THE **CAMBRIDGE** WEEKLY

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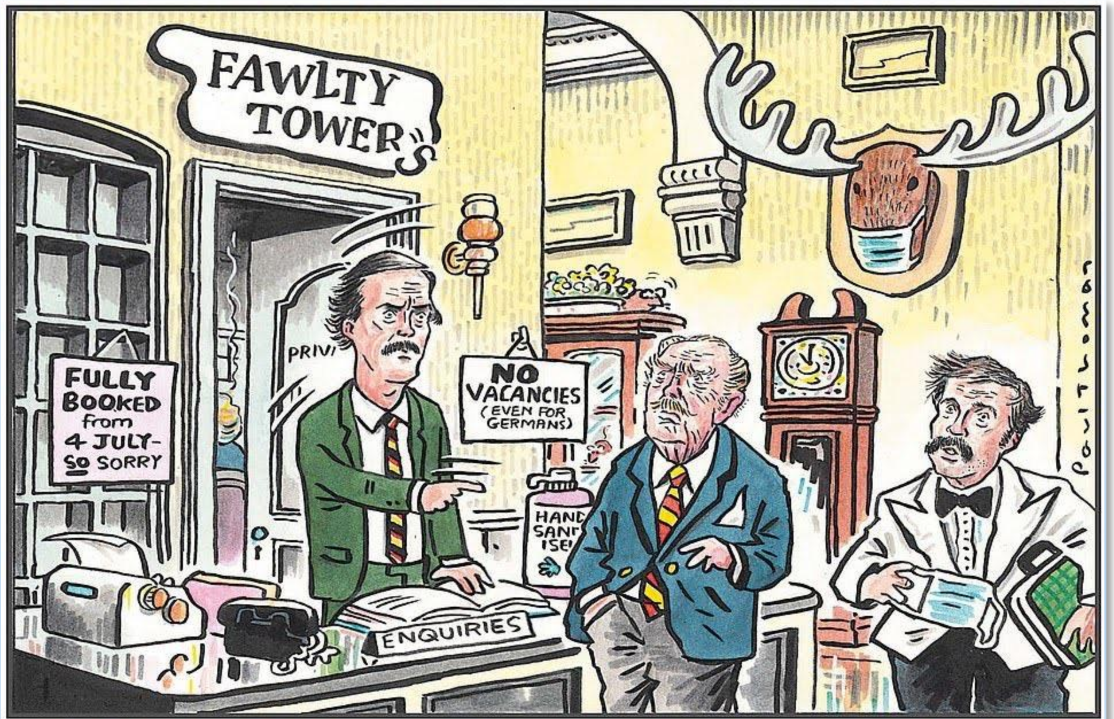


'Statistically he's a lower coronavirus risk than us British, major – he's from Barcelona'

Fawlty Towers way of dealing with 4 July concerns, 25 June 2020

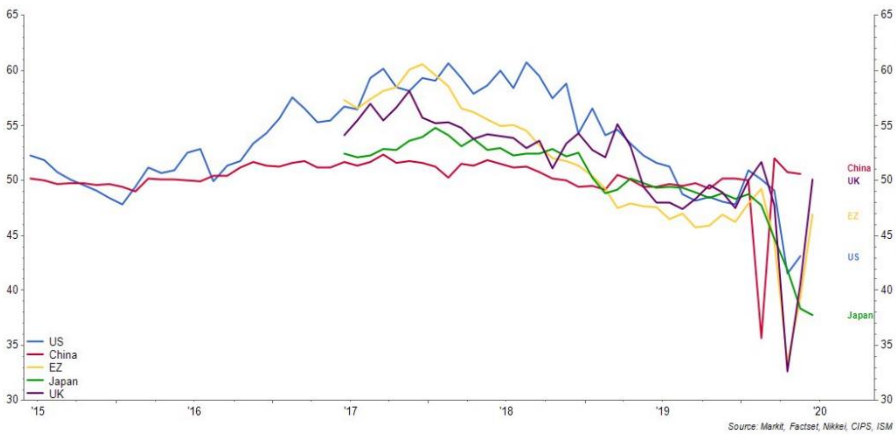
Support balances increasing strains – for how long?

The consolidation in stock markets continues. After a brief sell-off at the beginning of last week, capital markets staged a recovery to leave things almost unchanged from a week ago. All in all, markets are now just slightly above where they were after the significant recovery rally throughout April and May.

