THE **CAMBRIDGE** WEEKLY

17 August 2020

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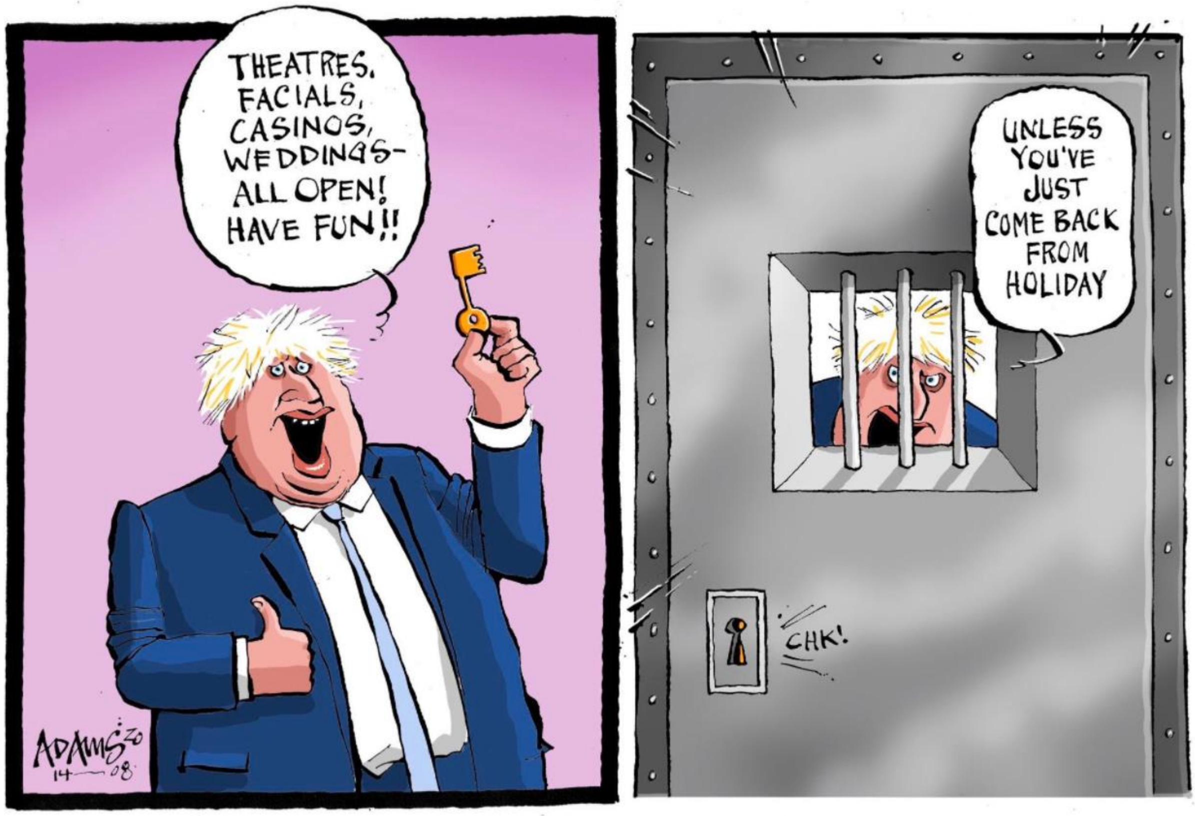


