THE **CAMBRIDGE** WEEKLY

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Lothar Mentel

Lead Investment Adviser to Cambridge

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UK public told to stay at home; Source Bob Moran, 26 March 2020

Extraordinary: bear and bull market all in one month

It is the era of superlatives, the most frequent being "unprecedented". The term is unavoidable and, I suspect, carries a level of unease only comparable to what many of our grandparents must have felt following the declarations of war that heralded World War II. Except that the state of emergency we find ourselves in now is far harder to grasp than a conventional conflict situation.

Perhaps this is why this month stock, bond, currency, commodity and all other traded asset markets which in aggregate we refer to a capital markets have displayed quite extraordinary dynamics. The week's headline is that over the course of March 2020 we experienced both bear market conditions due to falls in excess of 20%, but also bull market conditions with some stock markets this week rising in excess of 20% over three successive days of recovery. On Friday the rebound ended, and the week's recovery now looks very much like the sort of short-term bounce common during bear market periods.

Despite the extraordinary events of last week, history will remember the last week of March 2020 for different reasons. For the UK public the (soft) lockdown came in force and 10 Downing Street (including our Prime Minister) had to quarantine itself as well. From an economic perspective, since last week's update we have experienced governments and central banks taking pretty precisely the action we had outlined. Policymakers are doing their best to quell the worst of existential fears spreading through businesses and households, while hospital staff around the world are fast becoming the unintended heroes of the 2020 coronavirus crisis.

While most people will have found their daily lives have deteriorated significantly over the week, that was not the case from the perception of the economy at large and by extension capital markets. The reason for this is that central banks have enforced sufficiently effective monetary intervention measures to prevent the virus crisis triggering another financial crisis. Governments meanwhile announced sufficiently large economic support programs to create the hope and expectation that the economy – and households – will emerge from the current lockdown reasonably intact, and ready to carry on more or less were they were before entering into hibernation.

This has put a floor (or safety net, if you like) under capital markets, with most participants no longer having to assume that the saving of thousands of human lives will come at the expense of a global depression – at least as long as the economic hibernation does not carry on indefinitely.

For those who think further ahead, and wonder where this may all lead to, it was a week of intense reflection about and a revisiting of economic principles of both monetary and fiscal intervention, monetarisation of government debt through central banks, moral hazard and potential lack thereof. All the while also learning and searching about new insights on the spread and impact of COVID-19, given that the actual turn in fortunes of this recession and bear market will only come about when we can identify the likely end of the pandemic.

As a result of all this, we dedicate one article this week on providing an overview of all the measures that have been announced, and another on how it all works under the title *"Governments and central banks make sure the big wheel keeps on turning"*. This is followed by an insight into how we are affording the measures taken and an assessment of the likely medium to longer term consequences of the absolutely necessary actions of the coming weeks in the article; *"How do we pay for all the fiscal support?"*

The ultimate learning of the week, however, was made by those investors who had thrown their long-term investment plans and beliefs overboard and encashed their portfolios last week or on Monday in a bout of panic and apocalyptic vision. We were very relieved to observe that there were very, very few among our portfolio holders, and we would hope that our unrelenting flow of updates and insights – together with the highly-skilled advisers we work with – contributed to this. However, the rapid 20% recovery evidenced our point that unless investors have some innate ability to know when the bottom of a bear market is reached, then converting their holdings into cash is of not much use. The recovery is likely to happen so unexpected and vehemently that most will miss it, leaving those outside of the market nursing crystallised losses, while those who stayed put will find themselves rewarded for their patience.

Governments and central banks make sure the big wheel keeps on turning

After weeks of nosediving asset prices, the 'whatever-it-takes' attitude displayed by governments and central banks this week has made a difference. The unprecedented level of support set in motion by policymakers has rebuilt enough confidence among investors to send markets shooting up this week, even though they are still showing very significant losses since the end of February. We are not out of the woods yet as far as the bear market volatility goes (which we cover in more detail in the next article) but we can be sure that, without the huge fiscal and monetary stimulus packages announced by governments and central banks around the world, markets would still be trading as if there is no conceivable bottom to the rout.

The same is true of the underlying economy. Without huge levels of support through the rough ride ahead, businesses and consumers would be cut adrift – causing catastrophic long-term damage to the economy and human welfare. Notably, governments around the world have realised that desperate times require not only desperate measures, but coordinated ones. It has been encouraging to see collaboration to stave off disaster for the global economy while society fights COVID-19.

