CAMBRIDGE
INVESTMENTS LIMITED

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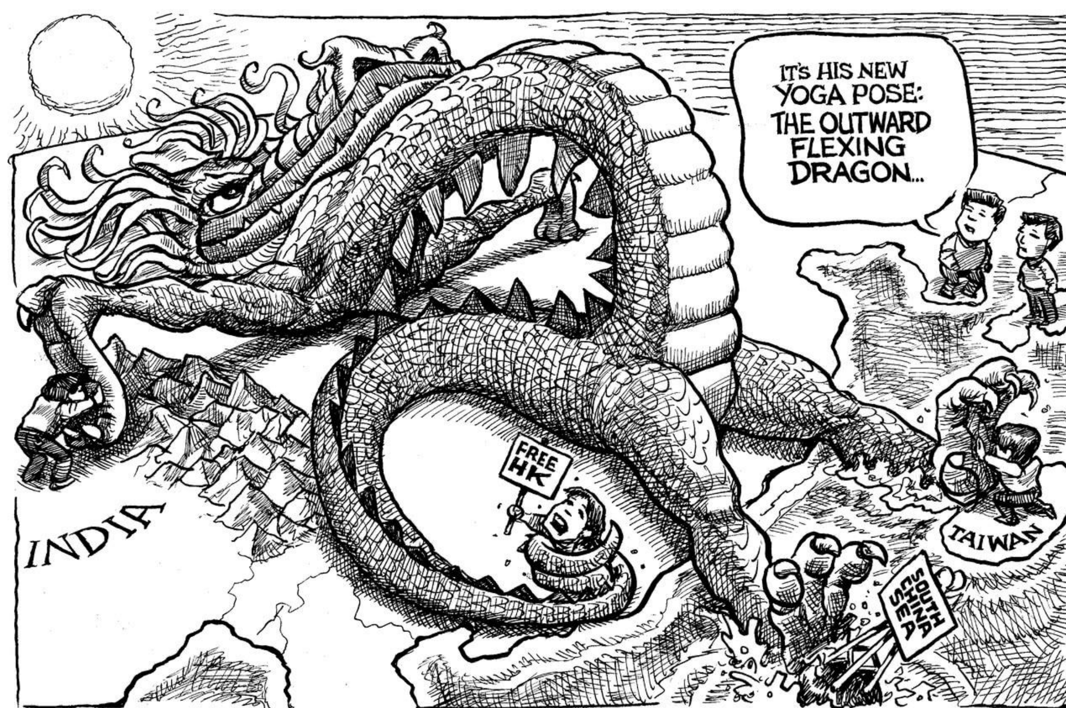


KAL, China – more risk than stimulus this time around, 19 June 2020

A new normal

After a wobble, capital markets have stabilised again. Global stock markets have not quite regained their previous highs, but seem to have found a level, trading sideways since last Tuesday. For onlookers though, risk asset prices probably look anything but stable. Economic activity is plummeting around the world, deep-seated social problems are rearing their heads and geopolitical tensions are flaring up every day. But in the midst of the chaos, equity markets have soared. Stock valuations – in terms of price over earnings – are now at their highest since the dot-com bubble 20 years ago. How can markets be so stable when they seem to be on a tightrope?

As noted many times over the last few weeks, these eye-watering valuations are due to the combination of extraordinary central bank measures and high demand from retail investors flooding the financial system with liquidity. And liquidity flows into whatever gives investors the best bang for their buck, which in the current environment, is equities. With central banks busy buying practically unlimited amounts of government bonds, leaving their yields non-existent – equities even with their measly dividends relative to pre-crisis levels – look more attractive by comparison. Or to look at it from a different angle: What drove bond yields down and bond values up during the post Financial Crisis rounds of quantative easing, is now doing the same to equities – rising stocks are lowering the earnings and dividend yields of companies relative to those higher capital values of stocks – equalising them back down towards the historical spread between bond yields and stock returns. So, as long as investors do not expect a total loss of capital – through mass defaults – markets should avoid the nosedive we saw in March.

