THE **CAMBRIDGE** WEEKLY

13 July 2020

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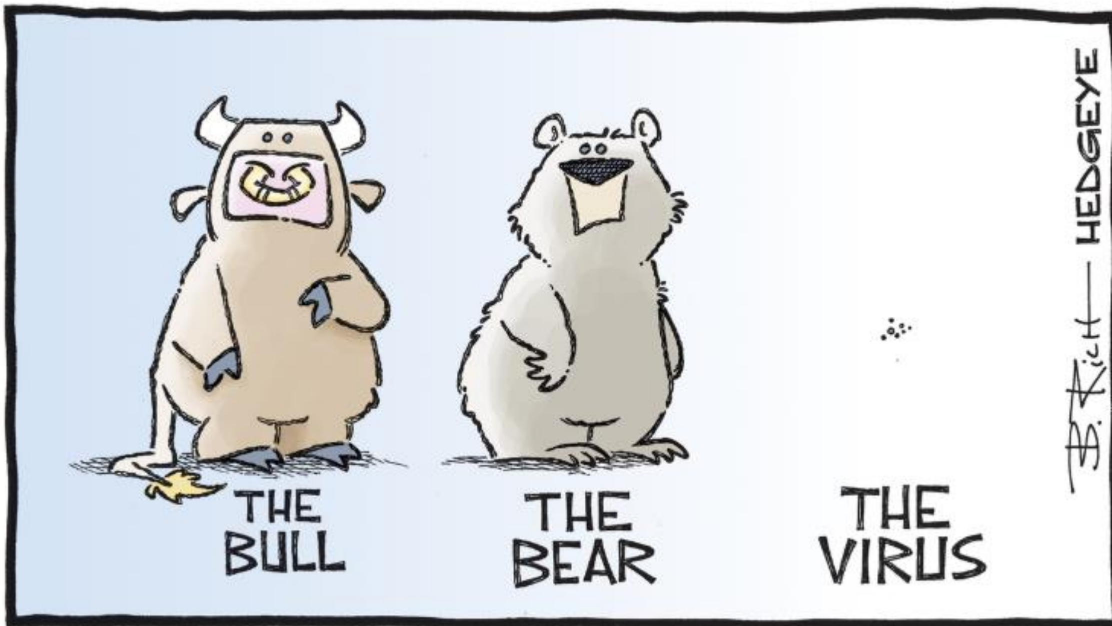
CAMBRIDGE
INVESTMENTS LIMITED

