CAMBRIDGE
INVESTMENTS LIMITED

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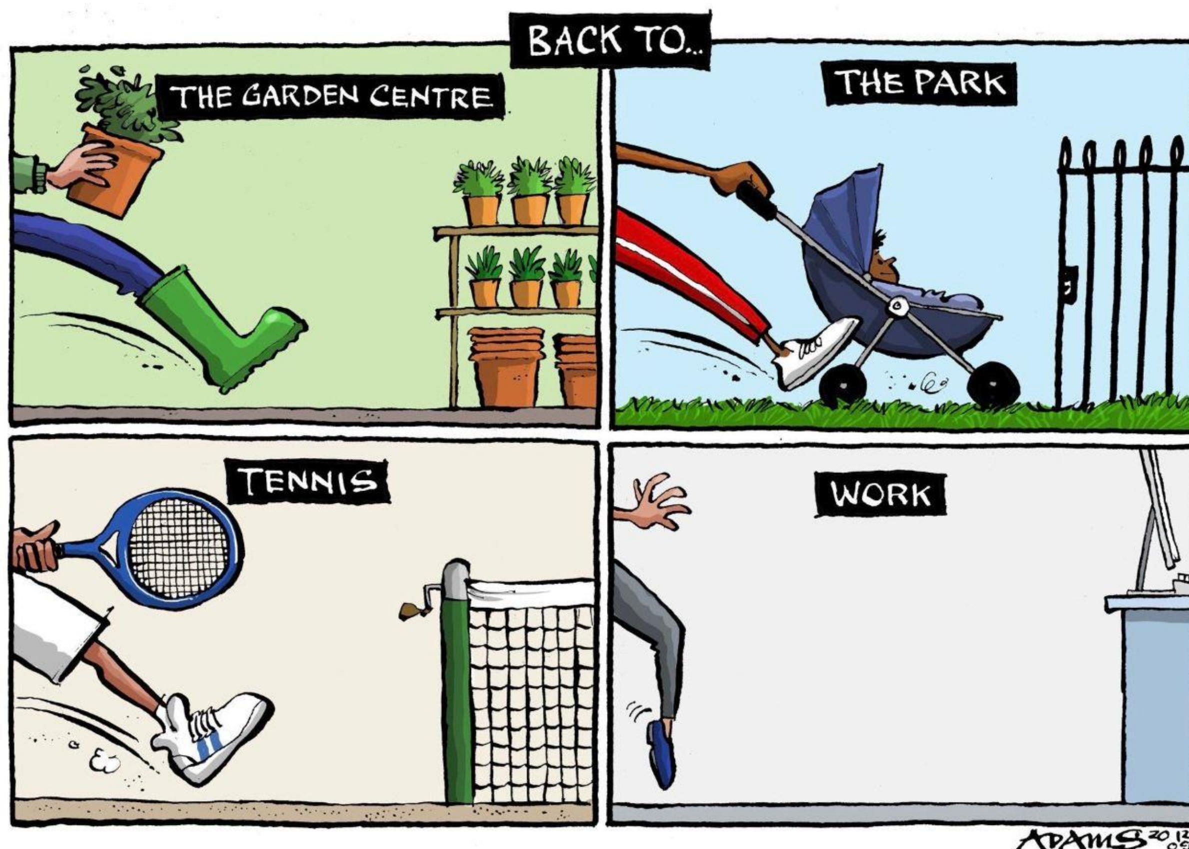
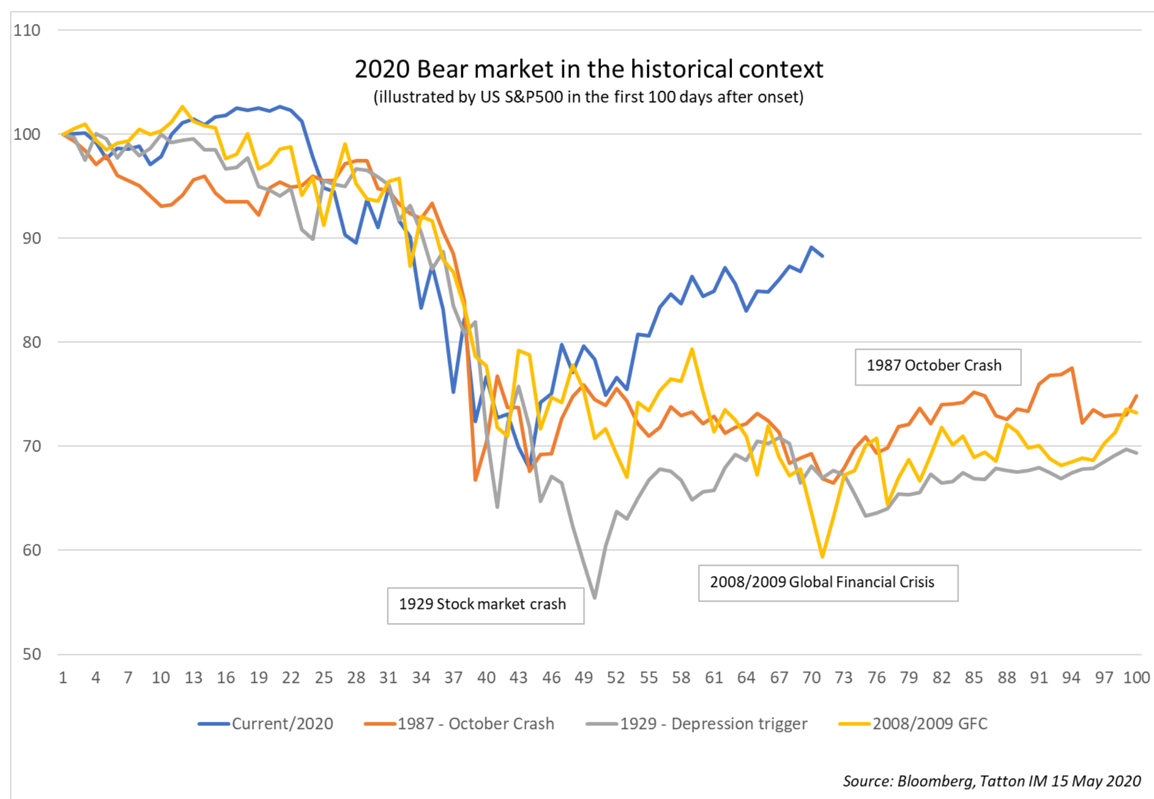


