10 March 2023

From the Chief Investment Office

All investments can fall in value. You may lose capital. Please note that past performance is not a guide to future performance.

Our perspective

Are we really about to repeat the 1940s?

The similarities between the 1940s and the 2020s have been multiplying in the eyes of some.[1] Certainly, there is rhyme in the build-ups. Following a period of soaring inequality, indebtedness, and asset prices, the global economy slumps into a crisis. This crisis is followed by an anaemic recovery, which in turn provides fertile ground for increasingly toxic politics. Democratic stability is undermined in Europe, the US, and further afield as the extreme ends of the political spectrum make hay. Then comes a global emergency, which forces governments in all the major economies to respond with giant (further) borrowing and spending. Out of this rolling tragedy however comes a range of useful innovations and the impetus to implement them. Also, the public sector's necessarily muscular fiscal response has the unexpected benefit of restoring some (economic) health to the private sector, driving down joblessness, reflating incomes, and shrinking real debt burdens. Eventually the emergency ends, leaving much of the world to enjoy decades of sustainable rapid increases in living standards.

The above could either describe 1921 – 1950 or (up until the boom part at the end) 2002 – 2023. For this week, we look at whether we could be about to follow the historical lead and enjoy a very welcome economic boom.

Technology and productivity

A good deal of that post-second-world-war boom for the US and world economy is surely not repeatable – the increases in female labour force participation cannot be done again for example. There may even be some move in the other direction in the quarters and years ahead – as the global population continues to age and many emerging markets hit their own fertility sludge, we may find that the size of the global work force acts against rather than for global output growth.[2]

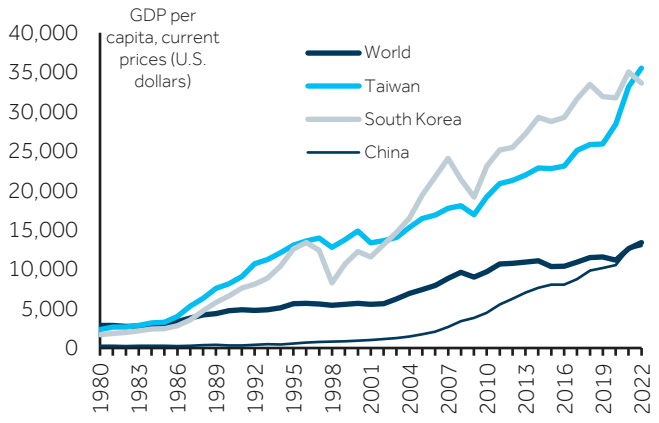
"Technologies forged in the cauldron of war and its cooler successor were deployed more widely."

However, there are some areas where the rhyme could be more useful. The 1950s and 60s were a time of sharp productivity growth increases, as technologies forged in the cauldron of war and its cooler successor were deployed more widely. For example, the military's need for large stocks of penicillin during the war led to a production process that ended up being useful with a wide range of pharmaceuticals.[3] More broadly, from the transistor to the jet engine to various advances in materials science, wider commercialisation of these innovative breakthroughs drove breath-taking increases in living standards in the years after World War 2.

The coalescing of various technological breakthroughs of the last few decades was similarly important in our contemporary battle against the pandemic. Again, crisis proved an accelerant to help commercialisation. However, there are also several other areas of promise today, beyond the leaps forward in Artificial Intelligence seen so far this year.[4]

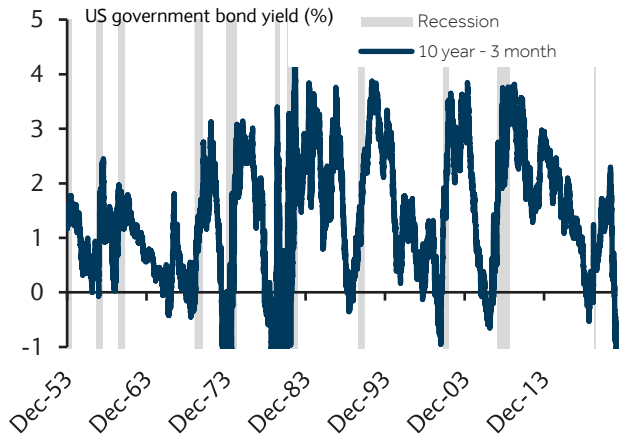
[1] *Matthew C. Klein, 8 March 2023, Reconsidering the "2020's as the 1940s" Analogy - Substack*
[2] *https://blogs.lse.ac.uk/businessreview/2020/09/18/the-great-demographic-reversal-and-what-it-means-for-the-economy/*
[3] *https://www.federalreserve.gov/boarddocs/speeches/2004/200401042/default.htm*
[4] *Ethan Mollick, Secret Cyborgs: The Present Disruption in three papers (8th March 2023) & Feats to astonish and amaze (5th March 2023) – Substack*