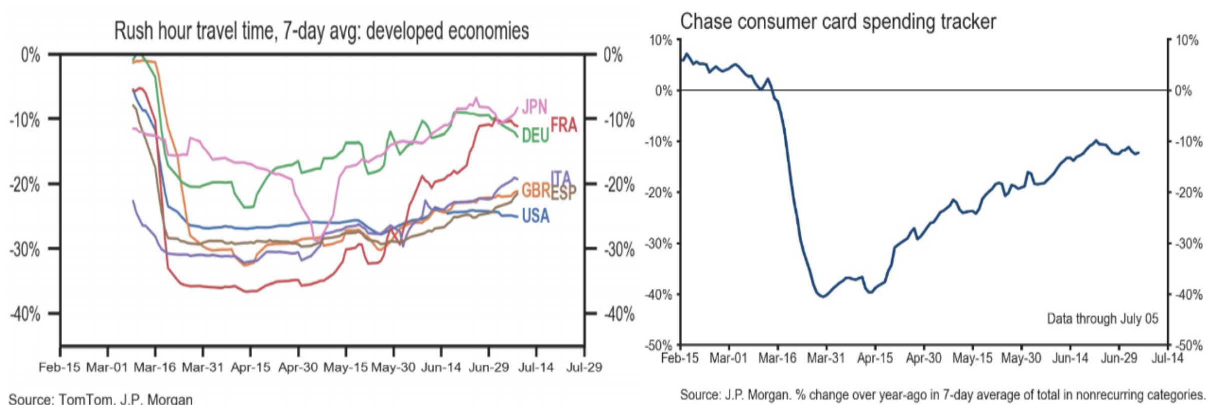
13th July 2020



Source: Hedgeye May 2020

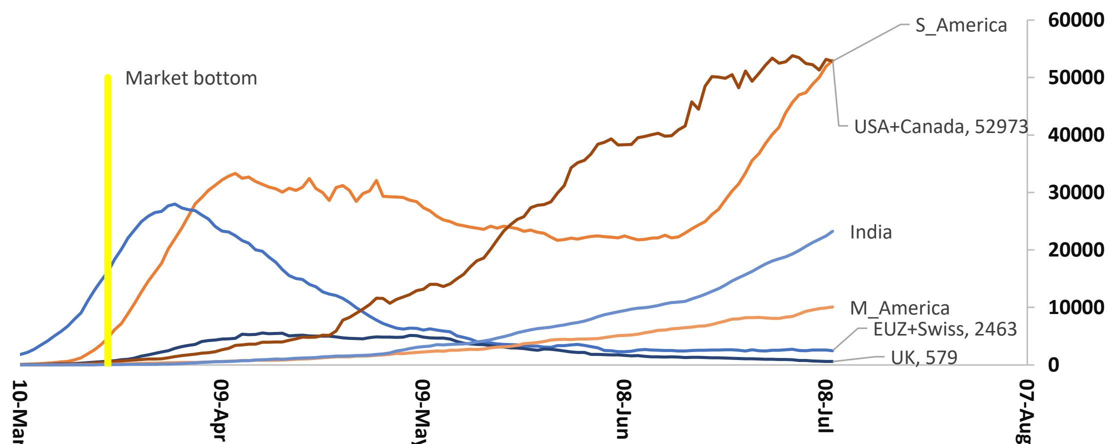
Fast and freewheeling – markets move as economies slow

As they have for most of the year, pandemic developments dominated the economic news flow last week. Though restrictions continue to ease here and in Europe, the virus is now spreading at a quickening pace in the US, from the previous hotspots in the north-east to the south and west. That renewed virus threat is undoubtedly impacting the economy once again – just five weeks after the US began to open up. The high-frequency data (tracking daily movement, travel and leisure purchases, etc.) are showing a drop in economic activity, as one would expect. JP Morgan's research showed the charts below, with credit card spending flat-lining and the US rush-hour now the most impacted across nations. Of course, we should be careful when looking at these sorts of data. As one can see, Germany also seems to be registering a pullback without any suggestion that they have any significant resurgence in virus cases:



Global stock markets sold off in the early stages of the pandemic when cases began climbing rapidly. In the US, the virus is now spreading at a significantly faster rate than back then. And yet, equities continue their impressive rally. The tech-heavy NASDAQ, for instances, is breaking its all-time highs.

COVID-19: 7-day average of daily cases



Source: ECDC, Tatton IM

Why? As we have noted before, the answer seems to be liquidity. On top of the extraordinary measures being rolled out from central banks, US retail investors appear to have amassed a lot of savings throughout the pandemic, and many of them are putting their money to work in stock markets. They have gone for the recent winners, particularly in the big-tech sector. Amazon and Tesla stand out in nominal cash terms, but even smaller companies in the lower echelons of the NASDAQ Composite are seeing a lot of trade. Indeed, when looking at the volumes of shares traded (numbers of shares rather than their value), the levels are returning to the heady days of the dot.com era.

Politicians are also doing their part to support sentiment. Donald Trump has a history of talking up the market, but he's nothing compared to China's authorities if last week is anything to go by. Last Monday morning, the state media outlets joined in a chorus of cajoling: *Shanghai Securities News* ran a story entitled "Hahahahaha! The signs of a bull market are more and more clear" while others talked of a "healthy" bull market and that investors could (not might) look forward "to the wealth effect" of higher prices. The CSI index rose 5.7% on the day and rose each day until Friday's 2% fall, peaking at +8.7%.