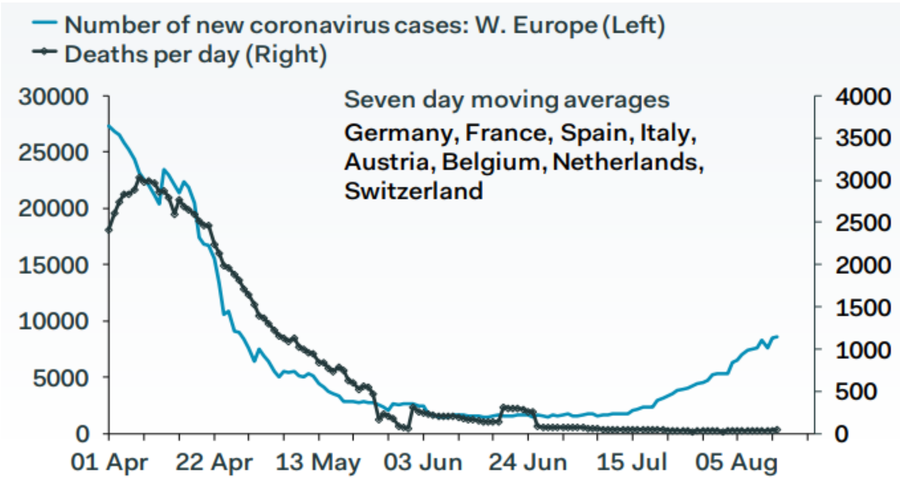
Christian Adams: Confused UK public, 14 August 2020

COVID II the sequel – as scary as the original?

The pleasures, and then increasing discomfort, of the UK's unusually broiling August weather offered a welcome distraction from the seemingly never ending COVID news flow of gloominess. As the heatwave came to an end with a thunderous bang, so too did many of the UK's summer freedoms. The reintroduction of widespread lockdowns at local level, and travel restrictions for most of Europe's holiday destinations, reiterated that the virus has not been overcome and, indeed, we may already be in the midst of a second wave, or at least a formidable resurgence.

Confirmation that the UK suffered the worst economic decline among the G7 countries during the second quarter of 2020 soured the mood further (see separate article). The recent pick-up in the rate of recovery no longer feels quite as encouraging given it hardly looks sustainable against a backdrop of returning activity restrictions.

However, there is a remarkable change in the public health picture compared to the first wave of the pandemic. As the chart below shows, the resurgence of infections across Europe has not led to a meaningful increase in the number of fatalities. It is conceivable that this trend persists on the basis that the affected are mostly the less vulnerable young, care homes are better shielded, and the medical profession now far better equipped in preventing severe cases from deteriorating towards life-threatening stages. Should this be the case, the public is likely to become increasingly reluctant to obey government restrictions as diligently as they did during April and May. Politicians would struggle to maintain the unanimous backing that is necessary to persevere with severe and economically harmful measures that are for the greater good of society. The Netherlands already appears to be heading that way and we would expect the pressure to do likewise will be strongest with those countries whose economies suffered most under the first lockdown.



Source: Pantheon Macroeconomics, 14 Aug 2020

We cannot be sure whether this is indeed the way things will pan out, but we do observe that the economic damage of restrictions is now in a far worse ratio to the potential health benefits they bring than back in April/May.

Before getting too bogged down in the return of COVID news, it is worth mentioning the positives for investors. Stock markets around the world have been remarkably resilient to the turning COVID news flow and have continued to trend upwards, while only briefly interspersed with bouts of downside volatility. Of particular note from a global economic perspective is that the value of the US$ has over the past 3 months fallen between 6 to 7% against the other main currencies. Regular readers will remember that a lower external value of the 'greenback' is stimulating for the global economy, as export prices tend to be quoted in dollars, which increases demand when the lower exchange rate allows exporters to cut prices or earn more on the same volume of trade.

Russia's announcement that they have become the winners in the race to licensing a COVID vaccine has to be taken with the same pinch of salt that we now apply when looking at sporting achievements by Russian state athletes. It is also slightly disappointing that they will only begin mass-production of the drug now, while most other leading vaccine developers that follow the due safety test protocols of the profession like Astra-Zeneca have already put their vaccines into mass production, valuing mass inoculation of the global population the more important objective than the PR stunt success.

It is also worth mentioning that the post-COVID fiscal stimulus restart program in the US is edging towards political compromise (highly likely with the US elections fewer than 100 days away), while there is still US$ 1.7 trillion in government funds waiting on the sidelines to be deployed into the US economy (see separate article). In total, the US programme is thereby of similar magnitude as the European Union's restart package.

