THE **CAMBRIDGE** WEEKLY

26 May 2020

Lothar Mentel

Lead Investment Adviser to Cambridge

Big trouble in big China

Over the past week, it felt as if the new normal of enforced idleness paired with less stringent lockdown rules and summer weather would lead to a happier mood across Western Europe, including the UK. The same applied for investors, whose portfolios also enjoyed some time in the sunshine. However, the outlook began to cloud over somewhat again towards the end of the week.

Stock markets jolted upwards at the start of the week on news that a viable coronavirus vaccine may become available before the start of the next cold season. A surprise announcement by Germany and France that they supported the issuance of quasi-joint European bonds – to the tune of half a trillion €-Euros – with the aim of pump-priming the European Union's post-COVID-19 recovery added to the positive air within markets. Some thought such Eurobonds could become a very powerful counterweight to US Treasury bonds and help overcome one of the core fiscal and monetary weaknesses of the Eurozone.

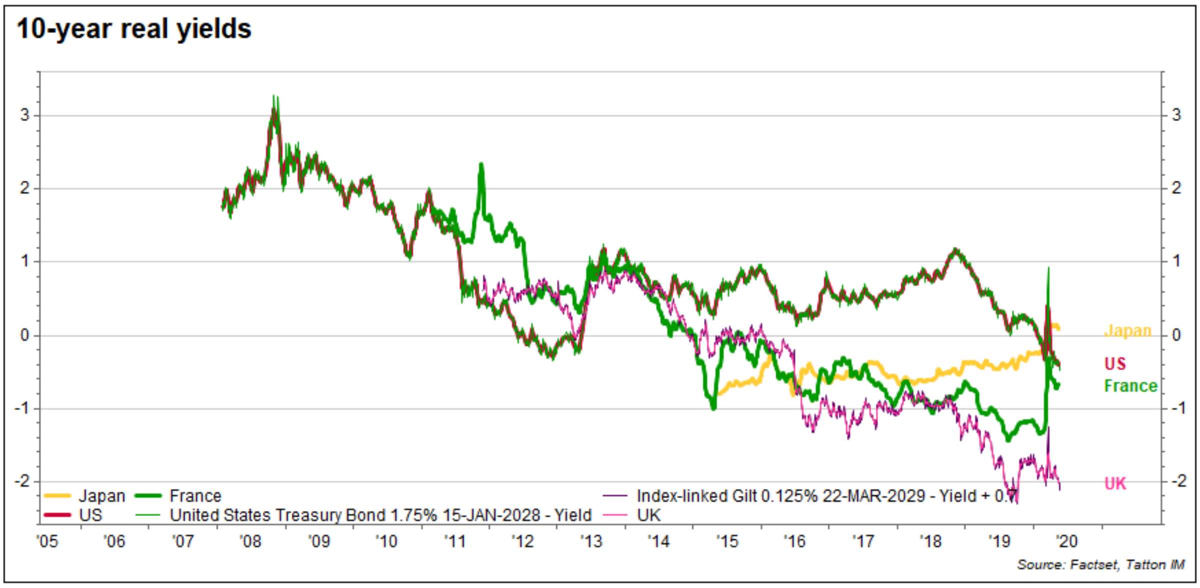
Economic news flow later in the week cheered up economists, who have recently been expecting the worst. As a result, data that is only 'really quite poor' rather than outright 'devastating' is being greeted more warmly than we ever thought recession-indicating numbers possibly could. That, combined with oil prices stabilising at levels above $30 per barrel (see separate article), does tell the story of a tide turning, after so many weeks of economic doom and gloom.

The positive stock market movements of the past weeks have all but anticipated this turning already and it takes considerable, optimistic imagination to see stock markets rising higher without considerable risk of 'altitude sickness' hounding capital markets once more. It is undeniably positive that the loosening of lockdown restrictions across Europe has led to an already notable rise in levels of economic activity, but without – thus far – a rebound in the rate of infections. Quite the contrary, many formerly strongly affected areas are not registering any new cases.

Given the rate of infections is still growing in countries blessed with permanently warmer climes, like India and Brazil, we cannot be sure whether COVID-19 is following the seasonal pattern of influenza, but for the moment it would appear that the coronavirus' decline, together with the prospect of a vaccine before the winter, is providing a better near-term outlook than we could recently have dreamed of.

