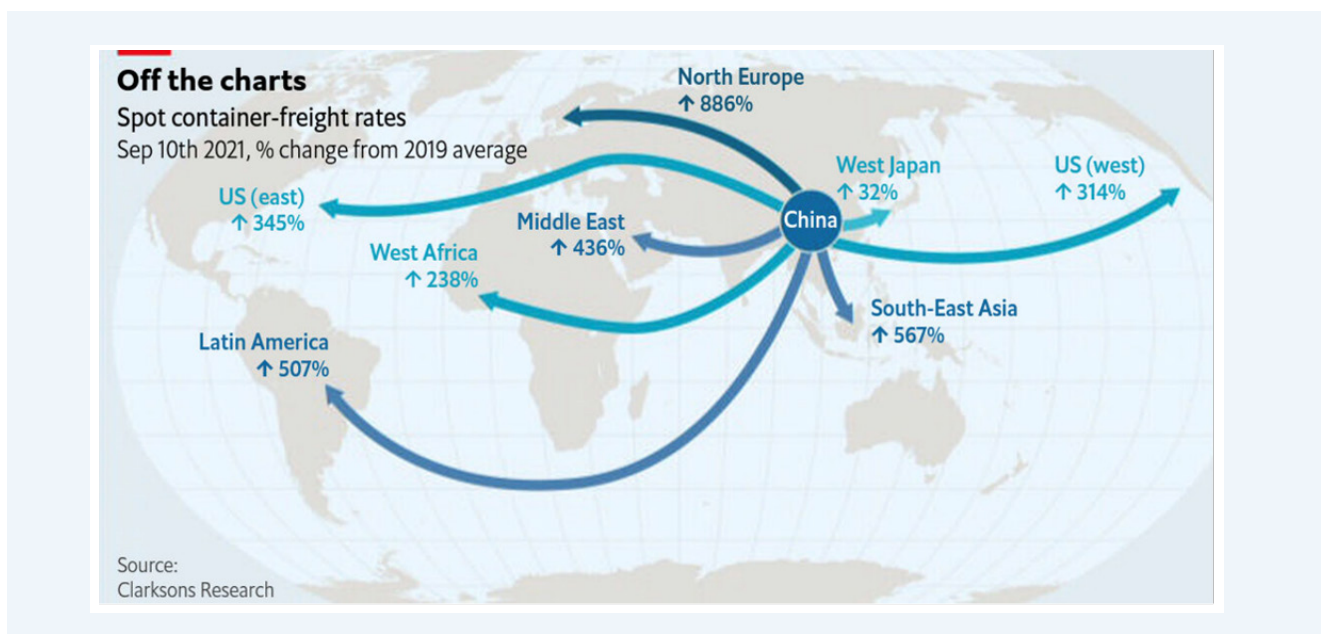
Addendum: The UK economy

Regardless of where one stands vis-a-vis the great issue of Brexit, both sides acknowledged that a modicum of pain would be involved with the process. Those against feared that the pain would be insurmountable and that despite its obvious shortcomings, the EU wasn't worth leaving. Those for believed that short and even medium-term pain was a worthy price to pay for an envisioned 'new Britain'. What neither side could have ever contemplated was that Brexit, really a trade challenge, would be implemented at the height of the greatest trade disruption the modern world has ever known.

Global supply chain arrythmia after a protracted pandemic is a key feature shaping the global economy today. As the western consumers went into lockdowns and shops closed, production across the world slowed or halted altogether. Not knowing how the pandemic would play out, producers decided not to over-stock, but wait. After the Covid-19 vaccine was licenced, developed economies quickly came out of their slumber with a lot of pent-up demand. Factories in the East struggled to cope. As a result, huge backlogs were created, significantly pushing up transportation costs. According to Clarcksons, a UK-based shipping broker, costs to transfer goods from China to the US have risen by 350% and to Northern Europe by a whopping 890% in the last year. Waiting times in ports have almost tripled since before the pandemic. This sort of disruption means shortages of imported goods, and inflation; an economic element most modern consumers haven't really experienced in over twenty years. Companies like Intel forecast microchip shortages for all of 2022. After the initial rebound, global growth is now slowing again, even as the pandemic continues to grip countries with low vaccination rates, where most supply chains begin. The labour force is also struggling to cope, as school program disruptions persist, keeping many parents away from employment or forced to work from home.

