THE **CAMBRIDGE** WEEKLY

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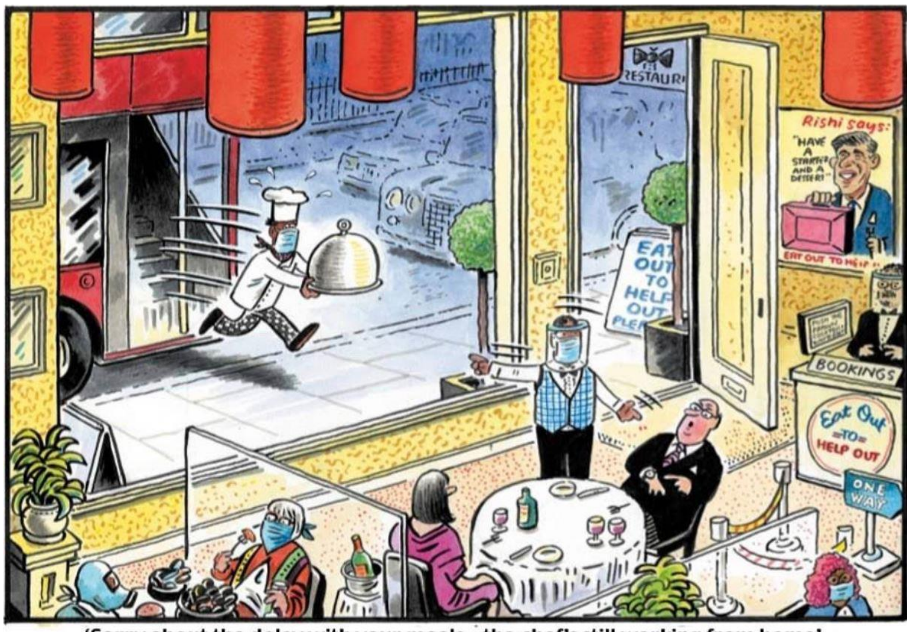


'Sorry about the delay with your meals – the chef's still working from home'

Paul Thomas; Competing messages for living and working under COVID, 4 August 2020

Living with COVID- settling into an interim 'new normal'

Compared to the rest of 2020, July proved almost uneventful as global capital markets consolidated strong gains made during the previous quarter, with only emerging market equities and gold delivering notable advancements (see returns table further below). At the other end of the scale, poor returns from Japanese and UK equities confirms the trend of investors preferring long-term growth prospects of the 'new economy', versus short term earnings stability or recovery potential (value) of the 'old economy'. This has much to do with the fact that the yield investors could safely earn– until this long-term growth materialises – is so close to 0% that they much less mind waiting than usual - and not much with concerns over diminishing recovery potential of value investments.

As we noted in our 27 July edition, while gold has hit new all-time highs, this does not for the moment seem to be driven by a general loss of trust in money, but rather an expectation that economic growth will return in the foreseeable future. This would put upwards pressure under currently depressed bond yields, thereby lowering the capital value of those bonds (due to the inverse correlation between bond yields and valuations). As a result, a considerable migration from bonds into gold has been observed, and appears rational. While both assets are deemed safe-havens, as gold is an asset that never distributes a yield, it positively lacks the inverse yield correlation.

On the economic front, July proved much more interesting. A month ago we stated that the quarterly earnings announcements of companies would be very closely watched for signs of encouragement or disappointment relative to expectations. We also noted that those expectations were based on little more than guesswork, given the lack of historical precedence for research analysts to base their work on. As expected, corporate results declined by a larger rate than ever witnessed over such a short period of time. However, they were still on average better than analysts had predicted, which provided some support for valuations. The general economic picture also improved more rapidly than many had feared, and we cover the latest improvements in unemployment and businesses' outlook this week in a separate article.