Regained freedoms – and challenges; Christian Adams – 12 May 2020

US-China Cold war: Threat or blessing?

Halfway through May and stock markets have continued to deviate markedly from the classic bear market pattern described in "The anatomy of a bear market" in The Cambridge Weekly of 30 March (see graph on next page). What looked very much like a bear market rally in the last week of March is increasingly looking like a V-shaped market recovery, and thereby quite different from what we have come to expect from the restarting of the economy. As more and more countries are anxiously lifting restrictions of movement for their citizens, it is becoming clear everywhere that it was far more straightforward to send workers home than bringing them back to work is proving.

In the absence of truly effective anti-viral drug treatments against COVID-19, or vaccines (even in the best case) only becoming widely available towards 2021, we cannot seamlessly switch back on what we switched off and many activities that make up considerable parts of our Western economies will take much longer to return than a V-shaped recovery would require. This means that the recession the lockdown has caused is likely to last somewhat longer and be more pronounced in sectors that depend on close social proximity. When the upward trend in stock markets seemingly ran out of fuel this week, many were quick to exclaim that, at long last, equity markets were coming to their senses. There is also the belief that very elevated valuations are desperately out of step with the severity and length of the depressed corporate earnings ahead.



While we agree that valuations are out of lockstep with the near-term reality of depression-level economic activity levels, the playbook for capital markets has been just as much upended as the rules we normally follow in our private and business activities. Without precedent to take clues from for what fair value should be under these abnormal circumstances, it is best to hold on to and take guidance from what we do know. The enforced economic hibernation will eventually end, either with the emergence of drug treatment/vaccines, or more gradually as we learn to contain the virus spread and protecting the vulnerable and elderly. At that point, the economy will still be there with everybody particularly keen to catch up on the aspects of their life that have been missed.

Over the past three weeks urbanites have been gradually emerging from lockdown and flocking into in open spaces. It is remarkable to observe that the COVID-19 infection reproduction rate R is now lower in London (0.4) than it is in Yorkshire (0.8). If it remains so, this means either that Londoners have learned not to spread the virus (despite widely flouting the two-meter distancing rule and mostly still not wearing face masks), or that the capital's population – which had the highest infection rate in March and April – has already established a level of herd immunity that puts a natural barrier in the path of the virus.