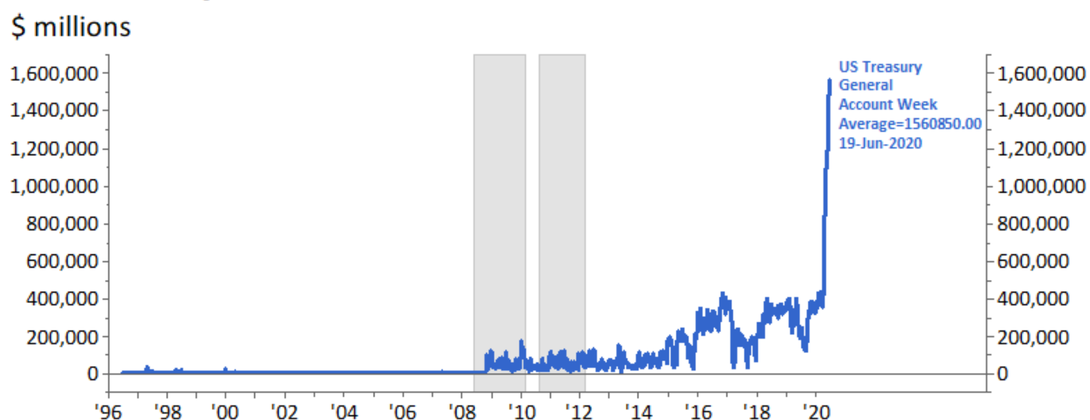
The problem is that mass defaults are precisely what people are still worried about. Businesses are scrambling to survive the lockdown, and almost all of their contingency plans involve laying off huge numbers of workers. This is where global government policy comes in – plugging the gap between now and normality with huge spending sprees, and central bank printing presses have given them carte blanche to do so. Some governments – notably in Europe – have even added long-term fiscal investments into the mix, to see their economies not just out of the pandemic but beyond.

We expect similar fiscal policies to follow here in Britain, backed up by the £300 billion bond purchases pledged by the Bank of England (BoE). We cover this in a separate article below, but should note that not everything in the BoE's announcement pleased markets. It said its purchase program would finish by the end of the year, leading to market pessimism on the UK economy and a subsequent sliding of sterling against the US dollar.

That downward currency move is significant. Theoretically, debt monetisation – where a central bank prints new money to fund government spending – should decrease the relative value of a currency. But in the current environment where almost every central bank is expanding the domestic monetary base, markets are now rewarding those currencies whose central banks are effectively funding unlimited spending and punishing those whose banks are not. That is, central bank monetisation is currently seen as a positive by capital markets.

Last Wednesday, US Federal Reserve (Fed) chair Jerome Powell appeared before US Congress and pushed them to spend more to help unemployed Americans and small businesses. He noted that the US economy is in a "critical phase", and any additional fiscal support would be crucial. Powell said economic rebound is underway (as evidenced by the bounceback in employment numbers last week) but that output and employment levels are still well below pre-pandemic levels. As such, the Fed's $2 trillion in asset purchases are "precautionary" in case the economy weakens again.

Meanwhile, the US Treasury is taking full advantage of the Fed's blank cheque, building up a cash reserve of $1.5 trillion, shown in the chart below. If things take a turn for the worse, the Treasury should have enough firepower to see the economy through.

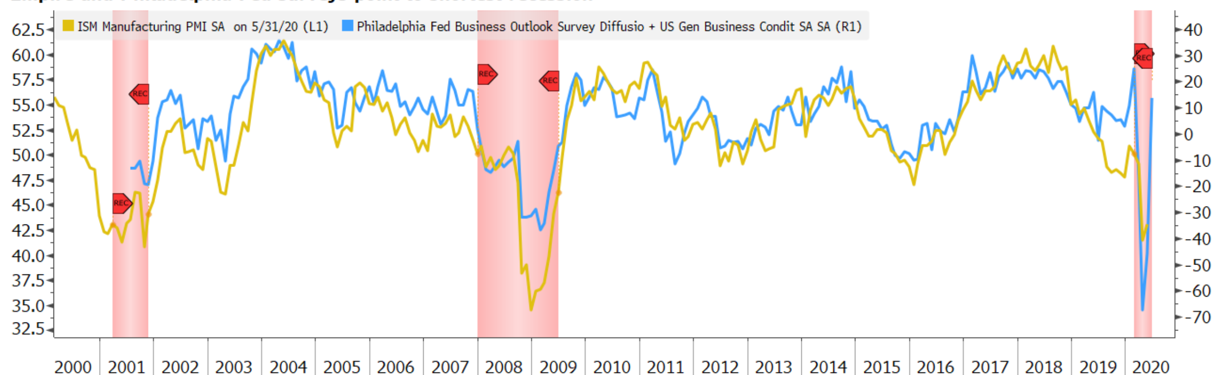


This may present some issues for how the Fed will manage general liquidity in the financial system, but the fact is that this cash will get spent. In July, various income support programs in the US are scheduled to end. But in spite of the recent improvement in jobs data, the lingering virus threat should give policymakers more than enough reason to extend these programs.