Asset class returns at 31 July 2020

Asset Class	Index	YTD	12 months	3-yrs to 31/7 annualised	5-yrs to 31/7 annualised	July
Commodities	LBMA Spot Gold Price	30.9	28.8	16.0	12.8	5.0
Equities	NASDAQ (US Technology)	21.5	23.9	20.4	17.2	0.6
Bonds	FTSE Gilts All Stocks	9.4	9.4	6.0	5.7	0.4
Bonds	Barclays Global Aggregate Bond Index	7.3	0.6	4.5	7.8	-2.9
Bonds	£-Sterling Corporate Bond Index	4.9	6.2	4.9	5.9	1.9
Equities	S&P 500 (USA)	3.3	4.4	12.2	15.4	-0.6
Cash rates	Libor 3 month GBP	0.5	0.8	0.7	0.6	0.0
Inflation	UK Consumer Price Index (annual rate	0.0	0.5	-	-	0.1
Equities	MSCI All Countries World	-0.4	0.0	7.0	7.4	-0.9
Equities	MSCI Emerging Markets	-0.8	-0.6	2.8	6.1	2.6
Property	UK Commercial Property (IA Sector)*	-3.3	-4.0	0.6	1.4	-0.4
Equities	MSCI Europe ex-UK	-4.1	-3.4	1.6	1.6	-1.6
Equities	Nikkei 225 (Japan)	-7.7	-5.5	0.3	-0.2	-7.4
Equities	FTSE 100 (UK)	-20.4	-19.2	-3.3	1.5	-4.2
Equities	FTSE4Good 50 (UK Ethical Index)	-20.5	-20.7	-5.4	-1.7	-3.8
Commodities	Goldman Sachs Commodity Index	-33.3	-35.9	-8.9	-9.2	-2.3
Commodities	Brent Crude Oil Price	-33.4	-37.6	-6.2	-3.8	-0.7

Data sourced from Morningstar Direct as at 31/07/20. * to end of previous month (30/06/20). All returns in GBP.

Any positive summer sentiment took a dent after a resurgence of infection rates among holidaying Europeans, while other global regions were still dealing with high infection rates from their first wave. This effectively led to one economic uncertainty being replaced by another. The strong rebound has shown that V-shaped recovery expectations were not pipe dreams, but whether we can expect to finish the upwards travel along the 'V' is now depending on how western societies will be able to live and operate while we wait for a vaccine.

There are widespread fears of a return of blanket lockdown and a repeat of a suspension of economic activity. We do not share those fears, because we observe how much better the medical profession can now treat severe infection cases and how society has learned to contain new flare-ups without the same economic damage as before. There is a risk that too many hopes are attached to the release of an effective vaccine this side of Christmas, but equally there seems to be an underestimation of our much-increased abilities to contain the damage, both in health and economic terms. Nevertheless, encouraging progress from various vaccine development projects, while displaying strong signs of efficacy, is also worth keeping in mind. Goldman Sachs suggested last week that the early arrival and administration of a vaccine was currently not priced into stock markets, an optimistic suggestion which is not entirely unfeasible.

If anything, July has shown that while we may not yet have the virus truly under control, we have learned to live with it in a way that means the economy will be able to get by until a more permanent countermeasure becomes available – whether through treatment or vaccine.

On the political front, there has been much to be positive about, and plenty that could prove hugely counterproductive. The most constructive development came from the European Union, which at last found a way of using their combined economic and financial power in a solidary act to the benefit of all members. Donald Trump's increasingly jarring actions against Chinese companies occupy the other end of the spectrum, but also tell us that he seems increasingly fearful his days in the Oval Office may not extend beyond a single term. The UK comes out somewhere in the middle, or neutral. Brexit noise increased, but encouragingly, the self-imposed Brexit negotiation deadline of 31 July passed without any negative consequences. This makes us optimistic that both sides are in the background continuing to work towards a constructive rather than destructive divorce path.