Thursday's G20 'virtual' meeting was remarkable in a number of ways, the most being an estimation that the aggregate value of the global support would reach $5 trillion. The world's GDP for last year was about $89 trillion (according to the World Bank and our estimates), so the support would add an incredible 5.6% to nominal activity. That vastly exceeds the total support measures for the Global Financial Crisis, which totalled 2-3% of global GDP, spread over a number of years, according to the International Monetary Fund.

Perhaps the most crucial point of this coordination is the joint front on fiscal and monetary policy. In short, the strategy most governments are following is to spend big to see their populations through the crisis, while central banks ensure funding by balancing bond markets through virtually unlimited asset purchases (explored later in this update). This combination of fiscal and monetary stimulus is vital to treating the economic impacts of the disease. In past crises – such as the financial crash – problems emanated from one or more particular parts of capital market themselves, and so had be targeted with more specific – and often unpopular (bailout) measures. But this crisis is external and all-encompassing; nothing short of a blanket approach will do.

On the monetary side, central banks are doing everything they can to ensure money keeps flowing through the system. We have become used to massive asset purchase programs since 2008, but the current measures could well turn out to be larger both in depth (amount of bonds and assets purchased) and scope (with central banks buying corporate debt as well as government bonds). Neither the US nor Europe has yet started buying up equity, but the Bank of Japan has been doing so since long before the pandemic and will likely continue to do so. As well as providing liquidity to prevent markets seizing up, central banks will also be indirectly writing blank cheques for governments, and even corporates.

Governments will use that funding to prop up those parts of the economy in forced hibernation. Through business aid, fiscal policy will support the supply side. And through the support for individuals, it will prop up demand. Of what has been announced for far, the measures to support businesses are largely the same. Guarantees, emergency loan access, tax breaks and other payment freezes have all been promised.

On the demand side, however, measures differ by country. In the Anglo-Saxon world, big increases in unemployment and sick pay benefits have been announced, whereas in the large European economies, there has been relatively little change. But this does not reflect a difference in approach to the crisis, but rather a difference in the existing structure of the labour markets. European nations tend to have more generous and robust unemployment schemes already, which quickly kick in (the so-called 'automatic stabilisers') when a downturn arises. In Germany, for example, labour agencies have large reserves which they can quickly deploy in an emergency, and pay out benefits for an extended period of time without the government resorting to extra spending measures.

In the US, the Senate has proposed a $2 trillion package consisting of direct fiscal spending and grants and loans, including of direct cash transfers to citizens (so-called "helicopter money") in addition to unemployment benefits. Meanwhile, in both continental Europe and the UK, the state has promised to keep paying a percentage of people's wages, as well as paying for employers' social insurance. This latter scheme aims to keep up aggregate demand by preventing a short-term spike in unemployment, while allowing companies to keep hold of their employees even when they cannot afford the wage bill. This way, companies will be able to quickly resume business as usual once conditions improve, with no need to start rehiring.

In the UK, an additional complication comes from the larger number of self-employed people compared to the rest of Europe. It looks as though the government's answer is to calculate pay-outs for the self-employed based on their most recent tax returns. The government's efforts appear focused on lower earners (self-employed with annual profits of more than £50,000 won't be eligible). Higher earners could be the big losers from this, and will likely feel more pain the longer the lockdown lasts.

That there will be winners and loser from this is unsurprising. Given the skew of payments and benefits, over the medium and long-term this could translate into something of a redistribution of wealth – away from those with assets and towards the labour force. But all of that will only be possible with the combined weight of the world's governments and central banks. On this front, their willingness to "do whatever it takes" is a welcome sign.

	monetary	**fiscal**
UK	Bank Rate cut to 10bps	Covid 19 spending measures: GBP 50bn (2.3% of GDP) not yet including help for the self-employed but assuming 10% of employees will take up furloughed workers scheme (worth ar. GBP10bn)
	Additional GBP 200bn of asset buying, split between gilts and non-financial investment grade corporate bonds; total APF QE holdings will rise to £645bn,	Loan guarantees for business (GBP 330bn)
	Enlarged term funding scheme TFSME scheme, which provides banks with funding which an be passed on to the real economy.	