Alas, this is the optimistic view. There are just as many who believe lockdown has been lifted prematurely and that a second wave – and another enforced lockdown – would be even more devastating to the economy than the first. As in the past, we prefer to take our leads from countries in Far East Asia, which remains a several weeks ahead of us. While they have struggled to stage a V-shaped recovery for their economies, they have rebounded pretty strongly and, thus far, been able to prevent a major second infection wave.

We think a period of consolidation within equity markets should be welcomed. It is certainly preferable to seeing a continuation of April's upward surge, which would increase the vulnerability of stock markets and create volatility and unhelpful wider economic instability. At the same time, the old investment adage of 'sell in May and go away' feels misguided this time. Not because we cannot 'go away' very far yet anyway, but because so many things are in flux, which could change the current forecasts and expectations rapidly.

When major negative and unexpected events happen, humans have a tendency to further extrapolate the negatives rather than expect positives. We have collectively experienced a classic 'Black Swan' event, (i.e. something quite devastating but with a relatively low probability of occurring). The currently discussed future negative virus scenarios saddle another 'black swan' event on the first one, without sufficiently taking into account that our ability to fight back has vastly improved.

Sadly, new and entirely man-made headwinds are on the horizon, as politicians like Donald Trump are desperately trying to distract from their disastrous crisis management by blaming others for their own failings. As long as the threat to cut all relationships with China is no more than hollow short-term campaign noise it does not matter too much. However, should maverick populist leaders like Trump, Putin, Erdogan and Bolsonaro actually embark on a major and immediate de-globalisation program, the recovery the world so crucially needs would be more in greater peril than a second virus wave could cause. Luckily being populist rather than dogmatist also brings a high dependency on swing voters who are highly exposed to the gyrations of the economy and the jobs market. With Donald Trump striving for re-election in the autumn, return of economic vibrancy is paramount, and at odds with restarting major trade wars.

For the moment, the accelerating rivalry between China and the US may actually carry a benefit for humanity. Both are desperate to win the race of being the first to possess and produce an effective vaccine in large quantities. The ability to inoculate large populations would allow the winner to not only establish a domestic economic advantage over the other but also earn gratitude and respect with regions they would like to increase their influence over, like Africa and South America.

China is six to eight weeks ahead of the US in the pandemic and its vaccine development may also be able to progress quicker. It will be very interesting to see whether Chinese pharma firm Sinovac will finish its phase two clinical tests and begin producing and distributing their vaccine in July, as indicated by CEO Weidong Yin. A cold war-like 'arms race' of this nature strikes us as far more beneficial to mankind than all the currently popular black swan scare scenarios.

We are by no means out of the woods, but the foundations are laid for a summer with greater potential for fast-changing expectations than any 'sell in May and go away' maxim could ever assume.

The curious relationship between bricks and mortar and land

Land Securities – the second biggest property investment trust in the country – released a grim annual report this week that disappointed capital markets. In the 12 months leading up to March, the property group wrote down its £10.3 billion property portfolio by 11.6% or £1.2 billion, after a slump in retail property valuations.

Of course, economic hibernation worsens the situation, but fewer than half of Land Securities' asset revaluations were ascribed to this. As investors in UK open-ended property funds know only too well, the Brexit referendum accelerated commercial property's issues. Figuratively and literally, the issues are structural.

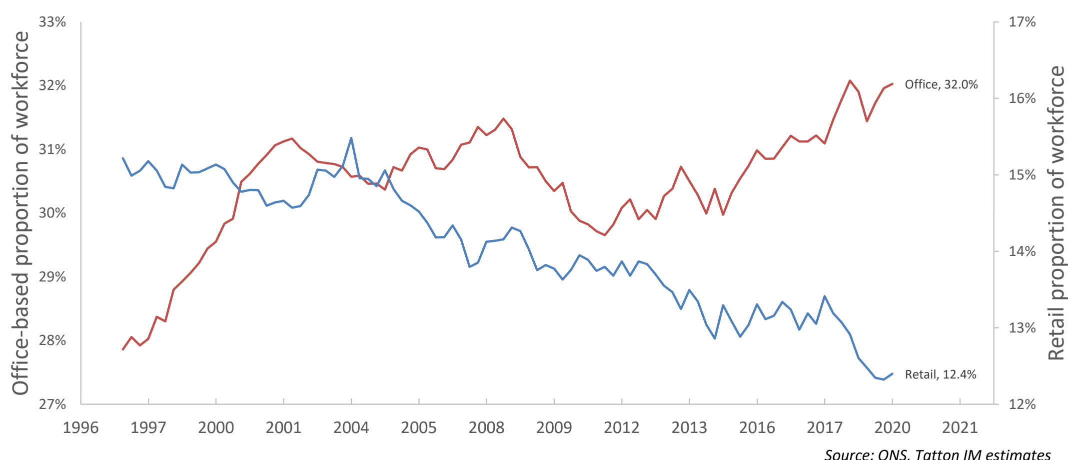
Perhaps most visibly, the move towards online services had already weakened retailers, robbing owners of high-street shops and older shopping malls of crucial rents. Offsetting this has been the virtualisation of retail, which has meant strong premiums on new fast fulfilment warehousing in both long distance and last-mile distribution.