August has historically brought elevated market volatility – with surprises occurring while investors are on holiday spreading liquidity much more thinly than usual. But this year we are still far away from 'usual', not just in holiday and travel patterns, but also in terms of the usual sources of liquidity. Central bank-provided liquidity remains plentiful and policymakers remain poised to act when needed. It is also worth noting that, so far, the gargantuan fiscal stimulus packages that have been announced have yet to be deployed – acting more to offer reassurance that they will be there to be called upon when needed. It is quite possible that this stopped the previous week's market weakness deteriorating into anything more than a short-term blip, which was mostly recovered during last week.

The coming months are likely to be unnerving. But despite new uncertainties appearing, July has given us several indicators that suggest we are getting through the economic side of this global pandemic better than originally feared. With this trend continuing, optimism should prevail and lead to a continuation of the recovery that has begun so successfully – even if the path of this recovery is slower, and lower, than we have witnessed so far.

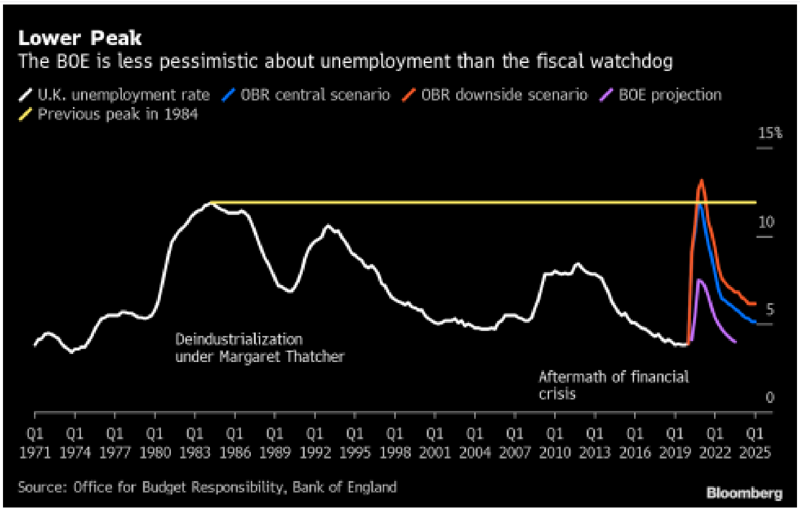
Unemployment – a tricky economic variable

At the Bank of England's (BoE) latest meeting last week, a more optimistic than expected short-term outlook for Britain's economy emerged. One of the most notable forecasts was its call on employment. While furlough and other emergency government measures have allowed many to keep their jobs and paycheques, some fear these policies are just papering over gaping holes in the labour market, and that when they change or expire the number of jobless Britons will rise sharply.

The BoE's Monetary Policy Committee (MPC) agrees with this general diagnosis but is substantially less pessimistic about how bad things will get. The chart below shows their employment outlook against that of the government's fiscal watchdog, the Office for Budget Responsibility (OBR). MPC members now expect unemployment to peak at 7.5% by the end of the year, a milder bout of joblessness than after the global financial crisis. The OBR, by contrast, expects unemployment to peak around or above the previous all-time high back in the early 1980s.

The vast difference between these two outlooks is rooted in the extremely uncertain economic prospects for the coming months. High unemployment is the hallmark of all normal recessions. As revenues start to fall, businesses scramble to cut costs, the biggest chunk of which is almost invariably wages. Rising unemployment naturally then leads to falling aggregate demand, as households lose the confidence – and ability to spend, hitting company revenues and perpetuating the vicious cycle. As such, keeping track of employment figures is clearly important – they can tell us if and when the current crisis shifts from a short government-induced recession into a drawn-out 'classical' one.

Source: Bloomberg, Tatton.



However, we should be careful not to overstate employment statistics' importance in terms of their effect on capital markets. Even at the best of times, employment figures tend to be a lagging indicator of economic recovery – as firms only start hiring when demand for their goods is already picking up. As such, equity markets often 'look through' and beyond high unemployment rates to the light at the end of the tunnel. In the US, in the midst of the last recession, the S&P 500 began its long recovery rally while unemployment was still rising – with unemployment not coming down until 2010 (see chart below). Equity investors tend to factor-in improved earnings for the next few years, even if the unemployment rate remains elevated.