We are now half-way through the volatility-prone month of August, and adverse news continue to have the potential to upset stock markets – as last week's extensions of quarantine rules for British holidaymakers has demonstrated. Economic normality is not likely to return in full for a while but, in some sense, the resurgence of infections we are observing is a very good test-bed for our collective ability to cope with the viral threat until an effective vaccine arrives – hopefully in the next six months. Should the level of severe cases remain as low as it has been since the middle of July, then we can put August's pessimism down to feeling excessively hot and bothered.

Please sir! How long will the UK stay bottom of the class?

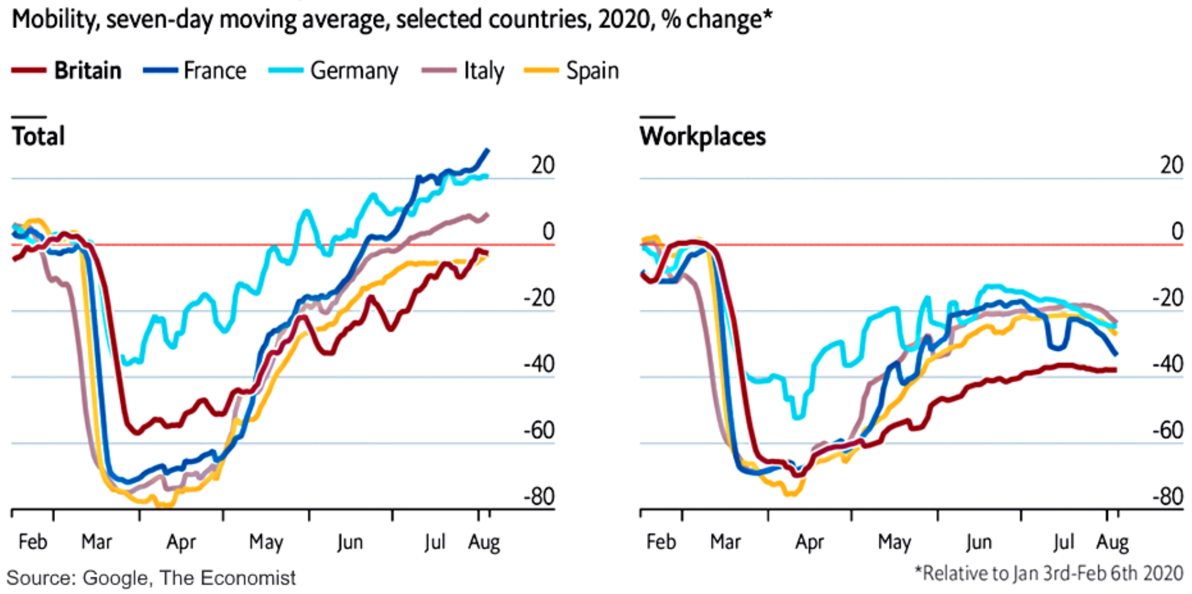
Throughout the pandemic, the UK has been beset by a host of unflattering comparisons. The statistics on virus cases, deaths and other health figures have consistently put Britain as one of the hardest hit countries in the world. Last week, the press focused on a different kind of bad news: In GDP terms, the UK economy shrank more than 20% in the second quarter of the year – making it the worst-performing country in Europe over the three months to July. For the first half of the year, economic activity fell 22.1%. That puts the UK bottom of the table for G7 countries, and ahead of only Spain among its European peers.

Understandably, these statistics make sobering reading. On their release, Chancellor Rishi Sunak told the nation frankly that the "hard times are here". The media ran with stories of 'economic doom and gloom' and the Labour party lambasted the government's handling of the crisis in health and economic terms. But historical comparisons do not tell the whole story. Although this recession is the deepest on record, this is less to do with the shrinking demand of a 'classical' recession, and everything to do with an economy effectively forced to shut down for an unprecedented period. If anything, the nearest comparison would be the economic impact of a natural disaster – minus the physical destruction element.