	monetary	fiscal
US	Purchases of US gvt treasuries (at least USD 500bn), MBS and agency commercial MBS (at least USD 200bn); hence purchases are effectively unlimited	US 2trn support package (~ 9% GDP), incl. direct fiscal payment and loan guarantees
	Various measures to support the flow of credit to corporates and municipalities, where the Federal Reserve co-operates with the Treasury	Loans for business (USD 500bn): caveat of keeping payrolls whole, along with restrictions on executive pay, dividends, buy-backs, and the like
	Rates cuts down to 0.00-0.25%	Funding for government programmes (USD 500bn). For hospital, medical, healthcare
		Support for small business (USD 367bn) through loans which sometimes can be turned into grants
		Support for individuals (USD 250bn in individual payments, USD 733bn in increased unemployment insurance). (cheque sent: USD1200 per adult earning USD75,000/year or less plus USD500 per child)
		These measures include tax credits for retaining employees, worth up to 50% of employees wages.

	Monetary (Eurozone)
ECB	In total EUR 1.1 trn of buying likely in 2020; pledge it can be more if necessary
	Pandemic Emergency Purchase Programme (PEPP): EUR 750bn until (at least) end of the year. This came on top of ongoing EUR20bn p.m. and additional EUR 120bn until end of year purchases.
	On PEPP:
	Importantly, the ECB will be flexible using its capital / country key, which means the ECB can potentially buy more in countries with acute stress
	Assets: the ECB buys government bonds, corporate credit and non-financial commercial paper (the latter is new)
	Eligibility criteria have been softened, such that Greece is now included in the purchase programme
	Previously, the ECB already softened conditions for its long-term bank funding scheme
	Fiscal (Eurozone)
DE	suspends the debt brake
	EUR 122.5 bn of new spending measures (3.6% of GDP)
	EUR 600bn for Economic stabilisation fund, aimed at bigger corporates: EUR 100 billion for equity measures; EUR 400 billion for guarantees, up to EUR 100 billion to refinance existing KfW special programmes
	Unlimited support for predominantly smaller companies through publicly owned bank KfW (loan guarantee programmes)
	For corporates there is more flexibility on paying taxes
	Short-shift / furloughed worker scheme, which has been used for Germany over years, has looser conditions in response to Covid ; is paid for one year
FR	EUR 45bn (~1.9% GDP) scheme for small businesses, sectors hit by the virus crisis
	EUR 300bn in bank guarantees for companies
	Furloughed worker scheme: 70% of gross pay, up to EUR 6 927 gross per month; minimum income earners get 100%
IT	EUR 25bn direct measures (1% GDP)
INT	Internationally, Central Banks have agreed to USD swap lines which keeps down USD funding pressures.
	Equally, a lot of regulators have relaxed (temporarily) oversight rules for banks enabling them to grant payment holidays to their customers.

Source: National Central Banks and Ministries of Finance, UK IFS,Lombard Street research, Absolute Strategy, newswires

Note: numbers can vary on the back of various factors: direct measures against the virus, automatic stabilisers, uptake of 'on demand' labour market support schemes & how loan guarantees are accounted for

Support measures become the 'ventilators' for the economy; Source: Hedgeye, 23 March 2020

How do we pay for all this fiscal support?

To deal with the fallout from the pandemic, governments around the world have unveiled enormous fiscal and monetary stimulus measures. In Britain, the government has pledged a £50 billion fiscal package in addition to £330 billion in loan guarantees to support businesses and individuals during the tough times ahead; importantly, this also includes a scheme to pay 80% of wages for companies in affected industries. On Wednesday, the US Senate passed a bill promising $2 trillion to support its economy. The package includes direct transfers of $1,200 to each citizen, beefed-up unemployment benefits and provisions for those working in the precarious "gig economy". If the bill passes the House of Representatives, at 9% of total US GDP in 2020 (again including guarantees to businesses which may or may not be drawn) it will easily become one of the largest spending plans in American history.

These fiscal measures are also being backed by unprecedented monetary stimulus from central banks. The Bank of England and the Federal Reserve (Fed) have already slashed interest rates and, together with the European Central Bank (ECB), promised huge asset purchase programs to support the financial system. The ECB has pledged €750 billion to aid the struggling Eurozone economy, and the amount of money the Fed is expected to inject into the system seems to increase every time you check.

Given the chaos currently infecting every aspect of our daily lives, worrying about government budgets and central bank balance sheets might hardly seem like a pressing issue. But still, one might wonder, with all this talk of unprecedented spending and cash injections, how do we pay for it all?

First, even without a clear answer on *how* the bill gets paid, *that* the bill needs paying is beyond any doubt. As we wrote last week, if no spending measures or rule changes were announced, the government-ordered shutdown we are in would be absolutely catastrophic for the economy and – consequently – human lives.