Figure 1: GDP per capita growth from 1980 for Korea, Taiwan, China, and the World



Source: IMF, Barclays

Figure 2: Yield curve inversions since WW2



Source: FactSet, Barclays

Energy is one such area. As one of the external members of the Bank of England's Monetary Policy Committee reminded us this week, almost every activity in the economy requires energy input.[5] With that in mind, one of the (many) theories trying to explain the more subdued trends in global productivity growth this last few decades riffs on a plateauing of energy technology.[6] In the early 18th century, it was muscles that dominated – ours and those of our livestock. By the 19th century, we had switched to coal, which was cheaper, more abundant, and more energy dense. In the 20th century, we progressed to oil which trumped coal on all of these fronts. Since that ascension, there has been an uneven flirtation with nuclear fission, but there has been no new, all-consuming, energy revolution to re-power our global economy more inexpensively higher since.[7]

"In the early 18th century, it was muscles that dominated – ours and those of our livestock."

The scale of the cost declines in solar and other renewable energy we are seeing, combined with the incoming advances in storage are therefore perhaps extremely important.[8] That is not just from the perspective of our collective capacity to avoid irreversible climate damage, but also for the future of productivity (and therefore living standard) growth.

Is the world turning Chinese?

There is also an interesting policy angle that is loosely comparable with the post-war period. For much of the last several years, an ideological battle has raged with important consequences for policymaking in various parts of the world. On one side is the idea that market prices have all the answers and the state's reach in an economy needs to be curtailed at all times – the private sector is where productivity comes from, and the state is more often than not a dead weight for living standards improvements. On the other is the idea that market prices don't care about a lot of things that we feel are very important – from social issues to the environment – only the state can provide.

"Some persuasively argue that the UK's current productivity malaise can be linked to the period of public sector austerity that followed the Great Financial Crisis."

These are, of course, caricatures. However, what is clear is that China's rise this last few decades and indeed those of Korea and Taiwan before it, owes much to the role of a degree of state planning – a particularly muscular form of industrial policy (Figure 1). China's success has perhaps forced a rethink from some developed world governments as the latest legislative slugs from the US testify. The Inflation Reduction Act contains an array of subsidies and supports, even a degree of winner cherry-picking. Europe is brewing a response in kind.

One of many interesting points here from an investment perspective surrounds the role of the state in innovation. Some persuasively argue that the UK's current productivity malaise can be linked to the period of public sector austerity that followed the Great Financial Crisis. The inference being that, in some areas, companies need the presence of the state to help drive and nurture innovation. The state's role, if designed correctly, is complementary. The tight collaboration that prospered between state, universities, and private sector in the post-war period in the US is often seen as one of the decisive factors in that aforementioned productivity surge.

[5] https://www.bankofengland.co.uk/speech/2023/march/swati-dhingra-remarks-on-cost-of-living-crisis-and-inflation-at-the-resolution-foundation
[6] Noah Smith, Why I'm so excited about solar and batteries, 7th Feb 2023, Substack
[7] William Nordhaus, Dec 2004, A retrospective on the 1970s productivity slowdown – National Bureau of Economic research
[8] https://ourworldindata.org/grapher/levelized-cost-of-energy

The present day – recession, inflation, interest rates, and confused markets...

This is all part of the context for what continues to be a very disorienting present. Ominous augers for the outlook continue to quietly assemble. Most obvious of those is the ever-greater inversion of the US yield curve – long-term interest rates are now as far below short-term equivalents as we've seen since 1981 (Figure 2). Incoming (hard) data on the US and wider global economy are still not speaking with one voice about the outlook. The US economy continues to look too hot, as this week's testimony shock from Federal Reserve Chair, Jay Powell, reminded us. The market action in the latter part of the week has centred on the plight of Silicon Valley Bank, a possible canary in the coalmine with regards to the effects of the interest rate shock already inflicted on the US economy. Our hunch remains that a downturn is ahead, and our tactical positioning would argue that that downturn is still under-realised by a range of market prices.