Perhaps this was in response to foreign selling across the past month, following China's effective removal of Hong Kong's autonomy. As the *Financial Times* pointed out, it brought back memories of 2014 and 2015, when state media cheered a more than doubling of stock prices. That rally later unwound in spectacular fashion with a 40% collapse.

Indeed, this form of action does not suggest that China is responding to international pressure with conciliation. In itself, it's not an aggressive act, but it is a very visible show of internal strength. While we don't think there is an immediate issue for international investors, the danger remains that politics gets in the way of the free flow of capital.

Copper continued its push higher last week, helped by the moves in China, and is a good sign for the global economy. However, wariness about US domestic demand has been affecting other markets. Prices of government bonds and gold moved higher, while small and mid-caps struggled.

Part of this easing in optimism may come from perceptions that governments are becoming less willing (or less able) to support economies. The US faces the prospect of a sharp retrenchment if time-limited measures are not renewed by the end of July, but there is a clear market consensus that there will be a new package. However, Treasury Secretary Mnuchin said the administration will push for narrower support in the next two weeks. For us, the biggest issue revolves around spending undertaken by individual states rather than the federal government. Politics really comes to the fore here, and Trump seems to be prepared to push Democrat-led states into real problems, ones that will actually affect the overall economy. November's ballot is also about the Congressional elections, especially the fight for control of the Senate. A third (33) of the seats will be contested and control may swing to the Democrats if things go very badly for the Republicans.

We talk about the Chancellor of the Exchequer's "Plan for Jobs" in the article below. UK large-caps wilted in line with the dwindling growth optimism, but sterling staged a mini-rally, a signal that the package got a small thumbs-up.

We also take a look at Japan in a separate article. Japanese government support has been large but monetary support has been less apparent. The Bank of Japan (BoJ) meets this week, although few think it will come out of its shell. The Governor did, however, make some concerned noises last week, so we there is a chance of a positive surprise.

As we head towards the holiday months, market remain more volatile than normal, but that volatility appears to ebbing slightly. Nonetheless, risks remain elevated. The reporting season for the end of the second quarter will get underway in earnest this week. It's been notable that analysts have started to edge their expectations down again in recent days, which hasn't helped valuations. Let's hope that the awful pick-up in US virus cases turns around, for their and all our sakes.

Sunak spends big to kick-start the economy

Rishi Sunak's short time at the Treasury has been a trial by fire. A year ago, the current Chancellor of the Exchequer was Chief Secretary to the Treasury under former Chancellor Sajid Javid. But after Javid's controversial sacking in February, Sunak's foot was barely in the door of Number 11 before the global pandemic shuttered Britain's economy. Less than five months into his tenure, the second youngest Chancellor over the last century has contended with the deepest recession in Britain's modern history.

He has, according to his colleagues in Whitehall and wider public opinion (a recent poll puts his net approval at +41), performed admirably. In his latest appearance before Parliament, Sunak drew applause as he unveiled yet another wave of fresh fiscal stimulus: a £30 billion job support package plus an additional £33 billion in previously unaccounted for public spending. It comes after the £130 billion fiscal package announced in March and leaves total pandemic-related spending at £190 billion so far this year. That spending is alone 9% of UK GDP, and puts total government borrowing on course for £350 billion this fiscal year.

The fact that Sunak, a Conservative Chancellor whose party spent the last decade rolling back government spending, has loosened the public purse strings to such an extent speaks volumes about the scale of the current economic crisis. In normal times – even in a normal recession – these spending measures would be baulked at. But this is no ordinary recession. With the whole world forced to reduce its economic output, the government has had to intervene on a level never before seen in peacetime.

