THE **CAMBRIDGE** WEEKLY

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Peaks of differing magnitude; Bob Moran, 17 April 2020

Lifting lockdown remains a delicate balancing act

The post-Easter week brought continued relief for long-term investors, with a consolidation of the recovery from previous weeks followed by reacceleration towards the end of the week. That said, the continued strength of markets has not been welcomed by everyone. Perhaps it was telling that the most vociferous criticism of the recent economic and humanitarian support efforts from global policymakers came from the hedge fund community, many of whom chose to describe these efforts as either unjustified market interventions or the first steps towards state ownership and socialism. Might these hedge fund managers be frustrated at being wrong-footed twice, having missed the March crash, and subsequently doubling down by 'betting' on new market lows?

As discussed last week, two scenarios remain rational and entirely possible, namely a) new lows may lie ahead and b) the worst is behind because investors at large now consider holding equities to be the preferable long-term position compared with holding cash or low risk assets. This decision is reached by weighing short-term downside risks against the medium-term certainty that there will be a post-coronavirus recovery.

The latter scenario came increasingly into focus last week, as the balance of public opinion shifted from open-ended blanket activity constraints to a gradual re-opening of public life and the economy across differing age groups. This will have been promoted by a combination of falling new hospital admissions, reports of coping healthcare systems and increasing economic hardship pressures. The most market moving, however, proved news of some quite encouraging, even if still somewhat anecdotal, rather than as of yet scientific, evidence of treatment efficacy of some of the front runners amongst the anti-viral drugs undergoing front-line testing in hospitals around the world.

While it is still very early days to assume that the peak of the global COVID-19 epidemic has passed earlier than modelled, it is increasingly reasonable and rational to believe that the key reasons for full lockdowns are beginning to dissipate. The statistical evidence has confirmed that the infection is most dangerous for the elderly and infirm, who are at elevated risk of infection when the virus spreads uncontrolled through communities (In most regions, fatalities among the over 60s accounts for 95% of all loss of life due to Coronavirus). Once this group has been shielded from wider community contact – as has been the case in the UK after communal contact peaked on Mother's Day (22 March) – hospital admissions and fatalities reduce.

But dangers persist. The broader, younger population evidently suffers severe illness to a lesser extent, but can still fall victim to the virus without it being entirely clear what factors beyond pre-existing heart and lung conditions are determining this. The understandable fear of this risk would prevent a wider return to pre-virus public life for the working age population, unless a vaccine or effective treatment becomes readily available. Despite some positive reports, a widely-distributed vaccine looks unlikely to appear before 2021. Therefore, it is understandable why so much (market) hope and excitement is attached to any positive news from the antiviral drug tests.

Hope is powerful but can lead to over-optimism. We cannot be sure whether the latest developments are reason enough to follow China's example and end the blanket restrictions of free movement across society. The experience of those countries across Continental Europe who are now daring to ease their national lockdowns will be most instructive for those who are a few weeks behind in the epidemic.

Should this bold experiment prove successful, it is reasonable to expect a gradual return to public life starting from May. Should the scientific results of the antiviral drug tests confirm the anecdotal efficacy evidence, then it could even make the 'herd-immunity' approach a viable public health strategy again. On the other hand, should re-opening society lead to renewed spikes in hospital admissions, or the tests on antiviral drugs return inconclusive results, it may mean further lockdowns are necessary.

We think markets are currently choosing to focus on the former rather than the latter, and being awash with central bank liquidity, and gargantuan economic stimulus, could keep propelling upwards. Whether this proves to be justified or wishful thinking, only the coming weeks will tell. However, positioning one's investment strategy decisively towards one outcome or the other seems high-risk at this point – just ask those 'feather-spitting' hedge fund managers.

Large cap gains vs smaller company pains

Stock markets seem to have found a floor. After being in freefall throughout March, equities have rebounded strongly over the last couple of weeks, and this week entered a period of consolidation. Major indices in the US, UK and Europe all held onto recent gains. The newfound market confidence stands in stark contrast to the sheer panic so prevalent in March, when investors joined in with frantic doomsday preparations by selling everything that wasn't nailed down.

