CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

27 April 2020

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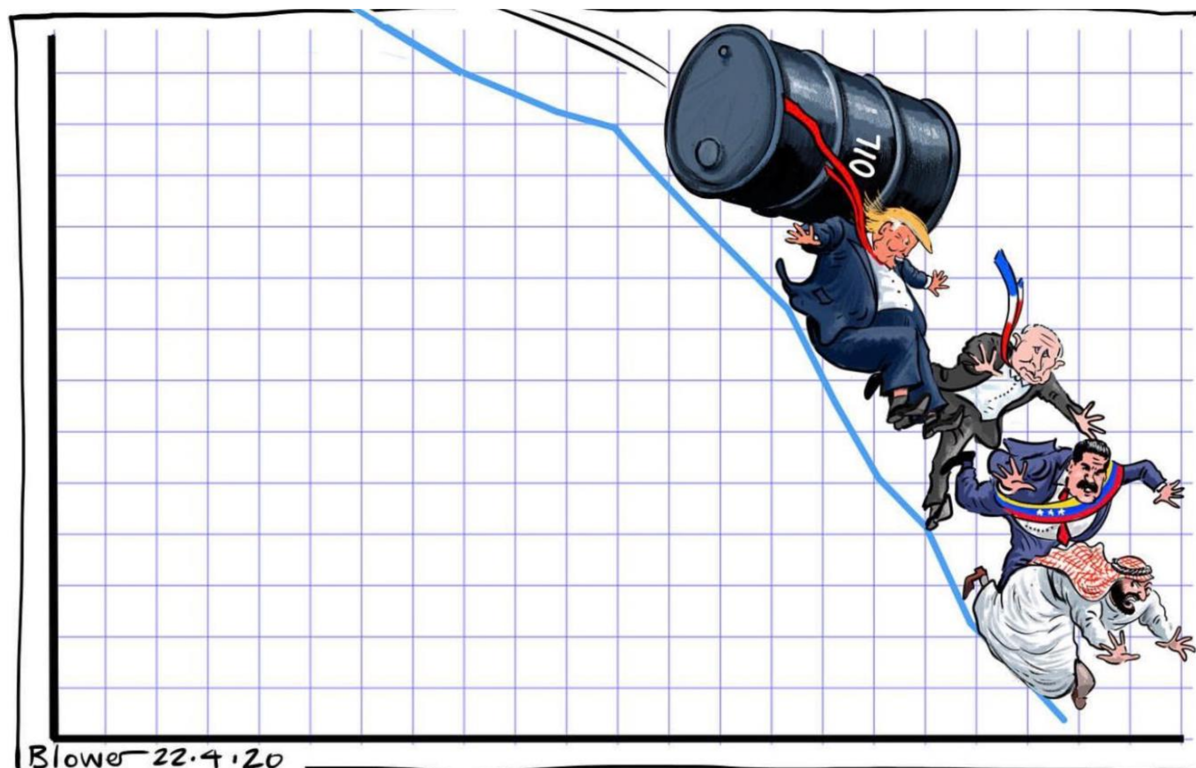


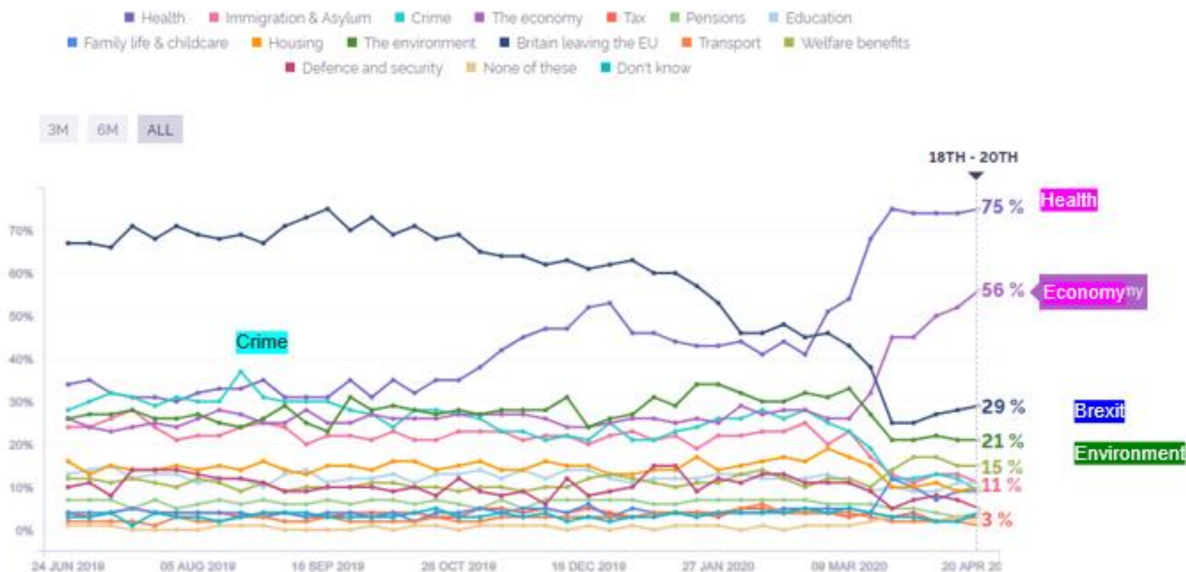
Oil tumble trouble for autocrats; Patrick Blower – 22 April 2020