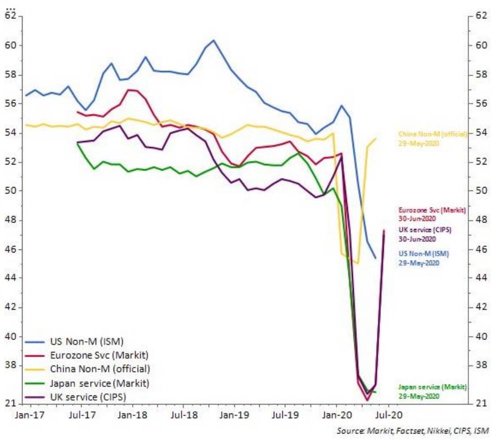
That is, in large part, down to the immense support provided by governments and central banks all over the world. This reliance on policy leaves markets particularly sensitive to the political or virus-related news flow. Recent weeks have seen markets rally on the back of better-than-expected recovery news and then sell-off on new COVID flare-ups or political tensions. Last week we saw all of the above, so the market gyrations are unsurprising. Importantly however, neither direction gained the upper hand – hence the consolidation or sideward movement.

On the positive side, we saw a recovery of economic sentiment across Europe and the US (see chart further down). On the negative side, there is increasing talk that the handsome V-shaped rebound we are already seeing may not take us back up to where we were before the coronavirus shuttered the global economy. The fear is that the recovery could level off while still in recessionary territory – with activity staying depressed until a long-term solution to the virus is found. Only after the virus is well behind us will sectors like hospitality, mass entertainment and travel be able to fully reopen, and likewise more virus-vulnerable parts of the population may continue to curb their consumption, as they prefer to stay at home more. At that point, governments would have to decide whether to continue with their support programmes. If they do not, we will experience a rise in unemployment which will turn what currently

Global Manufacturing PMIs



Global Non-manufacturing / Services PMIs



looks like a sharp but short economic blip into a full-blown 'classic' recession, with all the attached negative 'scarring' that governments have been so desperate to avoid.

Continued, concerted supportive actions by governments worldwide (as shown by central banks and inadvertently governments up to this point) would be a vital crutch for those large parts of the productive economy that cannot operate. Unfortunately, this is where last week brought disappointment. The Trump administration once again swung its populist tariff-threat club against China and the European Union (EU). Clarifications from the White House quickly dispelled and contradicted the apparent threat to China, but the tariff threat against the EU remained. Markets wobbled for a day and then moved on – perhaps thinking this is just more of Trump's sabre rattling. Hopefully there is still a more constructive way forward, even if that means a series of bilateral agreements between the US and China, China and the EU and then EU and US.

It is a positive that markets are taking these news stories in their stride, rather than looking for things to get upset about. As we wrote last week, the groundswell of positive sentiment remains. Nevertheless, a minimisation of political tensions would be very helpful. Some market media commentators blamed the loss of upward market momentum on Joe Biden – the Democrats' 2020 presidential candidate – increasing his lead in opinion polls over Donald Trump. We are doubtful for that to be the case, given the economic policies of a populist Republican (conservative) are very similar to the traditional redistribution tendencies of a Democrat lead administration. Added to this, markets may well prefer a less erratic US President.

On the corporate side, the news of German Fintech giant Wirecard's collapse into insolvency due to a multi-billion euro accounting fraud (see separate article) tells us that we have witnessed the first hallmark of a more standard recession. Every crisis has its corporate collapse scandal: what was Polly Peck in the late 1980s, WorldCom and ENRON for the 2000-2003 recession appears to be Wirecard for the 2020 economic crisis. We are not sure whether we should take comfort from the fact that the biggest of past recessions – the 2008/2009 global financial crisis – went without a major corporate fraud scandal (Bear

Stearns, Lehman Brothers and Northern Rock collapsed on incompetence rather than deliberate fraud – only Bernie Madoff's hedge fund collapse would count as fraud but that was not a company). For the time being, we observe that the risks of a classic recession are increasing, and will continue to do so until a vaccine or effective treatment against COVID-19 is found. For us, the question is whether the enormous up-forces of the 're-start stimulus' programs drawn up around the world, together with the continued positive sentiment will be enough to counter-balance the negatives inflicted on businesses by social distancing. For the time being, they remain finely balanced. Governments and central banks remain committed to tying all parts of the economy over to the post-pandemic world.

