Investment Strategy Update

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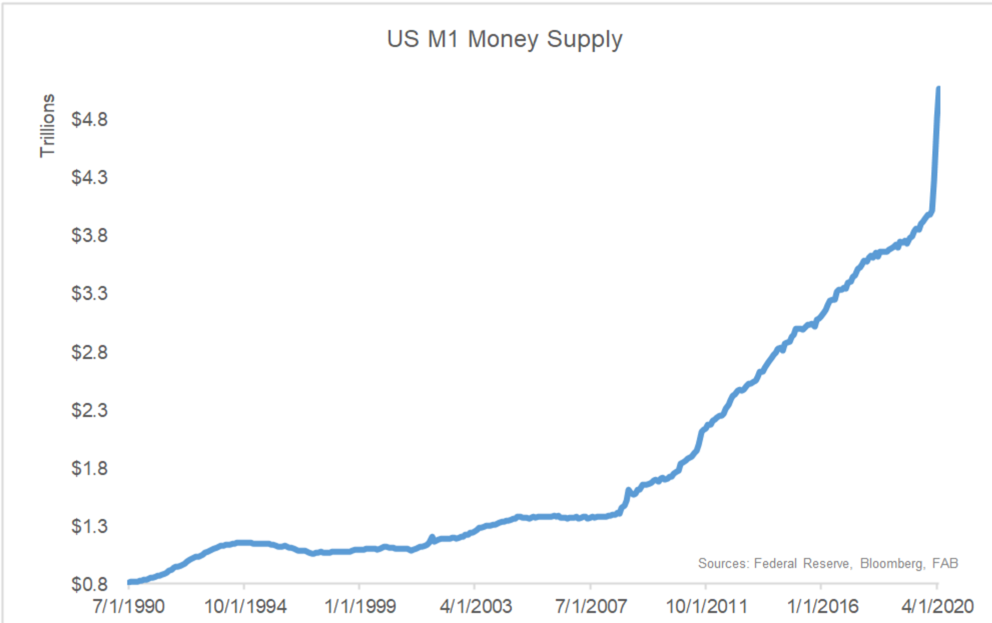
What happens when the wall of money moves again?

- **Fiscal stimulus in the US and elsewhere has increased the savings rate to all-time highs.**
- **Deposits in the banking system are at unprecedented levels as stimulus checks are mailed and people remain cautious about spending.**
- **High unemployment and uncertainty about the future as well as lockdowns are holding back consumers.**
- **However, this could change quickly once the fear of the virus subsides and life returns to normal.**
- **FAB AAC remains overweight high-quality investment grade bonds.**



The economic news continues to be bad and there is a growing consensus that activity will not return to the levels at which they were in December for at least another two years. However, there is also increased awareness among economists that the massive fiscal and monetary stimulus effort will eventually give the world economy a massive boost.

The one number that seems to indicate how strong that jolt could be is the most basic measure of money supply, the M1, which in simple terms is the amount sitting in deposit accounts. At the end of June, the M1 in the US was at a record US$5.33 trillion, a 33% increase from February. Most of that was created as a result of the nearly US$2 trillion fiscal stimulus package. That pushed the savings rate in the country to 32.2% in April, as people in lockdown avoided spending, its highest since the US government started to track the measure. It has retreated to 23.2% in May but it remains very high.

The key now is whether that money will get back into the system and how. It is so much cash, that some economists have been saying that it could spur a comeback of inflation. While there is support for that in the monetary theories of Milton Friedman and his followers, over the past two decades there has been little correlation between the supply of money and rising consumer prices. More money in deposit accounts does, however, often result in faster economic expansion.

This could help explain why the stock market has been so giddy. The same spike in M1 has been seen in Europe, China, Japan and other major economies. The rise happened in the second quarter, when most economies were closed, so the impact will not be felt in the second quarter GDP numbers. However, once things normalize, there could be a significant acceleration of growth, assuming that people in these countries go back to their old spending habits.

The money stock in the US increased by more than US$1.3 trillion in two months

That assumption is the biggest hurdle in the way of a growth spurt for the world. A 2 July YouGov survey found that 71% of Americans would not feel comfortable going back to retail stores. This suggests that, while the money is there, people may be reluctant to spend. However, once again, as soon as consumer confidence returns, that money could be spent.

This would favour a strong run for cyclical sectors, which benefit when the economy is strong, such as financials, industrials and materials. Those sectors have also lagged the wider market, which means their valuations are more attractive. Still, with unemployment still at record highs, that extraordinary growth could take longer than expected, despite all the cash.

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