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End of lockdown tensions? Graeme Keyes – 7 May 2020

Phase II kick-off – from staying home to staying safe

Last week was a short week for most regions. Friday's VE day holiday here in the UK was labelled "Victory in Europe" in 1945 and marked the huge victory against the forces of tyranny and isolating nationalism. We know those forces are not dead, however. In the face of a terrible external threat, victory can still only be achieved together as nations. The effectiveness of lockdown at the micro (community) level is not only about structures (stay at home) but requires individuals to also behave appropriately (staying safe). Similarly, at the macro (national) level success over a mutual enemy requires consideration of our neighbours as well as ourselves. We must trust that our neighbours think likewise and choose to act responsibly in the spirit of that collective goodwill.

Much of what occurred last week has reminded us of this theme.

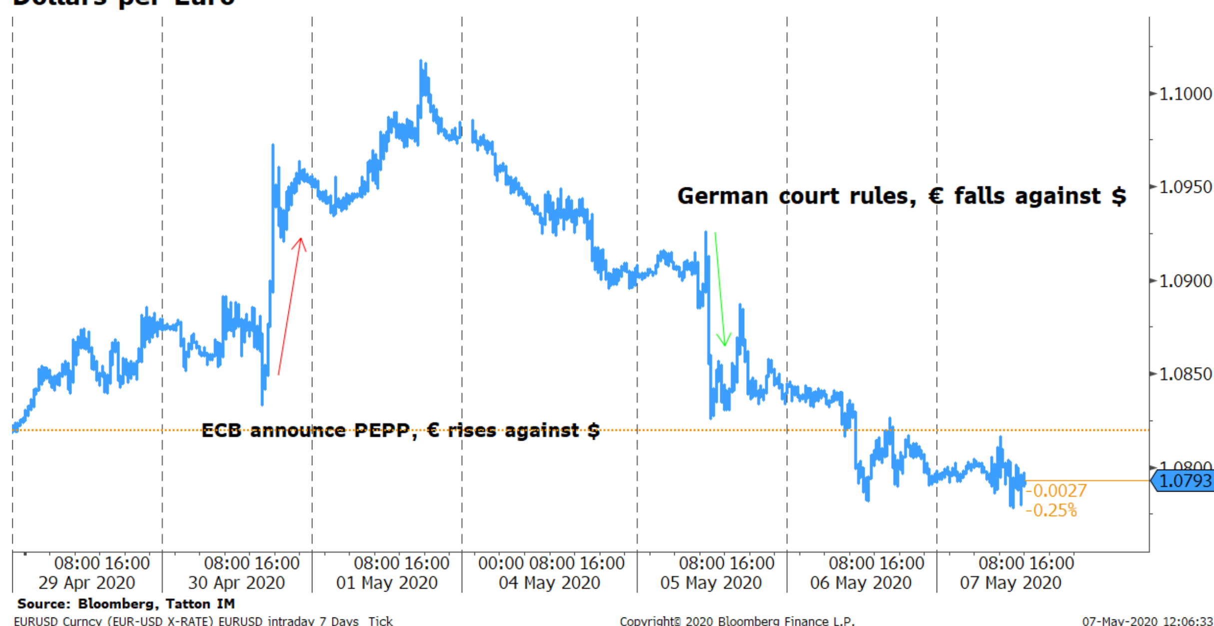
Among the reasons that the British public decided to leave the European Union (EU) was an impression of its fragile structure failing amid a weakening common purpose. On Tuesday, the highest court in Germany ruled that the German government had failed to hold the European Central Bank (ECB) to account for its latest asset purchase programs, which are intended to carry the EU's economy across the void of coronavirus-related inactivity. The court did not say that the recent Pandemic Emergency Purchase Program (PEPP) was a problem, nor did it say the ECB had exceeded its remit, but reading between the lines we deduced that the European Monetary Union (EMU) would do better to address its structural weaknesses through a common mandate, rather than 'muddling-through' yet again.

The ECB was given three months to provide explanations. The markets did not see the ruling as great for Europe but while it clearly raises some risks to the continuation of printing Euros to fund asset purchases, the ECB should be able to satisfy the court's conditions.

Despite the court not questioning the PEPP, the program's major beneficiary had been Italian Government bonds (known as BTPs). Before the intervention, bond investors started selling BTPs, with the spread against (the interest burden above) ten-year German bonds widening by 0.25%, the ten-year BTP heading back to a 2% yield. For Italy, and Europe as a whole, not disastrous but not helpful.

