THE **CAMBRIDGE** WEEKLY

4 May 2020

Lothar Mentel

Lead Investment Adviser to Cambridge

Lock-down, Open-up

In April, the virus ended the lives of over 190,000 people across the world. Of those, 13% were in the United Kingdom, nearly 25,000. The UK has been one of the worst affected countries during this pandemic. The US has suffered a similarly heavy death toll, with nearly 58,000 deaths recorded with the coronavirus as a cause.

It seems remarkable that, as we enter May, an end to 'lock-down' is either underway or being considered. Many will think it not just foolhardy but morally wrong. Yet the slowing of the rate of change in underlying cases and fatalities is allowing the discussion to progress.

"Open-up" is expected to be announced here in the UK next weekend. Nobody thinks enforcement will end completely. Steven Bell, the much-respected Chief Economist at fund managers BMO expects something along these lines for the UK:

Easing the lockdown:
a possible schedule

End May / June	More retail opening; limited return for schools; some sport; manufacturing begins to restart
July	Hairdressers and beauty salons reopen with strict limits, Pubs & restaurants with outside facilities reopen
August / September	Schools & universities reopen with severe restrictions
November / December	Social distancing relaxed for non-vulnerable groups
2021	All restrictions gradually relaxed

The template will be similar elsewhere.

Enforcement is different to how individuals and groups will feel and actually behave. Governments have to be guided both by the science and the views of its people. In the US especially, views have become so deeply intertwined with politics that the Michigan State Capitol Building had rifle-toting members of the public attending a vote to end the Democrat governor's lockdown law.

Thus, the sense of "open-up" in the US is perhaps stronger than elsewhere, which has affected not just their politics but also their markets. That means that should the science start to conflict with the policy, there may be a renewed bout of volatility on the downside.

"Open-up" is strongly helped by early but undeniably positive news regarding treatments. US pharma company Gilead announced that the early trials for Remdesivir (the treatment developed for the Ebola virus) has been (probably) positive in terms of recovery outcomes and thus confirms previous anecdotal evidence.

If nothing else, this reduces fear. It reinforces the belief that medical science can save the day, even if that day is still in the future. Bill Gates said this on Thursday: "The world is creating this vaccine on a historically fast timeline. Dr. Anthony Fauci *(the US's Chris Whitty-equivalent)* has said he thinks it will take around eighteen months to develop a coronavirus vaccine. I agree with him, though it could be as little as nine months or as long as two years."

Even at nine months, that's a long time. But people, businesses and markets can see an end, a resumption of "normal".

In the meantime, governments and central banks (which met last week) have our collective backs. In the US, Federal Reserve Chair Jerome Powell reaffirmed the commitment to do whatever it takes in his post-meeting statement following the 28-29 April meeting:

"In determining the timing and size of future adjustments to the stance of monetary policy, the Committee will assess realised and expected economic conditions relative to its maximum employment objective and its symmetric 2 percent inflation objective. This assessment will take into account a wide range of information, including measures of labour market conditions, indicators of inflation pressures and inflation expectations, and readings on financial and international developments."

There is no direct mention of financial markets, despite markets having improved substantially since the 19-20 March meeting, which is a good thing for investors. Economic indicators will be slow in showing a resurgence as and when it happens. The central banks, particularly the Fed, will wait to see it in the data, and that data emerges one or two months after it happens. Earnings expectations will increase before that, and markets will go up before analysts publish those expectations. That means the Fed won't start taking back the liquidity just because the markets have gone up.

Equally if the economy has reason to head back down, perhaps because of a new spike in virus cases, we can expect yet more central bank liquidity and government fiscal support.

The European Central Bank (ECB) also held its meeting last week, which contained another slice of good news. They appear to have devised a way to buy government bonds by proxy – funding regional banks at levels below market interest rates while removing the constraint that the funds must go to private sector borrowers. In other words, banks have been given the green light to buy their national governments' bonds and make money. This will effectively overcome the bank profitability challenge we discussed in last week's edition that comes as a side effect of a low interest rates and could have held back a swift recovery. Governments can then provide the profit for banks and spend the proceeds on public investment.

It's not absolutely clear that this is what is intended or, if it is intended, whether it will be effective. Goldman Sachs pointed out the subsidy would currently benefit only the Italians, and that both the time and size limits of PELTRO (Pandemic Emergency Long Term Financing Operation) mean banks could really only buy short-term maturities, not long-dated bonds. Still, share prices for European banks bounced strongly.

There were other welcome signals; the US dollar's recent bout of strength may have come to a close, both against developed and emerging market currencies. Sterling hit $1.26 before falling back (after Shell's disappointing dividend cut). Commodities strengthened mildly, as did oil, provided you squint at the prices for delivery later in the year.