March's chaotic sell-off stemmed from the fact that this pandemic – and the enforced shutdown – has plunged us into a recession of unknown depth or duration. But the basis for the stock market rebound has nothing to do with actual economic recovery. We are still very much in an economic coma, with the latest data beginning to show the consequences of the shutdown. Faith in markets has instead come from the resolve of governments and central banks to do whatever it takes to beat not just the virus itself but the economic harm it will bring. Policymakers have effectively thrown a safety net under the financial system and wider economy.

For asset markets, the biggest component of this is probably central bank action. Central banks around the world have effectively written blank cheques to their respective governments (and in some cases, corporate debt markets) and promised to ensure the financial system is awash with liquidity. For the real economy, the most important element is how governments spend that money.

Huge fiscal packages have been pledged to support businesses and consumers through the tough months ahead. But despite the promises of politicians that no one will be allowed to go under from this natural catastrophe, in practice that may prove easier said than done.

In the UK, the emergency assistance package was estimated to total £330 billion. The Coronavirus Job Retention Scheme – whereby the government pays a significant amount of furloughed employees' wages – is in theory the simplest and most accessible of emergency measures introduced. Indeed, there are reports that businesses are taking advantage of it to good effect. There's also the Coronavirus Business Interruption Loan Scheme which is making loans of up to £5 million available to small and medium-sized enterprises (a similar scheme is available to larger companies). Firms will have their first 12 months of interest payments and loan fees covered by the scheme, and lenders will receive an 80% guarantee on each loan as an incentive.

However, there has been substantial political backlash against some companies' use of the scheme to pay its staff – most notably some Premier League Football clubs – where businesses are seen as being already flush with cash. Beyond this, many employers who do not employ staff on a fixed basis (such as staff on zero-hours contracts) would have to find other funds to supplement the scheme if they elected to support their workforce to ensure them returning.

Where the scheme falls short in particular is for the owners of small business owners, who often forgo a large salary and instead rely on the business' profits for income. While the salary part can be covered by the government's scheme, there is nothing to replace the income from profits.

Businesses have other sources of capital they can tap into, but these come with their own issues. While the government has promised emergency loans with generous repayment terms are available to those in need, reports suggest many small businesses cannot access those loans quickly enough, or even at all. Despite businesses facing a cash crunch, only 2% of firms have secured funding so far, according the British Chambers of Commerce. And, as yet, Chancellor Rishi Sunak has ruled out giving 100% government backing to credit handed out under the scheme.

Even if the government is liberal in its edicts on which companies should be eligible for the loans, the final decision ultimately rests with the intermediaries – the local banks. Businesses must prove they were solvent and trading before the lockdown began, and must meet banks' pre-lockdown lending criteria. The bank manager or loan officer can put in some more margin of safety by asking for personal guarantees from the applicant (despite assurances from the government that this would not be required for loans below £250K).

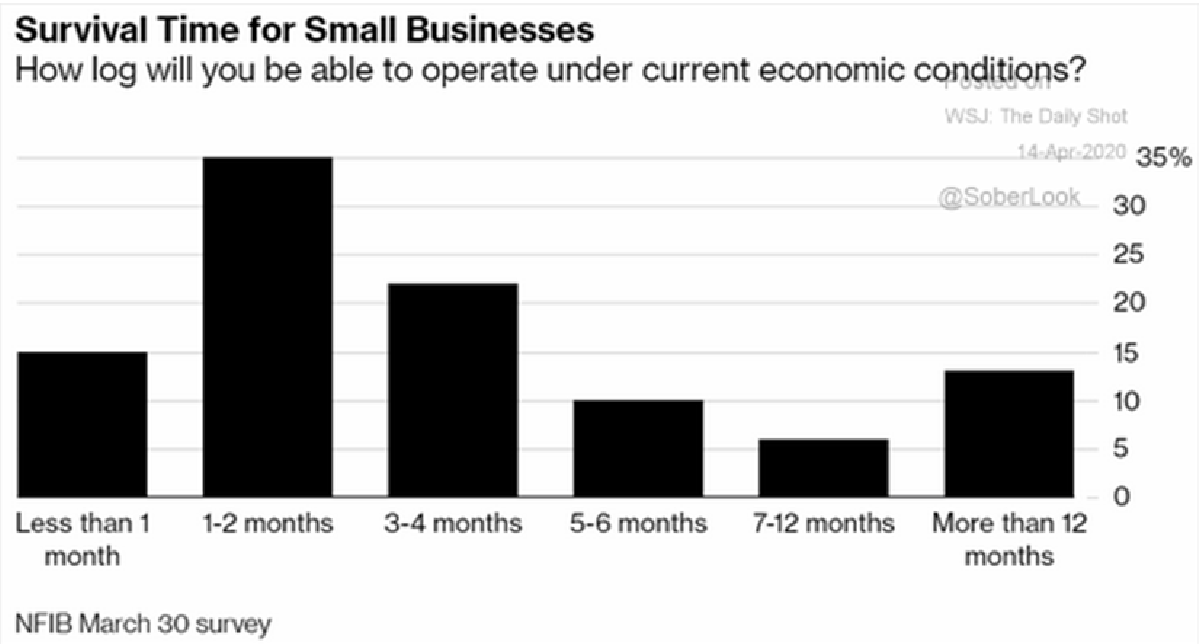
Finally, even when loans have been approved, reports are that payments have not arrived soon enough to meet pressing short-term costs.

