CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

16 March 2020

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It's been mostly about toilet paper this week – well sort of; Source: Dave Brown, 12 March 2020

Notes on a crash: the short, medium and long term

Last week will remain in the memories of the investment community for a very long time. Because of the extremely rapid fall from the all-time high that global markets had reached on 19 February, this stock market crash is right up there with 2008, 1987 and yes 1929. However, this is where any obvious similarities end. Compared to those historical precedents, this one has been caused by an external – and widely expected to be temporary – shock to global economic activity levels.

Last week the headwinds that markets had to contend with were boosted by three further factors which all could have been avoided, if those in charge had acted more responsibly and with a bit more foresight. First, the latent oil supply overhang that has been an issue for a while, meant that OPEC and Russia had to make some painful calls and compromises. When they failed to do so, the virus crisis was doubled up with a (reverse) oil price emergency. Since slumping oil prices derailed stock markets in 2015/2016, it was not surprising stock market participants reacted to the news with heavy sell orders.

The next two accelerators hit on the same day. Donald Trump's COVID-19 action plan was so clearly insufficient, or barely even competent, that the full-blown virus scare had finally arrived for the US public. At the same time, capital markets experienced its very own 'toilet paper panic buying' moment. Except that it was cash that so many investors wanted to desperately get hold of, before someone else got hold of it first. Why such an outsized dash for cash? Well, as we already commented in separate notes over the few last days, shutdowns require higher levels of cash in circulation than in normal times. When, on top of this, speculative investors become distressed sellers to meet margin calls, then cash-raising pressures further push down liquid assets – be it stocks or bonds – quickly below valuation levels that cannot be explained by rational reassessments of the near-term future of the global economy.

We have noted with interest that private investors have acted far more rationally in this environment and did not join the panic selling in the herd mentality of old, as global fund flow figures showed. Have they perhaps learned from the financial crisis of ten years ago that market events like this week are best sat out, or if cash is available could even be seen as long-term buying opportunities?

We believe unbiased and factual information and assessment is the best guide to investments, so this week we have dedicated the majority of the full version of the Cambridge Weekly to a full assessment of the short, the medium and the long-term considerations we believe any private investor should consider, and be cognisant of, in these turbulent days and weeks.

Covid-19 over the short, medium and long term

A point made by many over the last few weeks is that the coronavirus pandemic could well affect the world's economic health more than anything else. For us in financial services, this has been made abundantly clear by the recent carnage in capital markets. As we wrote on Thursday, not all the selling pressures look fully justified as far as future economic expectations go. But it is clear that the global economy will take a substantial hit and likely fall into a recession – if only a brief technical one. The question is no longer whether the virus, and the measures taken to prevent its spread, will hurt the global economy and investment portfolios. It is how badly – and for how long – it will do so. The answer to that is hugely uncertain and changes depending on the timeframe you look at. Below, we look at what the pandemic may mean over the short, medium and long term.

Short-term

The short-term diagnosis for capital markets and the global economy is not good. Italy, the second-largest outbreak hotspot in the world, has been shut down by its government. Countries like France, Germany and others are following suit, with widespread closures of schools and public events. The British Government has, for the moment, opted against this heavy-handed strategy, but made it clear that they may still do so in the upcoming weeks and months. Even if they do not, the self-isolation tactics many people are already following will see most businesses take a big hit to their revenues.

The measures taken by governments (Italy's suspension of household mortgage payments and the UK's rollout of statutory sick pay) will hopefully alleviate defaults on a grand scale. But there is no plausible scenario where short-term economic output remains at pre-virus levels.

In market terms, equity indices around the globe have nosedived in recent weeks and are now oscillating between viciously sharp sell-offs and impressive recoveries. As we explained on Thursday, the initial sell-off could be described as an orderly re-pricing of assets in light of the hardships the pandemic could bring. The falls have been exacerbated by the fact that stock markets had been trading at or near all-time highs, (i.e. stretched in valuation terms because they were anticipating a decent re-acceleration following last year's marked slowdown in global trade).