That's where the 'onward and upwards' narrative ends and pressing concerns have to be discussed. First comes the prospect of negative interest rates and bond yields in the UK. This may be a new and alien concept to UK investors, but it has been the norm across the Eurozone, Switzerland, Sweden and Japan for considerable time (and they have coped with this relatively well in recent years). To put this prospect into perspective, for institutional investors the 'real' interest rate is far more relevant than the 'nominal' rate (i.e. the yield after the impact of inflation).

As the chart below shows, holders of UK inflation-linked government bonds have endured 'negative yields' since 2015, lower than other major nations' inflation-linked bonds. Another way to think about this is that investors expected UK inflation to be higher than elsewhere – so nothing really new there.



On the positive, the lower the rate at which the government can borrow to pay for all the coronavirus expenses right now, the less of an interest burden this constitutes for the future. And, given all western nations are increasing their borrowing at a similar rate versus their GDP, there is much less pressure to reduce the national debt levels in the near future in order not to be shunned by the bond markets for 'profligate spending habits'. This is why economists are currently far less concerned about austerity coming back to bite us in quite the same way as after the global financial crisis more than ten years ago.

The other concern is once again that of international politics. Following Donald Trump's tirades against China of the past weeks, last week was China's turn to strike back. Their once-a-year parliamentary session rubberstamped a proposal to align Hong Kong's legal status much more closely with mainland China, which will give the Chinese authorities far-reaching powers to crack down on the freedom-defending people of Hong Kong. Sadly, this also entirely devalues their parallel announcement of intending to honour the US-China trade truce of January (Phase I trade deal), because the US would never be able to do the same if China effectively annexed Hong Kong.

Against this new and unexpected development, we will be assessing whether this move is as much a domestic manoeuvre driven by domestic political needs as Trump's election campaign anti-China rants are. We are not overly optimistic at this point and may have to revise our previous optimism towards China – that has benefitted portfolios nicely so far over the course of this year.

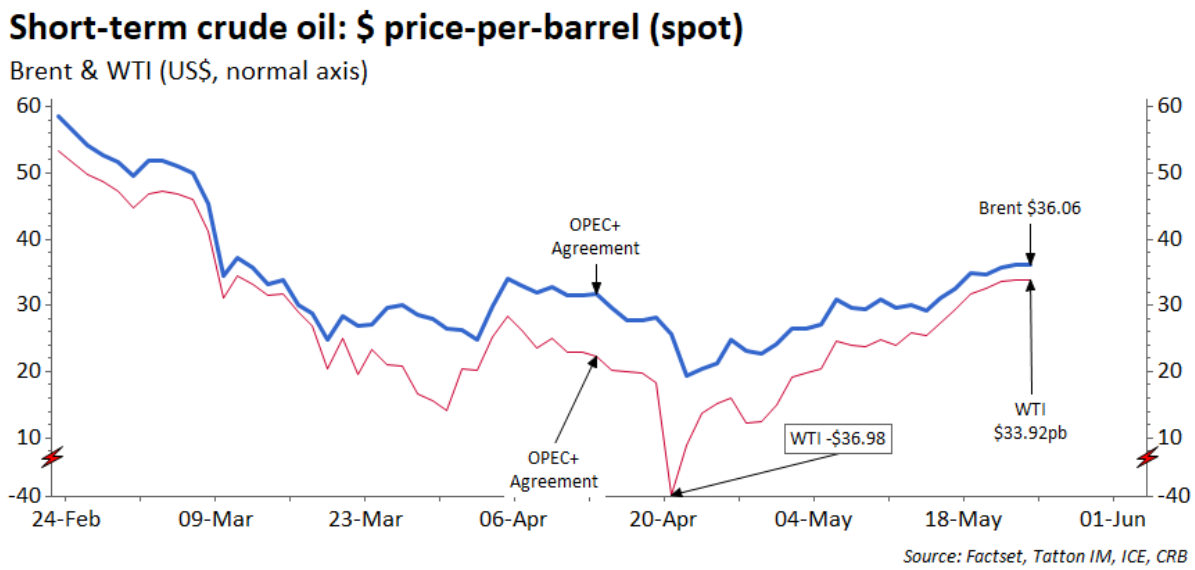
Oil is back

Time has started to have little meaning during lockdown, but it was just one month ago when the financial world looked on in collective awe at a 'never-event' in the oil market. Just as economies around the world were shutting down, OPEC+ (OPEC led by the world's largest producer, Saudi Arabia "plus" other producers, led by the second largest, Russia) ended the previously-agreed production restraint and began flooding global markets with oil, resulting in a monumental supply-demand mismatch. This meant the West Texas Intermediate (WTI) benchmark for US oil prices, sank into minus territory.