Industrial property had been a brighter spot and did not suffer much immediately after the Referendum. But last year proved more difficult as the widening of trade conflicts outside of Europe coincided with the potential Brexit cliff-edge to curtail confidence, and therefore slow demand for employees and factory space.

Up until 2016, the financial services industry had recovered enough from the 2008-2009 crisis for London to enjoy an old-style office construction boom. Only five years ago in the City and Canary Wharf, cranes were busy pulling up vast office towers, accompanied by 76-floor apartments built on the footprint of old pubs! The Brexit referendum halted this construction boom and caused office landlords to offer reduced near-term rents to fill the new space. By the start of this year, older office valuations were clearly under pressure.

Still, outside London, city office space was in much greater demand, thanks to burgeoning UK service sector growth. Indeed, we only have to look at the striking rise in UK employment to know that employees have been working somewhere.

UK Office and Retail Employment
Estimated Proportions Of Overall UK Workforce



Source: ONS, Tatton IM estimates

This highlights the age-old conundrum about property investment, particularly when it comes to the commercial sector. It takes a long time and a lot of capital to build it. You need rents to be high for a reasonable number of years, in order to gather enough reserves, before moving to a renovation cycle. Slow secular change is ok, but fast change is really damaging.

This is where the pandemic has thrown a spanner in the works. It is, as yet, unclear whether the current experimental work-from-home model we have been forced into will prove successful enough to significantly reduce demand for office space in the post-pandemic world. But if that is the case, it would suggest falls in office commercial property are not temporary.

The gyrations of the property market present a conundrum for investors. To most people, it seems common sense that 'bricks and mortar' property is a safe investment. After all, unlike the complex and ethereal financial instruments traders deal in on a daily basis, property is really 'there'. But it is crucial to distinguish between property and the land it gets built on. The two things are of course intimately linked; property values are higher in better locations and land prices vary depending on what you might be able to do with it. That said, land has intrinsic optionality value, but property is more tied to its specific use. Sometimes, land can be worth even more without any buildings on it. So, if property isn't itself a 'safe asset', how safe is the land it is built on?

Unfortunately, this is where it gets complicated. It depends on the exact definition of 'safe asset'. One influential definition is that safe assets are those taken at face value with 'no questions asked'. That is, the intrinsic value of safe assets is so widely agreed upon that they are immune to the costly production of information about that value. They are, in other words, immune to speculation.

Usually this comes with some other defining characteristics: safe assets are a store of value that can readily be converted into cash without significant loss. As such, they must have low volatility and low or negative correlation to the general market. Because of this, safe assets stabilise investment portfolio values in times of capital market stress.

When other investments take a turn for the worst, investors prioritise staying solvent, keeping cash flows stable enough to meet their payment needs and (if possible) having a little spare cash (or 'dry powder' in the financial lingo) around to capitalise on glaring opportunities. Real, physical assets can be very useful in achieving these aims – but not all such assets are equal. Land and property cannot always be quickly turned into liquidity. Property in particular – since it is so heavily tied to consumer confidence – which itself is tied to job security – is cyclical. In times of growth, property prices benefit and vice versa.