Trial and error

After making a cameo appearance in the build-up to March's COVID-19 market crash, last week saw oil return in dramatic fashion to reclaim the spotlight. This time the performance veered almost into parody, with the oil price falling into the negative in US markets, thereby displaying price dynamics previously thought impossible. However, just like other 'unprecedented' macro-economic data points that we predicted would start to filter through, the story behind the headlines only relates to very near-term misbalances between excess oil supply and much-reduced current fuel demand – negative prices occurring due to the nature of fixed time delivery contracts versus very limited US storage capacity. Stock markets reacted to this oil news story with far less lasting excitement than in March and, after a day of downdraft, instead continued on their path of upward consolidation. We have dedicated a separate article this week to the oil price dynamic, because within the forward contract nature of oil we have noted an underlying market predicter for the return of economic normality over the coming weeks that appears to be worth monitoring.

Indeed, 'peak lockdown' appears to have replaced 'peak virus' as the most discussed topic, not just in finance circles, but up and down the country and internationally. As daily news registers falling fatality numbers and healthcare systems coping without the need for 'triage' decisions by hospital staff, attention appears to be turning towards the economic damage versus loss of life trade-off that was initially accepted with very broad support. The fast-increasing focus on economic concerns shown in the YouGov chart

below is not limited to the UK and has created the impression that we have passed the peak of global activity lockdowns.



Source: https://yougov.co.uk/topics/politics/trackers/the-most-important-issues-facing-the-country

While many have warmly welcomed the idea of a gradual relaxation of the strictest lockdown constraints, for those working hard at assessing the probabilities for a fast and sharp recovery (the famous V-shaped version) versus a protracted slowly-slowly return of economic normality (the less popular U-shaped version) it has been a week spent comparing what can best be described as 'trial and error' national approaches.

The comparisons offer a range of different scenarios. China is clearly ahead and their fast improving economic indicators tell us they have managed to turn their economy back on. However, this is focused on the manufacturing sector, while any part of the service sector that involves close human to human proximity remains dormant. The reason for this is a very strict "track, trace and isolate" policy, based on a mobile phone app that regulates individuals' ability to access places outside their home depending on previously-recorded movements and encounters. Any accidental encounter that was more than a mere passing in the street with anybody who later tests COVID-19 positive means going back indoors into strictest 14-day quarantine.

This 'hiding from the virus' approach has proven highly effective in preventing higher fatality rates, but comes at the cost that unless a cure or vaccine becomes available in short order, society remains exposed to the risks of a second wave and therefore has to remain in an economically painful soft lockdown for the time being.

Sweden and some Developing World countries have deliberately (or out of sheer inability to afford economic lockdown) chosen the other extreme. This approach has aimed for self-immunisation through infection, also referred to as 'herd-immunity', by allowing the virus to spread slowly and thereby paying the

price of a higher fatality rate amongst – in particular - the elderly and vulnerable. Clearly, once a population reaches 'herd-immunity' the risks – to public health and the economy – of a second wave disappear.

Most western industrialised nations, including the UK, find themselves somewhere between China and Sweden – usually out of coincidental combinations of lockdown timings and varying hospital bed capacity. Should effective anti-viral drug treatment prove impossible in the near term, and mass vaccination roll-outs arrive only in 2021 as predicted, the Swedes' herd immunity approach could turn out to have been the winning strategy, as long as they can maintain public backing by keeping fatality rates to levels no higher than elsewhere in Europe.