Fiscal cliff-edge fears

For many businesses and individuals, emergency government support measures have been the only thing keeping them from financial ruin over the last few months. That is not just true here, where the government's furlough and emergency business loan schemes have provided a necessary crutch. In the US, as well as the furlough scheme, citizens were given direct cash transfers. And all across Europe, wage-paying schemes have helped firms survive the COVID hiatus. We still do not know what the economic fallout from this forced shutdown will be. But it is fair to say that, without the extreme fiscal support governments have provided, we would be facing widespread bankruptcies and unemployment.

But as for right now, that creates a problem. Europe is now well on the way out of lockdown, with only relatively minor restrictions still in place across the continent. In Britain, we are a little way behind, but things seem to be getting more relaxed by the day. The US has opened up considerably over the last couple of months, although recent infection spikes in some states have prompted a couple of states to effectively halt their relaxation of lockdown guidance. With the global economy waking from its hibernation, leading economies face the decision to extend extraordinary fiscal support, or let it run out – which introduces the risk that the fiscal bridge stops before the other side of the river will have been reached.

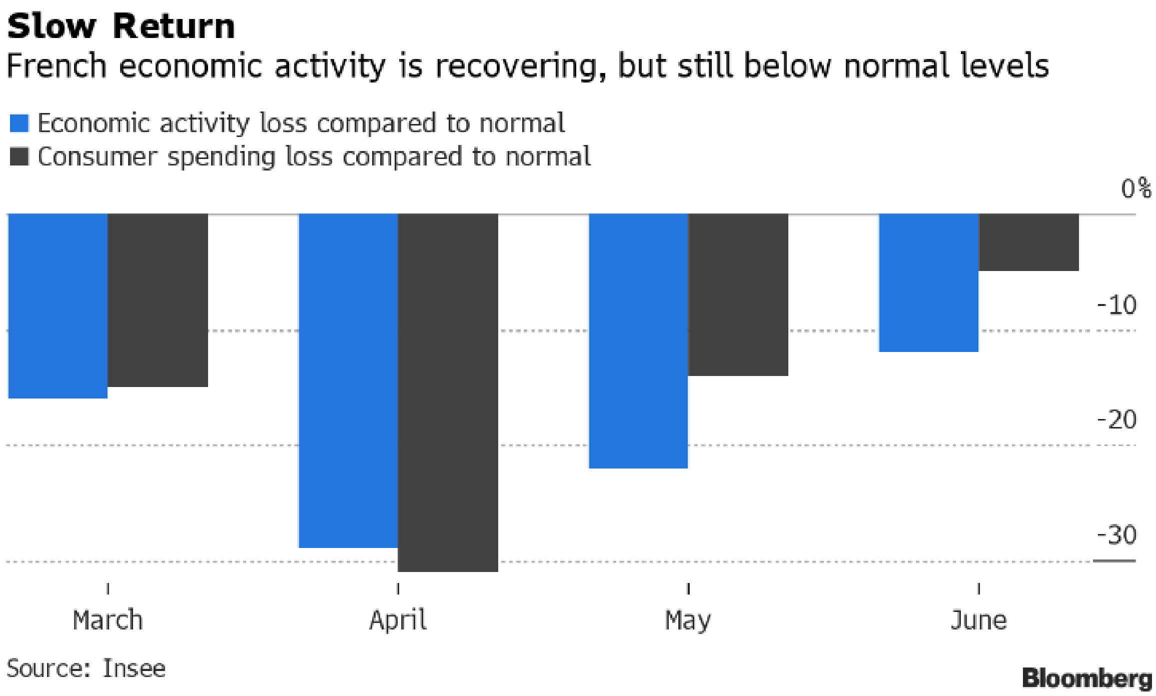
The most explicit fiscal cliff-edge presents itself in the US: the extraordinary income support for unemployed people (USD 600 per week) will expire at the end of July. We discussed previously that this substantial support led to a sharp rise in household income and greatly alleviated the negative impact of the lockdown. On the corporate side, the last day to apply for the Paycheck Protection Programme (PPP) loan scheme, which targets small and medium-sized companies, is 30 June. Around 100 billion of the USD 660 billion programme has not been used, and debates persist over whether the scheme should just be extended, or the money earmarked for other programmes targeting smaller companies. With expiry approaching, US politicians have been debating the way forward, but as yet no precise proposal is on the table.

