CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

27 July 2020

Lothar Mentel

Lead Investment Adviser to Cambridge

DISCLAIMER

Good as Gold, B Rich, July 2014

PPE = Politics, Pressure and Economics

In this delicate economic and financial environment, the world of politics can have a big impact on capital markets. Last week, we saw both heads of that political beast, with news stories first buoying and then bruising market sentiment. Earlier in the week, Europe's top politicians slogged through marathon negotiations to reach a historic deal on a €750bn common budget designed to spur recovery from the deepest recession since World War Two. We cover this in more detail separately below, but suffice to say that investors took it well, with the Euro gaining on other global currencies.

Then came the bad. Tensions between the US and China escalated further last week, as the Trump administration closed a Chinese consulate in Houston and US Secretary of State Mike Pompeo called on western nations to take a firmer line against China. Each day it becomes harder to see a path to de-escalation, and the recent flare of tensions brought up the rhetoric of a 'new cold war' between the world's two largest economies. That weighed heavily on stock markets globally, despite a better-than-expected showing in the US corporate earnings season so far.

Interestingly, the shifting sentiment in markets has been neatly reflected in the fates of two assets: the Euro and precious metals. We devote separate articles to both this week, but it's worth reflecting here on what their fates mean for economic growth and financial markets.

One can argue about how effective the recovery fund hammered out by the European Union (EU) will be. It is also worth remembering that the EU's potential growth remains relatively low. But the fact that markets turned positive on the Euro shows that they see last week's announcement as an improvement on the continent's medium-term growth prospects. The virus crisis – and its potential scarring effects – give many reasons to be pessimistic about global growth, at least over the next few years, but forceful and timely interventions from governments (aided by generous central banks) have been crucial lifelines, and the EU's current plan has added another.

As noted recently, there are reasons to expect an improvement in the prospects for European growth. After China, Europe was the second hotspot of the pandemic, and is now firmly on its way out of lockdown (albeit with some well-publicised local outbreaks). What's more, due to the export-heavy makeup of its industries, firms on the continent are well-placed to take advantage of a rebound in global growth. When you add in the possibility of a fiscal push to unleash Europe's demand potential, European assets look well placed.

Compare this with China, which has similar sensitivity to global economic activity, without the huge central bank liquidity push of some of its peers, but with an extra dose of major political tension. In economic terms, recent data out of China has looked positive and, despite the lack of monetary largesse, Beijing has bent its internal savings and banking systems to push capital towards another large investment programme. China's currency, the Renminbi, is the strongest indicator of normality on the global trade front and has been doing well against the falling trade-weighted US dollar level.

Gold – the quintessential 'safe-haven' asset – has been on a good run throughout the crisis, as one might expect, and, as two of the world's most economically and militarily powerful countries continue to ratchet up tensions, its rally has continued. However, as we cover in a separate article, the price of other metals – particularly copper, used extensively in technology building – have been going even higher in recent weeks. We suspect this is a great deal to do with China's extensive infrastructure spending, which, despite global political concerns, does seem to be leading the way in terms of industrial activity.

Even on the trade front, relations between China and the US are doing much better than global headlines would suggest. For example, last week China bought the largest ever single-day amount of US agricultural products, a success that President Trump flagged in one of his daily pandemic updates.

