THE **CAMBRIDGE** WEEKLY

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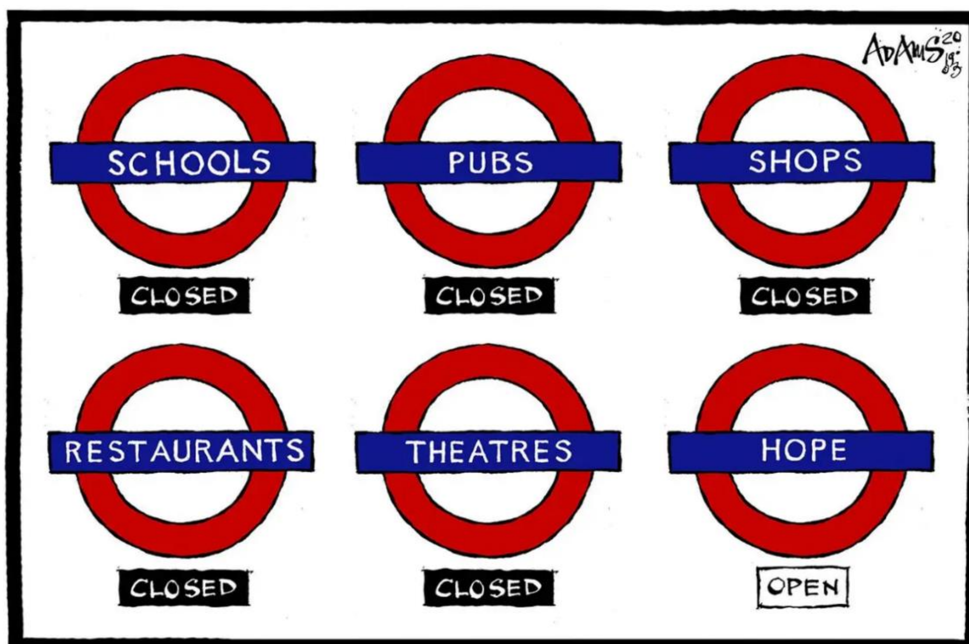


When the near term looks bleak we need to look a little further ahead; Christian Adams, 19 March 2020

Government ordered recession

Just like the spread of the COVID-19 coronavirus itself, the rate of policy change over the last few weeks has been astounding. A week ago, Boris Johnson and co. were content to isolate the sick, have the public wash their hands and provide £30bn to fight the virus – but otherwise go about business more or less as usual. Since then, the country has been told to stay at home, schools and universities have closed, 20,000 military personnel have been put on standby and the government has increased its fiscal support against the virus fallout to £350bn. In London, heavy travel, shopping and socialising restrictions are to be imposed and – despite the government's claims otherwise – rumours abound that the capital is to be sealed off and put into lockdown. Given how fast things are now changing, this could be out of date news by the time of reading.

It has also become rapidly and abundantly clear that we are plunging into a global recession of potentially unknown proportion and duration. Under government orders, economic activity for this quarter, the next and possibly beyond, will be substantially lower than before. Consequently, risk assets have nosedived as analysts continuously adjust their corporate profit expectations downwards while faced with unprecedented levels of uncertainty over the parameters of their estimates. Every day, as the virus restrictions affect more people, the capital market rollercoaster begins the moment trading opens.

Last week we saw equity markets still experiencing huge gyrations. However, it has been violent swings rather than constant falls. However, assets hitherto regarded as safe havens, like gold and government bonds, have had a much tougher time amidst a frenzied cash grab. Some have argued that prices for all types of assets this week became detached from any form of economic reality, bar global Armageddon. Indeed, some central banks and others have given up even trying to forecast what that economic reality might be.

This has raised the fear that capital markets trading very close to the borderline of 'disorderly' may trigger another global financial crisis akin to 2008/2009. We think there are crucial differences. Back in 2008/09, the problem was a systemic financial one. Investors bought debt that looked safe because it was 'secured' with assets. But those assets were themselves debt; and often they were also secured by more debt. When trust 'left the room', that circularity meant the whole system came crashing down around us. Because the borrowing spiral started with real peoples' mortgages, the feedback loop with the real economy paralysed global activity. But the problems began in markets and spread from there.