We talk about the role of central banks creating/printing money to fund short-term government spending in the following article. In normal times, most people (and here we count old-fashioned economists in that group) would think that printing large sums of money is poison for an economy and its currency. Surely then, if the ECB is to be kept away from its printing press, the Euro should rise?

Dollars per Euro



Source: Bloomberg, Tatton IM

As the graph above shows, the Euro has been falling. At least in the short-term, investors appear to see printing money as a medicine, not a poison. This medication may have side-effects if taken too long but, right now, there is no other remedy.

Faced with the task of rescuing the European economy from the brink, policymakers might consider the court's ruling and the market reaction as an opportunity to use the shared experience of the coronavirus to revive the sense of collective purpose and solidarity among eurozone citizens, and to finally fill some of the conspicuous gaps that the structure of the common currency has suffered from since the start. A commonly funded, post-virus 'reset and rebuild' investment program might be a good starting place.

The coronavirus has been damaging to the world's health in so many ways. Here at Cambridge, we believe it will pass without leaving the world in an irreparable state. But its effects will linger, especially in its impact on national relationships. As we ended 2019, much of the new-found optimism revolved around a thawing relationship between the US and China, and the establishment of the 'Phase 1' trade deal. 'Phase 2' was expected to emerge in the first half of this year. However, the virus put paid to face-to-face negotiations. The finger-pointing, the clear rise of American anti-China rhetoric (on both sides of the political divide) has been more damaging. Economists have been forecasting a very tepid bounce in the global economy based

on the expectation that tariffs might remain in place. Indeed, the strength of ill feelings has led to concerns it could get worse.

It was encouraging to hear the news on Thursday that US-China Phase 2 negotiations will be restarting this week over the phone. That said, we should not get ahead of ourselves. Negotiations last year were decidedly bumpy, and we should expect a similar passage now. No 2020 US presidential candidate will benefit from being seen directly as China's friend during the election campaign, but Donald Trump will benefit greatly if the US economy is bouncing strongly. Indeed, we can expect him to shout about how tough he has been, while trying as hard as possible to close more deals. Every incumbent benefits over his rival by having the power to actually do things, especially if they are seen to be successful, as Richard Nixon's visit to China in 1972 (and subsequent re-election) duly proved.

Trump may be able to blame a recession on somebody or something else, but he would much prefer to have exited recession well before the 3 November election day. Restarting the US economy and getting people back to work as soon as possible increases his chances. It is accepted that virus cases will spike again. Trump may well have been advised the spike will be 'containable', but he will be a hostage to fortune to some degree.

The UK's progress away from lockdown was outlined on Sunday evening. As mentioned last week, opening-up will be slow, and the emerging, if temporary new normal will remain painfully different to what we are used to. Meanwhile, markets are benefitting from the global monetary infusion and their ability to look across the void to a more distant point in the future.

Nevertheless, we are entering a different phase in the days ahead. The loosening of lockdowns means a partial restarting of the wider economy, but also the chance of rises in reported cases. That may increase the risk of restrictions being tightened again. As such, markets could find the going to be quite a bit heavier – they may have to transition from not worrying too much about the present to having to gauge the likely speed of recovery once extraordinary support measures are gradually withdrawn. For this brave new experience to be successful, good behaviour – and a commitment to ensuring everybody 'stays safe'– will be required from citizens, communities and governments. Fingers crossed.

Who pays and repays our way out of the crisis?

On a global scale, government spending is at historically high levels and only comparable to the spending incurred by World War II. With economies around the world shut down, policymakers have been rolling out huge fiscal packages to ensure businesses and individuals get through the tough times. But with businesses in hibernation, the cash drain through the bump-up in spending will be worsened – in the short term at least – by falling tax revenues. Most governments agree that the combined budget hole this opens up needs to be filled with public borrowing, and that this debt will have to be financed by huge monetary interventions from central banks. The UK, US, France and Spain are all expected to end this year with debt-to-GDP ratios of more than 100%, while the figures for Italy and Japan are 160% and 237% respectively.