In the Eurozone, the situation is mixed, but it is fair to say that conditions are less acute in the two biggest economies: Germany and France. Both opted for a relatively generous furlough scheme. In Germany, it runs for 12 months and in exceptional cases for 21 months. France has tightened its scheme's conditions, but it is still set to run until March 2021, and companies in exceptionally difficult circumstances can apply for state support for two years, but have to commit to keep staff employed. Economies with smaller fiscal leeway, such as Portugal, for now see themselves forced to cease some of their extraordinary measures.

The UK appears to occupy the middle ground, ending its furlough scheme from the end of October. Focus is now moving onto different potential stimulus programmes, including a cut in the VAT rate, although nothing has been announced yet. Indeed, the Chancellor downplayed the possibility in a Bloomberg broadcast on Friday. Rather, he talked of a "double down" on the government's pledge to invest in infrastructure, with more likely to be announced by Boris Johnson this week.

Given the close co-operation between fiscal and monetary policy in response to the crisis, it is also worth having a look at the attitude of the main central banks. The good news is that both the US Federal Reserve and the European Central Bank have committed to supporting their economies, with no imminent cliff-edges on the horizon. In this context, we were mildly surprised last week by comments from Bank of England Governor Andrew Bailey that central bank asset purchases "shouldn't always be taken for granted", and that the robustness of the financial system needed observation. It was more the timing than the content of the comment which made us read it twice. Given Bailey's pedigree in financial regulation and supervision, we suspect the ground is being laid for a post-virus review of the financial system – this time with less focus on banks, which have been already at the heart of a post-financial-crisis regulatory drive.

With fiscal cliff-edges on the horizon, and new programmes being debated, it is worth noting that although the economy may be gearing up again, social distancing and public fear are likely to keep demand well below pre-pandemic levels for some time. France, which is one of the furthest along the road back to normal, is still seeing economic activity significantly below that at the start of the year – as the chart below shows.



If the government spending tap gets turned off while companies are still facing a large shortfall in demand, they are sure to try cutting costs by laying off employees or, in some cases, going insolvent.

Many businesses have seen a pickup in demand from the moment they opened. But for some sectors, any kind of restriction makes the business model unviable. We have seen here how hospitality groups fought hard to reduce the two-metre distancing rule down to one metre-plus – for fear that business would be otherwise impossible. But in the travel and leisure industries, businesses will likely be unable to stand on their own feet until restrictions have faded entirely, and consumers have regained their confidence to shop, dine, and live a normal life again.

For the most part, throughout lockdown the usual "how do we pay for this" chorus that accompanies government spending measures has been subdued. But with economic activity bouncing off of its April lows, those concerns are coming to the fore again. Republican Senate Leader Mitch McConnell warned last month that the next coronavirus stimulus bill would be the last one, as emergency spending plans have left the Federal budget bloated. In Europe, leaders of the 'Frugal Four' (Sweden, the Netherlands, Denmark and Austria) have warned that any pandemic spending needs to be paid back down the line.

It is true that, one way or another, current spending measures will have to be paid for. But this is unlikely to come from tax revenue in the short or even medium term – unless we see a stonking post-virus recovery. Central banks around the world have embarked on huge bond purchase programmes that are pegging down borrowing rates for governments. Many have all but committed to buying whatever bonds their respective governments put up for sale, meaning government spending is effectively being 'monetised' (funded through money-printing by the central bank).

Of course, money-printing is a scary sounding tactic, bringing images of hyperinflation in 1930s Germany or 2000s Zimbabwe. But here is one of the most interesting things we have noticed about markets in the pandemic: after news flow suggesting more debt monetisation, capital markets have turned positive on that country's asset (currency in particular). Conversely, when the news flow suggests only limited spending, the country in question has (generally) taken a beating. In other words, markets are rewarding the big government spenders.

This means governments should have little incentive to curb their spending programmes now. Given the urgency of the economic problem facing the world, it is hard to justify frugality. Certainly economies are opening up again and hence fine-tuning fiscal support to those who really need it has become more challenging. But at the same time, yields are being pegged down by central banks and investors are rewarding largesse.