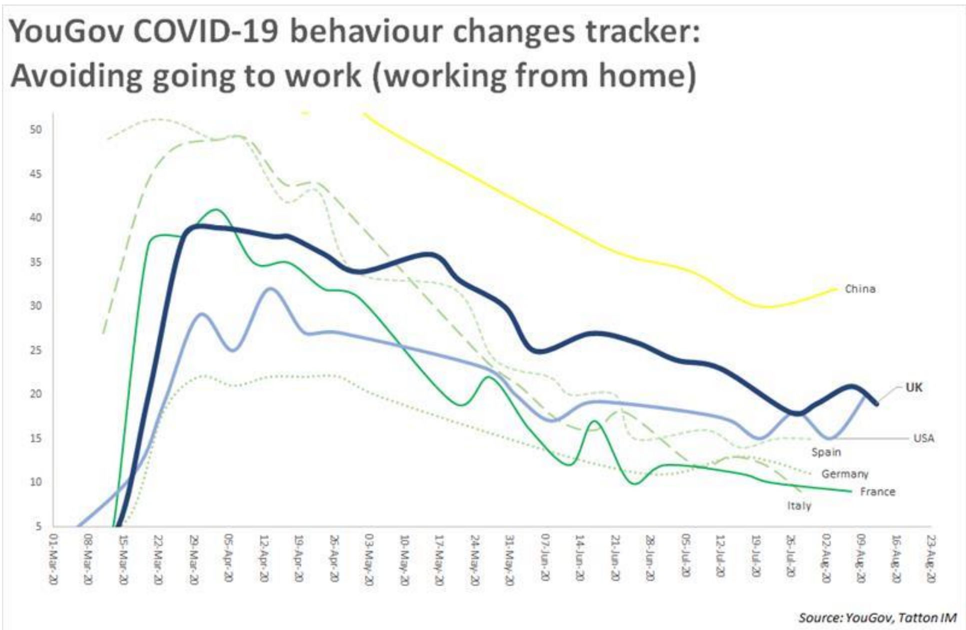
Regional comparisons can also be somewhat misleading. The UK was slower into lockdown than its European peers and – as a consequence of higher virus cases and deaths – significantly slower to open up. As such, the UK spent most of Q2 following instructions to 'stay home, save lives', whereas European nations were gradually opening up their shuttered economies. To illustrate this, the Q1 GDP declines for France, Spain and Italy – where lockdown measures began earlier – were all more than double that of the UK.

Of course, none of that is to suggest that things are all rosy on the home front. That the UK's H1 contraction was among the sharpest in the world – and more than double the similarly slow-into-lockdown US – clearly shows the mountain we have to climb. But there are signs that the recovery has already begun. In June, for example, month-on-month growth came in at 8.7%. With businesses now opening up, some of that rebound was inevitable. But the speed of June's recovery still surprised economists. In fact, June's growth figure is consistent with the Bank of England's most recent forecasts – discussed in last week's update –which many suggested were overly-optimistic about Britain's short-term recovery.

More important than the depth of the immediate downturn is how quickly things can return to something like normal. The high-frequency data on activity – measuring movement, traffic, daily purchases etc. – can give us some idea of this. As shown in the chart below, the UK is indeed lagging its European peers. Again, we should be cautious about how to interpret this, given different lockdown timeframes and possible seasonality effects (with Britons coming out of lockdown straight into the summer holiday season).



Nevertheless, it does seem that the UK public are somewhat slower on their road back to normal. Part of this is likely to be the difference in 'fear factor'. Having experienced a bigger wave of virus infections and deaths than those on the continent, Britons may be keener to avoid public spaces or office environments. The chart below shows individuals' likelihood of avoiding travelling to work, based on survey data from a handful of countries. Although those working from home in the UK has been steadily declining as lockdown has eased, the number remains higher than most others.