With that in mind, we would do best to avoid the usual "how do we pay for this?" rhetoric. Payment for these extraordinary measures – most likely in the form of higher taxes – will eventually come due. But it will not happen in the next couple of years, or before we get back to normality. Thanks to the Bank of England's enormous bond buying program, interest rates on government debt are pegged at historic lows, giving the Treasury the leeway to spend what funds it deems necessary.

As such, the question is not what we can afford but what we need. On that front, the Treasury faces two main challenges. The first involves plugging the gap between now and normality, and the second is in laying the foundations for solid and sustainable growth afterwards. Sunak's initial spending measures in March were almost entirely focused on the first problem, but this new package is aimed squarely at the second. With businesses slowly opening up around the country, the government's attention is now on getting people back to work and boosting consumption.

On the employment side, the £1,000 promised for each employee returned from furlough is designed to help businesses keep workers on even when short-term emergency measures wind down. In addition, the kickstart scheme for under-25s promises six-month work placements for young people "at risk" of long-term unemployment, as long as those jobs are "additional" (that is, where subsidised young workers are not just cheaper replacements for existing workers).

On the consumption side, there will be a temporary 5% cut in VAT on food, accommodation and entertainment and, in August, customers will get a discount of up to £10 a head on restaurant orders (Monday to Wednesday). Homeowners can also benefit from government support when planning on improving the energy efficiency of their home (with £3 billion earmarked in the spending package).

According to a report from the Institute for Fiscal Studies (IFS), the crucial issue in these plans is timing. Fiscal spending is a powerful tool, but only if it is used at the right time and not cut off too early. For instance, the IFS highlights that much of the money spent on returning workers could end up as dead weight, as firms that already planned on bringing back employees will be eligible for the £1,000 bonus, while others that cannot yet open could miss out. This would undoubtedly be a boost for some businesses, but might well end up disproportionately benefitting those not struggling as much.

Timing is even more important on the consumption side. Strong consumer demand is a vital pillar of the economy, but the country can only consume as much as is supplied. Social distancing has forced pubs and restaurants to operate at reduced capacity. If that capacity is already full, a boost to demand will have little effect. As such, the IFS has warned that the VAT cut could well be absorbed by higher business revenues, rather than passed onto consumers.

The even bigger concern comes at the other end. At the moment, most of these measures are set to run out around the end of the year. But that could be when we need them the most. Even when social distancing measures fade, the scarring effects of the pandemic – either through lingering virus fears or reduced consumer confidence – are likely to remain. If government support wanes while the economy is still struggling to find its feet, we could end up with a longer and more damaging recession.

Fortunately, Sunak also made clear that further spending will come if and when it is needed. He was forthright that the next budget update in the Autumn – when the scale of the economic crisis will be clearer – will be a bigger event than this announcement. If the virus can be contained between now and then – and

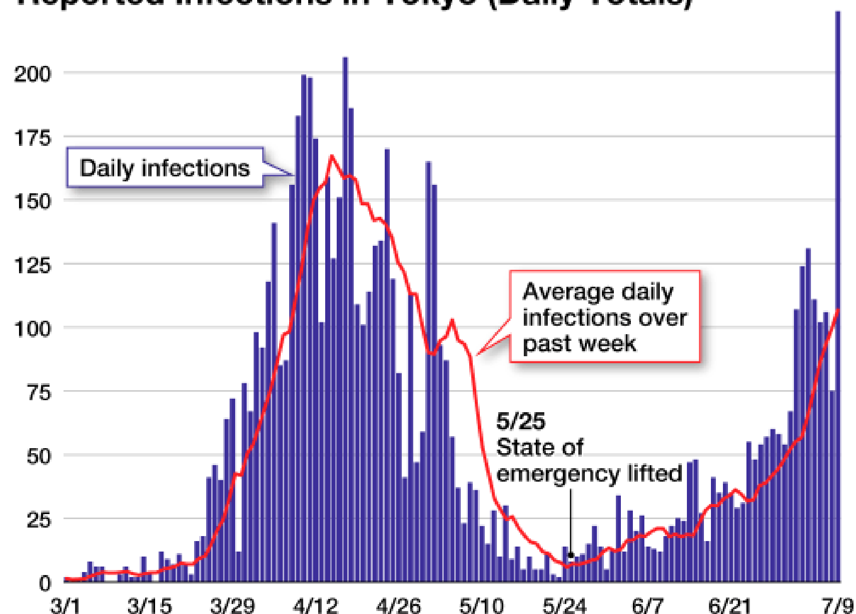
it is a big if – the gap-plugging exercise will end, and the rebuilding exercise will begin. According to Sunak, "Our 'plan for jobs' will not be the last action, it is merely the next, in our fight to recover and rebuild after coronavirus".