As such, we suspect not only that governments will have to provide (modified) virus relief programmes, but that they may look to increase long-term fiscal investment, laying the bedrock for a stronger economy post-pandemic. We have seen this already in Germany – Europe's traditional stalwart of the balanced-budget mantra. And with virus cases now skyrocketing in many US states with previously low rates, further fiscal spending is likely there too. Governments may even use further spikes and flare-ups as a justification for continued spending. If so, it's unlikely that businesses and individuals will raise too many objections.

Wirecard turns wirefraud

It just wouldn't be a crisis without a proper corporate scandal. German payments firm Wirecard filed for bankruptcy last week. Initially, the story was that it had "misplaced" €1.9 billion in cash (a bit like losing some coins down the back of the sofa). Now it seems the lost amount was somewhere around €3.5 billion, and the entire sofa has been spirited away.

Last weekend, the firm's chief executive Markus Braun quit over the fraud allegations, while the chief operating officer Jan Marsalek was, apparently, not at home. Meanwhile, the hunt for the missing billions came to a dead end in the Philippines, and management was forced to admit the money may not ever have existed. Last week, Wirecard's shares and bonds all plummeted and Braun was arrested, while Marsalek issued a statement from somewhere that he would give himself up. The end came on Thursday morning when the company filed for insolvency, which was a surprise to creditors, who thought they were still in talks about further possible support. Scandals of this size usually generate as much fear as they do publicity. Wirecard is the only firm in the history of the German Dax Index to have gone bust.

Let's look at the specifics of this case first. As of Wednesday 17 June, according to Bloomberg data, the market capitalisation of Wirecard shares was €12.9 billion, having peaked less than a year ago at over €24 billion on 3 September 2019.

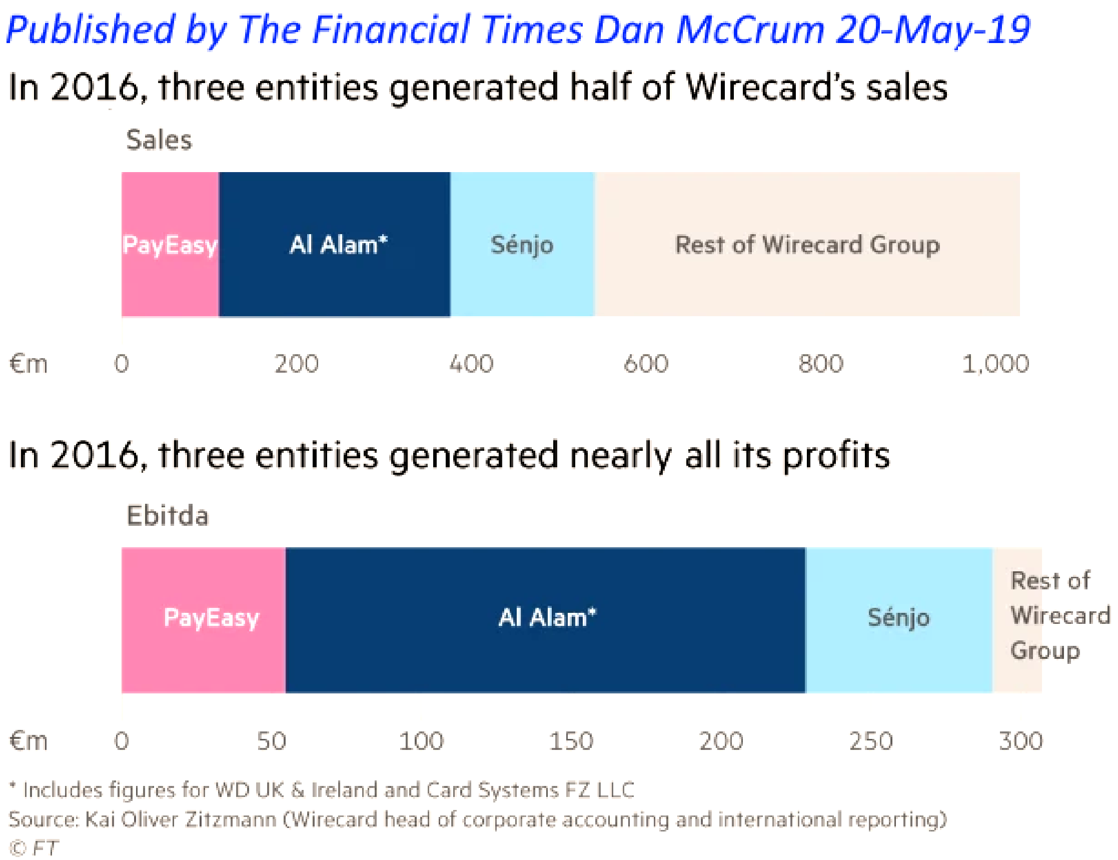
Meanwhile, Wirecard's outstanding debt seems to be at least €3 billion but (according to Reuters) probably stands at around €4 billion.