The state of the British economy

The challenges for British people are exacerbated due to Brexit complications. Waiting times in ports are increasing further because of increased paperwork. Imports through the Irish sea are becoming contentious. Where in other countries labour participation rates have dropped, in the UK the situation is made worse by the mass exodus of European workers. As a result, and despite adequate inventories, British people are experiencing gasoline shortages due to a lack of drivers. Similar pressures can be seen across hospitality, retail and construction, where at least the pool of workers is large enough to keep those industries afloat. Overall, shortages of skilled labour pushes wages higher. Housing prices rising 5% to 15% per annum, put further angst on consumers. All of these factors are further exacerbating inflation which has reached 3% per annum, a level not seen for nearly a decade and with no signs of abating. Meanwhile, economic output (GDP) virtually stalled, up only 0.1% for the three months to July 2021. We are now entering an economic phenomenon called 'Stagflation' (Stagnating Growth + Inflation).



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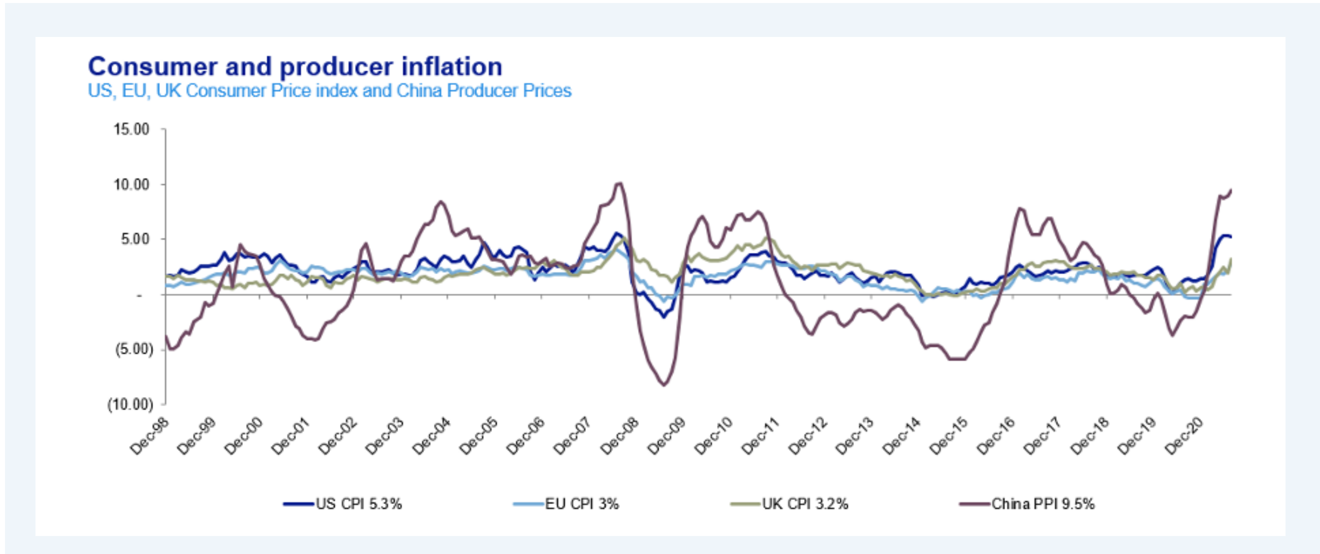
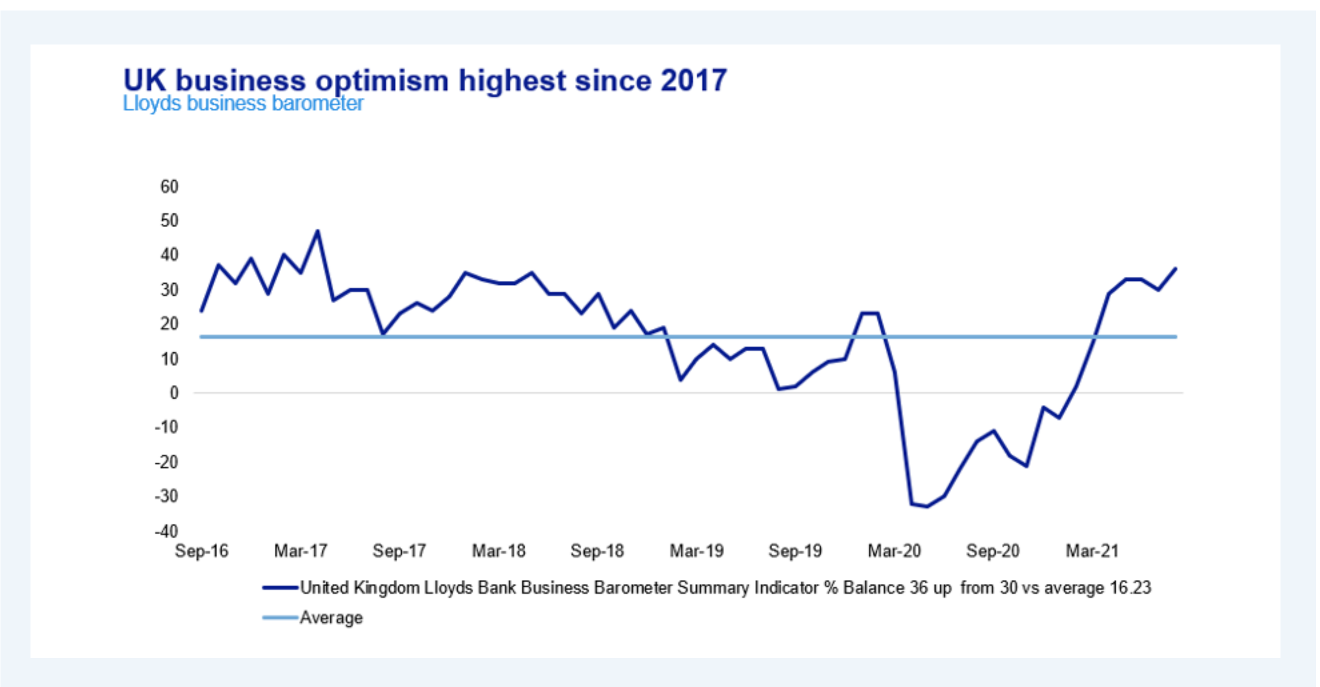