That is an encouraging sign from the fresh-faced Chancellor. Some of the austere minded in his own party have asked for the government's plans on how to rein in public finances over the long term, but he has done well to ignore them. And the GBP and gilt market seems to support the Chancellor's approach, for now. How effective these measures will be for struggling businesses and consumers remains to be seen. But the fact that the focus is only on what is needed for recovery, and not what can be 'afforded' over the long term, is a positive.

Japan: The Tokyo go slow

Like all nations, Japan faces a delicate balance between economic and health concerns in the wake of the pandemic. But until last month, the powers that be in the world's third largest economy thought it was a balance they had struck perfectly. Prime Minister Shinzo Abe declared triumphantly at the end of May that the "Japan model" had "all but brought this epidemic under control in the last month and a half," and subsequently ended the national state of emergency. Japan earned plaudits on the international scene for the fact that, even without a compulsory lockdown or significant testing regime, virus cases have been limited to around 20,000, with under 1,000 deaths. Shops, clubs and entertainment venues were allowed to open, and the economic recovery had begun. At the start of June, cases were averaging below 40 a day.

However, from 23 June, things changed. Cases began to rise almost every day, centred on Tokyo. On 10 July, Tokyo registered 243 new infections, its highest-ever daily figure, breaking the previous high of 224, set on the previous day (data according to Nippon.com):



Created by *Nippon.com* based on data from the Tokyo Metropolitan Government.

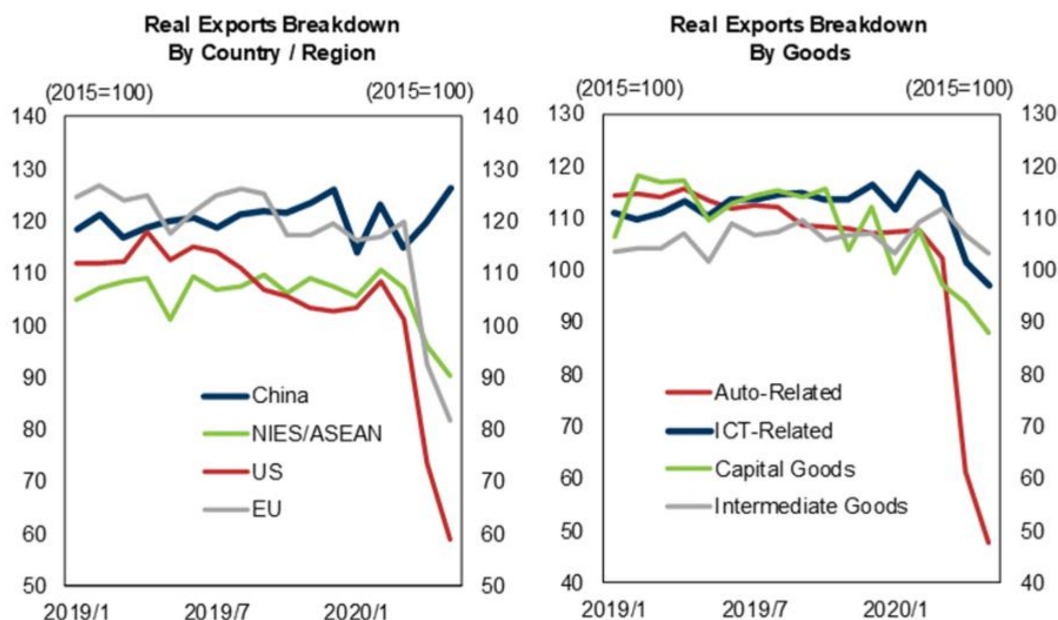
Japan did not lock down significantly during the April surge, and the government is maintaining the same viewpoint now, and that is partly because of the economy's performance. So, it is worth examining how Japan's economy has fared through the pandemic.