Should COVID-19 suddenly disappear in May – as SARS did back in 2003 – or the pharmaceutical industry wins the race, then the Chinese approach of buying time through quarantine would be deemed to have made the most reasonable balance between the human and the economic cost.

Politicians everywhere will be following the relative success of both approaches very closely over the coming weeks. That, together with each countries' ability for mass infection and antibody testing will inform their decision making. It would appear each countries' speed and ability of returning to pre-virus activity levels will determine whether their recoveries will follow the V or the U recovery pattern. The increasing focus on the looming economic consequences amongst western societies leaves us wondering whether politicians will soon find their ability to take decisions severely hampered. It is therefore not inconceivable that 'peak-lockdown' has passed, no matter what warmer temperatures and pharmaceutical progress may hold.

Over the past few weeks we have noted the friction between the resilience of stock markets against the backdrop of truly shocking – down to levels never recorded before – economic dataflow. We suspect that the growing determination to countries 'get back to work' has to do with this resilience. However, beyond what we discussed last week, stock markets are also possibly being bolstered by asset price inflation, given the inflationary tendencies of the extraordinary monetary support measures that have been enacted over the past six weeks, and with the prices of goods and services suffering a deflationary demand and supply shock. This at least was what we observed and learned during the post financial crisis rounds of central bank QE.

All this still does not leave us with any more conviction than 50/50 odds that March will prove to have been the worst month of this COVID-19 bear market – however long it lasts. That said, it is important to remind ourselves that past recessionary periods can offer little guidance to this current crisis, and that global stock markets – and asset prices – are undergoing their own period of trial and error.

What the negative oil price tells us – beyond US storage incapacity

As widely reported on the news, this week the impossible happened. The price of American oil sank so low that it went below $0 – and then some. On Monday, WTI – the benchmark for a barrel of US oil – saw its May contract end trading at -$37.6. Stories like this call for something a little stronger than the well-worn "unprecedented" label. Never before have oil traders been willing to pay to have delivery contracts taken off their hands. For many, how this could occur is somewhat confusing. For others, it is a glaring sign of how much trouble the global economy is in.

To clarify, a negative oil price does not mean anyone is getting handed a chunk of cash the next time they fill up their car. Whoever is holding an oil futures contract on the day of its expiry has to take the physical delivery of crude. But a barrel of crude oil is not something you can store in your basement (it is extremely toxic if not ventilated properly). And the massive oversupply of oil we have been experiencing for the past few months – as a consequence of collapsed fuel demand for transport – is expected to soon max out US storage capacities. On Monday, this culminated in a huge frantic sell-off, with WTI sinking around $56 throughout the day as traders sought desperately to avoid being stuck with the delivery.

The price of oil can be a key indicator of the health of the global economy – with demand for energy effectively a proxy for economic activity. But we should not take Monday's incredible price event as signalling an oncoming economic apocalypse. That much is common sense: if it really were an accurate indicator for global demand, it would mean that businesses and individuals were so unwilling to consume that they had to be paid for it.

The dramatic collapse of WTI into negative territory is almost entirely due to the peculiarities of futures trading in commodities, and the structure of the US oil market. Unlike other oil-producing nations, the US lacks the ability to export much of what it gets out the ground. This means that when demand falls and storage gets overrun, they have nowhere else to go. In contrast, on the same day, Brent Crude – the international and arguably more important oil benchmark – stayed positive at over $20 per barrel.

Nevertheless, the factors underlying this extreme event are significant. The global economy is in an induced coma and demand has taken a significant hit. At the same time, Russia and Saudi Arabia – the world's two largest oil exporters – have only just called a truce to the price war that had been intended to drive out weaker competitors, by ramping up production which will continue to flood the markets at least until May. We now have a huge oversupply of crude oil, to the point where tankers are increasingly used as additional storage facilities as land-based tanks are already at 75% capacity. This backdrop explains why US oil prices managed to sink as low as they did.