This time, it is the other way around. A huge, natural, external shock has caused an economic downturn, one that has been ordered by governments as a trade-off against mass loss of life amongst the elderly and infirm. In turn, this has dampened market expectations and also raised fears over mass defaults by companies and private individuals. True, market dynamics have now picked up their own steam – which could cause problems of their own later. But the problem is, first and foremost, a natural shock.

That has important implications for how we get over and out of it. Back in 2008, there was no clear consensus on what the right policy response should be. In the public's eyes, a small group of irresponsible gamblers lost everyone's money and then asked for huge taxpayer handouts so they could continue their lives of luxury. Bank bailouts were therefore harder to come by, and politically were hugely unpopular when they did occur. What's more, when the economic fallout from the banking collapse hit home, many governments around the world eschewed fiscal support programs through public funds in favour of the popular 'tightening our belts' soundbite.

None of that seems at all likely now. When it is an overarching societal interest and consensus that human activity has to be temporarily suppressed, then it is just as acceptable to bridge the financial chasm this action opens for businesses and individuals through unprecedented fiscal heavy lifting. That is why no one seemed to be particularly objecting to the government committing vast amounts of money, not only to containment measures or healthcare but also as a way of supporting those suffering under unprecedented activity restrictions that are no fault of their own.

Chancellor Rishi Sunak announced on Tuesday the £350bn support and rescue package for UK firms struggling with the impact of coronavirus. This comes on top of the already-guaranteed access to statutory sick pay and other benefits for individuals, as well as promises on tax exemptions. Across Europe – where budget rules have long prevented highly desirable public investment to overcome the slow growth malaise of the past decade – a consensus is building that the state has to act boldly. Indeed, expectations are that states must use every measure at their disposal to ensure that the global economy can as suddenly be switched back on as it has been switched off. This will only be possible if the collateral damage suffered in the meantime is limited to the absolutely unavoidable.

Crucially, unlike over the last decade, the dissenting voices of 'how do we pay for this?' are almost nowhere to be heard. This has nothing to do with government or central bank balance sheets suddenly being in a better position around the world – far from it. Rather, the agreed upon strategy is just that governments will borrow heavily via bond issuance. Interest rate costs will remain around the current historic lows nearing 0%, because central banks will buy existing government bonds with money they just printed.

In short, the plan is: central banks print money for governments, who give it to their citizens to see them through the crisis. If that seems extreme, that's because it is. But the growing consensus among policymakers – and the public – is that the world simply has no choice.

That kind of approach of course can bring its own challenges later down the line. Once the world opens up for business again, depending how 'de-mob happy' consumers will greet that event, these measures will likely result in a recovery boom that will push both bond yields and inflation substantially higher than we have been used to since the financial crisis.

We would note that this might not necessarily be a bad thing, at least for the economy. In these extraordinary times, extraordinary measured are required to mothball the status quo before the virus outbreak to keep things in working order until we emerge on the other side. If we manage to get it right, then our economy's productive capacity will still be there and more or less ready to be used once things return to normal. There are of course many complications along the way, but there is light at the end of the tunnel.

Why fighting this particular enemy calls for wartime measures

Boris Johnson has told the nation that his government "must act like a wartime government and do whatever it takes to support the economy". Analogies to the war, and rousing calls to band together and win the fight, have been a common theme during the coronavirus crisis – not just in the UK. They are not wrong. Britain has not faced disruption to daily life on this scale since World War II. And, as part of that effect on daily life, businesses and households up and down the country are worried about their own prospects. As such, Chancellor Rishi Sunak is within his remit to announce that "We have never in peacetime faced an economic fight like this one".