Those inclined to look further ahead are understandably worried about the long-term implications of this burgeoning debt load, but no one seriously thinks those worries should stop governments from spending now. Without measures to bridge the gap from here to normality, economies and people's livelihoods

would be in ruin – making a swift recovery all but impossible. Even beyond the end of lockdown, there is an increasing sense that genuine long-term public investment is needed. For now, the usual "can we afford it?" rhetoric that accompanies any fiscal stimulus discussion is largely absent. But not all countries will have equal ability to borrow and spend. Governments trusted by investors (through past fiscal prudence, reserve currency status or otherwise) will do better in the balancing act than others.

First of all, we should point out there is no 'one size fits all' level of government debt. An optimal debt-to-GDP ratio across all regions does not seem to exist. Japan has done no worse than other developed nations, yet has more than double the debt-to-GDP ratio of many. And while some evidence suggests that debt-financed spending usually becomes less effective the more a government does it, the current scenario is anything but usual. Even in normal times, the crucial issue is not "how much debt does a government have?" but "how sustainable is it?" – since debt levels and deficits are linked to interest payments. As a rule of thumb, a country's debt-to-GDP ratio is deemed sustainable or stable when nominal GDP growth is less than or equal to the government's interest payments on its debt (assuming the government's tax receipts fully cover its spending in the first place).

In practical terms, this means that bond yields will stay low for the foreseeable future. Fortunately, central banks are seeing to that with massive bond purchases. Ideally, this should also create some inflation by raising nominal growth and 'inflating away' the debt.

Crucially, maintaining a stable debt-to-GDP ratio does not always mean lowering debt levels. Debt can rise as long as nominal GDP rises more quickly. Equally, if governments are trying to reduce debt through austerity, GDP could (and if pursued right now almost certainly would) fall much faster than the pace at which debt is being repaid.

In fact, there is currently a popular line of thought that austerity – and even borrowing for that matter – are never necessary if the state can print its own money. Modern Monetary Theory (MMT) starts from the observation that currency-issuing governments can spend without first collecting taxes or dipping into bond markets, and then suggests that taxes and borrowing are just means by which the government controls inflation. This, of course, requires the government to have perfect foresight on the arrival of inflation, and be motivated to counter it. This would go against the prevailing belief that an independent central bank should take care of handling inflation.

That may seem an extreme position, but it does remind observers of what central banks are doing right now. Huge fiscal stimulus programs by governments are being funded by practically unlimited bond purchases by central banks. In effect, government spending is being 'monetised'; authorities are just printing the money they need. Central bankers have been quick to point out that their aim is carrying over the economy through lower yields and supporting demand, rather than plugging budget holes, but many have noticed the whiff of monetisation. A few features which are used to distinguish outright debt monetisation from bond buying for economic stimulus reasons are whether the bond buying is permanent (which could explain the Fed's decisiveness in shrinking its balance sheet in 2018), and to what extent the central bank can generate a profit out of holding government securities.

The 'money printing' accusation brings images of the destructive hyperinflation seen in 1930s Germany or 2000s Zimbabwe, but few seriously think it will happen this time around. The crucial issue of debt monetisation is whether it remains transitory (i.e. how long it lasts), and therefore whether central banks

can maintain public and market trust in their own currency. To keep that trust, a few things need to be ensured:

First, central banks must declare a **finite horizon** for financing spending. On that front, the partial opening up of economies is a positive since it means less economic activity needs 'bridge financing'. Second, authorities also need to maintain **control of inflation** within the boundaries of what society deems credible. In other words, while inflation should make a comeback it cannot be allowed to get too high too soon. Third, policymakers need a **proper implementation mechanism**, so that the use of fiscal money in the economy is well understood by markets and the public.

The fly in the ointment comes when society faces a multi-year challenge that requires a massive initial commitment, but continues over time, making all three measures increasingly difficult to achieve. A case in point is climate change, where the future costs of inaction are extremely high, but financing everything now through a 'traditional fiscal approach' could prove challenging. This example is often used by proponents of MMT. In our view, the credibility issue could be more difficult to communicate on a decade-long time horizon, but again a lot would hinge on having a consensus on the purpose and finite feature of such a programme.

Balancing these factors will be harder for some than others. The US, by virtue of issuing the world's reserve currency, has enormous implicit trust from bond markets, and so can probably afford to print more money than most. Since debt monetisation happens on a national scale, things will be much more difficult for Eurozone nations, who cannot print their own currency.