The danger here is that there may be some pushback from politicians – particularly the 'balanced budget' minded conservatives in Washington. Recent regional purchase manager surveys for Philadelphia and New York suggest businesses are feeling relatively sanguine about the current recession – hoping it may prove sharp but short.

Is Recession Already Over?

Empire and Philadelphia Fed surveys point to shortest recession



Source: Bloomberg, Tatton IM

EMPRGBCI Index (US Empire State Manufacturing Survey General Business Conditions   Copyright© 2020 Bloomberg Finance L.P.   19-Jun-2020 12:13:35

Ceasing spending programs now would be a dangerous game, and for seemingly little reward. As mentioned above, markets currently view fiscal spending sprees as a positive. And given an election is coming up in just five months – we suspect there will be little appetite to curb government spending now.

The fly in the ointment for all this comes from geopolitical tensions, which continue to intensify. Last week, a border clash between Chinese and Indian forces made headlines and will likely only increase the anti-China sentiment in Washington. The US Congress has over 300 anti-China bills with bipartisan support waiting to be passed, and skirmishes on the Himalayan border will not help the situation.

As we see it, this is the main downside risk for China specifically. Beijing is aware that a weak global economy means weak demand for their exports, and as such have tried to stimulate their domestic economy. Fiscal policy is a crucial part of this, but unlike other central banks, the People's Bank of China (PBoC) is extremely wary of money printing. Its preferred tactic is to allow banks to lend more by lowering their reserve requirements. But this approach has its limits. Banks do not want to be liable for lending mistakes – particularly if economic activity is weak – and so the transmission of money will be more muted. Chinese stocks did well off the back of the PBoC's announcement, but the medium-term benefits are looking more limited than elsewhere. Given our previous positivity on China, this is a story that continues to deserve close attention.

Overall, we understand the 'valuation vertigo' investors may be feeling, but stress that a sustained downturn can only happen should the underlying reasons for those valuations change. At the moment, we see nothing to suggest that is likely. But even without a storm on the horizon, the waters may still be choppy from

here. US markets are on the cusp of the June expiry for stock index options – an event which can spark market volatility. Given the uncertainty and fear around, short selloffs and quick recoveries could be in store over the next few weeks.