Like everywhere else, the drop-off in economic activity throughout the initial virus spread was dramatic. On traditional indicators like manufacturing and retail sales, Japan's decline was less pronounced than the US throughout March and April. And, on high-frequency indicators such as flight bookings and movement trackers, Japan suffered a much calmer slowdown than the rest of the world. This suggests that Japan's recession might be shallower than the one engulfing other countries.

However, like many nations, Japan's exporters are struggling, perhaps because support programs have been domestically-focused. Japan's exports account for less than 14% of GDP, well below the global average. The UK exports over 18% of GDP (and that's not counting exports to the European Union).

Domestically, the Japanese economy is famously stable – particularly in recent years in terms of employment. Over the last ten years, much of the country's swings in growth has come from its exports, particularly to China and other Asian markets. Those exports have suffered greatly throughout the global lockdown.

Car manufacturers offer a case in point, with auto-related exports now at half the levels they were all the way back in 2015, according to a report from Goldman Sachs. What makes things worse for Japan is that the buyers of their goods are mostly concentrated in just a few regions, such as the US and Europe.

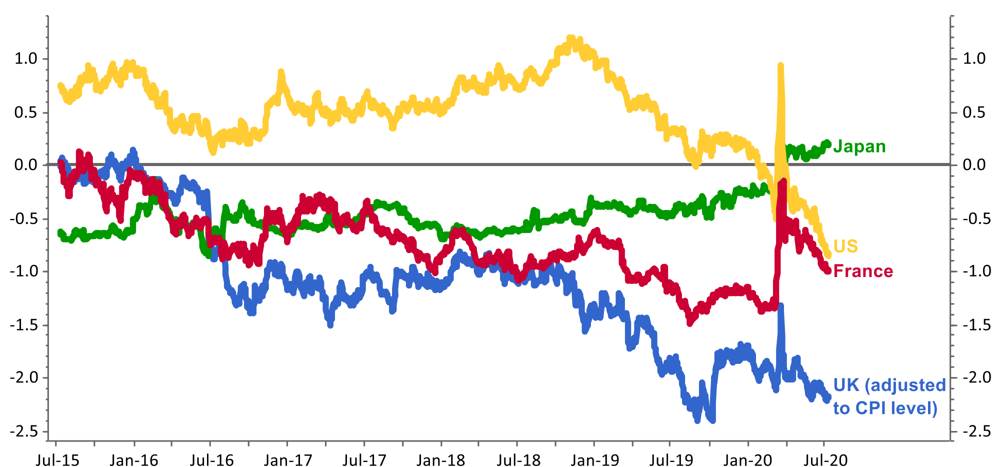


Source: Goldman Sachs Research

Japan is a big manufacturer of machine tools (manufacturing for other manufacturers). And demand for machine tools is heavily linked to businesses' capital expenditures (capex) which the economic shock has made especially weak. Unfortunately, capex is unlikely to come back until firms get much more positive about the global economic outlook and can rebuild reserves. This suggests that although Japan's overall activity drop off was less severe than elsewhere, manufacturing output and sentiment is now lagging, and may continue to do so for some time.