The massive fall in oil demand was no surprise. At the beginning of April, nobody was driving around. All the storage was filled with unused oil. With no tanks of their own, traders had to pay somebody to take it off their hands. Contracts for American crude went as low as -$37 per barrel (pb). It wasn't just in the US. Negative spot prices occurred in Russia's markets. Brent crude, a more international benchmark, avoided negative prices but still touched intraday lows of around $10pb. Over the last four weeks, both indices have staged steady recoveries. At the time of writing, WTI and Brent are trading at around $34pb and $36pb respectively. So, is this another case of 'crisis averted' in the oil market?

The main driving force behind the recovery has been a reversal of the oil production free-for-all. By March-end, oil prices had fallen far below sustainable levels relative to OPEC+ national producers' expected government spending. Russia has the lowest budgeted level, reportedly around $40pb. Possibly, it could sustain a couple of years closer to $20pb. For the other members, any extended period below $30pb would prove very difficult. So, whatever is normal, current readings, even if off recent record lows, remain a challenge for most oil producers.

On 12 April, OPEC+ announced its intention to cut production by 9.7 million barrels a day in May and June, the deepest cut ever agreed to, along with committing to a steady return to previous production levels until the agreement expires in April 2022. Nonetheless, near-term demand remained close to nil. Meanwhile, given Russia's starring role in the initial free-for-all, many oil-trading veterans were sceptical it would take its commitments seriously, having never got close to complying with previous production cut promises.



One of the desired outcomes of flooding the market with oil was to inflict deep wounds on the US shale industry by slowing down drilling operations, driven by the knowledge that the only place to store oil was for it to remain in the ground. Russia's deputy energy minister Sorokin was quoted on 6 May: "We see that the production drop in the United States may range from two to three million barrels daily this year either on account of storage capacities filling or merely because it is not possible for certain companies to work in the conditions of the price being $30-35 [per barrel], to say nothing of $20 [per barrel]."

Reopening shale production in the short term is possible but not easy, and some producers have gone to the wall. More importantly, the fragile equilibrium of supply and demand means only the most cost-efficient new production can expect to make a profit. Very little new capacity will be forthcoming.

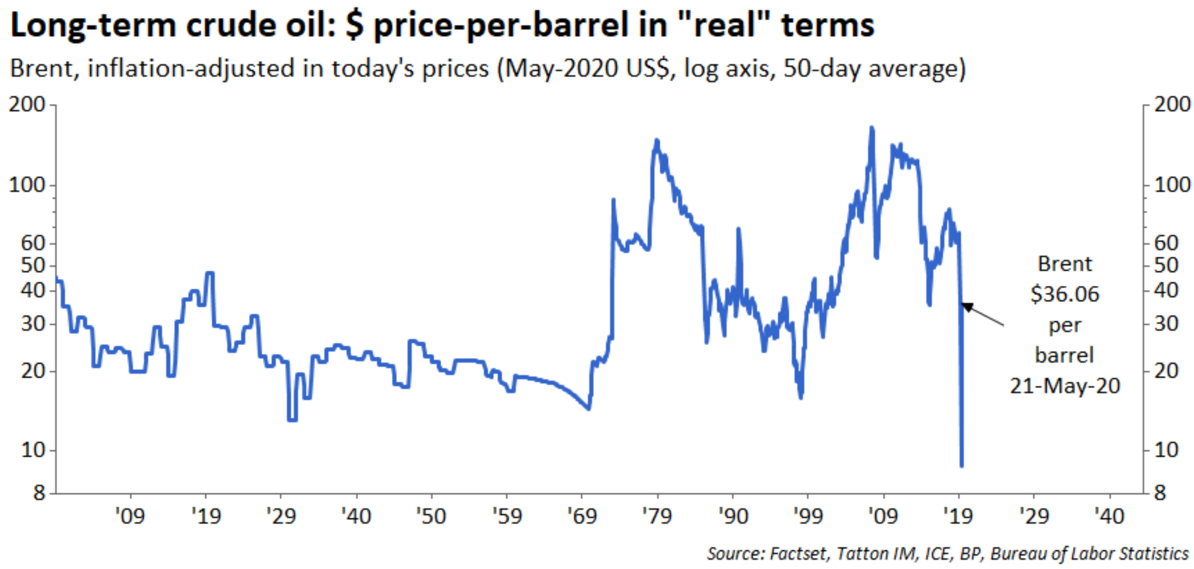
So, the oil veterans have been surprised. Russia's commitments to produce 8.5 million barrels per day (a cut of about two million) has nearly been achieved. Non-OPEC production has also fallen back more sharply than expected.