Spring Budget...

Former Chancellor Kwarteng has perhaps managed to re-insert some long-lost jeopardy into the wait for UK Budget announcements. Current Chancellor Hunt is set to benefit both from higher-than-expected tax receipts and lower spending this time around – sharp changes in forecast energy costs are central. However, the outlook for the UK economy remains a little more precarious than some of its peers. Key here is mortgage refinancing risk. Much of the mortgage book in the UK will need to be refinanced in the next five years, at interest rates that would have been hard to conceive only a few years back. Admittedly much of this incoming drain on household cash flow drain is forecast to fall on households more able to bear it. However, for both the Bank of England and the Chancellor, this suggests a cautious approach in the months ahead.

This week's theme:
Estate planning – why it's never too early

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Lee Platt, FPFS
Wealth Planning Director

The question on the lips of many wealthy families is how to transfer money to loved ones without triggering large inheritance tax (IHT) bills. There is a huge amount of money in the UK held by the over-45s. In fact, over 80% of household wealth is held by the over-45s. Over the next 30 years this is set to be transferred between generations as inheritance or gifts (according to the Office for National Statistics).

The so-called 'Great Wealth Transfer' could amount to £5.5 trillion globally over the next 30 years[1]. The majority of the wealth held by UK baby boomers is held up in property, where prices have been soaring, and in their pensions.

The risk is that without proper financial planning, much of this wealth will be handed over to HM Revenue & Customs in the form of Inheritance Tax (IHT).

The rules

The standard IHT allowance allows individuals to pass on £325,000 without any tax being due – otherwise known as the Nil Rate Band (NRB). For those with children or direct descendants who can inherit the family home, this could increase by £175,000 per person following the introduction of the Residence Nil Rate Band (RNRB) in 2017. This means that for a married couple or civil partners, the first £1 million of their estate could potentially be free of IHT.

However, for estates over £2 million, this additional RNRB is reduced by £1 for every £2. Should the total estate exceed £2.7 million, the additional RNRB is lost entirely. With IHT charged at 40% of anything over the £325,000 nil rate band threshold, the tax liability could vastly reduce the amount that goes to your loved ones.

How can one limit IHT liabilities?

The solution is to use careful intergenerational wealth transfer, legacy planning, and IHT planning. There are several ways in which you can reduce tax liabilities that are worthy of consideration.

Giving away assets during your lifetime is a very simple way of reducing your estate for inheritance tax purposes – and providing a much-needed boost to grown-up children moving up the property ladder or even to grandchildren saving for their first home.

The 'annual exemption' allows individuals to give financial gifts, tax-free, to the value of £3,000 without them being added to the value of your estate.

You can give away all types of assets, including cash, property, and shares tax-free, so long as you live for seven years after making the gift. Crucially, this so-called 'Potentially Exempt Transfer' (PET) has to be an outright gift from which you can no longer benefit.

There is a way of giving away unlimited cash without falling foul of the seven-year rule – so long as it's from surplus income and doesn't reduce your standard of living or force you to dip into your capital to cover day-to-day costs.

An important part of gifting is keeping a record of what you give, to whom, when it was handed over – and its value. Otherwise, it's up to your family to provide proof that the gift was made more than seven years ago which could prove tricky.

Trusts are another popular option to help mitigate IHT. They are useful for setting aside a sum of money to be used at a later stage, perhaps where grandchildren are still young.

When making a Will, you can include a Will trust which allows you to make provisos on any assets left to heirs. Specialist advice is crucial to ensure the right trust is chosen for your needs and goals.

It is also possible to take advantage of tax perks that come with certain investments which become IHT-free after a two-year qualifying period. These can help older people to save IHT successfully, so long as they are comfortable taking higher levels of investment risk.

Taking action

Getting the right plans in place requires time and effort – and family discussion. Many people find this a rather difficult topic to talk about and end up addressing these matters too late.

Prudent planning, flexibility, and sound advice are key. Talking to a professional adviser will ensure your family receives a full and lasting legacy. It's never too early.

[1] https://www.kctrust.co.uk/wealthtransfer