The market movements last week have been anything but. We now seem to be in that phase of a bear market often called 'capitulation' – where the weaker participants are suddenly in danger of having no (or even 'negative') cash balances, and are forced to sell what they can, not what they want. To other investors, the behaviour of markets becomes irrational – for example, last week we heard the cry "Why are US treasury (bond) prices going down? Why is gold going down? They should be going up!!"

That loss of certainty about how markets 'should' work effectively lowers investors' risk appetite generally. It can also cause participants to start selling everything in a panicked cash-grab. That is, markets go down because markets are going down. This can be seen from the fact that equity markets have fallen over the week despite a parallel fall in bond prices (which tend to be inversely correlated). Even government bonds – the supposed 'risk-free' rate – are too risky for some at the moment. This could be because insurers, banks, businesses and public bodies simply need cash to cover their short-term requirements during the isolation period. Or it could be because market moves have produced a number of big and small forced sellers due to their geared previous positioning, leaving 'DIY' investors scarred and bereft of risk appetite. It most likely a combination, but either way it is bad news for assets in the short-term.

The flipside to this, however, is that the more that asset prices fall away from reasonable economic expectations, the bigger the buying opportunity. When risk premia (the return demanded for a given level of risk) are high, the reward for taking risk is too. This might be why we saw some sharp rebounds in equity indices on Friday, after a few titbits of good news boosted market morale (including new technology which can supposedly speed up the virus testing process). We are far from out of the woods yet, but opportunities may be opening.

Medium-term

Governments around the world have announced measures to cope with the economic fallout from the COVID-19 pandemic. The key measure of whether or not these are successful will be how quick a recovery the global economy can muster in the second half of 2020 and beyond. Here, the British seem to be leading the way among western nations (covered more in our article below). A £30bn fiscal stimulus plan was announced just hours after a 50 basis point interest rate cut (0.5% down to 0.25%) from the Bank of England – with the hopes of giving the economy a double-boost to see it through this difficult time. China has already ramped-up funding to virus-hit areas, cut interest rates and encouraged banks to loosen lending standards. And the US and several European countries are suspending many tax payments for businesses and individuals.

On the central bank front, the US Federal Reserve has already cut interest rates and the European Central Bank (ECB) has said it will lend to banks at a rate as low as -0.75%. Some responses from policymakers were found lacking, however. Donald Trump has been the subject of much media derision for his handling of the pandemic – which is perhaps why US stocks have fared among the worst this week. Despite announcing some measures, the ECB declined to cut interest rates, insisting instead that the onus was now on European governments to ramp up their fiscal spending.

This is something the ECB has been saying for some time. President Christine Lagarde, since taking charge of the bank, has made it her mission to move the European political establishment into action on spending. Past attempts have been unsuccessful, but if anything is going to convince overly prudent eurocrats to open the public purse, a global virus crisis of this scale should do the trick. On Monday, the Eurogroup will meet to discuss what response its nations will offer. And if ever there was a time to revise old rules forbidding public spending, it is now.

As we see it, a globally coordinated stimulus response is the best chance the global economy has at rebounding later on. The early signs of this are encouraging. Many have been critical of the UK's decision this week not to close schools or ban large public gatherings – as many other governments have done. But as we discuss below, underneath this decision is a clear recognition that economic vulnerability is as much a focus as public health worries. The British economy was already at risk from suffering from a return of pre-Brexit uncertainty malaise before the virus hit, and the COVID-29 crisis only highlights this more.

It may seem callous to trade off a 5% reduction in the virus peak to keep shops and public spaces open. But this is no simple decision. The virus poses a serious threat to those in already vulnerable positions, but bankruptcies, layoffs and food shortages can kill just as many or more. Unfortunately, this terrible calculation is the reality this government faces. Opting for efficient strategies while trying to minimise disruption is not unreasonable – particularly when thinking about the consequences later down the line.