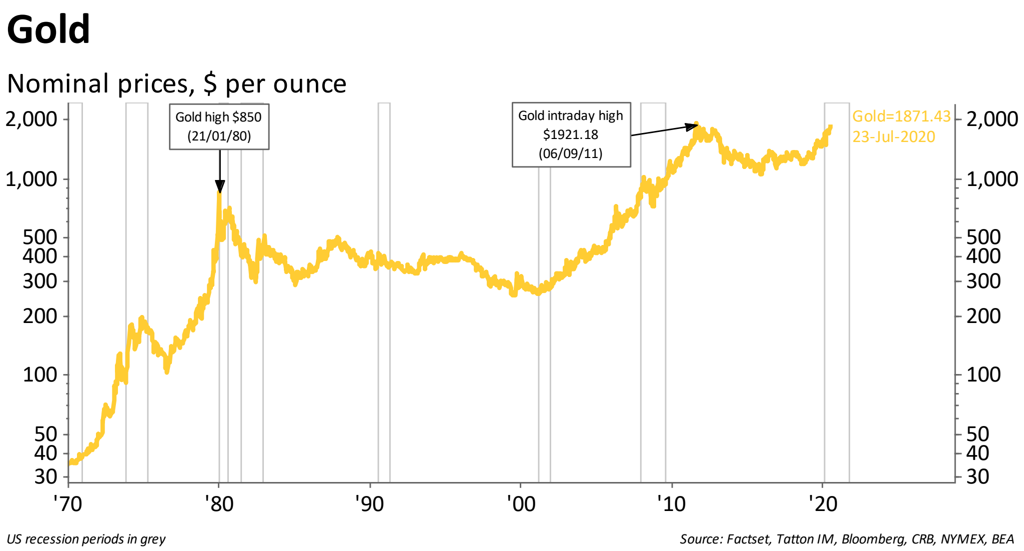
Domestically, Chinese growth is substantially stronger than any other of the large blocs – even though consumption is weaker than its government would have hoped. Employment levels in the services sector are likely to catch up soon, though they are lagging for now. But for all this domestic strength, the export side of their economy remains weak, with Baltic freight shipping rates having peaked a few weeks ago.

In normal times, Chinese assets would be a definite buy, given the global backdrop. But the US conflict has compromised this, and neither side are looking to back down. According to Professor Rory Medcalf of the Australian National University, China has "almost created a dynamic where it has to be externally assertive in order for the party to maintain control domestically, so there's almost a kind of impulse of clashing with the interests, values and sensitivities of other countries". The rise of tensions also threatens to undermine the free flow of capital, and the possibility that this happens sometime soon is affecting the willingness of investors to chase the opportunity. That includes us.

Capital markets reacted negatively to these political factors in the latter part of last week. But overall, the signals coming from markets last week have been mixed – just like the underlying economic prospects. On the one hand, corporate earnings are faring relatively well, there is optimism over the EU's recovery fund and metal prices are signalling a turnaround in economic activity. On the other, a US-China spat looms and the threat of coronavirus is as present as ever.

Lastly, we note that the outsized effect that global politics is having on markets shows how sensitive they have become. Since abundant liquidity and recovering sentiment pushed up asset prices, just as the global economy sank into one of its deepest ever recessions, valuation levels (price over earnings) for equities have soared. In this environment, even a small bit of bad news can frighten investors.

Going for gold



Gold prices have been on a good run lately. Last Thursday, gold reached an intraday high of $1898 per troy ounce, within touching distance of its all-time high of $1921 back in 2011.

Physical or safe-haven assets typically benefit from periods of unease or uncertainty. Gold's credibility comes partly from its centuries-old use as a store of value, but also from its physical qualities. Its weightiness, durability, malleability and downright attractiveness make it physically ideal as a coin. It is decidedly old-school – it doesn't require a plug and will always be there – even when your internet access isn't.

To some extent, gold's main use is still as a currency, an alternative to the 'modern' 'fiat' (Latin for "let it exist") currencies of major nations – which are today supported by the Central banks. In more normal times, those currencies have an advantage over gold: you can place them in a bank and earn some interest. Gold's very physicality means it does not generated interest.

Of course, times are not normal. On top of ever-present uncertainty, the currencies of the major nations, with interest rates around 0%, no longer give a return. At the same time, many central banks are creating more and more of their own currencies to funnel into the financial system.

Central banks' money printing exercise is unlikely to go on for the long-term; central bankers will be expected to taper their operations when the economic crisis abates. But in the meantime, the US Federal Reserve (Fed), the Bank of England and the European Central Bank have allowed governments to borrow in the open market, and soaked up almost all of that debt by buying it from the original purchasers with newly-minted 'reserves'.