Source: Bloomberg, Tatton.

That they will do so now is less certain, though. Extraordinary central bank action – and returning risk appetite over the last couple of months – has already led markets to price-in future good news. As such, a bout of bad news could knock equities off their path. A more dire trajectory for unemployment – as the OBR predicts for the UK – could certainly do that. This could happen should markets perceive governments to have made a policy mistake, or if they abandon their faith in the 'reflation trade' (optimism that a decent recovery will happen) – instead believing that global activity will remain depressed for some time.

As we can see in the resilience of household incomes and retail sales, policymakers have so far been reasonably good at plugging the virus gap. But with the harshest phase of lockdown now hopefully behind us, both policymakers and the public are craving normality. At some point, that will mean an end to emergency support measures. The UK's furlough scheme ends in October, but if a resurgent virus forces workers home just as the scheme winds down – and the government is unable or unwilling to extend it – markets would have to drastically adjust their economic recovery expectations in light of rising unemployment. Equity prices would almost certainly fall, to reflect lower household spending and a weaker earnings trajectory.

If policy mistakes or a deepening of the crisis caused markets to abandon hope of a reflating economy, things could get significantly harder for investors. As we have written before, rising inflation expectations can push real (inflation-adjusted) yields into the negative. This reflects investors' belief that policy will be successful in generating growth and inflation and, as the chart below shows, has been supportive of equities. As such, loss of that faith could cause a period of stagnation (as seen in Japan during its "lost decade") where investors come to expect no positive changes in the underlying economy. Fortunately enough for now, the opposite is happening. Real yields keep falling, and inflation expectations recover.

Source: Bloomberg, Tatton.

Returning to unemployment specifically, one of the key difficulties is gauging how much of the fall in demand is due to short-term government edict, and how much is due to longer-term health or income-related concerns undermining the public's confidence to spend. This can make labour market comparisons misleading. For example, in the UK, the unemployment rate for April and May remained at just 3.9%. But since this excludes those on furlough or other virus-related measures, it is an inaccurate reflection of Britain's labour market. In the US, unemployment shot up to a record high of 14.7% in April, recovering only to 10.2% in July. But the differing statistics across the Atlantic have little to do with differing economic prospects; rather it is because the US government's emergency wage schemes are largely through unemployment benefits instead of job retention schemes.

This is why unemployment changes – particularly in this crisis – are not the best indicators of economic prospects. After a shock like this, the businesses that have survived long enough to take advantage of rebounding demand will be the ones to do well – and the ones to begin hiring again. So, business confidence surveys such as purchasing managers indices (PMIs) can give us some more insight here.

The latest non-manufacturing PMIs for the US show that, while the outlook for employment is still in contraction (as in the UK), other indicators like price, activity and – especially – new orders show that things seem to be turning around. If this continues, the employment outlook will inevitably improve with it – and a swift bounce-back (albeit not fully to pre-crisis levels) does not look far-fetched. What's more, that personal incomes have been relatively well-maintained (compared to past recessions) means overall demand could return quickly when governments allow.

As ever, aiding that recovery will depend on authorities here and elsewhere keeping monetary and fiscal policy as accommodative as possible. On their part, the BoE suggested they may do the opposite and taper down their policies towards the end of the year. We suspect this was intended to underline the Bank's confidence in its own rebound forecast, but is nevertheless hugely unlikely – at least if the Bank does want to fulfil its less gloomy forecasts. And, in defence of 'The Old Lady', the MPC's policymakers have assured markets that tools remain at their disposal should the economy need more support.

Property funds not such hot property

Property can be an attractive investment. Like everything else, property prices have their ups and downs, but investing in 'real' assets can appear to hit a sweet spot, relative to financial assets like equities, bonds or cash. There is enough of a positive yield that holding it is preferable to holding cash, and not so much price volatility that investors get skittish.