For many small businesses, lending is no cure-all either. Large companies are used to running up debts to leverage their expansion, but for small business owners, the thought of borrowing against a deeply uncertain future cashflow is an uneasy one.

While the UK furlough scheme has lifted a substantial burden from companies with employment as a major cost, smaller firms are left in a more difficult space, with loans (or personal savings) being the only avenue to cover payments. Up until the end of last week only £1.1 billion of loans had been issued under CBILS.

In the US, the CARES Act was signed into existence on 27 March, providing $376 billion of relief. It primarily provides loans, with potential 'forgiveness' for those which came under the Paycheck Protection Program (PPP). Here, the pace of take-up has been the complete opposite to the UK. On Thursday this week, all of the available government funding for PPP had been taken up.

The chart below (from the US National Federation of Independent Business, with data gathered before the US rescue packages were brought into play) shows how long small businesses expected they could last in the current environment.



So far, government action has avoided the tumbling domino effect of corporate defaults. But all the political will in the world cannot stop a business going insolvent if the transmission mechanisms are not able to pump the money. On their part, banks will argue they are only following government guidelines in managing the distribution of the bridging funding money in accordance with their own credit process – they have not been instructed to simply hand out cash grants. This was a deliberate choice by governments to prevent the risk of widespread fraud by maintaining moral hazard on the banks' side. But unless banks are given more clarity or direction for their emergency lending, the bottleneck of government funds in the banking system could get worse.

Despite these issues, stock markets are continuing their recovery. Are investors simply not aware of the problems posed by systemic defaults in small and medium-sized enterprises? It is worth remembering that the major equity indices feature large-cap companies, for whom financing is usually not too hard to come by. In the US in particular, the presence of the tech mega-caps has long distorted overall equity trends (Amazon's share price surged by more than a third in the last month).

Nevertheless, a spiralling default cycle – the domino effect we mentioned – would be a huge blow to the economy overall, because it stymies economic activity as businesses become increasingly reluctant to rely on and trust each other for order fulfilment. If markets expected this to happen, we would undoubtedly see another huge sell-off, even if the short-term prospects for the large-cap companies were not so dire. The fact that markets are not selling off therefore suggests this scenario is not expected. And the reason for this, we suspect, is once again policymakers' resolve. Even with the transmission issues highlighted, should defaults start to ratchet up, governments would undoubtedly amp up their support – through clearer instructions to banks or even direct cash grants to small businesses. The teething troubles we are seeing now should not be ignored, but when authorities declare the willingness to do 'whatever it takes', the pledge has to include making sure they course-correct so that the support reaches everyone it was intended for.

Emerging Markets stand ready to emerge from the crisis

With the world economy closed until further notice, the main investment concerns now are not *if* we will see a global recession, but how long it will last, how bad it will get and – crucially – what will change after it ends. Regular readers will know that one of our main investment calls for the post-pandemic world is that the future looks brightest for China and wider emerging market assets.