This has added up to a better week for cyclical shares. And while we never want investments to perform poorly, it is a healthy signal when tech is not the only winner. The big tech names reported last week, and Apple announced much better sales than expected. Amazon did well on sales, but its margins were surprisingly much weaker than expected.

Before anybody gets too excited about the latter, we would note that now is not a great time to appear to be a winner. We have entered into a period where there will be many who have not done so well, and with a very important US presidential election now only six months away. Physical retailers are disappearing fast and, with them, lots of jobs. Jeff Bezos is already the world's richest man, and he can sustain a bit of underperformance of his stock-holding.

For the time being, May brings opening up optimism to capital markets, which has extended the good news of the fiscal and monetary support of April. Together, this has meant investors worldwide have continued their streak of good fortune from the post-global financial crisis period, and experienced a far less painful hit to their personal fortunes than they could have reasonably expected given the depth of recession we find ourselves in. Our monthly asset class returns table below shows the broad base of the rebound during April and, at the same time, contains some of the highest single-month returns since the autumn of 1987. If it later turns out to have been no more than a bear market rally, it will have been one of 'unprecedented' size and rigour.

Asset Class	Index	April	YTD	12 months	2019	5-yr rolling annualised	3-yr volatility
Equities	FTSE 100 (UK)	3.9	-20.9	-17.1	17.3	0.7	13.9
	FTSE4Good 50 (UK Ethical Index)	3.4	-21.1	-18.0	13.9	-2.5	13.3
	MSCI Europe ex-UK	4.4	-13.9	-8.0	20.0	0.4	13.8
	S&P 500 (USA)	10.9	-4.7	4.2	26.4	13.5	13.2
	NASDAQ (US Technology)	13.5	4.4	14.7	31.4	13.7	16.4
	Nikkei 225 (Japan)	3.6	-7.9	0.3	15.0	-0.1	14.6
	MSCI All Countries World	8.8	-8.6	-1.8	21.7	4.4	14.9
	MSCI Emerging Markets	7.3	-12.4	-9.1	13.8	-0.1	17.4
Bonds	FTSE Gilts All Stocks	3.0	9.5	15.0	6.9	5.8	5.7
	£-Sterling Corporate Bond Index	6.3	0.3	6.1	11.0	4.8	6.0
	Barclays Global Aggregate Bond Index	0.2	6.7	10.1	2.7	7.0	7.9
Commodities	Goldman Sachs Commodity Index	-11.2	-45.3	-46.5	13.1	-16.3	24.1
	Brent Crude Oil Price	-1.2	-57.9	-62.0	17.9	-17.0	38.5
	LBMA Spot Gold Price	5.2	18.4	38.1	14.2	7.3	10.0
Inflation	UK Consumer Price Index (annual rate)*	0.0	0.1	0.9	1.3	-	1.05
Cash rates	Libor 3 month GBP	0.1	0.3	0.8	0.9	0.6	0.1
Property	UK Commercial Property (IA Sector)*	-2.0	-1.6	-0.7	-0.8	-N/A	2.8

Data sourced from Morningstar Direct as at 30/04/20. * to end of previous month (31/03/20). All returns in GBP
Data sourced from Morningstar Direct as at 30/04/20. * to end of previous month (31/03/20). All returns in GBP

Earnings: is optimism getting ahead of reality?

The grim realities of this global pandemic become clearer by the day – economically as well as in health terms. Businesses and individuals are struggling with vanishing revenues en masse, becoming reliant on emergency loans and other government measures. As such, the prospects for company earnings have nosedived around the world (except for a few lucky superstar businesses like Amazon). And yet, equities – whose value is supposed to be determined by the underlying earnings – have continued to soar. Is this a case of 'buy the rumour, sell the fact'?

In late February, before the global pandemic was declared and the world shut down, capital markets had their panicked frenzy. Equities nosedived, eventually joined by other asset classes as investors frantically sold everything they could. For the world's major stocks in aggregate, led by the US markets, the speed of the fall throughout March was the worst on record. Some felt investors had jumped the gun on how bad the underlying economy would get and had pushed stock valuations – price relative to underlying earnings – to levels that could only be justified by an economic apocalypse.