The main problem, as anyone who has tried to buy or sell a house could testify, is that property is hard to sell – or at least hard to sell *quickly*. Money tied up in physical property can take months to turn into usable capital, which can be off-putting for investors – particularly those requiring flexibility in their portfolio.

That is where some fund managers have come in with a seemingly perfect solution: open-ended direct property funds. These funds are invested in a variety of properties but can be bought and sold on a daily basis. They claim to offer investors the stability and returns of property, but with the liquidity of daily-traded assets. Unfortunately, the recent history of these funds has shown that, like most things that seem too good to be true, they are.

Over the years, UK open-ended property funds have suspended investor redemptions – their ability to get their money back – during three separate bouts of market volatility. They closed in the financial crisis of 2008 as investors rushed to sell. Some funds reopened after about nine months, while others took well over a year, with 20% and 40% losses. In the aftermath of the Brexit referendum, almost all open-ended property funds closed again amid heavy redemptions, before reopening 10-12 weeks later, with losses of about 10%. Last December, suspensions started again, with the funds blaming Brexit uncertainty and structural shifts within the UK's retail sector. Some investors were selling, but this time the funds responded quicker to close their doors. They invoked their "material uncertainty" clauses, meaning that the underlying property valuations were being called into question by their valuers.

These incidents prompted the Financial Conduct Authority last week to release proposals for drastically changing the way open-ended property funds handle their trading. Their main proposal is that investors' ability to liquidate their positions daily is removed, replaced with a notice period of several months. This would stop values crashing when groups of investors head for the door, but would close much of what is "open" about these open-ended funds.

In normal times, open-ended property fund managers only have to ensure that likely redemption amounts are balanced with enough spare cash on hand. But major issues occur when things are not normal and the promised liquidity dries up. The manager's only option in such times is to suspend the fund. These suspensions can save investors from undue losses, but repeated occurrences tell us that the funds are not what they promise. As the FCA puts it, "the daily liquidity that these property funds offer cannot always be delivered and comes with a price."

While fund managers have ways around such problems, those too come at a cost. There is a fundamental mismatch between the way these funds are presented to the investing public – as highly tradable assets – and the nature of the underlying assets in the fund. To correct for this, fund managers have had to hold increasingly large amounts of cash in their funds instead of property to prevent forced suspensions of trading. That cash pile generates no return, and so eats into the returns of the overall fund. The FCA's proposal states that "Holding these cash balances is inefficient and reduces expected returns to investors".

The imposition of a fixed notice period would go some way to addressing these problems. Removing the ability to sell the fund quickly would dispel illusions that illiquid assets like property can be traded in a liquid way. The apparent stability and lack of risk that these illiquid assets have is not, in fact, to do with how they are valued by investors but instead just a result of their illiquidity: If an asset cannot be revalued every day, it cannot see huge daily volatility.

That false stability is what made these funds so attractive. For many investors, open-ended property funds looked just like a higher-returning alternative to money market (cash) funds. In other words, an investment 'no-brainer'. This also seems to have led to professional investors taking advantage of the fund structure by using them as a short-term (and more lucrative) alternative to cash. These investors were better aware than others of the timing of the underlying assets' revaluations, keeping their capital in the fund while there was little near-term chance of downward revisions, and collecting a steady and high yield. When the revaluations became more likely, they would get out, leaving the retail investors in the lurch.

The FCA's proposals are welcome, as is the wider signal they send. Trying to provide open-ended liquidity for assets which are inherently illiquid is a dangerous game, and often obscures the real risks involved. But we should recognise the effect this is likely to have on these funds themselves. If selling an open-ended fund today means you will see your money only in December, then the fund becomes much less attractive to investors.