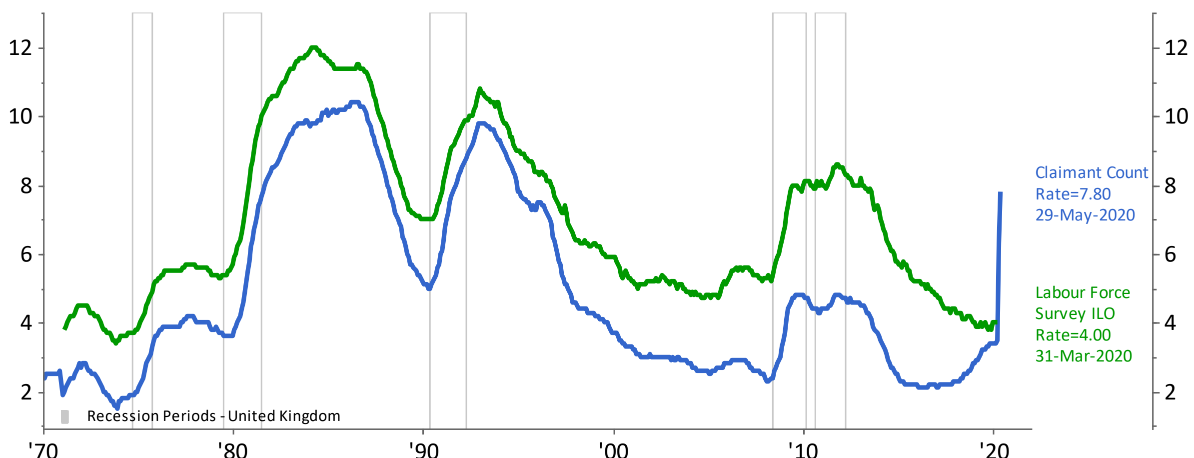
More life support for Britain's economy

After three months of shutdown, Britain is slowly but surely opening up. The government has been keen to stress that this process is only possible because of the steadily falling infection and death rates across the country, but clearly the relaxing of restrictions is also prompted by economic concerns. With pubs, clubs, shops and many other businesses shuttered since the end of March, the UK economy has been on life support. For many businesses, the government's furlough scheme and emergency loan measures have been the only thing keeping them afloat. These policies have only been possible through the extraordinary fiscal and monetary stimulus measures from Whitehall and the Bank of England (BoE) respectively.

But even with the UK opening up, these desperate measures will likely be needed for some time. Last week the BoE announced it will add an extra £100 billion to its bond-buying program, as well as keeping interest rates pegged down at the historically low 0.1%. This leaves its asset purchase target at £745 billion, with some market participants expecting even more could be added by November. While this is no small sum, it came at the lower end of market expectations, especially as asset purchases will be at a slower pace than before. Even more surprisingly, the BoE's chief economist Andy Haldane voted against the move, preferring to keep liquidity injections unchanged.

The BoE's Monetary Policy Committee (MPC) noted that the UK economy is faring slightly better than it had expected. In May, policymakers sketched out (calling it a "scenario" rather than a "forecast") their outlook for Britain over the next three years. The MPC expected a 3% contraction in GDP for the first quarter of 2020, and a 25% fall in the second quarter. In fact, the economy fell only 2% in the first three months of the year, and the latest data show a 20% fall to be more likely for Q2. Likewise, the unemployment rate was slightly lower than the 8% BoE prediction for Q1, although the more timely claimant count data does suggest it may already be at that level.

UK Unemployment Rate



Source: Factset, Tatton IM, ONS

Nevertheless, these are unparalleled rates of economic decline. The BoE's scenario has the unemployment rate declining from 8% this year to 7% in 2021, back to 4% only in 2022. And there is growing sense that the recovery may be longer and more arduous for Britain than its global counterparts. The Organisation for Economic Co-ordination and Development (OECD) expects Britain to be one of the worst hit nations economically, with GDP falling more than 11% and not reaching 2019 levels until beyond the end of next year. That would be the deepest recession in over 300 years.

The BoE's bond purchases will be crucial in avoiding an even worse scenario. So far, the bank has been eagerly snapping up bonds to keep down the cost of finance for the government's massive fiscal stimulus program – which only looks set to grow through the rest of the year. Rishi Sunak has been Chancellor of the Exchequer for just four months, but in that time has presided over one of the biggest increases in government borrowing in British history. With the Treasury footing wage bills for businesses all over the country, economists expect the budget deficit for 2020 to top £270 billion. That would amount to 14% of Britain's GDP – the biggest borrowing surge since World War II.

There was surprise that the BoE indicated a slowing in the pace of asset purchases from £13.5bn to £4.5bn per week. This led to the FT reporting that the BoE would no longer soak up all the additional debt that the government is creating. Admittedly this does not align with previous statements from the various MPC members and, in particular, the Governor Andrew Bailey. After the MPC meeting on Thursday, in a conference call, Bailey again alluded to the need to do more QE. To us, it seems most likely that the BoE is worried that government bonds would actually not have a functioning market if they were to continue at too strong a pace.

So we think one should expect the spending spree to continue, and increased if necessary (subject to the caveat below about Brexit). The message from the BoE – like virtually all the world's major central banks – is still that it will keep liquidity flowing to support the funding of whatever measures are necessary to get on the road to recovery. And, unlike the recession following the financial crash a decade ago, policymakers have no appetite for 'tightening belts' through cuts to public spending. As we have written over the last few weeks, there is a growing sense among politicians around the world that fiscal stimulus is needed not just to 'plug the lockdown gap', but also to provide investment for growth over the long-term.

For Britain, this is particularly true given the still-looming threat of Brexit. The UK's exit from the European Union has become the 'forgotten but not gone' issue throughout this crisis, but last week Boris Johnson pledged to intensify talks with European negotiators and break the deadlock. Needless to say, if we divorce our largest trading partners without a deal while the nation is still reeling from a global pandemic, the results would be disastrous. But we doubt the prospect of a 'no deal' Brexit. While it is unlikely that the current transition period will be extended beyond the end of this year, we expect that a rough deal will be ready by around November, at which point it will almost certainly pass through the House of Commons with little or no resistance.