Second, as we've also noted previously, in our current state of 'wartime economy', the government spending seen now should not be thought of as government spending in any usual sense. Governments will dip into bond markets to fund their massive aid programs, and those bond values will be pegged down by the extraordinary monetary injections from central banks. In short, the answer to 'how do we pay for it?' is: we print the money.

That solves the immediate problem of where the money comes from. But of course, it raises plenty of other concerns. Mention of the 'money printing' tactic conjures the memory of the barrels of worthless cash in 1920s Germany and the destructive hyperinflation in 2000s Zimbabwe. When the need for cash is regularly met just by printing more of it, demand for more money from the economy, inflation soars and currency ceases to function, either as a store of value or as a medium of exchange.

That is the usual concern with money printing. But to be clear, few seriously think that the current policy will result in hyperinflation. In the short term, it is unlikely to result in any inflation at all. Economists would describe the current state of depressed economic activity as a deflationary shock. For at least the duration of the lockdown, government measures will at most only compensate for falling demand elsewhere (i.e. falling labour demand from the private sector) and thus the money injected is merely and at best replacing money flows that are no longer occurring.

The fiscal injections are mostly a substitute for payments and transfers that would otherwise go on in the private sector if it weren't for the lockdown. When the economy slows down massively as it has now, less money is created (through loans, bond issuance, capital investment, etc.). Policymakers' hope, then, is that their support measures act just as an equaliser. Central banks provide liquidity that otherwise the private sector, and predominantly private banks and financial markets, would create. Governments and central banks are not adding in extra cash to the economy, there are just making sure enough money flows around to keep the economy whirring and those that had to be 'mothballed' from falling over for no fault of their own.

However, the main complication to this strategy is what happens when we come out the other side. Authorities will want to avoid a situation where emergency support measures are cut off suddenly – and businesses and consumers face a cliff-edge scenario – just as things are slowly returning to normal. That poses a dilemma: if measures are tapered too quickly, economic recovery is choked off and what was a short-term technical recession becomes a sustained one of the conventional type. But if they are tapered too slowly, the economy comes back online while huge amounts of money are still being pumped in. The total monetary base would therefore exceed the total amount of goods and services – causing an inflation spike.

We suspect governments and central banks will be more concerned about the former than the latter. And, as such, we will likely emerge from this crisis with a (slight) inflation bias. This would be particularly true if consumers come out of quarantine wanting to unleash their pent-up demand. This is not necessarily a bad thing. Since the financial crisis, the global economy has been stuck in stall speed, with low growth and low inflation. What's worse, the liquidity central banks have been pumping into the system for over a decade to solve this has mostly found its way into asset markets, leading to artificially-inflated values and bubbles forming in different markets at different times (property, commodities, growth and tech stocks).

Now that governments have agreed that a huge and coordinated response is needed, we could finally be about to see the end of that stagnation. In investment terms, this would bring its own challenges and opportunities (a bad environment for bonds and a good environment for equities, for example). But looking long-term, governments can turn this crisis into an opportunity. If the return to normal includes investment programs to repair the collateral damage caused, as well as creating better preventive healthcare and initiate long overdue infrastructure improvements that create enough economic activity to absorb the additional money in circulation, then it could be just the thing we need to leave the stalled economy behind us.