In market terms, as we said above, rising risk premia present opportunities over the medium and long term. The self-reinforcing falls this week have also had the consequence of pushing the weakest investors – those with highly-leveraged positions – out of the market. History shows us that sorting the 'wheat from the chaff' leads to a solid base for recovery later down the line. To be clear, we are far from out of the woods yet in capital market terms. But the falls in equity prices have definitely put valuations far more in line with reality. And if a coordinated response from governments can do the trick of rebuilding confidence in the underlying economy, the outlook for equities into the end of this year and next is no way near as dire as current levels would suggest.

Long-term

The problem with most emergency treatment is that it often does little to address the underlying problems. We can be pretty confident that COVID-19 will not be a big problem in 18-24 months' time. But the crisis has already highlighted a number of underlying issues. The most obvious of these is showing just how vulnerable our increasingly globalised world is to new and rapidly spreading diseases. But it has also laid bare the chronic global economic problems we have been discussing for some time now.

Since the financial crisis, the world economy has been hamstrung by weak productivity, stagnant living conditions and slow profit growth (outside the US at least). These problems make growth incredibly fragile and susceptible to external shocks. Due to structural issues, growth has not been strong enough to give any confidence in long-term economic health. Central bankers around the world have been saying as much for a while. They have been clear that monetary policy on its own is not enough to solve the problems we face. A strong bout of social investment – investment in public goods – is needed to move out of the stagnant era. Central bankers have also made it clear that the private sector is ill-suited to fulfil this need – which is why Mark Carney, Christine Lagarde and Jerome Powell have all been pressuring politicians to pick up the slack in terms of public spending.

In response to this crisis, governments have shown they are willing to act for the good of the public and the economy. Over the long-term, that change in mindset could be the biggest benefit. We have certainly already seen this in the UK, where the government – a Conservative one, no less – has already committed to a wholesale program of public investment. Over the past few decades, the biggest barriers to public investment have been in Europe, where cumbersome EU budget rules have prevented governments from dipping into bond markets, even in times of crisis. As we mentioned above, a crisis like this one could be just the thing to finally jolt European holdouts into action. We are reminded of an old political saying: Europe integrates one crisis at a time.

The crisis has also highlighted a longstanding problem in financial markets: the lack of liquidity provided by market makers. Financial markets have changed substantially over the last two decades, with new technologies and macroeconomic trends giving large banks (the traditional market-makers) less of a role while giving high-frequency traders a huge role. This means that, in the good times, high-frequency traders abound, and markets are awash with daily liquidity. But in the bad times – when high-frequency traders go running for the hills to cover their positions – there is no one left to pick up the slack and stop the rot.

When markets get scared, the so-called 'gap risk' increases massively – as we have plainly seen over this week. But the deterioration in risk appetite opens opportunities for those willing to take risks – in particular, those willing to pick up depressed assets at a cut-price rate and wait for the inevitable rebound in public sentiment.

But don't think 'inevitable' means 'tomorrow'. Risk appetite can take a long time to rebuild. These are the times for long-term investors.

UK – Bank and Budget

The British economy, like those all over the world, will take a substantial hit from the COVID-19 pandemic. As the Prime Minister said in his Thursday broadcast, the question is how severe and lengthy the downturn will be.

The responses from policymakers will be crucial. A technical recession (defined as two consecutive quarters of null or negative growth) is almost inevitable. For the UK to avoid an even longer period of contraction will still need significant, swift, and measured responses from policymakers. It will probably also need some good luck. The one bit of good news to come out this week is that the UK can at least count on the former.