Economic activity is literally fuelled by oil, so the price of crude is often read as a key indicator for the health of the global economy. We wrote a month ago that circumstances meant the oil price's usefulness as an economic indicator – even for the short term – was probably diminished. But we also noted that the oil futures market could give valuable insight into when capital markets expect the world to return to something like normality – which we put at around $30pb. Of course, even though oil prices are now above that level, we are still some way from 'normal'.

In theory, cheaper oil is a good thing for most businesses and individuals, since energy prices are effectively a tax on consumption. But in reality, the energy industry is so huge – and so intricately woven into the fabric of the global economy – that when its profits fall, there are often big knock-on effects. This is why, when pandemic fear set into capital markets at the end of February, falls in asset prices were accompanied by a nosedive in oil prices. Regardless, low oil prices should be good for the economy in the long-term, since low and stable prices make for a better bedrock for any post-lockdown recovery.

What's more, even though the price rebound has mostly been caused by supply-side constraints, there has been some recovery in demand. China, the world's second largest economy and the epicentre of the virus, is now well on its way to opening up. Europe, the second major hub to be hit, is also in the early stages of recovery. Even Britain and the US – the two worst affected regions – seem to be over the strictest of their lockdown measures. The Petroleum Retailers Association reported that demand for petrol and diesel this week was 40-45% lower than pre-crisis levels across the UK – but that is still substantially up from the negative 70% reported a month ago. Sectors such as air travel will be under sustained pressure for some time, but a rebound in other types of energy demand does not seem so far away.

Consistent with our overall predictions about the global economy, we expect Chinese demand will be crucial for oil producers coming out of this crisis. China's incredible rise is one of the main reasons why oil was on a secular uptrend for nearly the last two decades. Of course, as the global economy emerges slowly from lockdown, fuel consumption in traffic – cars and aeroplanes – should pick-up again. Some of this near-term recovery in demand is likely already reflected in oil prices. In the medium term, it is unlikely that oil prices will be as high as we have grown used to over the last few years, but stability in the $30-$50pb region is not fanciful. Another big component is the prospect of a 'green recovery' – led primarily by renewable energy – that many politicians have been agitating for. BP's new chief executive has gone as far as claiming that we may already be passed "peak oil". Over the long-term, so much the better.



Even though current oil prices look low by recent standards, they are quite typical by historical standards, as the chart above demonstrates. Periods of low oil prices may cause short-term troubles, but in the past, they have almost always boosted the global economy later down the line. We seem to already be stuttering along the path back towards 'normal', but may well end up arriving at an entirely new destination. Overall, that may not be such a bad thing.

Amazon & Walmart: two winners – but who loses?

We are, so politicians keep telling us, all in this together. Lockdown measures, and the deep recession they have brought, impact all sectors of the economy. But while all businesses are equal under COVID-19, some are more equal than others. With the world still mostly under quarantine, online and delivery sales have been booming. Unsurprisingly, the companies reaping the benefits are those with an established online presence and delivery network. In the US, the two that stand head and shoulders above the rest are Amazon and Walmart.

Aside from their online retailing expertise and technological know-how, these two firms share one key advantage. Both have tremendous economies of scale that few competitors can match. They have their own national and international distribution networks, a wealth of experience in logistics and deep data on their consumers' preferences. Such scale allows companies to turn a profit at prices that would be ruinous for most other retailers. This has entrenched their positions as leaders, not just in their own sector, but among equity markets at large. In the first quarter of 2020, companies across the board saw plummeting profits as the world economy went into hibernation. Meanwhile, Amazon and Walmart reported strong sales growth. Recession? What recession?