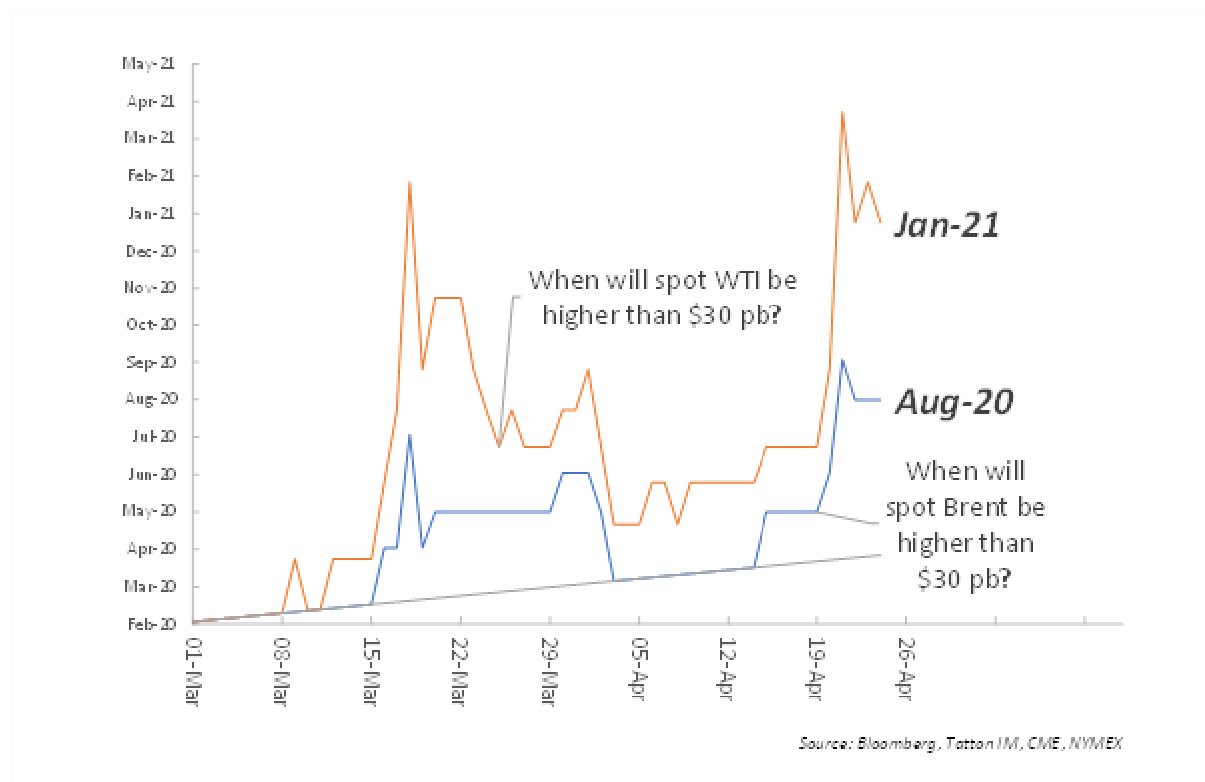
What this means for capital markets and the global economy is difficult to say. The world has a complicated relationship with oil. On the one hand, energy prices effectively act as a tax on global activity. So, when oil prices fall, everyone gets a cut in their costs. On the other hand, the oil industry is so huge that its own internal investment cycle has a massive impact on the global economy; oil companies have been among the world's largest spenders on physical infrastructure, plant and equipment for much of the last ten years. Much is also made of the fact that oil companies' dividends make up a substantial amount of pensioners' income pay-outs.

When oil prices went through a sustained slump four years ago, it triggered the second of the three mid-cycle slowdowns experienced by the manufacturing industry during the extended economic cycle that followed the global financial crisis. It also raised widespread concerns that it could lead to series of defaults that would destabilise the global economy.

These factors are so great that Donald Trump – president of the world's largest consumer of oil – recently spoke of the need for a higher oil price. Even China, where imports account for over 70% of oil demand, has called for a resolution on price stability to protect the investments of its large state-owned energy companies.

But there are reasons to be calm about the situation. Governments and central banks are working extensively to make sure defaults do not spike throughout the pandemic lockdown. Therefore, the risk of contagion spreading to the capital investment side of the equation looks like less of an issue than in the past. Besides which, the effect on investment is a short-term problem. Looking beyond the next few months – when the world is (hopefully) opening up for business – lower energy prices could prove to be another valuable stimulus boost that businesses and consumers need to get back on the road to recovery.