Earlier in the week, the Bank of England (BoE) announced an emergency cut to interest rates, from 0.75% to 0.25%. As the update published on its website confirms, the BoE is responding by continuing to 'print' money to maintain its holdings of corporate bonds, and 'print' some more to fund loans to small and medium-sized businesses. This willingness to print money (expanding the monetary base in £-Sterling) is helpful; no one is expecting inflation pressures now or in the medium-term. It was noteworthy that Andrew Bailey, the incoming Governor, made it clear that the BoE and the Treasury were "coordinated".

Even before the virus outbreak, much was expected from the first Budget since the Conservative Party's landslide election victory. Lingering Brexit uncertainties, a lack of investment and lethargic productivity growth had already left the British economy teetering on the edge of contraction – with zero growth in the three months to January. And so, Boris Johnson's promise to "unleash the pent-up potential" of Britain with a big fiscal stimulus package had markets waiting in eager anticipation. The coronavirus scare has compounded those underlying issues. Rishi Sunak's first budget as Chancellor therefore became a trial by fire.

Sunak seems to have emerged reasonably unscathed, if the following morning's press coverage is the yardstick. As Paul Johnson of the Institute of Fiscal Studies (IFS) notes, the government did the rational thing of rolling two Budgets into one. The initial Budget had been formulated in the aftermath of Johnson's election victory, with all necessary calculations necessarily done completed well before the last four weeks of the coronavirus "going viral".

Government investment spending over the next 5 years will average 2.9% of GDP, versus an average of 1.4% over the past 40 years

Source: Institute of Fiscal Studies

The first part of Sunak's Budget speech focused on combating the effects of COVID-19, with a headline spending figure of £12bn. This includes £5bn to help a potentially struggling NHS (over and above the targeted increase in the other budget), plus £7bn to support individuals and businesses and local councils. The £7bn aids those in self-isolation with quicker and easier access to statutory sick pay and universal credit; increased access to employment support allowance for the self-employed; small businesses can apply for handouts to cover short-term costs and delays in business rate payments. Some £500m is allocated to a hardship fund for councils in England. The IFS described the package as "timely, targeted and temporary", but worries persist that the support measures may miss individuals who lie outside normal employment channels.

Then there's the second part. This shows an unmistakable breakaway from the austerity policies of the post-financial crisis Tory governments, with a significant increase in public investment.

Sunak announced an extra £30bn for investment spending, which will translate into £27bn more debt than previously expected. The Government's detailed National Infrastructure Strategy will be released by July. It should set out plans for transformation of the UK's economic infrastructure. Bloomberg Intelligence notes that housing and commercial building will not be included in this.

According to the Office for Budget Responsibility (OBR), spending on consumption and investment will be 3% higher by the end of this parliament. This causes the OBR growth overall estimates to be slightly higher than those of the BoE.

The Budget may have brought some comfort for the fiscal conservatives, however. "Current" spending (the ongoing expenditure on public services) will rise 2.8% per year more than inflation out to 2024, but this is quite a bit less than the 4.1% indicated under the Theresa May government last year. While still marking an end to austerity, it won't make up for austerity cuts, especially when the police and other favoured departments receive the lion's share of the increase. The IFS points out that much of the increase in spending occurs in the next two years, suggesting a determination to 'kick the can' of future funding concerns firmly down the road.