Anecdotally, many US consumers say they have switched to shopping almost exclusively at Amazon or Walmart since the lockdown began. The two almost invariably have the lowest prices and most convenient delivery methods available, so there is very little incentive for consumers to shop around. Such has been the success of these companies that their free delivery offer – which comes with any order over $25 and $35 for Amazon and Walmart respectively – has become the norm that customers expect of all delivery services. It costs just $10 for Amazon or Walmart to ship an order to the continental US – this cost includes everything from transportation to inventory management, which only becomes more complex as retailers add more products in different sizes, colours and varieties.

In recent years, a backlash has grown against large companies like Amazon and the other tech superstars. But as yet the force of this backlash has been almost entirely from government or political groups, rather than from consumers. A huge part of that is just the convenience and low prices they offer. Amazon's $119 a year Prime subscription covers everything, from free and fast package delivery to premium music and films.

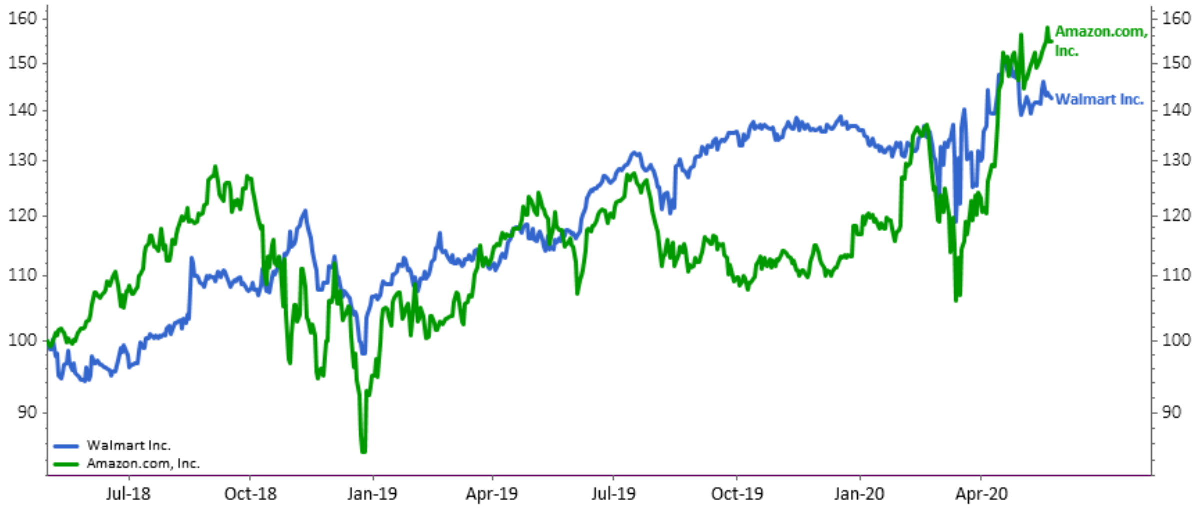
Even where national delivery is unfeasible or cost-prohibitive, both Amazon and Walmart have found ways to crowd out other market participants. Amazon's subsidiary Whole Foods has become a staple of many American households, while Walmart's membership-only retail warehouse service Sam's Club has seen considerable growth in recent years. In terms of local warehouses (in the US at least), Walmart has the advantage: they have 5,355 locations in the US and 11,000 globally, compared to just a few fulfilment centres for Amazon.

As we have written before, the pandemic is accelerating many structural economic changes already in play. Consumers have been using online retailers increasingly over the last two decades, but online services have been massively boosted by the current crisis. The really worrying question for many businesses is, after consumers make the switch to Amazon or Walmart delivery, how likely are they to switch back?

For these two firms, scale begets scale. The attraction of low prices and convenience only enables them to pour more money into solidifying their market position. That is why these trends will not stop on their own. Unless politicians step in, or we see some deep structural shift, their advantages will keep growing. Unfortunately for them, such an intervention is not that far-fetched.

A growing political consensus (a rare thing in today's incredibly polarised US politics) has formed that believes firms like Amazon have been left unchecked for too long. Amazon is now facing anti-trust scrutiny from the Federal Trade Commission, and last year had to pull its plans for establishing headquarters in New York after a torrent of local political opposition. In response, the company has raised its lobbying efforts, trying to paint itself in a more positive light. Last Autumn, Amazon raised its minimum wage to $15 an hour, and this year it hired 175,000 new employers just as layoffs were skyrocketing across America.