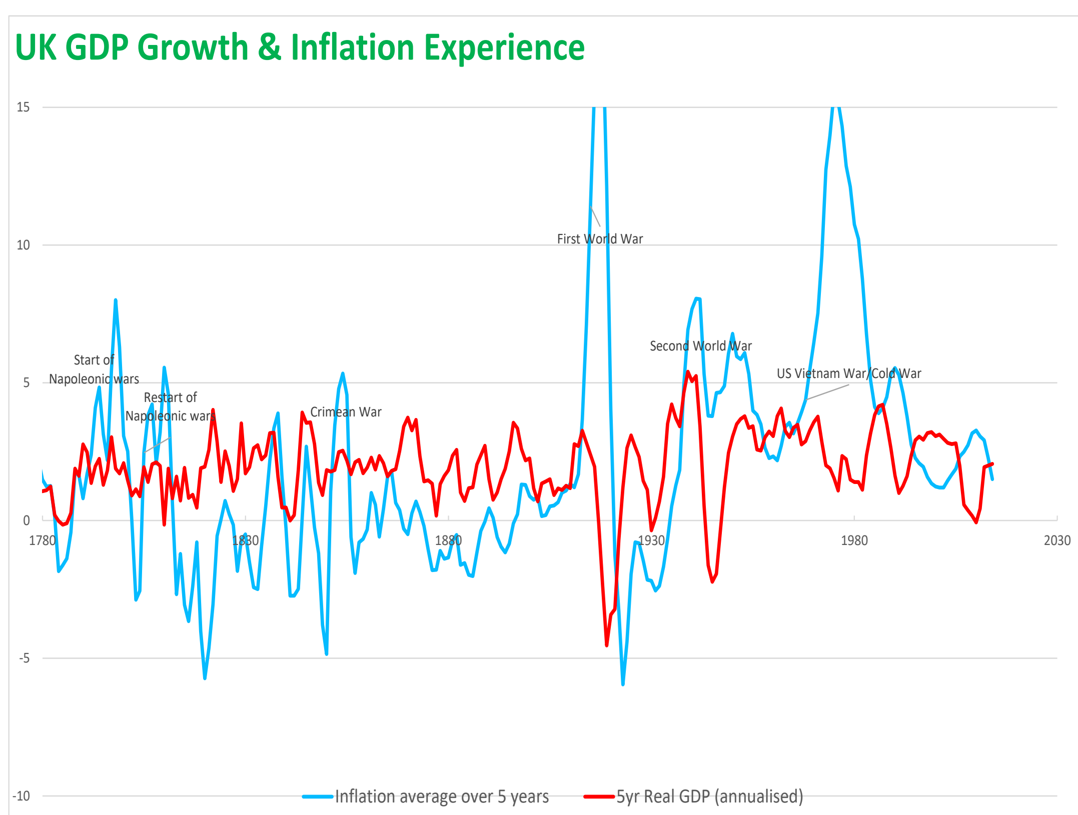
Just like during wartime, colossal government spending measures have been announced – backed by immense central bank action. As covered above, the recognition from governments around the world is that such measures are needed to see us through what can best be described as an enduring natural disaster. But the recognition of wartime conditions has deep implications for the economy and financial system.

First, we should note that any society going through a wartime phase effectively ceases to be a market economy at all - for that time period. Depending on how bad things get, businesses and consumers go into a near-catatonic state, and so regular market mechanisms stop operating. Without a central body to step in and ensure all of those usual services, even a short economic disruption could prove disastrous. The majority of businesses and the population would go bust, lose their livelihoods and become destitute.

We are certainly in that forced catatonic state right now. But the government has stepped in to help regularise goods, services and (crucially) capital to see the nation through. In a sense, the spending measures announced should not be classed as government spending in the traditional usual sense. They are a method by which the government takes command of the economy in the short term. That means most regular operating rules are put on hold. Just like the public pauses under curfew, so too does the economy and, to a large extent, also capital markets.

But one key consequence of the 'step-in' is that current asset valuations no longer reflect real expected values – just like the current lack of toilet paper in supermarkets doesn't reflect the supply/demand balance. Investment returns, just like our lives, must be put on hold until the 'war' is over.

Fortunately, we know this is a war we will eventually win – even if it takes much longer than any of us would like. But clearly, as we come out of the crisis and normality resumes, the short-term command economy measures will have other impacts over the medium and long-term. In particular, the 'print free money' approach, paired with people's desperate desire to catch up on everything they have missed out on, is likely to cause a spike in inflation. The chart below shows the comparison of UK growth and inflation over the last couple of centuries. It is clear to see that periods of war cause bouts of high inflation. But what is also clear is that the bouts of inflation don't necessarily mean bad periods of economic growth. In fact, the highest recorded period for GDP growth came during the Second World War.