Virus fears are one likely cause of this, but we suspect there could be structural reasons for it too. Britain's economy is overwhelmingly based around services. And while many of the client-facing service jobs can only be done in person (such as bar and restaurant workers, whose prevalence perhaps explains the severity of the UK's recession) those who can work remotely are doing so. Many businesses (ourselves included) have found the work-from-home model to be relatively problem-free. And with strict government guidelines on workplace safety, there is little incentive to fill up idle office blocks anytime soon. That is bad news for those working in pubs, restaurants and shops in city centres, but office-based businesses and their employees are increasingly seeing the commute as unnecessary – for now.

Again, we should be cautious about drawing grand conclusions. It is still early days on the UK's road to recovery, and business activity usually gets a little lighter over the summer months. But we can say that the record drop in GDP does not necessarily spell doom for Britain's long-term prospects. Over the next couple of months, when seasonal effects wear off and we get a better idea about how the virus containment is going, the economic outlook will become much clearer.

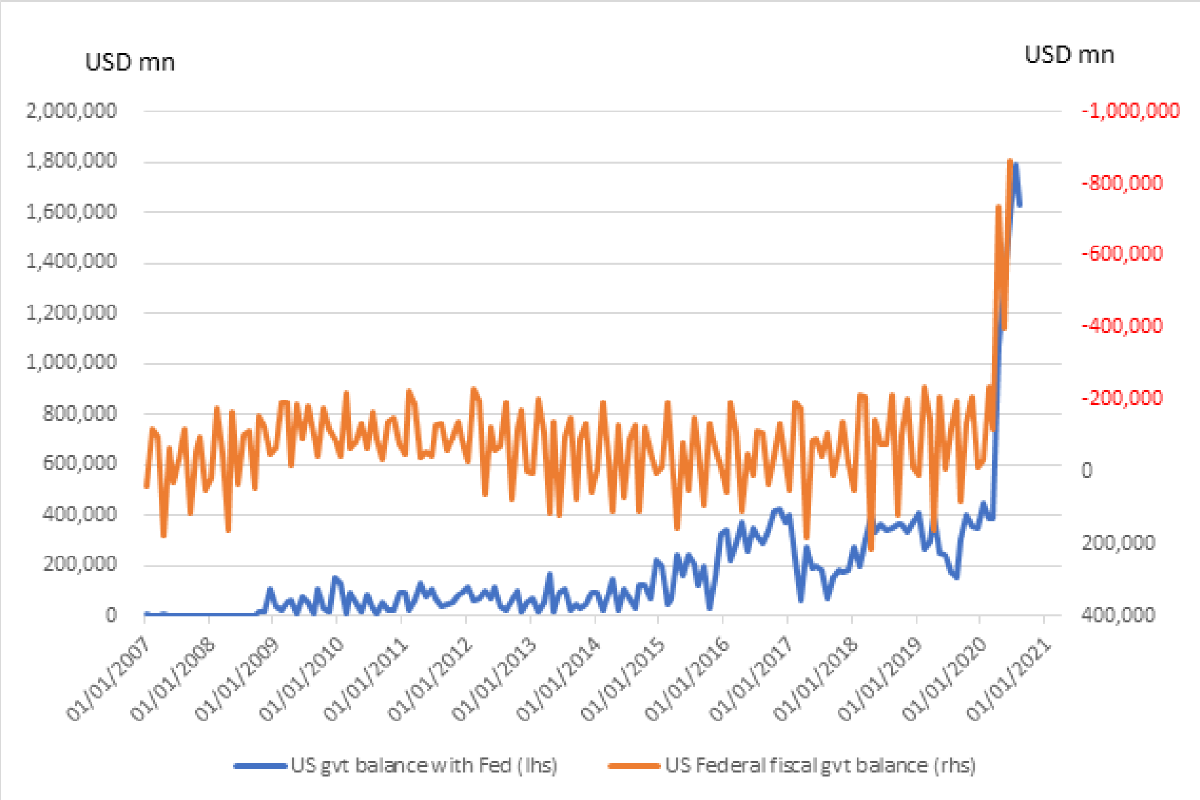
In particular, the government's decision to renew the furlough scheme or let it expire in October will be crucial. If activity is looking more normal, and the public health impact from the resurgence of the virus remains as contained as it is now, letting the economy find its own feet may not be such a terrible idea. But if one or both of those things does not happen, allowing wages – and therefore household incomes – to dry up could be disastrous. And in the meantime, businesses and individuals could be left with crippling uncertainty that would most certainly curtail their willingness to spend. For now, the rumours of Britain's economic demise have been greatly exaggerated.