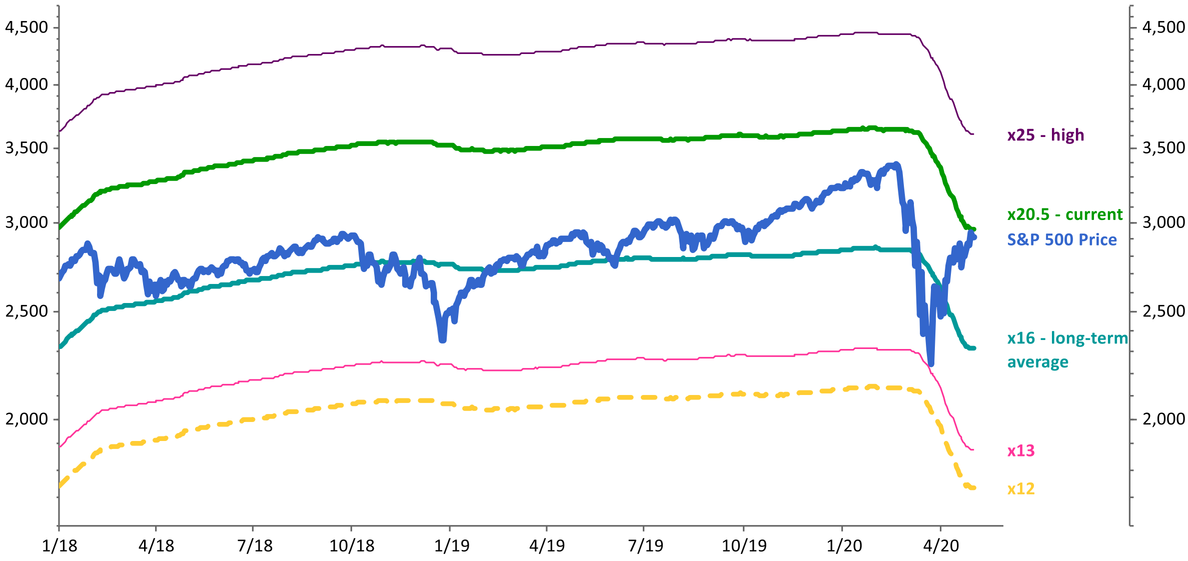
April was the reverse. The damage to the global economy started to feed through in official measures, with companies reporting that earnings were bad and forecasts were impossible. Yet markets staged an impressive recovery.

The S&P 500 has now retraced 60% of the losses since the February peak. The daily market moves indicate that investors are reacting to good news (more than bad) on the coronavirus front. Each positive story regarding medical advances (towards a possible vaccine or treatment) or the lifting of lockdown measures only furthers the rally, despite continuing harrowing accounts of the pain the disease brings.

But good news stories are not the whole story. What can justify this rally? There is no plausible scenario where broad company earnings (over the next 12 months) make the current level of the S&P500 index look anything but eye-wateringly expensive. Outlooks are dire and show little sign of improving in the near-term, even if a return to 'business as usual' were right around the corner. All current news-flow suggests that even if things get better, business will be far from usual for the foreseeable future.

The chart below shows the S&P 500 plotted against bands of multiples of its forecast earnings for the next 12 months.

S&P 500 and Price-to-Earnings Levels



Source: Factset, Tatton IM

In absolute terms, equity prices remain a fair distance below where they were at the end of February. But valuations are substantially higher, and above the 20x price-to-earnings multiple we had at the end of January. The apparent detachment of current prices from the economic fundamentals becomes even more stark. Equities seem to be walking on a tightrope, and each day the ground gets a little further away.

So why have equities become so detached? Liquidity is one explanation. Since the crisis began, central banks have committed to ensuring there is enough cash around to fill any shortages. The US Federal Reserve, European Central Bank and Bank of England have all injected unprecedented amounts of liquidity into the financial system and continue to do so on a regular basis. When capital is abundant, the return on capital that investors demand from markets will naturally be lower.

That is only a part of the story, however. Asset prices are, ultimately, always decided by the relative buying and selling of those assets. Any relative buying and selling pressures are in large part determined by the situations of the underlying traders. In March, there seemed to be a large number of overleveraged players (hedge funds, most likely) – for whom the initial market sell-off had proved too costly, and so they needed to keep selling their positions to cover their costs. Prices subsequently spiralled lower than any reasonable economic expectations would imply. That is because prices were not determined by reasonable economic expectations: instead, they were determined by the need for short-term cash. Those forced sellers have now mostly gone away.

What's more, businesses and individuals are increasingly piling money into their savings – either through fear of what lies ahead or simply because they have nowhere else to put it. This, combined with central banks' record injections of cash, has left asset markets awash with capital.

The only question, then, is where to put it. As we have argued before, the huge fiscal and monetary stimulus packages put forward around the world mean that, once we come out of this induced economic coma, we will likely see a spike in inflation. That is not a good environment to be holding cash or bonds – particularly with bond yields at historic lows. So, with nowhere else to go, investors see the stock market looking like the most viable option to preserve their money's purchasing power.