A cruder spin on this is that only the 'strongest' will be able to keep spending public money, while the 'weaker' economies could be constrained by a lack of trust, capital outflows and subsequently weaker currencies. But this is far from the whole story. One of the interesting things to note this week was the market reaction to the ruling of the German constitutional court on the ECB bond buying programme – placing a thorn in the side of the central bank's debt purchase plan. After this news, the euro went weaker, despite it being *less* likely that European governments would be allowed to spend their way out of the crisis. In normal circumstances, you would expect any hint of debt monetisation to be a huge negative for the currency being monetised. Yet in this instance, the opposite is true. This suggests that markets are fully aware of the gravity of the situation and – much like governments – are more afraid of not spending than they are of overspending.

US 2020 election – do markets care?

US presidential elections are global events. Such is the outsized importance of the US in the global economy that, in a normal election year, the race for the White House is always one of the most closely watched stories for capital markets. Of course, there is nothing 'normal' about this election year. The global pandemic, and the forced economic hibernation it has brought, dominate the global news-flow to the exclusion of virtually everything else. There is less than six months left to run until America visits polls (assuming in-person voting is allowed). But the election on 3 November is not just about the presidency: all 435 seats in the House of Representatives and 35 out of 100 seats in the Senate will be contested.

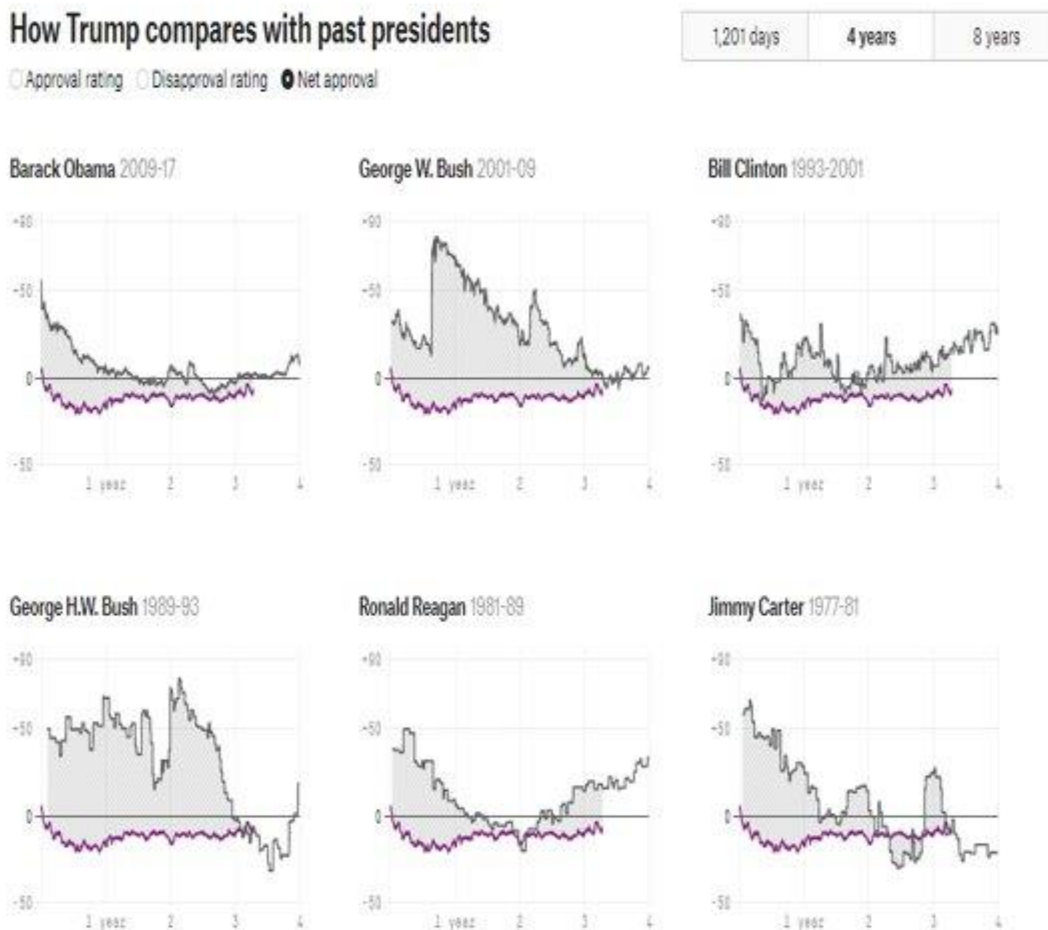
At such a pivotal moment for the world, this looks like the most important election in decades, for global politics and economies. Let's look first at the potential outcomes, and then at the implications for financial markets.