The US government's intriguing $1.7 trillion rainy day fund

These extraordinary times for the global economy have forced the world's central banks to extraordinary measures. As usual, the US Federal Reserve (Fed) has been one of the chief protagonists during the emergency, cutting interest rates close to zero and funneling trillions of dollars into keeping the financial system afloat. But in recent weeks, we have noticed a counterintuitive, and intriguing, trend. The pace of Fed asset purchases, which spiked to well over $1 trillion at the height of the crisis, has slowed to around $100 billion a month. At the same time, the Fed's excess liquidity – the usable cash it has sitting in the banking system – first spiked up at the start of its emergency interventions, and then started shrinking again to levels seen in 2014/2015. Given the lengths the Fed has gone to during the crisis, this retrenchment seems a little puzzling. What's more, the explanation brings up just as many questions.

Put simply, excess liquidity is the cash which financial institutions deposit with the Fed, and broadly equals the Fed's assets minus some of its liabilities. Those assets are the securities it has bought and the loans it has provided – both of which have shot up throughout the pandemic. Its liabilities include a variety of things, but are mostly cash in circulation, deposits held in Federal Reserve banks as well as the US Treasury's cash holdings in its Treasury General Account (TGA).

The one responsible for the fall in excess liquidity is the latter. Over the last couple of months, the US government has increased its holdings at the Fed by an astonishing amount. As the chart below shows, the cash in the TGA spiked up to $1.8 trillion, and at now stands at $1.7 trillion.



Source: US Federal Reserve, Bloomberg, Tatton IM

When the Fed buys assets (usually US Treasury debt), it generates cash. But should the Treasury choose to keep some of the cash in its coffers, less ends up circulating in the real economy and the financial system. As is well known, the Treasury has been borrowing huge amounts from bond markets in order to fund its emergency fiscal stimulus. But lately, instead of pushing its available cash out to the real economy, the government has been building up its cash reserves.

With the US economy still needing substantial support to see it through the crisis, this cash hording is, on the face of it, bizarre. As such, the multi-trillion-dollar question is: When, if ever, will this money be released into the real economy? This is a question we, and many others, have been looking into for some time – and to answer it we need to understand why it is there in the first place.

Some of the reasons for the government's impressive cash pile are circumstantial. For example, many tax payments were deferred because of the pandemic, and those that have now come in are piling up in the TGA, given that the US central bank also acts as the government's 'house' bank.

On the whole, however, the Treasury's cash piling appears to be planned, with the main reason being money management. The government's fiscal response to COVID has been extraordinary in both its size and speed – even though the US Congress has recently struggled to deliver new measures. To ensure it has the flexibility to keep delivering, the Treasury needs a substantial cash balance. What's more, it looks likely that the US government will have to convert many of the emergency loans it handed out to small and medium-sized businesses into grants. As such, it will need enough on its balance sheet to make the cash transfer. In short, the Treasury is making sure it plans for a rainy day.

There are also bureaucratic reasons, but they appear minor. By law, the Fed is only able to buy a very limited set of assets – mostly US Treasuries and mortgage-backed securities. By creating off-balance-sheet vehicles (SPVs), into which the Treasury pays some equity capital, the Fed can purchase private sector securities. And this equity capital sits also on the Fed's liabilities side.