On the European side, we continue to expect appetite to put the Brexit issue to bed, even if most of the political capital is currently channelled to strengthening the EU with its coronavirus recovery fund. This should also be helped by the fact that the presidency of the European Council will pass to Germany next month – along with Portugal and Slovenia. While the EU Commission's main negotiator remains the same (Michel Barnier), the political impetus, especially should negotiations get stuck, can also come from the EU

Council, which unites the EU's heads of states or governments. So, it is helpful that Germany has an inclination to keep the UK as a strong partner.

That said, we still suspect concessions will be more forthcoming from Boris Johnson's government than from the EU, especially as the latter will be careful to avoid the impression of 'cherry picking'. Europe is the bigger economy, and depends less on Britain than vice versa. As such, European politicians will likely feel they have more bargaining power, while our own government will need to get whatever deal it can to avoid worsening the current recession.

The Brexit path does present an additional headache for the BoE, which is that it might create a sharp downward path for Sterling if things go badly wrong in the negotiations. Managing interest rates in that environment could be very difficult. The crunch points approach towards the end of the year by which time we all hope the virus will be behind us. In the meantime, the BoE will want to maintain some flexibility even if, on occasions such as last week, that may be a slight disappointment for markets.

The path out of the pandemic is much less certain for the UK. And the economy will need a big helping hand from fiscal, monetary and Brexit policy if it is to start whirring again. Thankfully, the first two of those policy pillars are fully at the disposal of the UK government – given in these policy areas the country has always been independent of its European neighbours, thanks to not being tied into the less-than-perfect monetary union of the Eurozone. For now, and for better or worse, the UK's fate is still very much in its own hands.

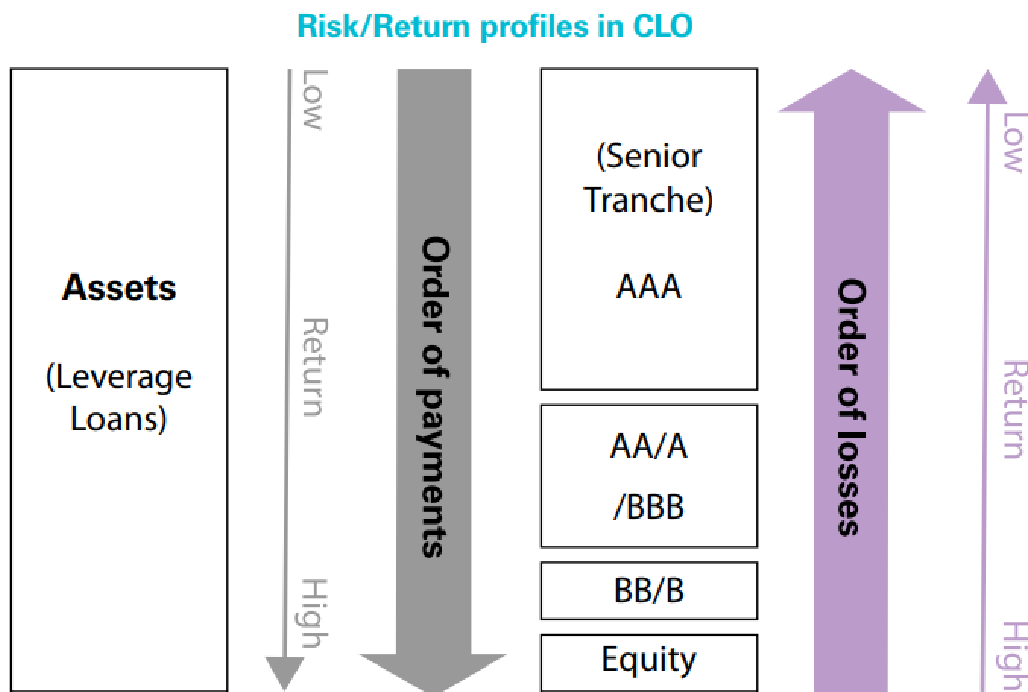
CLO chills for bond markets

Avid followers of the global financial media got a bit of a fright recently. Writing in *The Atlantic*, Professor Frank Partnoy of the University of California asked readers to consider a nightmare scenario: "Imagine if, in addition to all the uncertainty surrounding the pandemic, you woke up one morning to find the financial sector had collapsed". Like Kafka's *Metamorphosis*, Professor Partnoy takes us through what it might be like to wake up to such a terrifying situation.