This is especially so when we remember that closed-end property funds can offer many of the same benefits. Close-ended funds (usually in the form of Real Estate Investment Trusts (REITs) or Companies) are also highly tradable – but the difference is that investors in those funds are not buying the properties themselves (because they cannot vary their capital in an open-ended manner, except through formal capital raising events, just like quoted companies). Instead, the investor is purchasing an equity, the value of which is tied to the value of its underlying assets. The risk is more visible, with REIT prices varying with volatilities like other equities.

Another alternative is to copy Germany, where open-ended property funds with long notice periods remain extremely popular. This partly reflects differences in the German and British property markets, but the main distinction is the structure of investor ownership. UK mutual fund managers have always had to manage the registration of holders of their funds. This means ownership is not transferable in usual circumstances.

In Germany, the fund ownership is in ‘bearer’ form: the owner has a transferable certificate. They can sell it to somebody else, without the fund manager having to sell the underlying assets. This means the funds can behave like REITs while still being open-ended. It allows investor liquidity without the fund manager having to provide it.

These new FCA proposals are reasonable, but are not likely to halt the demise of open-ended property funds, many of whom have been forced to shut up shop already. Dealing with the fundamental ownership transfer will be required. Either way, the concept of liquidity for illiquid assets is little more than a mirage that does nobody any good.

CAMBRIDGE INVESTMENTS LIMITED

10th August 2020

Global Equity Markets

Market	Fri 16:53	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	6032.2	2.3	134.4	⬊	⬊
FTSE 250	17613	4.0	680.7	→	⬊
FTSE AS	3361.4	2.4	79.3	⬂	⬊
FTSE Small	5041.0	2.0	98.3	→	⬂
CAC	4889.5	2.2	105.8	→	⬊
DAX	12674.9	2.9	361.5	⬀	→
Dow	27310	3.3	881.7	⬈	→
S&P 500	3346.0	2.3	74.9	⬈	⬈
Nasdaq	11079.5	3.1	334.2	⬈	⬈
Nikkei	22329.9	2.9	619.9	→	→
MSCI World	2359.9	2.4	54.9	⬈	⬀
MSCI EM	1106.6	2.6	27.7	⬈	⬀

Top 5 Gainers

Company	%
Melrose	18.8
easyJet	16.6
Rightmove	14.0
Int'l Consol Air	12.7
Direct Line	12.7

Top 5 Decliners

Company	%
Diageo	-8.4
Centrica	-5.2
HSBC	-4.9
Imperial Brands	-2.1
Reckitt Benck	-1.7

Currencies

Pair	last	%1W
USD/GBP	1.304	-0.3
GBP/EUR	0.903	-0.3
USD/EUR	1.18	-0.0
JPY/USD	105.93	-0.1
CNY/USD	6.97	0.1
Bitcoin/$	11,659	2.8

Commodities

Cmdty	last	%1W
Oil	44.50	2.8
Gold	2028.5	2.7
Silver	27.89	14.4
Copper	282.5	-1.5
Aluminium	1777.5	3.3
Soft Cmdties	360.6	2.9

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.14	+0.04
UK 15-Yr	0.37	+0.03
US 10-Yr	0.56	+0.03
French 10-Yr	-0.21	-0.02
German 10-Yr	-0.51	+0.02
Japanese 10-Yr	0.01	-0.01

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.4	61.0	19.6	13.6
FTSE 250	2.8	35.6	25.9	14.5
FTSE AS	4.2	58.0	20.2	13.6
FTSE Small	3.9	14.3	-	13.8
CAC	2.2	43.2	24.5	13.8
DAX	2.6	38.9	20.0	12.8
Dow	2.4	22.9	24.6	15.4
S&P 500	1.8	26.0	25.9	16.4
Nasdaq	0.8	36.3	31.9	18.6
Nikkei	1.9	32.5	22.1	17.0
MSCI World	2.1	27.8	24.0	15.6
MSCI EM	2.3	18.9	18.0	12.0

UK Mortgage Rates

Mortgage Rates	Mar	Feb
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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10th August 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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