While the amount of fiat currency in circulation is increasing, the amount of gold available cannot be created on a whim – short of fraud. So, it should not surprise that gold is now relatively attractive. It does well when the incentives for central banks to print more money are greatest, when economies are struggling, when real activity and particularly employment is weak.

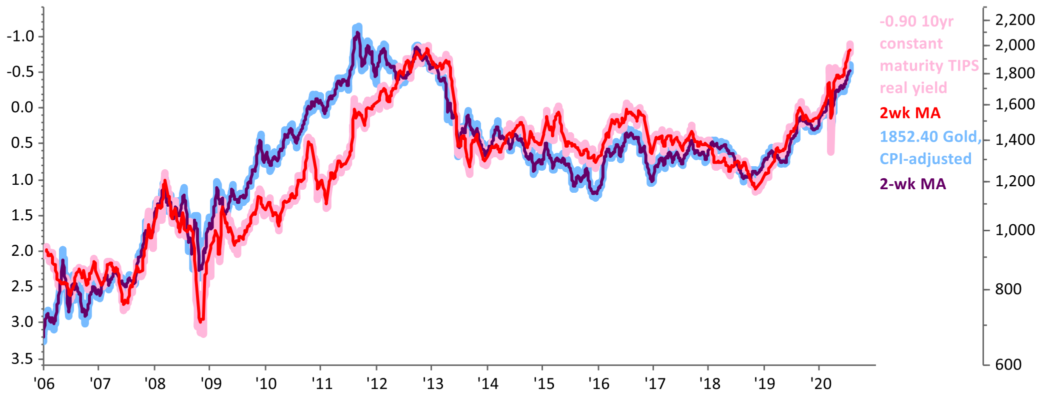
Indeed, even before the global economic shutdown, central banks had generally come to the conclusion that their economies could do with more activity and higher employment levels. To that extent, the Fed had already undertaken a review of its policy, one which many believed would lead to a long period of low rates, with inflation allowed to run up to a rate which would have induced rate hikes before.

It is unlikely that short-term interest rates will be allowed to go below 0% in the US or the UK for any meaningful period. But the economic damage caused by COVID has made it only more likely that, to boost economic activity, rates will be held substantially below inflation for quite a long period, possibly multiple years.

One can see the market's effective pricing of this by looking at bonds which give a real (inflation adjusted) yield. In the UK, we have inflation-linkers, bonds whose capital and interest payments rise in line with inflation. For some time, investors have been prepared to buy these bonds although the return does not compensate for inflation The UK 'real' yields have recently been at around -3% per year, while in the US, last week the ten-year real yield has fallen to -0.9% (investors receive a return of US CPI minus 0.9%). Gold has moved alongside, as the chart below shows.

Gold and US Long Real Yields

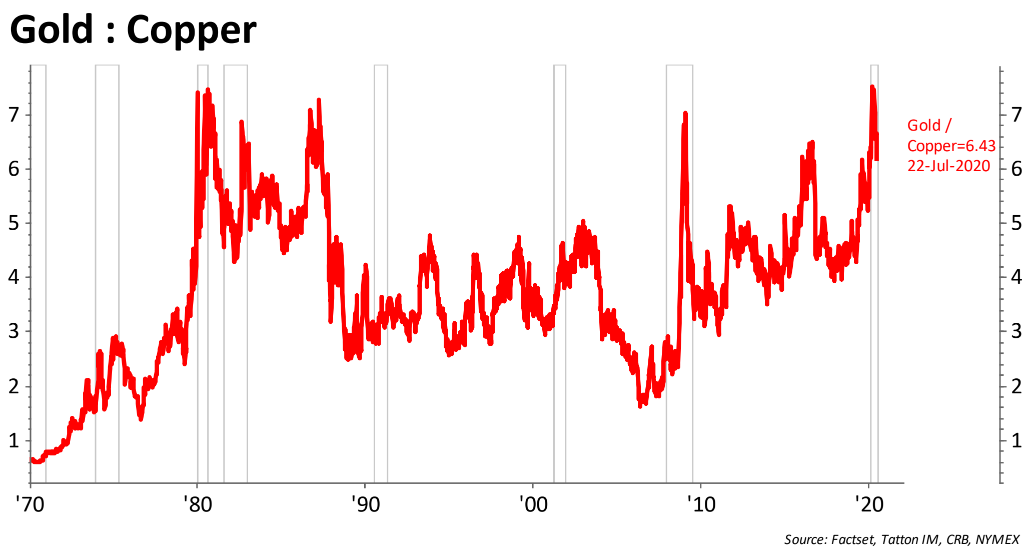
Right axis: Gold deflated by US CPI
Left axis: US real yield (upside-down)