All of this suggests we should not read too heavily into Monday's incredible events. Near-term oil prices are not always an accurate reflection of the health of the global economy. However, there is another sense in which oil is a useful economic indicator. The longer-term oil futures market tells us what traders expect the price to be in the months and years ahead. Given that oil prices are so heavily tied to economic activity, we can therefore see when markets expect the global economy to 'return to normal' by looking at when they expect oil prices to do the same. Let's call a 'normal' oil price $30 per barrel (there was an oversupply issue even before we entered the virus lockdowns). The chart below shows when markets expect the different oil benchmarks to cross this threshold, plotted over time (the horizontal axis shows the past two months and the vertical axis shows the implied point in time when the price is expected to reach $30 per barrel again. So, up until the middle of March, both WTI and Brent were expected to reach $30 sometime in early April).



As we can see, over the last month and a half, the market has been consistently predicting a return to normality some time over the summer (for Brent, at least). Over the last week, however, those expectations have been pushed out massively. This is worse for WTI (focused on the US), but even Brent is now showing a return to normal only around October – and is being pushed further and further into the future.

There are exacerbating factors to this. The secular transition from fossil fuels toward sustainable energy, and the latent oversupply position we started with, makes oil price moves more difficult to read into in general. In particular, we suspect the government-led investment push following this crisis may well focus on stimulating the economic recovery through investment in green solutions – to the detriment of oil prices. Nevertheless, if 'normal' oil price expectations keep being pushed further out, that indicates increasingly dire expectations for the likely point of the effective reopening of the global economy.

This, we suspect, is the real cause for concern behind the 3-4% stock market sell-off at the beginning of the week. Drastic near-term falls may make the headlines, but it is the market-implied assessment of 'lower for longer' in oil markets that signals the real harm. We know that this new predictor does not carry the same 'wisdom of the masses' predictive quality of some other market-implied indicators that are derived of forward contracts. For the time being, we can only hope that sustained low energy costs will boost the discretionary spending of businesses and consumers (as was the case in 2015/2016) and make a meaningful contribution to the post-lockdown global economic recovery.

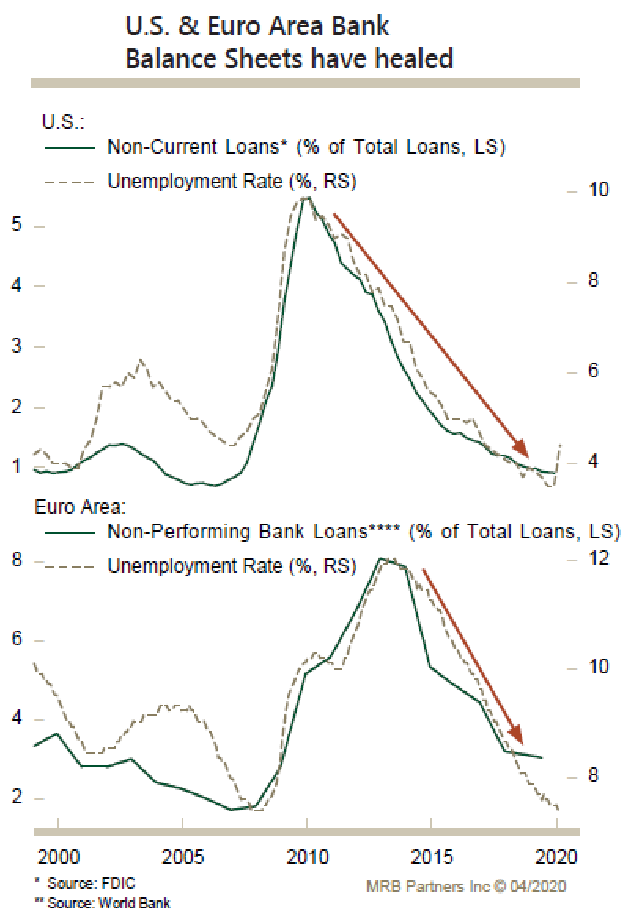
Good Bank, Bad Bank

We are used to banks being front and centre during times of economic and financial crisis. But this time around, banks are not being cast as the main bad guys in the media narrative. We regularly see stories of businesses big and small struggling to cope with the lockdown, but there has not yet been any Lehman Brothers moment and hardly anyone is expecting one soon (touch wood). Why not?

Well, for starters, the cause of the crisis had nothing to do with the banks. The pandemic is an external shock entirely unrelated to any systemic financial risks. More importantly, the financial system itself is far better equipped to deal with external shocks than back in 2008. That was, after all, the whole point of the post-financial crisis reforms. Institutions were shown to be ill prepared for a downturn, having become undercapitalised and (in many cases) grossly negligent of their own duties in the early 2000s. They were told in no uncertain terms by politicians, regulators and the general public that they needed to do better.