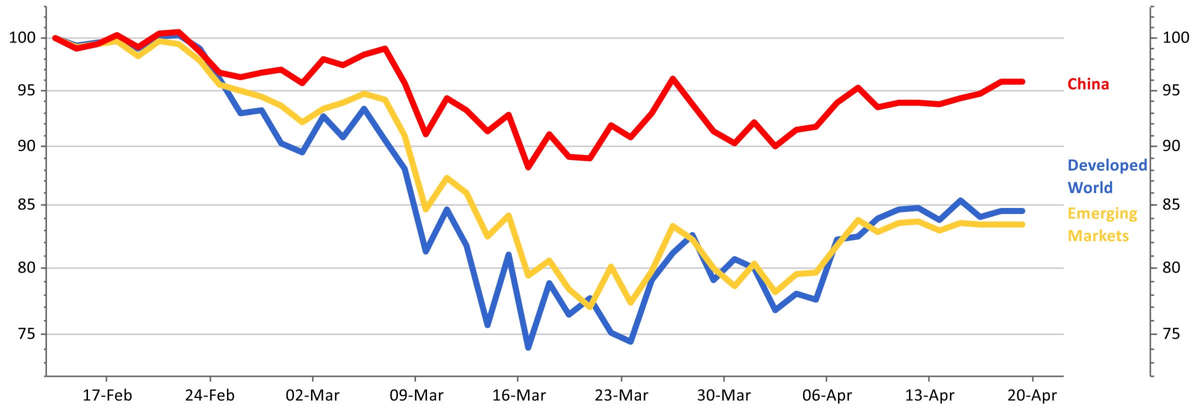
As outlined last week, our main reason for this is the outlook for the world's second-largest economy. The People's Republic of China was the first hit by the coronavirus and its government cracked down hard and fast. Now, things are slowly opening up again. And with Beijing's full-throttle drive for fiscal and also considerable monetary stimulus, we expect significant domestic demand allowing it to lead the way in the global economic recovery.

China is the largest economy with an official 'Emerging Market' (EM) designation (Chinese assets make up a third of MSCI's Emerging Market equity index and significantly more in many EM funds). In fact, it is dubious whether it should be called an EM at all, given it is one of the most economically and technologically advanced countries in the world. But it is nonetheless vitally important to EMs, acting as a source of demand (and more recently, capital investment) – particularly for its neighbouring countries. When China cranks up its economy, EMs benefit.

China is far from the only reason to be positive about wider EMs, however. Most are export-led economies – particularly those with large commodities industries. This means that when global economic activity is strong, they reap the benefits. Of course, in the short term, this is bad news: not only do EMs have to shutter their domestic economies, but the global demand that fuels them is falling off a cliff. But as the world starts to reopen – led by a wave of catch-up and stimulus-driven demand from China – they will be in prime position to take advantage.

The caveat to this is that external demand will be for nought if the collateral damage in the meantime proves too destructive. Poorer countries are unsurprisingly less well-equipped to cope with the pandemic – both in health terms and economically. This situation is worsened by the policy failings of many governments in the developing world. Leaders in Brazil, Russia, Turkey and many others have sought to downplay or outright deny the dangers of COVID-19. However, it is unclear whether the developing world – with its different economic pressures, often undersized healthcare systems but much younger demographics – will be making the same hibernation period choices as those witnessed across the richer western world.

MSCI Total Return Indices in GBP



Source: Factset, Tatton IM, MSCI

EMs are particularly at risk in economic downturns because of the currency risk carried by many of their businesses and governments, which often have large dollar-denominated debts on their books that become too great to service when their own currency falls in value. In recent years, many EM administrations have worked to improve this by building foreign exchange reserves (particularly in Asia) and improving their macro-prudential tools, giving their central banks more firepower in times of crisis. These factors should help them whether the current storm, though it still remains a risk, particularly as dollar leverage has also increased recently.

What should help more is the US Federal Reserve's decision to allow access to dollar swap lines to many central banks around the world. This should avert any immediate dollar shortage in capital markets, and thereby remove one of the key risks facing EMs. It means that central banks, governments and businesses will have more of an ability to seek credit around the world. But the bigger question is whether creditors will be willing to give it to them. This week, European and African leaders urged the International Monetary Fund (IMF) to create additional reserve assets to aid low-income countries during the pandemic. But the US, the IMF's largest shareholder, has not committed to the program – making progress unlikely.