Source: Factset, Tatton IM, BEA, NYMEX

Indeed, the relationship between gold and long-term US real yields has rarely been as tight.

Another interesting comparison for looking at the underlying economy is the relationship between gold and copper. Gold is useful as an electrical conductor, but copper is nearly as good and decidedly cheaper. Modern infrastructure uses it and governments are particularly keen on increasing valuable technology businesses. It has been very noticeable that copper demand has become tied to China's growth, especially when the government has tried to stimulate their economy – as they are right now. The price of copper is, in effect, a proxy for economic activity.



The chart above shows an index of the ratio of gold to copper, with the grey bands showing US recession periods. There are some notable periods of trending, with China's first bout of expansion (from the early 2000s) driving copper's price substantially higher, so the ratio fell.

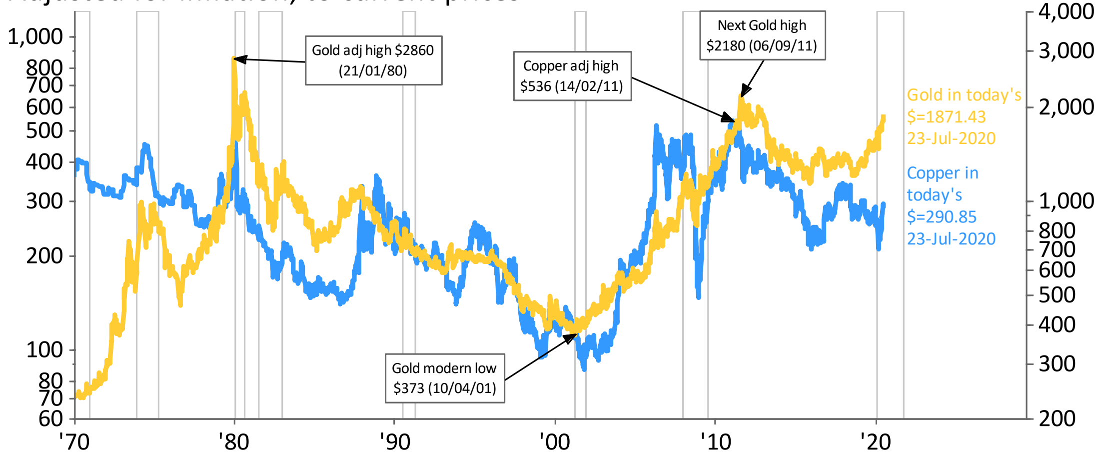
Gold tends to outperform ahead of recessions, as returns from other assets become less certain. But when activity picks up and the recession ends, demand for copper increases (since technology production picks up) and the ratio falls back.

Recently, the ratio has indeed swung in copper's favour. Gold has done well, and this could continue if central banks keep suppressing nominal government bond yields while governments shift towards greater long-term levels of investment and activity picks up. That would compress real yields further into negative levels. But right now, while gold has been doing well, copper has been doing better. That's a good sign for the global economy, and for nominal activity. In turn, leaving aside valuation considerations, it's a good sign for higher risk assets such as equities.

As a reference, we include a chart showing both gold and copper in today's US dollars but adjusted for inflation. One thing of note is that gold may be considered a safe asset in some respects. Still, many investors will have thought otherwise in the years after 1980. The log scale rather minimises the outcomes. By 2002, after inflation (which had been falling), gold was 25% of its 1980 peak value, having bottomed at 13%. Meanwhile, at the bottom of the dot.com bust, the US market total return index had risen 1400%, having peaked at around 2500% in 2000.