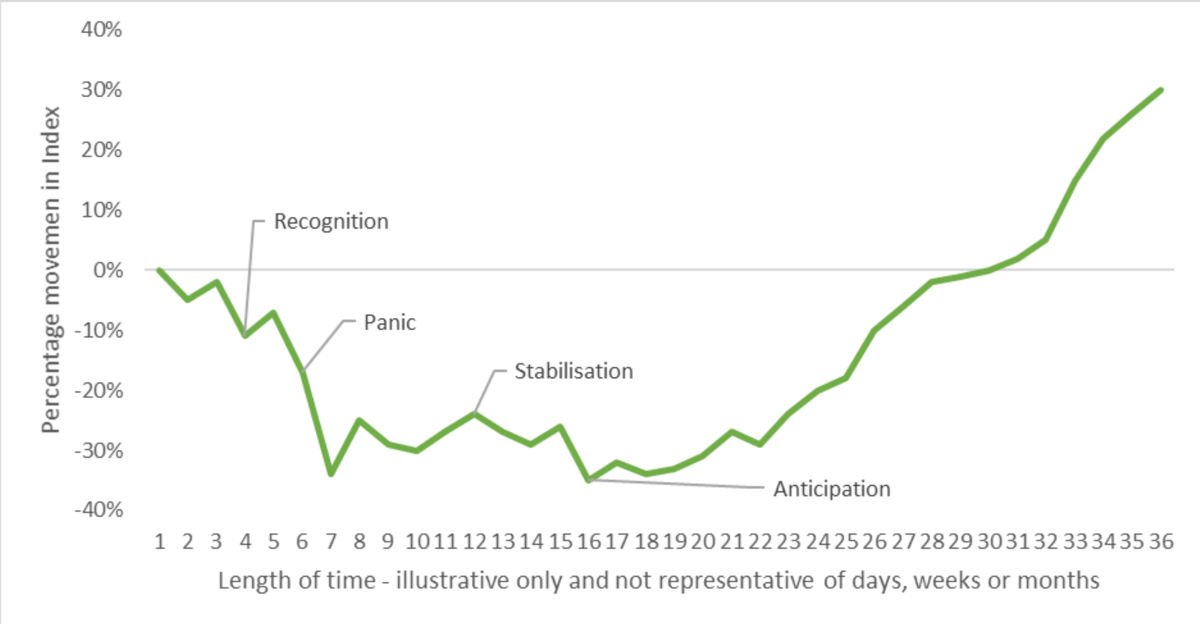
If they fail to take such steps and just revert to their previous strategy, then central banks could be forced to remove the additional money by selling government bonds back into the public domain. We saw what that does after the onset of the Fed's 'quantitative tightening' programme, where yields raced upwards and the global economy slowed right back down. On that note, the Johnson government's pre-COVID-19 infrastructure expansion plans may prove to be just what is needed for the UK when 'all this' is over.

The anatomy of a bear market

After more than a month of sinking asset values, this week capital markets rebounded significantly (before giving up some of the gains again on Friday). The key question is whether the moves we have seen represent a sustained turnaround in market sentiment (and therefore, asset prices) or just a short bounce on the tumble down.

As we wrote here before, the market carnage we have witnessed since the last few weeks of February has already made equities and other assets cheaper in valuation terms, even taking into account the huge cuts in earnings which are likely for this year. Market moves over the last few weeks have been driven more by an extreme liquidity preference than very specific expectations of future earnings or values. And as such, risk premia (the return for taking on a given level of risk) are high. This would normally act as a stabilising force in markets, since those savvy investors who smell opportunity amid the crisis eventually come to outweigh those running for the hills.

Unfortunately, these are not normal times. With the extreme uncertainty surrounding the coronavirus crisis (particularly its duration), fear and the need for liquidity dominates markets. We suspect that, even with the impressive rallies we have seen this week, the bear market we are in has some way to run yet. But we may well have entered a different phase. Thus, it's useful to set out some sort of anatomy to a bear market. John Rekenthaler of Morningstar believes that investors go through four emotional stages, akin perhaps to the Kubler-Ross/Kepler "Stages of Grief". Here is our version of his original from 20 March:



Source: Tatton, March 2020 (graph is not based on actual market data, but a pure illustration based on historic precedents).

Recognition: In the early stage of the sell-off, initial falls are seen as normal, and nothing to particularly worry about. But as prices continue to fall and volatility continues to spike, investors become aware that this time might really be different, and that a quick loss can result in a permanent loss. The current bear market went through this phase at the end of February. Before then, markets were still up slightly for the year. Then, a sudden 11% fall made it clear that the cause for concern was real. Many investors still reassured themselves that these things happen, and volatility is to be expected, but markets failed to hold on to any of their gains.

Panic: Once the realisation sets in, it becomes clear that the usual advice of "buy the dip" is not working. Faced with risks where there are lots of unknowns, human nature is to do something, and quickly. "Sell first, ask questions later" becomes the dominant strategy. And most of the time, that means selling whatever you have. During this phase, rational analysis of future asset values is futile. Asset prices are not a good predictor of future earnings streams because they do not reflect future expectations at all; they merely demonstrate the need for short-term cash. This is the stage we were in for most of March, with losses continually compounded by ever-worse news on the coronavirus crisis.

Stabilisation: Eventually, the panic starts to subside, either because moods change or because the panicked sellers have nothing left to sell. But overall sentiment remains fragile, and market rallies – even the most impressive ones – are short-lived. As such, it is a volatile and turbulent time, potentially stretching on for months. The one redeeming factor is that the bleeding has stopped, and the end is more or less in sight. We have arguably now entered this phase. The rebounds have begun, but are unlikely to be sustained until there is a clear path out of the health crisis.