So, what does all this mean for where the money will end up? Most analysts agree that the Treasury's extraordinary cash pile will come down – meaning more money circulating in the real economy. In the short term, this tends to do more good than harm. But just as important for how the economy fares is the level of yields in financial markets. Low nominal yields have supported risky assets in the market, and have also – together with rising inflation expectations – pushed down real yields in the market. We have written about the latter in the past; as long as this persists, the 'reflation' trade prevails. The government's actions on the bond supply side (through its bond issuance) and the demand side (through its fiscal spending) are vital in determining yield levels.

By having a pile of cash on hand at the Fed, the US government makes it much less likely that it will have to issue more bonds and cause a spike in yields through this draw on capital markets. That is good for riskier financial assets (equities) and for the underlying US economy. With the economy still reeling, and an election approaching, we can be confident that – one way or another – the money will be released at some point. When it does, it should filter through financial markets and into the real economy. That is certainly a positive.

CAMBRIDGE
INVESTMENTS LIMITED

17th August 2020

Global Equity Markets

Market	Fri 16:03	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	6095.9	1.1	63.7	→	↘
FTSE 250	17753	0.7	129.8	⬀	↘
FTSE AS	3400.9	1.0	34.8	→	↘
FTSE Small	5135.9	2.0	102.9	⬀	⬂
CAC	4969.9	1.6	80.3	→	↘
DAX	12895.2	1.7	220.3	↗	→
Dow	27868	1.6	434.0	↗	→
S&P 500	3374.8	0.7	23.6	↗	↗
Nasdaq	10991.5	-0.2	-19.5	↗	↗
Nikkei	23289.4	3.9	871.2	⬀	→
MSCI World	2390.1	1.4	34.1	↗	⬀
MSCI EM	1096.2	0.6	6.9	↗	→

Top 5 Gainers

Company	%
Evraz	10.5
Carnival	10.3
M&S	8.7
Admiral	6.7
GVC	6.6

Top 5 Decliners

Company	%
Direct Line	-6.0
Fresnillo	-5.3
Hargreaves Lansdown	-5.2
Sage	-3.2
Rentokil Initial	-2.6

Currencies

Pair	last	%1W
USD/GBP	1.311	0.4
GBP/EUR	0.902	0.1
USD/EUR	1.18	0.3
JPY/USD	106.49	-0.5
CNY/USD	6.95	0.3
Bitcoin/$	11,710	1.2

Commodities

Cmdty	last	%1W
Oil	44.88	1.1
Gold	1947.6	-4.3
Silver	26.85	-5.1
Copper	286.0	2.4
Aluminium	1763.5	-0.8
Soft Cmdties	365.0	1.2

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.25	+0.11
UK 15-Yr	0.51	+0.14
US 10-Yr	0.70	+0.14
French 10-Yr	-0.12	+0.09
German 10-Yr	-0.42	+0.09
Japanese 10-Yr	0.05	+0.04

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.1	63.7	19.8	13.6
FTSE 250	2.9	45.5	27.1	14.5
FTSE AS	3.9	66.0	20.7	13.7
FTSE Small	3.8	15.3	-	13.8
CAC	2.2	44.0	25.0	13.8
DAX	2.6	38.4	20.2	12.8
Dow	2.3	23.8	25.2	15.4
S&P 500	1.8	26.4	26.1	16.5
Nasdaq	0.8	36.0	31.6	18.6
Nikkei	1.9	37.6	23.4	17.0
MSCI World	2.1	28.6	24.3	15.6
MSCI EM	2.4	18.9	17.9	12.0

UK Mortgage Rates

Mortgage Rates	Mar	Feb
Base Rate Tracker	2.19	2.19
2-yr Fixed Rate	1.41	1.42
3-yr Fixed Rate	1.66	1.67
5-yr Fixed Rate	1.70	1.68
10-yr Fixed Rate	2.37	2.38
Standard Variable	3.66	3.66

* 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

If anybody wants to be added or removed from the distribution list, please email
enquiries@cambridgeinvestments.co.uk

17th August 2020

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.

Lothar Mentel