Gold & Copper

Adjusted for inflation, to current prices



Source: Factset, Tatton IM, CRB, NYMEX, BEA

EU recovery package: European, limited but still historic

European Union (EU) leaders never let a crisis ruin a good argument. With the global pandemic forcing Europe's economy into its worse slump since the second world war, EU heads of state butted heads during a tense Brussels summit, for four days and four nights. Their aim was to agree terms on a coordinated spending package to aid EU recovery. And, in the early hours of Tuesday morning, the deadlock was broken as they reached a deal on the landmark €750 bn recovery fund. Some may only view it as a formality, but the EU and national parliaments still have to approve the project.

The size of the fund remains unchanged from the European Commission's original proposal, with the remarkable feature that the money will be raised in capital markets, with the EU issuing considerably more bonds than ever before. This means the supranational European bond market will deepen with this initiative.

On the spending side, Brussels' top Eurocrats can now spend considerably more from 2021 to 2023 (with some front-loading into 2021/22) but will not have to pay back their debt until 2058 (the repayment schedule goes from 2026 to 2058). Concessions were made on how Brussels can disburse the money; €360bn is now allocated for loans – up from the recommended €250bn – while the funds earmarked for grants and guarantees has correspondingly been reduced to €390bn. Of that, €312.5bn will go into the EU's Recovery and Resilience Facility, allowing member states to directly invest in their own recovery and modernise their economies. The remaining €77.5bn will go towards topping up the Commission's usual budgetary programs.

As this is meant to be a policy of redistribution, the countries benefiting most from the plan are the Southern and Eastern member states. There are also a few questions on how the borrowing will be paid back: through future EU budgets or with the EU moving towards a proper EU tax (for example on tech multi-national, plastic), something the Commission has been pushing for.

Supporters of the deal heralded its historic significance. French President Emmanuel Macron, a long-time proponent of a fiscal union in Europe, claimed the support package "changes everything because we're creating a budget in the eurozone," adding that "These are legitimate transfers, so this is indeed a moment of great change for Europe". Dutch Premier Mark Rutte flatly rejected that the fund constituted fiscal transfers, claiming that it is "a one-off".

The so-called 'Frugal Four' – the fiscally conservative countries of Austria, Denmark, the Netherlands and Sweden – were, as usual, the main opposition to further spending measures (or to be fair, to how money is being disbursed). Other than adjusting down the grant allocation, the most significant concession they won was on rebates – a contentious issue often pushed by British prime ministers in the past. Austria came away from negotiations with a doubling of their agreed discount, prompting Macron to make unfavourable comparisons to David Cameron's tactics years ago. In return, the frugal states had to give up on a veto for disbursing money to member states should they not comply with a set of country specific reform and macro variables. This has now been replaced with a supervision mechanism, which ultimately lies with the Council and therefore carries a political element.

These concessions, and the usual political gridlock in Brussels, should temper any suggestion that this deal ushers in a new era of fiscal union. But aside from political friction, there are concerns over the effectiveness of the new measures. Generous spending plans are all for nought if the money cannot get to where it is needed. Domestic and national governance can be an issue, but also adequate projects have to be found. In this context, it is worth noting that the actual payment into investment projects can be extended until 2026. So, this underlines again the medium to long-term nature of the recovery initiative. And if this wasn't already complicated enough: some also wonder whether member states will make use of all the loans, as obviously they are likely to focus first on the grants.

We underline again at this point that the recovery fund is not, first and foremost, a pandemic bridging plan. Europe's politicians have been keen to stress that these measures are needed to recover and rebuild in the wake of the continent's lockdown, but the loans, grants and guarantees on offer are not just a way of plugging the gap between now and normality. This much we can see in the start date of the plans alone.