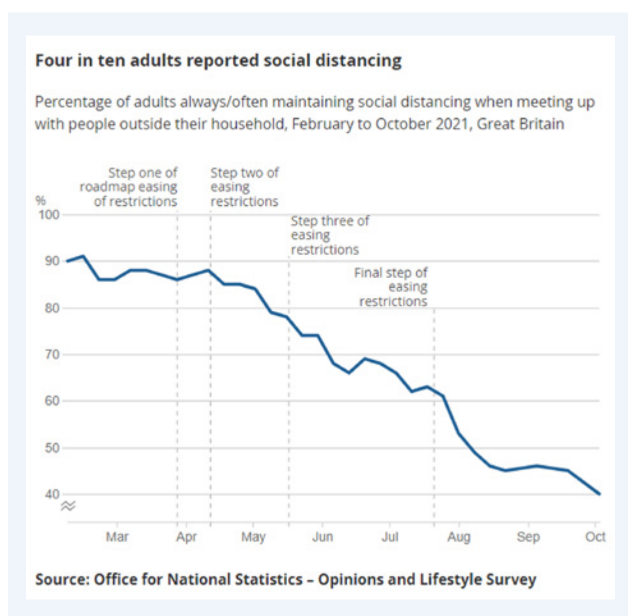
Despite those conditions, the Bank of England, whose primary objective is to fight inflation, has adopted a more 'hawkish tone' (econo-speak for a more aggressive approach to interest rates).

On the other hand, we have to note that not all news is bad. UK businesses are overall the most optimistic they have been since 2017. Consumers, empowered by higher savings, fiscal stimulus, low unemployment and a shift of bargaining power towards labour, are less worried about higher prices than they would be otherwise.