The political betting market is a reasonable place to find clues on the current state of play (we use Betfair Exchange). For Congress, the market sees a strong likelihood (about 80% chance) the larger House of Representatives will remain under Democratic Party control. In the equally important Senate (with only a third of the seats contested) the Republican Party has a 50-50 chance of retaining control. The Democrats have a 30% chance of seizing control, while the likelihood of a hung Senate stands at 20%. For the Presidency itself, a Republican victory is seen as a 50% chance which, by many counts, is a remarkably high expectation.

Now that the Democratic party has settled on former Vice President Joe Biden as its challenger to President Trump – with even 'socialist' Bernie Sanders giving Biden his backing – we can get more of an idea of how things might pan out. At first glance, November's vote looks similar to 2016, with the perceived establishment Democrat (then Hillary Clinton, now Biden) taking on the rogue anti-establishment Trump. But such comparisons are misleading. After almost four years at the helm, and with an entrenched supporter base among Republican politicians and voters, Trump can no longer claim 'outsider' status. Moreover, Biden seems to have a more united party behind him than his predecessor. Most important of all, the all-encompassing coronavirus crisis continues to make historical comparisons irrelevant.

Biden has an average 5.3% lead over Trump in national polls. More importantly, he is polling ahead of Trump in the key swing states of Michigan, Pennsylvania and Wisconsin – three of the states that narrowly went to Trump in 2016. The commander-in-chief currently has a net approval rating (the percentage who approve minus the percentage who disapprove) of around -8%, and has been continuously excoriated in the media for his handling of the coronavirus pandemic (with his infamous "injecting disinfectant" comments breaking through even to those not usually that political). The US lockdown has plunged its economy into a deep recession, and unemployment claims have surged to record highs. These factors would have been nails in the coffins of many a past president. But it may not be that simple this time.

The chart below shows Trump's net approval ratings (the purple line in each sub-chart) against those of his predecessors throughout their respective terms. Trump's numbers are historically bad. But what jumps out the most from these comparisons is that, compared to every US president since World War II, his below-average approval ratings have been astonishingly consistent throughout his term. Regardless of the ups and downs that have characterised his term in office, his supporters continue to support him, and his opponents continue to oppose him.



What's more, even if the economy continues to suffer, this will only affect Trump's chances if voters consider him culpable. Throughout the crisis, Trump has been consistent in his calls for lockdown measures to be temporary and limited, insisting first that America should not lockdown strongly and now that it should ease out of it. This has earned scorn from a public health angle, but it isn't hard to imagine that some of his supporters might view this as him being 'on their side' (recent scenes of anti-lockdown protestors seem to confirm this). By contrast, it will be difficult for Biden or any Democrat to advocate for an easing of lockdown soon, particularly with the recent images of gun-toting protestors inside state capitol buildings.

The fiscal response of the Trump administration has also been quick and substantial. The Federal government has promised a large fiscal stimulus package to see the country through the tough times ahead. With tax receipts drying up from the current economic hibernation, the US budget deficit is expected to

be around $3.7 trillion in 2020. On current projections, the debt-to-GDP ratio – already at high levels historically – will top 109% by the end of next year. It is quite incredible that the Republican Party, which spent two terms under President Obama lambasting funding gaps in the Federal budget, is now championing a spending increase of this size. But it means Biden and his party have little room to outflank the President on the issue.

The same is true for other policy areas. The blame game has been part of Trump's regular routine since before he entered office, and the current crisis has been no different. The President has moved to withhold funding from the World Health Organisation and fanned conspiracy theories over the Chinese government's role in the origin of the virus. But as we saw when he first launched his trade war against Beijing three years ago, the 'tough on China' approach has become a rare point of bipartisanship in America's divided politics. Rather than rallying against Trump's insensitive remarks on China, recent adverts for Biden have accused him of "rolling over" to Beijing and overpraising China's early handling of the virus.

Altogether, this leaves voters in a strange situation where, despite the two candidates appearing worlds apart on almost everything, their main policies on the crucial issues of the day might end up looking very similar. In which case, the main selling point for Biden would be that he isn't Trump. Recent polls suggest that may well be enough, but the crisis we are in – combined with how different Trump's presidency has been to past presidencies – makes the situation hard to read.