What's more, in this particular case, we know that most of the productive factors in the economy will come out of the crisis relatively unscathed (shops and factories will be intact, most of the working age population will be healthy). That means the economy will have the potential – and the fiscal stimulus – to stage a strong and sustained recovery afterwards.

But the increased inflation we can expect to come post-virus will have other impacts that are worth keeping in mind. In particular, if both nominal growth and inflation are high, the yield on long-dated government bonds will go substantially higher. Bond yields have been pegged in historically low territory ever since the global financial crisis – accompanied by weak inflation and sluggish growth. This current crisis, and the fact that governments around the world are committed to spending their way out of it, will likely be the catalyst to change that.

Due to inflation eating away at purchasing power, and the inverse relationship between bond values and the direction of yields, cash and bonds are likely to lose a substantial amount of value over the next few years. But on the flipside, the outlook for equities looks much better. If growth rebounds as we expect it to, equity prices will stand much to gain and – crucially – should act as a hedge against rising inflation. Overall, that is not a bad scenario for investors, who can take their eyes of the near-term and look beyond the horizon.

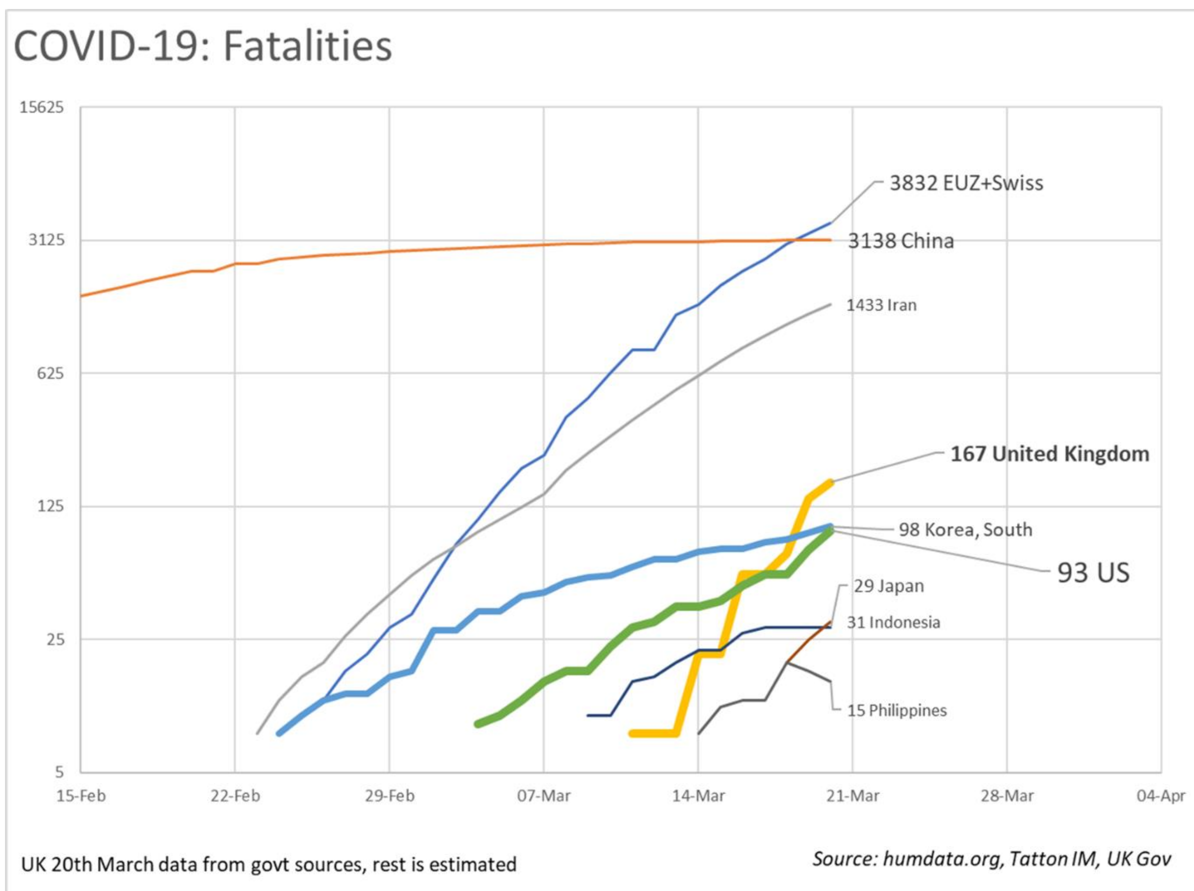
The 'wartime' economy we are currently in will inevitably be incredibly demanding on everyone and is likely to get worse before it gets better. But victory brings great rewards – especially for those with the risk appetite currently so lacking in markets.