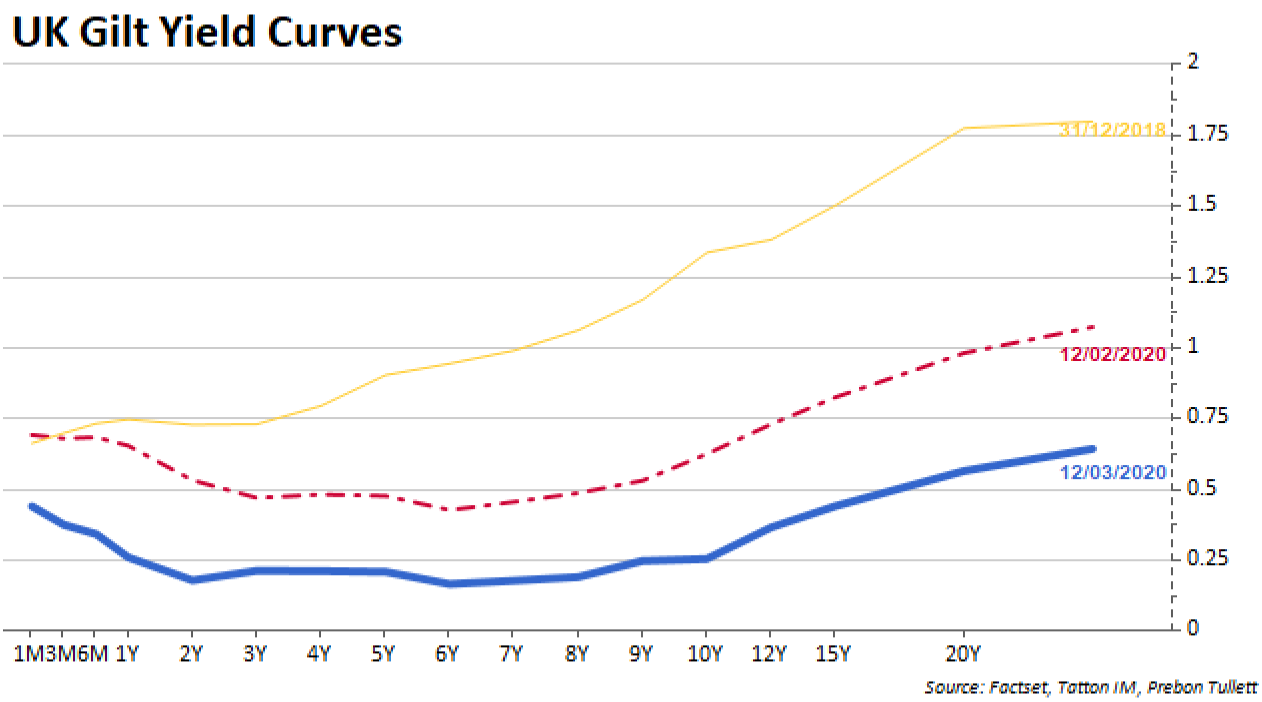
The planned tax take across the economy will be greater than previously expected. However, at a personal level, it won't feel like it. Personal thresholds for National Insurance contributions were raised and duties on fuel and alcohol remained frozen. Corporation Tax cuts announced in the last Budget, and scheduled to be introduced this year, will not happen.

Still, the bump-up in expenditure will be almost entirely covered by increased Government borrowing. The Chancellor was completely unashamed of this debt hike, with Sunak telling MPs he was "not going to make an apology" for the Budget. The Conservative party has spent a decade cutting and tightening the public purse-strings. But as the FT put it, "This government is not just ending austerity, it is murdering it and covering up the body." Tax increases are probable next year if the economy is on a stronger path. Still, the Johnson bet is that public investment will raise growth and, in turn, the general tax take will increase to cover it.

Such unabashed spending will worry the fiscal conservatives. Equally, one might think that a government not raising firepower now is a bit like not installing enough lifeboats on the Titanic. And one of the main consequences of the market carnage is that yields on government bonds have sunk as low as they have ever been. Despite UK Gilt yields rising somewhat this week, at the time of writing the Government pays just 0.27% annual interest to borrow for ten years. Markets are clearly willing (almost begging) to lend to the Government for the long-term, regardless of its debt pile. At this point, a spike in yields is unlikely, and irrelevant if the debt can be focussed on the longest maturities.

Unfortunately, all the fiscal firepower the Treasury could muster is still unlikely to be enough to save the country from short-term pain. It increasingly looks as though the country (and most of the world, for that matter) will have to shut up shop until the pandemic can be contained. That is as big an economic hit as they come, and it struck right after Britain entered the year with only the beginnings of momentum.