Of course, stocks carry a risk that other asset classes generally do not. Not only might the value of your capital go down, you may not get your capital back at all if the underlying businesses go bust. But this is the kicker: governments and central banks the world over have been at pains to promise businesses will not be left to go bankrupt as a result of this crisis. That makes this recession unlike virtually any other. Default cycles are the hallmarks of recessions, but this time round, policymakers will prevent that at any cost.

Clearly, we should not pretend that this means a spike in defaults is impossible or even unlikely. But it does mean that the most significant tail risk to buying equities – a total loss of capital – is diminished. That is why equity valuations have risen as high as they are. As long as the underlying companies survive, there are simply very limited alternatives.

That itself should provide a safety net for equities. But whether this is a good thing is less straightforward. For one, a stock market soaring higher while businesses and individuals struggle will only lead to a greater sense that it is the 'have-nots' bearing the brunt of this crisis, while the rich get richer. What's more, it means that – over the long term – equity prices have nowhere to really go, even when earnings kick back in. This could effectively lead to a stagnation in financial markets akin to Japan's infamous 'lost decade'.

That is perhaps speculative, but the underlying point is this: even if equity markets extend their gains over the coming weeks and months – that could have longer-term consequences. For now, the reason investors are piling into equity markets is the same reason people do anything during lockdown: what else are they going to do? When we emerge on the other side of COVID-19, the further fate of returns from equity markets will once again be determined by how dynamic or stagnant economic growth is. Should we simply continue where we got to before, it is hard to imagine much upside. However, if this global crisis becomes a catalyst for change that demands serious new capital investment all around the world, we could see considerable new upside to currently extended valuations.

Inflation primer: the three key pillars to consider

As long-term investors, our key focus during this enforced lockdown is what happens on the other side. We are in a deep recession, but this short-term pain is not the main determinant of current asset prices (as explained previously). Rather, it is when the global shutdown will end, and what will change once it does. Regular readers will know that, once we are on the road to recovery, we expect the current crisis-fighting stimulus policies to lead to higher inflation as the economy picks up and there is less spare capacity. If that is correct, there would be much more upside in equities – which have a natural protection against inflation – than bonds.

But the inflation outlook is, unfortunately, not quite that simple. Given the huge drop in aggregate demand that is sure to come during the lockdown – and the massive fall in global oil prices – inflation in the short-term will be subdued at best. And while we do expect that to change, there is no clear signal on when that might be.

It is worth reminding ourselves of what causes inflation in the first place. There are, generally speaking, three pillars of inflation that determine overall price levels: policy, cyclical factors, and structural factors.

Policy

One of the key determinants of price movements is monetary policy: interest rates and the amount of money put into circulation. As such, generally, the policy component of inflation comes from central banks. But fiscal policy also can – and many times has – greatly impacted inflation. How policymakers deal with inflation has changed dramatically since the 1970s, when the post-war policy consensus was rocked by an extreme and persistent bout of inflation – spurred on by the oil price shock.

Central banks reacted back then by aggressively hiking interest rates. But getting runaway inflation under control required more additional measures. Crucially, central banks put focus on controlling *inflation expectations* and, by extension, wage settlements (since wage increases are one of the key determinants of inflation). By getting inflation expectations under control, employees had less of a need to ask for salary increases. Interrupting the feedback loop between rising prices and rising wages led to a prolonged period of price stability, even when costs (especially oil) rose.

The impact of fiscal policy on inflation has been much less clear – especially in developed markets. A government's tax and spend policy is part of the equation, but ever since the neoliberal policies of the 1980s, most developed nations have endeavoured to control government spending. This is certainly set to change, in the short term at least, but whether it will have a big impact on inflation depends on how long the new fiscal drive lasts.

Cyclical factors

The cyclical impact on prices generally comes through periods of spare capacity, or when high-demand companies can raise prices and vice versa. There is a crucial distinction in cyclical inflation, however. *Cost-push* inflation comes when input costs go up, usually in the form of commodities. *Demand-pull* inflation comes when aggregate demand outpaces supply, thereby pushing up prices.

Cost-push inflation effectively acts as a tax on profits and consumption. When the economy is weak, or when there is a lot of spare capacity, costs do not usually get passed on. It can even be a strong brake on growth and cause the economy to slow. This can happen even when the economy is strong, since – as long as wages do not rise too fast – it is unlikely to have a disproportionate impact on prices. That is why controlling inflation expectations can be so important.