Global economic arrythmia

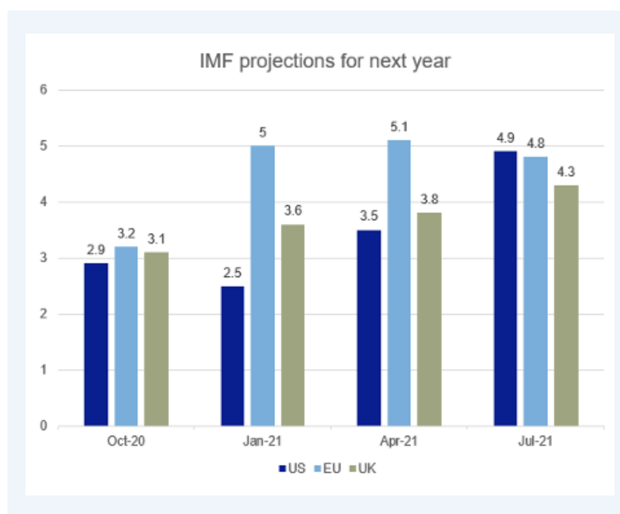
Purchase Manager Indices, popular forward-looking economic indicators, suggest that while economic activity is slowing, overall conditions are still expansive and the pace of the slowdown is actually lower than we would have anticipated. Meanwhile, empty city centres are slowly coming back to life, with 60% of Britons now saying that they are returning to some sort of regular commute.



UK economic outlook

The pandemic is very much still with us, with different variants threatening further economic instability. And while western consumers may be the first to learn to 'live with Covid', supply chain disruption may well last into 2023, or at least until the problem has been dealt with on a global scale. The UK, one of the most open economies in the world, is especially sensitive to those disruptions. Having said that, the UK, also one of the world's seven biggest industrialised economies, still has the resources and a strong enough currency to weather the storm.

The IMF has improved the aggregate growth outlook for 2022 from +3.1% to +4.3%, with some estimates bringing the number up to 5.5%. Macroeconomic volatility will probably persist into the next year as well, but we would expect fewer surprises as vaccination rates increase and the pandemic eventually subsides. We also expect the gradual return of the services and retail sectors to conditions close to pre-2020 after mid-next year.



We believe employment friction will continue well into the next year. The pandemic augmented 'Brexodus' and it will take some time before the UK has a big enough supply of skills to smooth economic performance.

Policy makers in Downing Street are also considering changes in the economic mix and fiscal stimulus especially after the end of furlough. However, they are probably holding out for the US government decisions as to how much the world's premier consumer economy will fiscally inflate its own output, the consequences of which will reverberate across the world.

Inflation 1.0 and Inflation 2.0

We left the thorny issue of inflation for last. Supply deflation was the biggest gift of globalisation. As long as supply chains remain global, supply side inflation is considered by and large transitory. Even if de-globalisation trends pick up, modern logistics chains have ways to efficiently source and produce. Having said that, if Chinese economic and political convulsions persist, we could see the transfer of factories to other countries, an event with at least a two-year impact on inflation and production capacity. This is inflation 1.0, one for which central banks and local policy makers can do very little about.

Then there is inflation 2.0, demand inflation. In the past twenty years, real incomes have stagnated across western economies. Demand has been muted and savings rates have picked up, especially after 2008. The US, the world's premier economy, is now considering breaking this cycle, with massive fiscal stimulus. If this does happen, other countries would have to follow, for fear that their currencies would rise in value and they would lose competitiveness.

Central banks may well maintain low interest rates if 'Inflation 1.0' remains dominant. But if and when western consumers become more empowered, then we would not only see a significant rise in disposable income, but also interest rates, to keep the economy from over-heating.

Inflation 1.0 is already happening, and the only relevant question is one of duration. Inflation 2.0 is the possibility of an empowered consumer. How and when this second part will occur, whether it will overlap with the first or leave a gap are still difficult questions with significant policy implications.

What it all means for consumers and business owners

- Business sentiment should fall slightly in the coming months, as consumption reverts to trend.
- Consumers may become a little more apprehensive as savings run out. Meanwhile, as the furlough ends and more workers become available again, wage pressures and competition for talent should abate and skill availability should increase.
- Businesses should not expect supply chain pressures to abate any time soon. In addition to these, Brexit-related issues could persist for some time, especially as tensions between the continent and the UK rise. Empty shelves and reduced availability (and thus demand) for goods should be a feature for this winter. This would put pressure on the Chancellor to maintain enough fiscal stimulus, even if it means more debt, raising taxes or a combination of both.

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