The Commission's fiscal spending will not kick in until 2021, by which time – hopefully – Europe will be firmly on its way back to normal. These measures are instead for what comes after – to address the tightening of credit conditions and downward spiral of sentiment that would normally follow from a shock like this. As such, the focus will most likely be on large infrastructure projects and investment aimed at improving productivity over the medium and long-term.

Those sorts of projects take longer to have a positive economic effect, but they are also easier to achieve through the usual channels than the 'get cash out quick' measures we have seen so far throughout the pandemic. Oversight of these projects should also prove somewhat easier, given they are directed by national governments.

As such, the Commission's spending plan is a long-term positive for Europe, with poorer or less modernised countries in the South and East the key beneficiaries. And, even in the short-term, it will be a positive for firms in the industrials sector – which stand to benefit from investment and infrastructure spending. Capital markets seem to agree here, given price moves last week. The Euro has now moved higher against global currencies, with Germany's DAX index – which includes many industrial firms – also rallying.

Enthusiasm on Europe should be tempered, as ever, given the longstanding political frictions and structural economic problems. But we remain cautiously optimistic. Before the COVID crisis set in, an agreement like this would have been unthinkable. That it took this level of shock for it to happen is testament to the fact Europe integrates one crisis at a time. But it is still a step forward.

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27th July 2020

Global Equity Markets

Market	Fri 14:14	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	6134.8	-2.5	-155.5	↘	↘
FTSE 250	17312	-0.2	-36.2	↘	↘
FTSE AS	3400.9	-2.1	-71.8	↘	↘
FTSE Small	4984.4	-1.2	-58.2	↘	↘
CAC	4969.6	-2.0	-99.8	↘	↘
DAX	12880.6	-0.3	-39.1	→	→
Dow	26652	-0.3	-82.4	→	→
S&P 500	3235.7	0.6	20.1	→	↗
Nasdaq	10461.4	-0.1	-12.4	↗	↗
Nikkei	22751.6	-0.8	-193.9	→	→
MSCI World	2308.1	0.6	14.2	→	↗
MSCI EM	1077.6	2.1	22.5	↗	↗

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
Centrica	14.1	GVC	-15.4
Sage	10.8	Burberry	-10.5
Hargreaves Lansdown	10.1	easyJet	-10.1
Kingfisher	9.2	Melrose	-9.2
Unilever	8.0	Carnival	-8.5

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.277	1.6	Oil	43.49	0.8
GBP/EUR	0.910	-0.0	Gold	1903.1	5.1
USD/EUR	1.16	1.6	Silver	22.84	18.2
JPY/USD	106.04	0.9	Copper	287.8	-0.3
CNY/USD	7.02	-0.3	Aluminium	1701.0	1.8
Bitcoin/$	9,534	4.1	Soft Cmdties	340.5	3.2

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.15	-0.02
UK 15-Yr	0.38	-0.00
US 10-Yr	0.60	-0.03
French 10-Yr	-0.14	unch
German 10-Yr	-0.44	+0.01
Japanese 10-Yr	0.02	-0.01

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.4	22.1	19.4	13.5
FTSE 250	3.0	27.4	25.1	14.5
FTSE AS	4.2	23.7	20.1	13.6
FTSE Small	3.9	13.2	-	13.8
CAC	2.2	20.0	23.9	13.7
DAX	2.5	24.9	20.3	12.7
Dow	2.4	20.3	23.8	15.4
S&P 500	1.9	23.7	25.6	16.4
Nasdaq	0.8	33.3	31.1	18.5
Nikkei	1.9	27.8	22.5	17.0
MSCI World	2.2	22.9	23.9	15.5
MSCI EM	2.5	17.7	17.5	12.0

UK Mortgage Rates

Mortgage Rates	Feb	Jan
Base Rate Tracker	2.19	2.19
2-yr Fixed Rate	1.41	1.42
3-yr Fixed Rate	1.66	1.67
5-yr Fixed Rate	1.70	1.68
10-yr Fixed Rate	2.37	2.38
Standard Variable	3.66	3.66

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

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Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet and is only valid for the publication date of this document.

The value of your investments can go down as well as up and you may get back less than you originally invested.

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