What the Government's measures can do, however, is provide a solid base for a rebound later in the year, and offer more concrete solid hope for an investment-led future. Currently, the crucial question is whether the virus-induced contraction will be a blip or a prolonged downturn. Hopefully, in six months' time, we will be back to worrying about trade deals and rising inflation pressures. The more economic support the Government gives now, the higher the chances of confidence remaining reasonably robust, with consequent reward later. Other western governments – particularly in Europe – would do well to follow this example. Much like in the wake of the financial crisis, if states around the world make a joint concerted effort to support businesses and individuals now, reinforced with investment in the future, the worst-case scenario should be avoidable. With this Budget, the Government has lowered the risk that weakness persists beyond the last case of coronavirus. Even if this cannot avert danger in the short-term, it is still a good sign.



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16th March 2020

Global Equity Markets

Market	FRI 16:48	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	5323.8	-17.6	-1138.8	↘	↘
FTSE 250	15528	-17.2	-3218.1	↘	↘
FTSE AS	2974.2	-17.4	-626.8	↘	↘
FTSE Small	4600.3	-13.6	-723.6	↘	↘
CAC	4101.2	-20.2	-1037.9	↘	↘
DAX	9179.2	-20.5	-2362.7	↘	↘
Dow	21873	-15.4	-3991.7	↘	↘
S&P 500	2541.0	-14.5	-431.4	↘	↘
Nasdaq	7516.7	-11.9	-1013.6	↘	→
Nikkei	17431.1	-16.0	-3318.7	↘	↘
MSCI World	1776.5	-17.3	-372.8	↘	↘
MSCI EM	883.1	-12.7	-129.0	↘	↘

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
Ocado	4.2	Carnival	-41.5
0	0.0	GVC	-38.7
Pearson	-5.5	Micro Focus Int'l	-38.5
Spirax-Sarco	-5.7	Centrica	-37.9
HSBC	-6.2	M&S	-36.7

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.236	-5.3	Oil	33.57	-25.8
GBP/EUR	0.895	-3.4	Gold	1522.0	-9.1
USD/EUR	1.11	-1.9	Silver	14.66	-15.5
JPY/USD	107.76	-2.2	Copper	248.3	-3.5
CNY/USD	7.01	-1.1	Aluminium	1656.0	-3.7

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.42	+0.18
UK 15-Yr	0.62	+0.21
US 10-Yr	0.93	+0.17
French 10-Yr	0.03	+0.37
German 10-Yr	-0.54	+0.17
Japanese 10-Yr	0.05	+0.18

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	6.5	15.3	10.0	13.3
FTSE 250	5.2	18.8	10.8	14.3
FTSE AS	6.2	16.1	10.0	13.4
FTSE Small	4.5	-	-	13.9
CAC	4.5	14.9	10.7	13.5
DAX	4.3	16.0	10.2	12.5
Dow	3.0	15.6	14.1	15.1
S&P 500	2.4	16.7	14.9	16.1
Nasdaq	1.2	23.0	19.3	18.1
Nikkei	2.6	15.4	13.9	16.9
MSCI World	3.1	15.6	13.3	15.3
MSCI EM	3.2	12.4	11.1	11.9

UK Mortgage Rates

Mortgage Rates	Feb	Jan
Base Rate Tracker	2.50	2.48
2-yr Fixed Rate	1.48	1.49
3-yr Fixed Rate	1.65	1.66
5-yr Fixed Rate	1.71	1.72
10-yr Fixed Rate	2.61	2.61
Standard Variable	4.26	4.24

* The *% 1 week* relates to the weekly index closing, rather than our Friday p.m. snapshot values
** LTM = last 12 months' (trailing) earnings;
***NTM = Next 12 months estimated (forward) earnings

For any questions, as always, please ask!

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16th March 2020

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.

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