The IMF has done all it can to extend credit to EM countries. It has already agreed debt relief for 25 of the world's poorest countries, and is still processing requests from others. It is a little ironic the IMF should be their saviour in this time of need, given that its entire purpose in the past was arguably to ensure that developing nations' governments acted in ways that protected the capital of external creditors. Nonetheless, the IMF – along with the world's other supranational organisations – now has the opportunity to play 'good cop' on the international stage, and offer the financial stability that the developed world's central banks have tried to create. Similarly, finance ministers from the G20 this week agreed a debt moratorium for 76 of the world's poorest nations until the end of the year.

These measures will not be a magic elixir for EMs and, unfortunately, there will likely still be plenty of pain in the short-term. But barring an apocalyptic scenario, forced production cuts will eventually subside and global demand will ultimately return. And, while the political finger-pointing currently under way among the leaders of the developed world could well mean big long-term changes for the global economy (regionalisation rather than globalisation), this will take time and demand for EM goods is certainly not going to disappear forever. In the meantime, the more emergency aid that can be channelled to EMs now, the more they will be able to take advantage on the other side. EMs may be the weak link right now, during the depth of western shutdowns, but we can expect that to change rapidly once we are on the road to recovery.

CAMBRIDGE INVESTMENTS LIMITED

20th April 2020

Global Equity Markets

Market	Fri 16:17	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	5774.2	1.7	96.5	↘	↘
FTSE 250	15794	-0.4	-68.5	↘	↘
FTSE AS	3182.1	1.3	41.9	↘	↘
FTSE Small	4566.5	1.2	56.1	↘	↘
CAC	4491.0	1.1	48.2	↘	↘
DAX	10593.0	2.5	260.1	↘	↘
Dow	23890	0.7	171.0	↘	↘
S&P 500	2843.5	1.9	53.7	⇘	⇘
Nasdaq	8581.3	5.2	427.7	⇗	↗
Nikkei	19897.3	2.0	398.8	↘	↘
MSCI World	1964.3	-0.4	-7.6	↘	↘
MSCI EM	884.9	-0.4	-3.3	↘	↘

Top 5 Gainers

Company	%
Flutter Ents	18.1
Ocado	14.3
AstraZeneca	14.3
GlaxoSmithKline	10.8
Halma	10.1

Top 5 Decliners

Company	%
TUI	-15.4
Hiscox	-13.1
Micro Focus Int'l	-12.1
John Wood	-11.4
BP	-10.2

Currencies

Pair	last	%1W
USD/GBP	1.249	0.3
GBP/EUR	0.871	0.8
USD/EUR	1.09	-0.5
JPY/USD	107.53	0.9
CNY/USD	7.07	-0.5
Bitcoin/$	7,056	2.0

Commodities

Cmdty	last	%1W
Oil	28.34	-10.0
Gold	1693.7	-0.2
Silver	15.19	-2.4
Copper	234.2	3.7
Aluminium	1512.5	2.4
Soft Cmdties	313.3	1.0

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.30	-0.01
UK 15-Yr	0.51	+0.03
US 10-Yr	0.60	-0.12
French 10-Yr	0.02	-0.09
German 10-Yr	-0.48	-0.14
Japanese 10-Yr	0.03	+0.01

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	5.4	16.6	14.6	13.3
FTSE 250	4.5	16.7	13.5	14.2
FTSE AS	5.2	17.3	14.4	13.4
FTSE Small	4.8	15.8	-	13.8
CAC	4.0	16.4	17.1	13.5
DAX	3.8	18.4	15.7	12.5
Dow	2.7	16.9	20.3	15.1
S&P 500	2.1	18.7	21.0	16.1
Nasdaq	1.0	27.0	26.0	18.2
Nikkei	2.2	17.6	16.0	16.9
MSCI World	2.7	17.3	18.5	15.3
MSCI EM	3.1	12.5	12.8	11.9

UK Mortgage Rates

Mortgage Rates	Mar	Feb
Base Rate Tracker	2.30	2.28
2-yr Fixed Rate	1.42	1.41
3-yr Fixed Rate	1.55	1.55
5-yr Fixed Rate	1.66	1.67
10-yr Fixed Rate	2.61	2.61
Standard Variable	4.09	4.13

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

For any questions, as always, please ask!

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20th April 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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