He makes some very good points. But of course, his article "*The Looming Bank Collapse*" doesn't just encourage us to *imagine* that fateful morning, it asks us to *believe* it is really around the corner. According to Partnoy, the reason financial collapse could be imminent is because bank balance sheets in the US and around the world are bloated with risky financial instruments: Collateralised Loan Obligations (CLOs).

These CLOs are similar to the dreaded Collateralised Debt Obligations (CDOs) that wreaked havoc on the global financial system twelve years ago. Indeed, CLOs are really just a class of CDO, but because CDOs gained such a bad reputation, most people talk about them as a separate entity.

The principle behind both is fairly simple: group a bunch of loans, bonds, mortgages or other debt together into a package, then sell off different 'tranches' of the package. Tranches differ in their yield levels, which in turn are determined by the level of default risk exposure each tranche of the overall package carries. If you buy the bottom tranche, you bear most of the risk should some of the package's underlying loans default – but you stand to win big if the underlying loans do well. Most CLOs have four risk-return tranches with only a small amount of residual risk remaining for the most cautious investor.



In 2008, CDOs mostly comprised mortgage-backed securities (MBS), the largest of which were made up of residential mortgages. These instruments were opaque (especially in terms of the strength of the individual mortgages – the 2015 film *The Big Short* has a great explanation). Ratings agencies handed them high credit ratings without doing their due diligence (Moody's, Standard and Poor's, Fitch *et al* get paid by the arrangers, not the investors).

When US house prices sank, and the subprime mortgage crisis hit, banks realised their highly-rated CDOs were full of hot air, investors ran for the hills and the entire system came crashing down.

CLOs are not made up of mortgages or MBS. They instead contain leveraged loans mostly made out to businesses –the market for which has exploded over the last decade through the availability of cheap credit. But according to Partnoy, they are filled with just as much snake oil as their CDO predecessors, and bank balance sheets are full of them. The loans that make up the CLOs – even the top tranches – are not themselves highly-rated and are prone to default in times of great economic stress, such as the current crisis.

Before we get onto whether banks are exposed to CLOs, we should first address how problematic these debt instruments are themselves. The argument above – that CLOs are unsafe because they are full of low-rated leveraged loans – is something of a 'fallacy of composition'. Just because the underlying parts may be

risky, doesn't necessarily make the overall package risky, particularly if risk is unevenly shared between the tranches.

With any investment, there are many potential problems: the buyer could be wrong about the level of risk, the seller could be lying about the investment or there could be 'moral hazard' – where buyers can take all of the upside while handing off the downside to some unlucky soul. In 2008, all of those problems were rampant.

But as a result of the post-GFC reforms, the CLOs of today are more transparent, better structured and better understood. What's more, buyers of CLOs are better educated, regulated and capitalised. With the massive increase in leveraged loans since the crash, it is true that the market has changed, and many loans have become individually less creditworthy and structured with fewer protection clauses than before. But these changes have (arguably) not changed the actual *level* of underlying risk, just made it clearer.

For example, the removal of loan covenants can make the loan more orderly if the borrower comes under stress. It also makes the market more homogenous, thereby increasing liquidity. Indeed, one of the great advances of Eurobonds in the 1980s and 1990s was the removal of covenants, a development which improved the overall market.

The CDOs of the last crash were made up of MBS and related instruments, and as such were entirely dictated by the property market – with its associated swings. In contrast, leveraged loans are more diversified, since they are spread across businesses throughout all sectors of the economy.

Professor Partnoy's inference that collateralised debt markets have not really moved on from 2008 is just not true. Under great political pressure, the understanding of risk has become more transparent, and the takers of that risk have much more capital.

Banks themselves also play a different role than in the early 2000s. They have faced competitive pressures, and fund managers have increasingly stepped in to fill their space in capital markets. As such, the amount of loans banks can obtain has gone down. Big banks in particular are now forced to hold much more capital on their books, while fund managers have faced virtually no increase in regulation.

The need to replace those loans is one of the main reasons that banks have dipped into the CLO market. Less risky CLO tranches fit the regulatory bill nicely, and so it is no surprise that they have increased their holdings – even though these tranches offer comparatively small returns.