Anticipation: When the road back to normality opens up, stocks eventually start their recovery. But the news-flow remains grim. It is, after all, always darkest before the dawn. The early recovery usually goes unnoticed by the general public, who are still focused on the dire short-term economic prospects. Long-term investors see improvement on the horizon, however. They make their bids, trading volumes pick up and prices begin to rise. For example, when the market eventually began to rally after the financial crash in late March of 2009, the global recession still had months left to run, and few believed that a market turnaround was already in train.

As mentioned, we are likely now in the stabilisation phase. This is good news as far as limiting losses goes, but it could well be a long and bumpy ride before things eventually get back to normal. The main problem is that the potential for significant economic damage – the 'tail risk' – is extremely difficult to estimate. And for now, investors still seem to be taking a risk-averse approach.

John Rekenthaler makes the point that these stages seem to occur when the bear market is caused by a swift, almost unanticipated recession (or shock). The current situation seems to be of that nature, rather than one which is driven by structural issues such as in the 1970s. So, there is a risk of further dislocation if embedded issues come to the fore later on.

As we said earlier, for a large group of investors, a looming danger of unknown scale creates an immediate emotional need to do something. Fortunately, governments and central banks feel the same need – only their actions work in the opposite direction. While investors are locked in a sell frenzy, authorities are pledging effectively unlimited aid packages to tide the economy over. That provision of a base for economic improvement also significantly reduces the 'tail' risk of very bad scenarios happening. In turn, that helps investors feel more confident about seeing into the future.

While we cannot know when the bottom of the market will come, it may be that policy actions are already reducing the chances of the worst outcomes. We may have stopped panicking and started to deal with the changed landscape.

CAMBRIDGE
INVESTMENTS LIMITED

30th March 2020

Global Equity Markets

Market	FRI 16:46	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	5498.6	5.9	307.9	↘	↘
FTSE 250	14741	8.4	1148.5	↘	↘
FTSE AS	3015.6	6.3	178.6	↘	↘
FTSE Small	4128.5	5.2	203.8	↘	↘
CAC	4339.7	7.2	290.9	↘	↘
DAX	9611.2	7.6	682.2	↘	↘
Dow	21876	14.1	2702.2	↘	↘
S&P 500	2540.4	10.2	235.5	↘	↘
Nasdaq	7666.5	9.6	672.2	↘	→
Nikkei	19389.4	17.1	2836.6	↘	↘
MSCI World	1875.6	13.6	224.6	↘	↘
MSCI EM	851.3	6.0	48.0	↘	↘

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	6.2	15.8	11.3	13.3
FTSE 250	5.4	16.0	10.3	14.3
FTSE AS	6.1	16.4	11.1	13.4
FTSE Small	5.4	-	-	13.8
CAC	4.2	15.8	12.3	13.5
DAX	4.2	16.6	11.4	12.5
Dow	2.9	15.5	15.1	15.1
S&P 500	2.4	16.7	15.8	16.1
Nasdaq	1.1	23.5	20.7	18.1
Nikkei	2.3	17.2	15.8	16.9
MSCI World	2.9	16.5	15.2	15.3
MSCI EM	3.3	12.0	11.4	11.9

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
Legal & General	33.6	Hiscox	-9.1
GVC	32.3	M&S	-8.8
Whitbread	26.4	Centrica	-8.6
Prudential	25.5	Micro Focus Int'l	-7.4
InterCont'l Hotels	24.9	Ocado	-7.4

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.241	6.7	Oil	24.48	-9.3
GBP/EUR	0.892	3.2	Gold	1628.9	8.7
USD/EUR	1.11	3.6	Silver	14.42	14.3
JPY/USD	108.13	2.6	Copper	219.0	-0.0
CNY/USD	7.10	0.0	Aluminium	1536.0	-5.8

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.36	-0.20
UK 15-Yr	0.56	-0.15
US 10-Yr	0.74	-0.10
French 10-Yr	-0.06	-0.17
German 10-Yr	-0.48	-0.16
Japanese 10-Yr	0.02	-0.07

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.

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

Lothar Mentel

www.cambridgeinvestments.co.uk | enquiries@cambridgeinvestments.co.uk
Tel : 01223 365 656 | CB1 Business Centre, 20 Station Road, Cambridge, CB1 2JD