Wirecard had a German deposit-taking retail bank that offered a suspiciously high euro interest rate of 0.75% (when others are nil or sometimes negative). But these funds appear to be intact (so the German deposit insurance scheme should not have to cover the funds).

There is no suggestion at this time that customers using Wirecard's payment services have had their money stolen – buyers have paid, sellers have received the proceeds. However, Wirecard's cashflow may have been used to give the impression that the business itself had cashflow and cash of its own on the balance sheet.

So, this is about the defrauding of investors; lenders, bond holders and equity holders. It may seem remarkable, but stories of malfeasance surrounding Wirecard have been around since at least 2015. The Financial Times published a series of articles lead-authored by Dan McCrum, with the allegations rising in seriousness all the way to late last year.

The FT pointed out that Wirecard's profitability was entirely due to three particular Middle Eastern and Asian entities:



Another allegation from The Foundation for Financial Journalism's Robbie Boyd pointed out that a 2015 purchase of Indian (and other) payment-processing companies had been channelled through a Mauritius fund. It appeared that of the €340 million paid by Wirecard, €285 million did not go to the sellers. The implication was that the disparity went to some of Wirecard's executives and friends.

Somehow, Wirecard deflected the stories and even managed to persuade some investors – and its German regulator – that the FT was in cahoots with hedge funds and "speculators". Indeed, it managed to raise long-term debt in June 2018, arranging a €1.75 billion revolving loan facility with a 2024 maturity. Last year, it appeared €800 million had been lent from the facility. Remarkably, in September 2019, Wirecard received an investment-grade credit rating of Baa3 from Moody's and raised a five-year bond of €500 million. It also got Softbank to fund a convertible bond of €900 million.

And, even more startling, it appears the revolving loan facility was drawn further, by another €775 million, probably around the same time as KPMG published the report (that Wirecard's supervisory board had commissioned), saying it could not verify €1 billion in cash balances, could not trace hundreds of millions in cash advances to merchants, and questioned Wirecard's acquisition accounting.

It is no surprise that cases like this come out when times are tough and companies are struggling. But one case of fraud, even if extremely high profile, is manageable. On the other hand, if this is symptomatic of a wider systemic issue, that presents serious problems for the financial system. So, is Wirecard one bad apple like Polly Peck, the UK darling of the late 1980s which collapsed in 1991? Is it more serious, like the Enron scandal of 2001? Or is the whole barrel rotten like in 2008? Just how far does this go?

We suspect this will be seen as more of a one-off than a deeper directly systemic issue. It seems Wirecard's management were able to use investors' positive sentiment towards a rare and rising German fintech star to defraud them in a particularly clear-cut and egregious way. While the losses do not seem to be concentrated but rather diversified among holders, as with any bankruptcy claim, debt holders will have a bad time retrieving their capital and, as happens with fraud, the chances of recovering anything at all are slim. Even if it were not fraudulent, this highlights why one might prefer holding tech company equity over debt. Since tech companies have little in the way of physical assets, debt recovery can be extremely difficult.

Contrast this with the widespread issues in the lead-up to the global financial crisis. Then, while many individuals in the system behaved badly, none were obviously breaking any law. Technically, those financial institutions involved were not obviously breaking the law either, just enabling a widespread mismanagement of culture and risks, and demonstrating a willingness to accept dubious practices like accounting 'tweaks'.

Returning to the present, there are certainly systemic and regulatory questions to be answered around the Wirecard collapse. Moody's will also face a lot of criticism for its Baa3 rating of last year's debt-raising. Investors will have to once again face the issue that it is not a good idea to have the borrower paying our agent to tell us that the borrower is a good credit risk.