From a market perspective, who holds the office may not make much difference. The lockdown issue aside, both candidates will promise investment spending in their next term. The Republicans will prefer to fund companies to trigger that investment, particularly smaller firms. That will help the beaten-up small and mid-cap areas that have suffered for such a long period. The Democrats will want help for these firms and also push for an increase in public infrastructure spending. Markets may not differentiate much on this basis.

However, if the presidency and Congress are aligned, speed and certainty of execution will be greater, and likely to be welcomed by markets. A decisive swing one way or the other could help equity prices, and a swing toward the Democrats is more likely.

Markets will certainly welcome less global confrontation. Although neither party will be keen to be seen by US voters as China-friendly, markets will prefer the candidate that stabilises global trade Indeed, stability on all fronts is generally a positive for markets. Here, Biden probably edges the market vote, especially if a unified government happens.

And while markets have preferred Republican presidents in the past (especially incumbents), this time the roguish Trump may find the markets, very slightly, endorsing his opponent. That would be very uncomfortable for him, given his repeated assertion of how good he has been for stock prices.

We have fewer than 180 days left. It will be fascinating.

CAMBRIDGE INVESTMENTS LIMITED

11th May 2020

Global Equity Markets

Market	Thu 16:25	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	5928.0	0.5	26.8	↗	↘
FTSE 250	16226	-1.4	-228.2	↗	↘
FTSE AS	3266.1	0.1	3.6	↗	↘
FTSE Small	4632.3	-1.0	-48.4	↗	↘
CAC	4485.9	-4.0	-185.2	↗	↘
DAX	10720.9	-3.5	-386.8	↗	↘
Dow	23977	-1.5	-368.4	↗	↘
S&P 500	2884.4	-1.0	-28.0	↗	⇘
Nasdaq	8965.6	0.9	76.0	↗	↗
Nikkei	19674.8	2.1	412.8	↗	⇘
MSCI World	2007.6	-2.2	-45.3	↗	⇘
MSCI EM	898.7	-2.8	-26.2	↗	↘

Top 5 Gainers

Company	%
Ocado	16.0
Hiscox	14.0
Experian	9.9
RSA Insurance	9.2
Halma	7.2

Top 5 Decliners

Company	%
TUI	-16.2
Int'l Consol Air	-14.4
Carnival	-14.0
easyJet	-13.4
Rolls-Royce	-12.2

Currencies

Pair	last	%1W
USD/GBP	1.230	-2.4
GBP/EUR	0.877	-0.8
USD/EUR	1.08	-1.6
JPY/USD	106.48	0.7
CNY/USD	7.09	-0.3
Bitcoin/$	9,545	8.1

Commodities

Cmdty	last	%1W
Oil	30.67	21.4
Gold	1703.9	1.0
Silver	15.19	1.5
Copper	237.1	0.7
Aluminium	1479.5	-1.8
Soft Cmdties	320.9	5.3

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.24	+0.01
UK 15-Yr	0.42	-0.01
US 10-Yr	0.66	+0.02
French 10-Yr	-0.04	+0.08
German 10-Yr	-0.55	+0.04
Japanese 10-Yr	0.01	+0.04

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	5.0	20.3	16.8	13.4
FTSE 250	3.7	17.4	15.8	14.3
FTSE AS	4.8	20.3	16.6	13.4
FTSE Small	4.6	13.7	-	13.8
CAC	3.9	17.5	18.5	13.5
DAX	3.5	19.6	17.5	12.6
Dow	2.7	17.7	21.7	15.1
S&P 500	2.1	19.7	22.6	16.1
Nasdaq	0.9	27.9	27.3	18.2
Nikkei	2.2	18.0	16.4	16.9
MSCI World	2.6	18.7	20.0	15.3
MSCI EM	3.1	13.3	13.6	11.9

UK Mortgage Rates

Mortgage Rates	Mar	Feb
Base Rate Tracker	2.30	2.28
2-yr Fixed Rate	1.42	1.41
3-yr Fixed Rate	1.55	1.55
5-yr Fixed Rate	1.66	1.67
10-yr Fixed Rate	2.61	2.61
Standard Variable	4.09	4.13

* 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.

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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