Structural factors

The biggest structural impact on inflation over the last few decades has been globalisation – particularly the extent to which the labour market has become global. The landmark event here was China's entry to the World Trade Organisation (WTO) in the early 2000s, but the general theme has been the increasing presence of emerging markets in the global economy.

Globalisation has acted as a strong disinflationary pressure. Since workers now compete more and more on a global scale (and with huge population booms in Asia) the global labour supply effectively went up. Subsequently, workers' bargaining power went down. Even the commodity super-cycle – brought on largely by massive Chinese demand – did not create much inflationary pressure, since global wage growth (in developed markets at least) was contained (coupled with some productivity increases).

This has been a long-term theme, but it cannot last forever. Indeed, there are signs it will subside over the next ten years or so. This is a complicated phenomenon, but the overall point is that, with the working population now set to grow less than in previous decades, there will be less downward pressure on wages.

So, what now?

In reality, central banks' management of inflation has probably worked a little too well. This has been especially true since the global financial crisis, with central banks unable to spur inflation even with extraordinary monetary policy. But even before then – particularly in Japan and Europe – inflation surprised on the downside.

In the current situation, the central bank response has been extraordinary, and is certainly showing an inflation bias. On the other hand, the global lockdown has shut off supply and demand at the same time. The key question is, which will come back faster when the world opens up again? This is as yet unclear, but it seems likely that, even if prices of some goods go up, as long as wage dynamics stay under control it is likely that price rises will be temporary.

Of course, only an apocalyptic scenario would result in *no* cyclical inflation. Over the long-term, what will prove most interesting is the link between cyclical and structural factors – and how they will be affected by the crisis. Could workers in the post-coronavirus world enjoy greater wage dynamics? And would this mean globalisation has peaked? Those factors would eliminate some of the main disinflationary pressures of the last few decades.

It is too early to tell. Indeed, it may be quite some time before we see inflation again. But the very expectation that inflation *will* come back is important, even if we don't know *when*. In particular, expectations of cyclical and structural changes are important from an investment perspective. Crucial long-term investment decisions – such as favouring equities or bonds – rest on them.

4th May 2020

Global Equity Markets — Technical

Market	Fri 16:20	% 1 Week*	1 W	Short	Medium
FTSE 100	5770.5	0.3	18.2	↗	↘
FTSE 250	16131	2.8	443.8	⬀	↘
FTSE AS	3192.5	0.7	23.6	↗	↘
FTSE Small	4617.8	1.1	52.3	→	↘
CAC	4572.2	2.7	121.2	↗	↘
DAX	10861.6	3.3	347.9	↗	↘
Dow	23887	0.5	111.6	⬀	↘
S&P 500	2852.7	0.6	16.0	↗	→
Nasdaq	8678.8	0.5	44.3	↗	↗
Nikkei	19619.4	1.0	189.9	↗	⬂
MSCI World	2052.9	3.3	65.2	↗	⬂
MSCI EM	924.9	5.2	45.5	⬀	↘

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	5.2	19.3	16.2	13.3
FTSE 250	3.7	17.3	15.1	14.3
FTSE AS	4.9	19.8	16.0	13.4
FTSE Small	4.6	13.6	-	13.8
CAC	3.9	16.9	18.3	13.5
DAX	3.7	19.9	17.5	12.6
Dow	2.7	17.6	21.3	15.1
S&P 500	2.1	19.2	22.0	16.1
Nasdaq	1.0	26.9	26.1	18.2
Nikkei	2.2	17.8	16.4	16.9
MSCI World	2.6	18.8	20.1	15.3
MSCI EM	3.0	13.7	13.8	11.9

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
Micro Focus Int'l	20.7	Royal Dutch Shell	-11.1
Centrica	20.0	Royal Dutch Shell	-10.4
Carnival	19.5	Hiscox	-6.4
Barclays	17.1	GlaxoSmithKline	-4.4
Ashtead	15.8	Rio Tinto	-4.2

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.253	1.3	Oil	26.30	22.7
GBP/EUR	0.878	-0.3	Gold	1691.8	-2.2
USD/EUR	1.10	1.7	Silver	14.89	-2.4
JPY/USD	106.77	0.7	Copper	231.1	-1.1
CNY/USD	7.06	0.0	Aluminium	1494.5	-1.0
Bitcoin/$	8,836	17.3	Soft Cmdties	315.7	4.2

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.26	-0.03
UK 15-Yr	0.45	-0.04
US 10-Yr	0.63	+0.03
French 10-Yr	-0.11	-0.19
German 10-Yr	-0.59	-0.16
Japanese 10-Yr	-0.02	-0.00

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!

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

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