The Chinese Roadmap to Recovery

When China's initial contagion prevention measures made international news two months ago, the world was shocked. Wuhan, a city of 11 million people and the epicentre of the outbreak, went into a total, crushing lockdown swiftly after the news got out. Similar measures followed suit around the country, and a total quarantine was imposed. Two months on, the country is now past the peak of infections, and things are slowly returning to normal. According to health officials, domestic transmission of the disease has stopped; the only new cases of coronavirus are coming from abroad. The consensus now seems to be that China's response was firm (and in some cases, brutal) but effective.

Naturally, looking at the Chinese case gives some hope about the speed of recovery. But comparisons to our own situation should be tempered. Authorities in China clamped down harder and faster than in the UK, and as such the 'peak' will come slower here. But the world's most populous nation certainly showed that the virus is worth fighting and can be beaten.

What the Chinese experience has also shown is that, in terms of the economic impacts of the lockdown, there is a way out. As we have said repeatedly, most of the lasting damage from this crisis will be economic. But the world's second-largest economy, like most of the major economies around the world, has promised to see the country through these difficult times with a massive fiscal and monetary stimulus package. Because of the actions of officials, there is no sign at the moment that there will be lasting damage to China's economy.



Given that China is further along the road to recovery than the rest of the world – it will without a doubt rebound stronger and sooner than anywhere else. We should expect the domestic economy to be among the best performing of all major economies this year (admittedly out of a bad bunch). The only caveat to this is that, since the developed world is effectively going into shutdown, external demand for Chinese products will be virtually non-existent. For a heavily export-oriented economy, that will dampen activity substantially, but there are ways around that problem.

For years now, the government has been trying to shift the economy from export-led to domestic demand-led. That shift has been accelerated in recent years by the trade war restrictions, which moved a great deal of production to smaller emerging markets and moved Chinese companies higher up the supply chain. The fact that domestic demand will now have to compensate for a nosedive in exports means that this process will now be turbocharged.

That opens opportunities for investors. Foreign access to Chinese markets and assets has always been hard to come by. But the process of 'opening up' has improved matters, and the fact that the government will need deep pockets to fund their plans means we can expect access to improve even more. China is increasingly seen as the new safe haven amid the virus crisis. The current market turmoil seems to have removed any semblance of rationale for moves in asset prices (leading to a spike in the dollar and fall in the Renminbi), but when sanity returns, we should therefore expect a big boost for Chinese assets.

Currency and equities stand to gain from this. The Chinese government will need to dip into bond markets to cover their spending, and bond investors around the world will be more than happy to front them the money, given the rise in the currency should prevent yields from needing to rise like elsewhere. What's more, the Chinese rebound is likely to spill over into surrounding countries and those that trade heavily with China. We saw this back in 2016, when a big burst of Chinese stimulus led to strong growth in emerging markets, and later the world.

That effect will likely be even greater now. Over the long term, demand for foreign goods – and China's 'Belt and Road Initiative' – could prove to be crucial for struggling countries. For many economies, Chinese infrastructure and development measures could prove as crucial as the Marshall plan conceived by the US after World War II.

China has shown how to defeat the virus and how to deal with its economic impacts afterwards. We missed the opportunity for rigorous early containment, but the response from our own government (and those around the world) suggests we are doing everything we can to seize the opportunity for a swift recovery – with, perhaps, unsurprisingly similar approaches to China. Aggressive social distancing will likely 'flatten the curve' of the disease, but cost us much more than China. If alternatives to the lockdown are found (such as a vaccine, or quarantining only the most vulnerable) the unprecedented fiscal response could prove to be an economic game-changer. And the Chinese economy will be at the forefront of that.

Disorderly markets – how much should we worry?

