CAMBRIDGE
INVESTMENTS LIMITED

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Hedgeye, 31 July 2020

Summer sunshine beckons, but politics still casts a long shadow

As July ends with stifling temperatures, thoughts can turn to the month ahead. August capital markets can be either quiet or decidedly choppy. As investors go on their summer holidays, daily trade volumes decline and liquidity drops out of the market – meaning even small buying or selling pressures can have outsized effects. Of course, this year we doubt many traders will be planning an August trip to Spain. But even if they do, overall market liquidity should not be an issue. Thanks to extraordinary interventions from central banks, capital markets are reasonably liquid. And for equities over the last few months, the rising tide has lifted all boats.

Those interventions have also restored investor sentiment from apocalyptic lows in March. As such, the stock market rally from early April has been about as impressive as the nosedive that came before it. But with harsh economic realities now setting in – the deepest global recession in generations – equities can only run so far on good vibes. For markets to continue upward, attention has to turn to the actual economic data.

Last week, the Gross Domestic Product (GDP) data for a number of countries showed that the last quarter was the biggest drop-off in economic activity since Europe's 'Great Frost' in the first quarter of 1709. The world's two-largest regional economies, the US and the European Union (EU), were both severely affected. EU GDP showed the more dramatic effect, with lockdown causing a fall of -12.1% quarter on quarter, 3.9% worse than the US. The chart below shows the GDP rate of change for both on the same (quarter-on-quarter basis, rather than the annualised version favoured by US statisticians):

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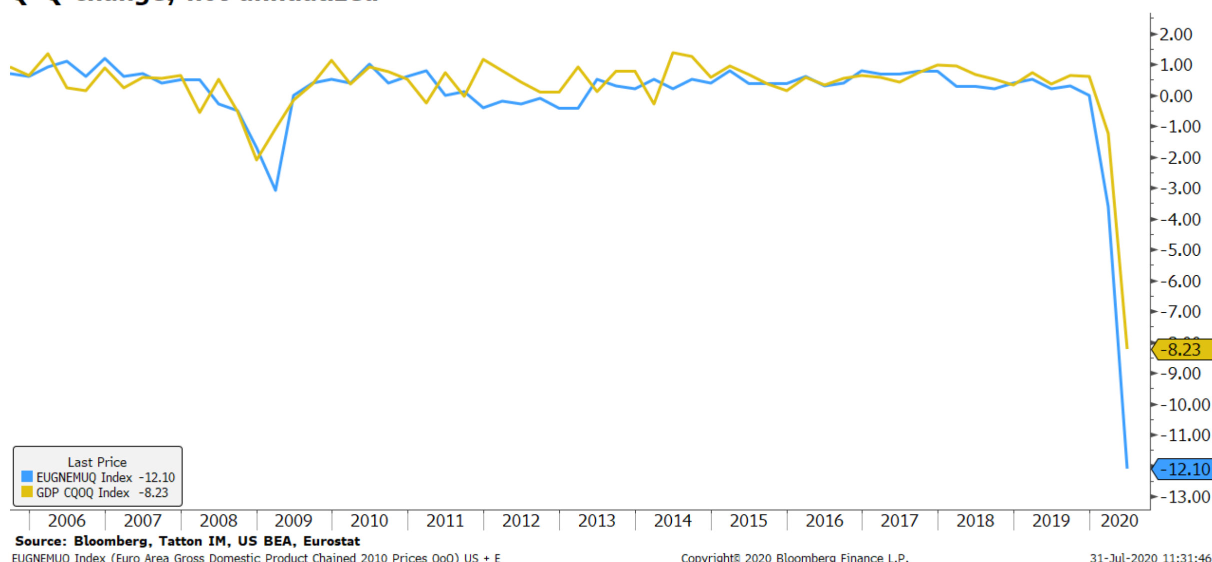


Germany disappointed in its growth figures, coming in 1% worse than expected with a drop of 10.1%. GDP data are often inaccurate on the first release – especially so in the current circumstances – so we should take this with a pinch of salt. Nevertheless, equity markets took a bit of fright. Worst hit was the UK market, which saw the FTSE 100 drop back below the 6,000 level. Markets had been skittish for a few days – with news of spiking European virus cases and quarantine impositions filtering through – but growth figures pushed sentiment over the edge.

Indeed, all through the week, economic positivity seemed to fade away, with longer-dated investment grade bond yields falling back noticeably. Dovishness from the Federal Open Market Committee (FOMC) was plain to see in their Wednesday statement, essentially promising to do "what it takes" for a long time. In a sense, bond investors now expect US rates to be at 0% for more than five years, so the US Federal Reserve (Fed) is now limited in how much more impact it can have through interest rates. As Chairman Jerome Powell noted in his press conference, the policy action that matters is now increasingly about fiscal rather than monetary largesse.

The politicians have been doing rather well in coming together to create action during the otherwise disastrous second quarter. However, in the US, the divisions have reappeared as we head into election season. It is noticeable that the divisions are not just along the traditional Democrat-Republican party line. In our article below, we cover some aspects of the Congressional Republicans' HEALS bill, their proposed replacement to the CARES Act provisions which are now expiring. It differs substantially from President Trump's more generous and conciliatory proposal of a temporary extension of the current $600 per week Federal payments to the unemployed. Many see these payments as more generous than necessary, so a proposal to reduce them is unsurprising. However, the transfer of burden to the states and away from the federal government could be economically disastrous. It seems to be driven by the local election dynamics, not by the needs of the economy.