In other words, the financial sector had its own apocalypse over a decade ago and has (under government orders) built up its defences since then. Not only are banks better capitalised and subject to regular stress-tests, compared to much of the wider economy, they are now well-equipped to handle working remotely too. Still, the fallout from a sustained global shutdown would be enough to ruin even the most well-prepared business. Policymakers responded to the coronavirus crisis by relaxing some of the most stringent regulatory features. But most importantly, the fact that governments and central banks are committed to

preventing the worst-case scenario – mass defaults – has limited the risks for lenders. Central banks have stepped in to underwrite systemic financial exposure. And if no one defaults, there is no banking crisis.

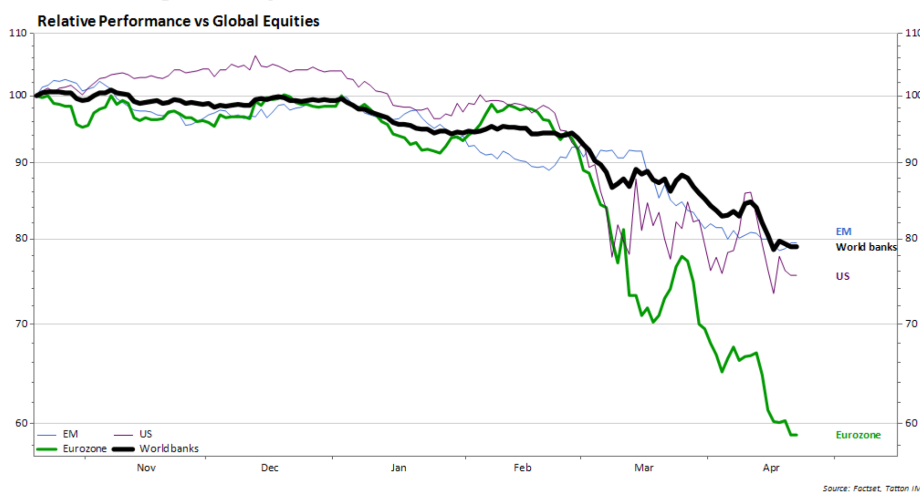


The problem is that there will be defaults. Unfortunately, all the political will in the world can't save everyone. This is especially true given that, so far, governments have chosen emergency loans as the mechanism to get cash to struggling businesses. Banks are therefore obliged to assess businesses through their standard lending procedures. We have seen in the UK how many firms have been unable to secure credit that politicians announced would be available to them At the time of writing, £2.8 billion in loans have been agreed through the Coronavirus Business Loan Interruption Scheme, but only 16,624 applications have been approved out of 36,000 applications received. Banks are working through the backlog, but even those businesses that have been successful have faced delays in getting their hands on the actual cash.

Even without a widespread banking crisis, we can expect bank results in the short term to be dire – it is after all one of the most cyclically exposed of all business sectors. Already they have had to make provisions in anticipation of growing numbers of loans turning sour on their books. And, as we have seen over the last decade, with interest rates now expected to remain lower for even longer, profitability will be hard to come by. You don't have to be a financial cheerleader to recognise that this could become a more serious problem as the lockdown continues. Governments, businesses and investors are all banking on a strong economic recovery after the pandemic subsides. But a banking system saddled with non-performing loans

(NPLs) lacks sufficient capital headroom to be able to provide credit. An economy that cannot borrow will be seriously held back in its ability to recover quickly.

This is particularly a problem for smaller businesses, who cannot dip into corporate credit markets and instead must rely on traditional lenders. If they suffer, this stops being a short-term shock problem and becomes a sustained systemic one.



That is a risk for everyone around the world, but not an equal one. In the US, banks tend to be more market-focused, with corporate financing secured more through credit markets than small bank loans. In Europe, traditional bank lending plays a much larger role. To make matters worse, European banks already went into the virus trouble with a large NPL pile of around €506 billion, or 3.2 per cent of their loan books compared their global peers. Italy and Greece have huge amounts of bad debt left over from the financial and Eurozone crises. This debt has been extremely damaging to growth over the last decade and is now proving a bad pre-existing condition for both countries' ongoing financial health and post-virus recovery potential.