On the domestic side, there are certainly reasons to be positive. Employment is relatively stable and Japanese consumers have high savings, laying the groundwork for improvements in demand. On top of that, Japan's fiscal response to the crisis has been one of the most significant of any nation – second only to the US as a percentage of GDP – and with the third-highest injection of loans or other financial measures in the world. But that fiscal stimulus has yet to significantly boost Japan's economy. We suspect that a great deal of this is cultural: Japanese consumers and businesses tend to be reluctant to spend their reserves quickly, so government support often just ends up as private sector saving rather than productive capital.

But the other crucial element to Japan's lethargic recovery is the inaction of its central bank. Unlike other major central banks, the Bank of Japan (BoJ) has been unwilling to flood its financial system with liquidity – instead opting to target government fixed-coupon bond yields. This policy has had an odd effect. Whereas other nations' real (inflation-linked) bond yields have fallen to substantially negative levels, Japan's real yields have risen into positive territory. They are now the highest among major nations.



There is room for monetary policy to become more accommodative. The BoJ meets this week, and commentators appear to have little expectation of a substantial move. This is despite some fairly pointed comments from Governor Kuroda after the publication of a very downbeat survey of Japan's regions. So, they could surprise markets by turning on the liquidity tap. Not only would this help pump up Japan's reflation trade, it would likely push the value of its currency down, thereby making Japanese exports more attractive. The BoJ has 'form' in this area from the early 2000s.

As with most things now, this all depends on how the virus situation pans out. Even with the recent spike in cases, Japan has done well to control the spread of COVID – partly through its decisive early lockdown. The government has less room than others for manoeuvre on the economic side, given that overall government debt remains above 200% of GDP. We will need to watch closely how they manage the balancing act from here.

Global Equity Markets

Market	Fri 16:10	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	6100.4	-0.9	-56.9	→	↘
FTSE 250	17215	-0.5	-87.4	↗	↘
FTSE AS	3383.1	-0.9	-29.2	⬀	↘
FTSE Small	5012.5	-1.0	-48.4	↗	⬂
CAC	4969.8	-0.7	-37.4	↗	↘
DAX	12625.5	0.8	97.3	↗	⬀
Dow	25838	0.0	10.8	↗	→
S&P 500	3158.3	0.9	28.3	↗	⬀
Nasdaq	10519.2	3.1	311.6	↗	↗
Nikkei	22290.8	-0.1	-15.7	↗	⬀
MSCI World	2240.7	0.6	14.3	↗	⬀
MSCI EM	1079.7	4.5	46.6	↗	⬀

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
Persimmon	16.5	Micro Focus Int'l	-26.5
Barratt Devts	11.3	DS Smith	-7.9
GVC	10.6	Int'l Consol Air	-7.2
Fresnillo	9.7	ITV	-7.2
Antofagasta	7.0	WPP	-6.3

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.266	1.4	Oil	42.81	0.0
GBP/EUR	0.894	0.8	Gold	1802.7	1.5
USD/EUR	1.13	0.6	Silver	18.69	3.7
JPY/USD	106.75	0.7	Copper	287.3	5.1
CNY/USD	7.00	1.0	Aluminium	1664.0	2.7
Bitcoin/$	9,186	1.0	Soft Cmdties	328.1	-2.0

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.15	-0.04
UK 15-Yr	0.36	-0.04
US 10-Yr	0.60	-0.07
French 10-Yr	-0.15	-0.04
German 10-Yr	-0.48	-0.04
Japanese 10-Yr	0.03	-0.00

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.4	22.0	18.3	13.5
FTSE 250	3.1	24.7	24.1	14.4
FTSE AS	4.2	23.2	18.9	13.6
FTSE Small	3.9	13.5	-	13.8
CAC	2.1	19.9	23.0	13.7
DAX	2.6	23.9	19.9	12.7
Dow	2.5	19.5	23.5	15.3
S&P 500	1.9	22.3	25.2	16.3
Nasdaq	0.8	33.8	31.6	18.5
Nikkei	1.9	27.2	21.9	16.9
MSCI World	2.2	21.8	23.3	15.5
MSCI EM	2.5	17.8	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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