The mayhem in capital markets continues. As written before, we now seem to be in a phase of capitulation, where asset prices become more a reflection of investors' fear and need for cash than the underlying economic fundamentals. This week, we saw a transfer of stress and illiquidity to different areas of capital markets.

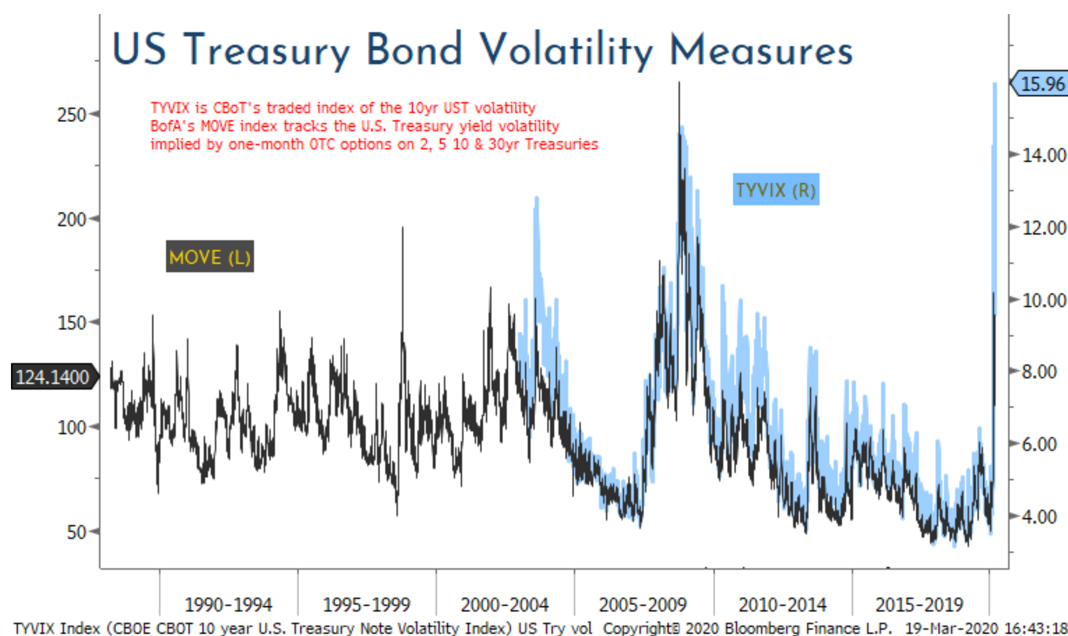
The good news – if there is any – is that the signs of stress in equity and credit markets may have abated. The 'sell everything' mad cash grab that characterised the last couple of weeks has, at least for the moment, ended. This is almost certainly the result of government and central banks actions across the globe. Policymakers have effectively told businesses, consumers and markets that they will do "whatever it takes" to see us through this crisis. This includes what effectively amounts to a mass exercise in money printing required to prevent widespread defaults which are not anyone's fault.

Most investment professionals we speak to agree that, when asset valuations become detached from economic realities and risk premia (the return that investors require for taking on a given level of risk) are high, it makes for a good buying opportunity. This rational response would usually create a stabilising force in markets, leading to a rebound in prices. But the problem comes when big market players no longer have the means to invest – even if they wanted to – and so are forced into a continual selling frenzy. We continue to see signs that this is happening right now.

A number of leveraged investment players – those whose liabilities exceed their capital base – appear to be having substantial liquidity problems. The usual suspects are the bond hedge funds (rather than equity

funds). This type of Illiquidity plays havoc with leveraged bond players that have hedged positions, since they have no choice but to sell to cover their cash requirements, and so are forced to take actual losses.

Unlike fully-capitalised investors who have some balancing cash, losses accelerate the need for cash. In normal markets, their positions may be large but risk-controlled to be within the tradable boundaries of market liquidity. But these are not normal times. The market carnage has flushed liquidity out of the system, and so the process of raising cash directly impacts the valuations of what they continue to hold.



In trading terms, the illiquidity is not to do with the difference between the bid and the offer price in the market. It's about 'depth': namely the amounts being bid (or offered) and the distance between the current bid, the next bid down and the bid below that. When things get bad, that distance can expand significantly. In investment terms, we see a big increase in the 'gap risk'. If a fund sells part of a position, the valuation of the residual position drops quickly as well (since it has to be done at the new bid). And that, by itself, can force the fund to have to trade again – a form of death-spiral.