Land itself is less cyclical. But it does not tick all the boxes you want from a 'safe asset'. Since there is finite supply, it does have some intrinsic value. This intrinsic value is also backed by the fact you always have the 'optionality' to do something different, useful with it (if Tesco and Sainsburys disappear, you can always build apartments or even grow food on it, for example). But it is also difficult to sell and not transportable, making it 'illiquid'. And, crucially, there is still some cyclical element. Land prices are, to a certain extent, always tied to what can actually be done with the land. In times where demand for building or agriculture demand is high, the land where you can build or farm will increase. When the French government introduced plans to expand what could officially be called the Champagne region (in which all Champagne grapes must exclusively be grown) some years ago, the value of the new Champagne land immediately rose from €5,000 per hectare to around €1 million. As another example, over the last decade rural land seems

to have risen in tandem with central banks' quantitative easing measures, as more and more capital piled into alternative investments.

Land clearly offers some security and store of value, but it is still tied to the property market. However, real estate itself does tend to have longer cycles than the typical business cycle. Since land is even less cyclical, and ownership tends not to change often, it can be a viable long-term investment – as long as the economy of the land around it thrives over the longer term. But it is still not quite the 'safe' asset some may think, due to its inherent illiquidity and value dependency on the health of the economy that surrounds it.

Will it be 'back to school' after the pandemic?

Virtually all sectors, businesses and individuals are now, one way or another, having to adjust to the current crisis. For most companies, this means either coming up with new ways to generate revenue or getting enough cash together to hold out until our economic ice age starts to thaw. Broad-brush government measures – like the furlough scheme or emergency loans – will help (if people can access them) but the problems facing each sector are diverse and particular; there is only so much a one-size-fits-all policy can do. In economic terms, it is notable how the coronavirus pandemic is accelerating themes already in play – the massive uptake in web-based and delivery services being a prime example. Different sectors must learn to adapt – not just for now but for the post-pandemic world too – and having an idea of how they will do so will be crucial for long-term investment.

Education is a case in point. A plan for returning to primary and secondary education has been one of the key parts of Boris Johnson's messaging. But in higher education, the situation is much less clear. Universities have moved quickly to put teaching modules and exams online, but like everything else, there have been teething issues. In the US, there are multiple reports of students demanding partial refunds for tuition fees – with some even resorting to legal action.

For the next academic year, the situation is precarious. Face-to-face teaching is unlikely to resume before November. There is much discussion about the Autumn term being missed entirely. Prospective students are questioning whether their previously-first-choice university can deliver an online course worthy of regular fees.

Meanwhile, with a reduced pool of students, the government is now asking universities to cap their admissions for the next academic year, in an attempt to stave off bankruptcies for those unable to fill their regular quotas. Even Oxford and Cambridge anticipate a significant drop in applicants, and there are anecdotes that offers are being made to previously rejected students.

A report from the University and College Union (UCU) has warned that with these measures British universities stand to lose around £2.5 billion in tuition fees next year alone. Of that, £600 million and £350 million comes from the fall in UK and EU applications respectively, but a huge £1.5 billion comes from the drop in international students. In Britain and the US, an influx of overseas students – who usually pay substantially higher fees – has been one of the main drivers of growth in the higher education sector. So, for many institutions, the prospect of long and drawn-out lockdown measures is extremely scary.

Like so many businesses, the main fear is that a large chunk of demand may never fully return. The growth in online-only course will likely be boosted by the pandemic. But while few expect web-based courses to ever truly replace face-to-face teaching (from student and lecturer anecdotes it certainly seems like no one is happy with the current set-up) the more pressing issue for university revenues is whether demand from abroad will recover once things open up.

The UCU report suggests around 30,000 university staff could lose their jobs, with disastrous consequences for research, wider education and social mobility. But, so far, the government has turned down pleas from universities for a £2 billion bailout, insisting the sector should not receive preferential treatment over other struggling industries. The Treasury has said universities should first use the furlough and emergency loan schemes, but one pro-bailout Whitehall official told reporters that delaying a rescue until the last minute was unrealistic. "The Treasury's faith in their ability to carry out highly targeted just-in-time interventions is extraordinary in current circumstances," they added.

We should not underestimate the knock-on effects either. Even if bankruptcies are avoided, university research will be one of the first areas hit by dwindling budgets. Besides the wider long-term impacts, this will also directly affect teaching – since doctoral and post-doctoral researchers make up a huge proportion of university teaching assistants. Pay conditions for university staff have been under considerable pressure in recent years – evidenced by the two national strikes this academic year alone – and Universities UK's bailout proposal promises to cut costs and tighten conditions even further.