In Europe, the solution now being discussed is the creation of a 'bad bank' – whereby banks can section off their NPLs into one pot to free up their balance sheets for new lending. Officials from the European Central Bank (ECB) have reportedly been in talks with Brussels over setting up a Eurozone-wide 'bad bank' to remove billions in bad debt from banks' balance sheets – a tactic which in the past has proven instrumental in getting the economy back on track.

Like everything in Europe, however, huge political obstacles await. A continent-wide bad bank could smell like debt mutualisation to the Northern member states – an idea that has been flat-out rejected whenever brought up previously. Moreover, as a consequence of post-crisis regulation, any kind of debt relief for banks will be extremely hard to come by. The Bank Recovery and Resolution Directive (BRRD), set up after previous crises, is designed to shield taxpayers from taking on any liabilities from the private sector without creditors being bailed in beforehand. As such, the situation would have to get very dire before a bad bank could be sanctioned. That said, existing NPL securitisation schemes established in Greece and Italy have not been considered in outright contradiction with the BRRD.

In any case, desperate times can call for desperate measures. The BRRD makes perfect sense when individual banks run into trouble – keeping the public off the hook for reckless lending. But when the sector

as a whole is facing disaster – for problems entirely unrelated to their own management – its justification is flimsy. European leaders have proved stubborn as ever in their economic response to the virus crisis, but if ever there was a crisis that could jolt them into action it should be this one.

We think that the creation of multiple bad banks at the national level is a more likely prospect. That would bypass the political problem wherein some member states feel they are bearing the economic burden of others. But it could also prove less effective. In any case, interpretation of the BRRD would likely have to be softened for any bad bank to work.

The solution is there – the issue is whether European politicians will take it. But the longer this global recession drags on, the more impetus there will be to do so. And while at the moment this is a European issue, we should not be surprised if other countries start talking about bad banks too. If that does happen, perhaps European leaders will feel more inclined to act.

Global Equity Markets

Market	Fri 15:50	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	5784.0	-0.1	-2.9	↘	↘
FTSE 250	15775	-0.5	-84.4	↘	↘
FTSE AS	3185.4	-0.2	-4.8	↘	↘
FTSE Small	4548.8	-0.7	-31.2	↘	↘
CAC	4408.7	-2.0	-90.3	↘	↘
DAX	10403.9	-2.1	-221.9	↘	↘
Dow	23531	-2.9	-711.4	↘	↘
S&P 500	2804.5	-2.4	-70.0	↘	↘
Nasdaq	8521.3	-1.5	-128.8	→	↗
Nikkei	19262.0	-3.2	-635.3	↘	↘
MSCI World	1974.4	-2.1	-43.1	↘	↘
MSCI EM	891.8	-1.1	-9.5	↘	↘

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	5.3	16.6	15.3	13.3
FTSE 250	4.3	16.8	14.4	14.2
FTSE AS	5.1	17.3	15.0	13.4
FTSE Small	4.7	13.4	-	13.8
CAC	4.0	16.1	17.3	13.5
DAX	3.9	17.8	16.2	12.5
Dow	2.8	16.6	20.4	15.1
S&P 500	2.2	18.5	21.2	16.1
Nasdaq	1.0	26.6	25.6	18.2
Nikkei	2.3	17.0	15.8	16.9
MSCI World	2.7	17.5	19.0	15.3
MSCI EM	3.1	12.7	13.1	11.9

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
Taylor Wimpey	12.2	TUI	-16.3
Persimmon	10.6	Burberry	-12.3
Berkeley	7.2	Hiscox	-11.8
Barratt Devts	7.1	easyJet	-10.5
Admiral	4.8	Pearson	-10.0

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.235	-1.2	Oil	21.61	-23.0
GBP/EUR	0.875	-0.7	Gold	1725.0	2.5
USD/EUR	1.08	-0.6	Silver	15.20	0.2
JPY/USD	107.45	0.1	Copper	232.1	-1.0
CNY/USD	7.08	-0.1	Aluminium	1510.0	-0.2
Bitcoin/$	7,475	5.9	Soft Cmdties	303.0	-3.3

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.29	-0.01
UK 15-Yr	0.49	-0.02
US 10-Yr	0.60	-0.04
French 10-Yr	0.03	+0.00
German 10-Yr	-0.46	+0.01
Japanese 10-Yr	-0.02	-0.04

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.

Lothar Mentel