To be clear, we agree with Professor Partnoy that not everything is rosy in the CLO market. The US Federal Reserve, European Central Bank, and BoE have all written substantially about these over the past 12 months. In itself, it's comforting that the regulators continue to be aware, but the risks still exist.

Some of the risks around CLOs – in the process of their creation and how they are run – are still less transparent than one would hope. Banks still provide liquidity, lending to CLOs, and while this smooths cash flows it can leave banks in a very difficult situation if things go wrong. Likewise, banks also still do something called 'warehousing', where stocks of loans are built up just before a CLO is created. These stocks can be enormous – and often lucrative – but in times of great stress they can leave banks on the hook for big losses.

But this is where the crucial caveat comes in. Since CLOs are diversified across the entire economy, for them to pose a systemic financial risk we would need to see defaults *en masse*. That is, by the time we should start worrying about CLOs, we should already be worried about the underlying economy – as we always are ahead of a major credit default cycle. In the current pandemic, that situation is not so far-fetched. But it is also one that governments and central banks around the world are dedicated to avoiding. In the first instance, they are doing their utmost to avoid a protracted recession that causes widespread defaults. Second, with their March pledge central banks demonstrated very forcefully their intention to act as open ended buyers of last resort. This means they will not let the selling pressures of panicking CLO-holding fund managers, drive up the market yield for business loans which could drive parts of the economy into bankruptcy even before the economic pressures of COVID started.

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22nd June 2020

Global Equity Markets

Market	Fri 16:10	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	6295.4	3.1	190.2	↗	↘
FTSE 250	17636	3.3	558.6	↗	↘
FTSE AS	3486.2	3.1	106.3	↗	↘
FTSE Small	5132.1	3.3	162.4	↗	⬂
CAC	4998.4	3.3	159.1	↗	↘
DAX	12373.2	3.5	423.9	↗	→
Dow	26244	2.5	638.4	↗	⬂
S&P 500	3137.4	3.2	96.1	↗	→
Nasdaq	10036.6	4.7	447.8	↗	↗
Nikkei	22478.8	0.8	173.3	↗	→
MSCI World	2215.6	2.4	51.2	↗	→
MSCI EM	995.2	0.8	8.2	↗	→

Top 5 Gainers

Company	%
Ashtead	16.3
SSE	12.6
Bunzl	11.7
Scot Mtge Inv Trust	11.1
John Wood	9.0

Top 5 Decliners

Company	%
BHP	-2.6
British Land	-2.3
Barratt Devts	-2.3
Fresnillo	-2.3
Rio Tinto	-2.0

Currencies

Pair	last	%1W
USD/GBP	1.237	-1.4
GBP/EUR	0.906	-0.9
USD/EUR	1.12	-0.5
JPY/USD	106.95	0.4
CNY/USD	7.07	0.2
Bitcoin/$	9,371	-1.0

Commodities

Cmdty	last	%1W
Oil	42.53	9.8
Gold	1740.1	0.5
Silver	17.71	1.3
Copper	263.0	1.2
Aluminium	1606.5	0.3
Soft Cmdties	338.9	-3.1

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.24	+0.03
UK 15-Yr	0.47	+0.06
US 10-Yr	0.71	+0.01
French 10-Yr	-0.09	-0.05
German 10-Yr	-0.41	+0.03
Japanese 10-Yr	0.02	+0.01

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.4	22.7	19.1	13.4
FTSE 250	3.0	23.5	21.2	14.3
FTSE AS	4.2	24.0	19.3	13.5
FTSE Small	3.9	12.5	-	13.8
CAC	2.2	19.9	22.4	13.6
DAX	2.9	24.3	20.6	12.7
Dow	2.5	19.4	24.1	15.3
S&P 500	1.9	21.9	25.1	16.3
Nasdaq	0.9	31.3	30.6	18.4
Nikkei	2.0	26.4	21.7	16.9
MSCI World	2.3	21.5	23.1	15.4
MSCI EM	2.7	16.3	16.0	12.0

UK Mortgage Rates

Mortgage Rates	Mar	Jan
Base Rate Tracker	2.19	2.17
2-yr Fixed Rate	1.42	1.39
3-yr Fixed Rate	1.68	1.65
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

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22nd June 2020

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

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