If the uptake for online-only course increases, we could see the emergence of a two-tier education system, with the more prestigious universities continuing courses as normal and others offering easier access courses (presumably at lower fees). This would have the benefit of making higher education more widely available, but could also be a barrier for social mobility through increased elitism among those in the 'top tier'.

Lower student numbers – particularly from overseas – will also have direct impacts on the property market. Growth in the higher education sector has resulted in more companies specialising in building and leasing student accommodation. Many of these companies are highly leveraged, so falling student demand could seriously impact wider property prices as well as credit conditions.

The Unite Group (the leading UK student accommodation REIT) said in its annual report on 22 April that after asking students to see if they wish to leave their accommodation it expects to forgo rent on about 43,000-46,000 beds, representing 62%-65% of all owned and managed beds in summer semester 2019/20. Here are some other key findings from The Unite Group's report:

- It received 94% of the rent due to date in April;
- It expects a reduction in income from the 2019/20 academic year of 16%-20% on a Group share basis, actually a slight improvement in expectations from March;
- Reservations across the Group for the 2020/21 academic year are currently at 80%, similar to the previous year, but most were made before the pandemic;
- It notes slower demand from international students but healthy levels of demand from UK students (again before the pandemic);

- It retained previous guidance for a £90-£125 million reduction in Group cashflow in 2020;
- It has modelled a four week-delay to the 2020/2021 academic year *(we would note the earlier comment on a possible delay till January)*.

Attending university has always been as much about life experience as education. If socialising is not available, our universities are at risk from previously un-feared competitors. They probably need the government to step in to upscale the IT infrastructure in education (as more online content is needed). That would bring an investment boost, as well as improving access to education later down the line.

The university sector is not immune to this health crisis and, like many sectors, is staring into an existential crisis as well. But this is a once in a generation opportunity for academia to rethink its approach and prepare its students for the new way of working that will face them when they finish their university education. This is a test that our universities simply cannot afford to fail.

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18th May 2020

Global Equity Markets

Market	Fri 16:44	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	5801.8	-2.3	-134.2	↗	↘
FTSE 250	15650	-3.7	-598.3	↗	↘
FTSE AS	3189.1	-2.5	-81.5	↗	↘
FTSE Small	4532.9	-2.4	-111.5	↗	↘
CAC	4274.5	-6.0	-275.1	→	↘
DAX	10458.8	-4.1	-445.7	↗	↘
Dow	23425	-3.7	-906.6	↗	↘
S&P 500	2833.5	-3.3	-96.3	↗	→
Nasdaq	8862.8	-2.8	-258.5	↗	↗
Nikkei	20037.5	-0.7	-141.6	⬀	→
MSCI World	1999.9	-3.0	-62.0	↗	⬂
MSCI EM	900.9	-1.2	-10.8	↗	⬂

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
Kingfisher	9.2	Land Securities	-18.8
Fresnillo	8.7	Micro Focus Int'l	-15.0
Hargreaves Lansdown	8.5	British Land	-14.1
Vodafone	7.3	Rolls-Royce	-13.1
Reckitt Benck	5.8	Hiscox	-13.1

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.213	-2.3	Oil	31.76	2.6
GBP/EUR	0.892	-2.1	Gold	1745.7	2.5
USD/EUR	1.08	-0.2	Silver	16.54	6.8
JPY/USD	107.26	-0.6	Copper	234.8	-2.5
CNY/USD	7.10	-0.4	Aluminium	1475.0	-0.3
Bitcoin/$	9,478	-5.2	Soft Cmdties	327.1	1.4

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.23	-0.00
UK 15-Yr	0.44	+0.03
US 10-Yr	0.64	-0.05
French 10-Yr	-0.03	+0.01
German 10-Yr	-0.53	+0.01
Japanese 10-Yr	0.00	+0.00

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	5.0	20.0	16.8	13.4
FTSE 250	3.7	17.8	15.8	14.3
FTSE AS	4.8	20.6	16.6	13.4
FTSE Small	4.6	-	13.4	13.8
CAC	4.0	17.0	17.9	13.5
DAX	3.6	19.8	17.3	12.6
Dow	2.8	17.3	21.3	15.2
S&P 500	2.1	19.5	22.5	16.2
Nasdaq	1.0	27.7	27.1	18.2
Nikkei	2.2	19.4	17.9	16.9
MSCI World	2.6	19.0	20.3	15.3
MSCI EM	3.0	13.5	13.8	11.9

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!
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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.

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