The reason that this has been more of a problem for bond funds, rather than equity funds, is that bonds are more closely related to currency flows. This week, we have seen a significant spike in the value of the dollar – due to the demand for dollar cash and the 'safe haven' effect. As such, currencies have been significantly more volatile. As you can see from the next chart, which maps the Deutsche Bank Currency Volatility Index, currency volatility has seen a massive spike.

Flows towards the US dollar came suddenly after huge stimulus packages were announced. Those packages could be the main cause for the move, or it could just be coincidental. Governments all around the world have been announcing huge stimulus packages throughout the week, so it seems likely this is not the main motivation.

Either way, what is clear is that pain in the markets is now less to do with the market itself and more to do with its participants. We are, fortunately, a well-capitalised investor that has the ability to start buying when we see the opportunity. But many are not so lucky. We are unlikely to see a sustained turnaround until those investors stop their forced selling – either because they come to a balance or because they go bust. Until then, even a good rational case for buying will mean little.

CAMBRIDGE
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23rd March 2020

Global Equity Markets

Market	FRI 16:17	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	5202.9	-3.0	-163.2	↘	↘
FTSE 250	13527	-13.1	-2034.9	↘	↘
FTSE AS	2838.4	-5.2	-156.0	↘	↘
FTSE Small	3834.2	-16.8	-775.6	↘	↘
CAC	4070.7	-1.2	-47.7	↘	↘
DAX	8978.6	-2.7	-253.5	↘	↘
Dow	19980	-13.8	-3206.0	↘	↘
S&P 500	2400.3	-11.5	-310.7	↘	↘
Nasdaq	7250.4	-9.3	-744.8	↘	→
Nikkei	16552.8	-10.8	-2006.8	↘	↘
MSCI World	1694.5	-9.9	-187.2	↘	↘
MSCI EM	766.4	-14.0	-124.8	↘	↘

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
J Sainsbury	15.5	Int'l Consol Air	-37.7
Ocado	14.5	John Wood	-32.6
BT	13.5	ITV	-26.0
M&S	12.9	Melrose	-25.5
Reckitt Benck	10.9	GVC	-24.8

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.173	-4.5	Oil	27.72	-18.1
GBP/EUR	0.913	-1.0	Gold	1486.7	-2.8
USD/EUR	1.07	-3.7	Silver	12.47	-15.3
JPY/USD	111.31	-3.3	Copper	218.5	-11.7
CNY/USD	7.10	-1.2	Aluminium	1630.0	-1.6

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.55	+0.13
UK 15-Yr	0.70	+0.09
US 10-Yr	0.96	-0.00
French 10-Yr	0.11	+0.10
German 10-Yr	-0.33	+0.21
Japanese 10-Yr	0.08	+0.03

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	6.7	14.9	10.0	13.3
FTSE 250	5.9	16.7	9.4	14.3
FTSE AS	6.5	15.5	9.8	13.4
FTSE Small	5.4	-	-	13.9
CAC	4.5	14.8	10.9	13.5
DAX	4.4	15.6	10.2	12.5
Dow	3.3	14.2	13.3	15.1
S&P 500	2.5	15.8	14.4	16.1
Nasdaq	1.2	22.2	19.0	18.1
Nikkei	2.8	14.6	13.3	16.9
MSCI World	3.2	14.9	13.3	15.3
MSCI EM	3.6	10.8	10.0	11.9

UK Mortgage Rates

Mortgage Rates	Feb	Jan
Base Rate Tracker	2.50	2.48
2-yr Fixed Rate	1.48	1.49
3-yr Fixed Rate	1.65	1.66
5-yr Fixed Rate	1.71	1.72
10-yr Fixed Rate	2.61	2.61
Standard Variable	4.26	4.24

* The *% 1 week* relates to the weekly index closing, rather than our Friday p.m. snapshot values
** LTM = last 12 months' (trailing) earnings;
***NTM = Next 12 months estimated (forward) earnings

For any questions, as always, please ask!

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Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet and is only valid for the publication date of this document.

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The value of your investments can go down as well as up and you may get back less than you originally invested.

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