Amazon and Walmart: Relative Share Prices Since May-18



Source: Factset, Tatton IM

One of the reasons Amazon has not fallen foul of the existing anti-monopoly legislation is that the established thinking says that the problem of monopoly is a problem of price control. When you are the only one offering goods, you can hold consumers to ransom and charge what you like. But the current batch of monopolists (or rather, oligopolists) have not hiked prices – quite the opposite. However, while consumers have benefited from a cost perspective, they have arguably lost out from an income perspective. With only one or two retailers to sell goods to, end-producers have taken a beating. Some have suggested this – along with increasingly globalised competition – as a reason behind the stagnation in wages since the financial crisis.

As yet, no sweeping anti-trust legislation has been tabled. But the mega-retailers – along with the US tech giants – are now firmly a part of the political conversation across the developed world. It is hard to say how the current crisis, and the steps we take to recover from it, will shape that conversation. Politicians might want to avoid rocking the boat by targeting big companies in the short-term, since their focus will be primarily on getting the economy back on track. But if the negative publicity around Amazon's share price growth throughout the crisis is anything to go by, increased public scrutiny for firms like Amazon and Walmart could be part of the long-term picture. What we can say is that, without it, there is little else to stop them.

CAMBRIDGE
INVESTMENTS LIMITED

26th May 2020

Global Equity Markets

Market	Fri 17:00	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	5993.3	3.3	193.5	↗	↘
FTSE 250	16399	4.7	738.1	↗	↘
FTSE AS	3301.9	3.6	113.4	↗	↘
FTSE Small	4686.9	3.4	152.9	↗	↘
CAC	4444.6	3.9	166.9	↗	↘
DAX	11073.9	5.8	608.7	↗	→
Dow	24353	2.8	667.5	↗	⇘
S&P 500	2940.7	2.7	77.0	↗	→
Nasdaq	9277.0	2.9	262.4	↗	↗
Nikkei	20388.2	1.8	350.7	↗	→
MSCI World	2074.1	3.3	65.7	↗	→
MSCI EM	930.0	3.2	28.8	↗	→

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.8	20.9	17.4	13.4
FTSE 250	3.5	18.9	17.2	14.3
FTSE AS	4.6	21.5	17.4	13.4
FTSE Small	4.5	13.8	-	13.8
CAC	3.9	17.7	18.7	13.6
DAX	3.4	20.9	18.2	12.6
Dow	2.7	18.1	22.2	15.2
S&P 500	2.1	20.4	23.5	16.2
Nasdaq	0.9	29.0	28.5	18.3
Nikkei	2.1	23.1	18.6	16.9
MSCI World	2.5	20.0	21.2	15.3
MSCI EM	3.0	14.5	14.4	11.9

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
DCC	17.6	Imperial Brands	-7.2
Intertek	16.2	Tesco	-5.3
TUI	15.5	HSBC	-5.2
InterCont'l Hotels	12.7	Wm Morrison	-4.2
Int'l Consol Air	12.6	National Grid	-3.9

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.218	0.5	Oil	34.69	6.7
GBP/EUR	0.895	-0.1	Gold	1731.6	-0.7
USD/EUR	1.09	0.7	Silver	17.09	2.9
JPY/USD	107.52	-0.4	Copper	239.5	2.6
CNY/USD	7.14	-0.5	Aluminium	1521.0	3.1
Bitcoin/$	9,224	-0.2	Soft Cmdties	334.5	2.3

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.17	-0.06
UK 15-Yr	0.37	-0.07
US 10-Yr	0.65	+0.01
French 10-Yr	-0.03	-0.01
German 10-Yr	-0.49	+0.04
Japanese 10-Yr	0.00	-0.00

UK Mortgage Rates

Mortgage Rates	Mar	Feb
Base Rate Tracker	2.30	2.28
2-yr Fixed Rate	1.40	1.41
3-yr Fixed Rate	1.63	1.58
5-yr Fixed Rate	1.67	1.66
10-yr Fixed Rate	2.61	2.61
Standard Variable	3.67	3.77

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

For any questions, as always, please ask!

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

26th May 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.

Lothar Mentel

www.cambridgeinvestments.co.uk | enquiries@cambridgeinvestments.co.uk
Tel : 01223 365 656 | CB1 Business Centre, 20 Station Road, Cambridge, CB1 2JD