The Germany regulator, BaFin, is also coming under intense scrutiny in the wake of the scandal, with accusations that it ignored reports about accounting irregularities to protect what was seen as a domestic champion. As mentioned earlier, after last year's police raid on Wirecard's office in Singapore, BaFin banned investors from betting against their shares for two months – the first time such restrictions had been put on an individual stock in German history. Shortly afterwards, the regulator filed a criminal complaint against two FT journalists who reported on the Wirecard allegations.

The role of accounting firms more generally is also on the radar. In response to the Enron scandal nearly 20 years ago, the Sarbanes-Oxley Act came into force, with strict new rules for accountants, auditors and corporate officers. Stringent record-keeping was supposed to follow from this, but 18 years after its passing, the fact that there are still such egregious examples of fraud as this, suggests more needs to be done.

The biggest systemic issue involves the role of external auditing. Enron put paid to Arthur Andersen and Wirecard's auditors EY will be dreading the next few months. Already, EY faces the inevitable class action from investors. For companies in general, and large companies in particular, the collapse in the number of skilled auditors presents a massive headache, given that auditor rotation is a regulatory requirement and that conflicts of interest mean there are none available. A shake-up of the industry is likely, with a potential rise in costs.

The episode may also affect how ready investors are to accept the high valuations of less transparent "tech" companies. But from what we have found out so far, there is little to suggest it poses significant systemic risks. And if financial fraudsters are now more wary, so much for the better.

CAMBRIDGE
INVESTMENTS LIMITED

29th June 2020

Global Equity Markets

Market	Fri 16:08	% 1 Week*	1 W	Technical: Short	Technical: Medium
FTSE 100	6172.2	-1.9	-120.4	⇗	↘
FTSE 250	17107	-3.3	-580.6	↗	↘
FTSE AS	3412.2	-2.1	-74.6	↗	↘
FTSE Small	5039.2	-2.0	-103.0	↗	⇘
CAC	4921.0	-1.2	-58.4	↗	↘
DAX	12099.6	-1.9	-231.2	↗	→
Dow	25283	-2.3	-588.0	⇗	⇘
S&P 500	3028.3	-2.2	-69.4	⇗	→
Nasdaq	9854.6	-0.9	-91.5	↗	↗
Nikkei	22512.1	0.1	33.3	↗	→
MSCI World	2193.4	-0.7	-15.6	↗	→
MSCI EM	1004.4	0.3	3.1	↗	→

Top 5 Gainers

Company	%
Ocado	4.6
Fresnillo	4.2
J Sainsbury	3.7
Antofagasta	3.1
Kingfisher	3.0

Top 5 Decliners

Company	%
Carnival	-22.3
TUI	-18.7
easyJet	-18.3
Int'l Consol Air	-17.8
Rolls-Royce	-13.9

Currencies

Pair	last	%1W
USD/GBP	1.233	-0.2
GBP/EUR	0.909	-0.4
USD/EUR	1.12	0.3
JPY/USD	107.22	-0.3
CNY/USD	7.08	0.1
Bitcoin/$	9,166	-1.6

Commodities

Cmdty	last	%1W
Oil	40.58	-3.8
Gold	1757.1	0.8
Silver	17.62	-0.0
Copper	265.9	1.8
Aluminium	1570.0	-2.3
Soft Cmdties	336.0	-0.9

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.17	-0.07
UK 15-Yr	0.39	-0.08
US 10-Yr	0.64	-0.05
French 10-Yr	-0.13	-0.04
German 10-Yr	-0.48	-0.06
Japanese 10-Yr	0.01	-0.01

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.5	22.2	18.6	13.4
FTSE 250	3.1	23.4	22.7	14.3
FTSE AS	4.2	23.5	18.6	13.5
FTSE Small	4.0	12.5	-	13.8
CAC	2.3	19.7	22.3	13.7
DAX	3.1	22.8	18.9	12.7
Dow	2.6	18.8	23.2	15.3
S&P 500	2.0	21.3	24.3	16.3
Nasdaq	0.9	31.1	29.8	18.4
Nikkei	2.0	26.4	21.7	16.9
MSCI World	2.3	21.3	22.9	15.4
MSCI EM	2.7	16.5	16.3	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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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