A US congressional recess is supposed to start at the end of this week, the deadline which matters most. Most analysts expect that a political compromise on the bill will be achieved before then, with another $1 trillion bill of spending at least. However, yet again, the fragility caused by the partisan US political system is on show, along with the tendency to hold the economy hostage.

Regarding additional spending, President Trump has an incentive to bolster the economy in the near-term. But his longer-term spending plans will not be higher than his rival (given the Democrats' traditionally looser fiscal policy) and that is not helping his chances. The stabilisation in virus case growth may be better news, but Trump really needs employment to be improving. It had been but has halted in the past two weeks.

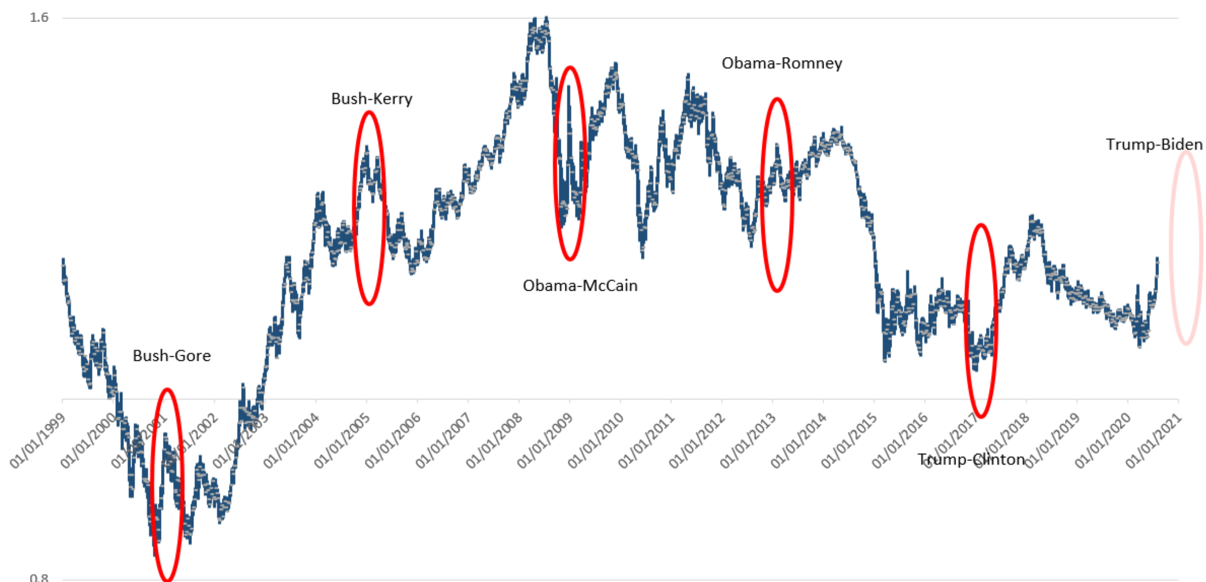
Maybe equity markets will help him. Across the world, companies have had the busiest week ever for earnings announcements, which we look at in another article below. Companies have had a torrid time, in line with the economic data. However, the larger US companies have been relative and, in some cases, absolute beneficiaries. The growth wobbles of early last week were pushed away by Apple and Amazon (although Google did slightly less well). Presidential challenger Joe Biden may have something to say about this if he wins. The current hearings over big tech's monopolistic tendencies could also add to this narrative.

Trump's tweets about the potential invalidity of the November vote seemed to have a markedly negative impact on the US dollar. A weaker dollar is usually quite a good thing for the global economy, but a rise of domestic tensions into the winter months may not be. If it were to seize up the US political system at a point when fiscal action is most needed, it could be a very unhappy outcome. The Euro strengthened rapidly last week, with the biggest gains happening swiftly after the tweets. In general, these sorts of political stories are not that important for markets, but in this unusual time investors seem to be paying them closer attention.

Currency stability depends on the trust given to the institutions of authority. For over a hundred years, the most stable have been in the US. To be relatively weak now, when an economic crisis is still in our midst, may mean that the currency markets could be heading for greater volatility.

As a reminder, the chart below shows the last few elections and the US dollar/Euro. The Bush-Gore election produced quite a significant weakening for the US dollar after the election result was disputed. As one can see, the past two elections were quieter affairs.

Dollars per Euro - Elections & Weekly Trading Ranges



Source: Bloomberg, Tatton IM

US partisan politics could leave states feeling the pinch

In dealing with the economic crisis – just as with the virus itself – policy is crucial. Throughout the worldwide economic shutdown, US authorities have joined their global peers in providing intense and sustained support to a shell-shocked economy. The government's fiscal aid programs, backed by the extraordinary bond purchasing programme from the Fed, has saved many businesses, and individuals, from going under. Tracking the course of fiscal and monetary policy is therefore an essential part of any outlook on the world's largest economy. Last week, we got an update on both of those fronts.

From the Fed, it was business as usual – or at least the 'new' usual. As expected, the FOMC announced it will keep monetary policy loose for the foreseeable future. Interest rates will remain non-existent and extensive bond purchases will continue, with the Fed keen on avoiding any whiff of slowing down the purchase pace. Chairman Powell stressed that the virus is the "central driver of the economy", affirming the FOMC's commitment to open-ended asset purchases and its readiness to use its emergency lending facilities. The Fed cannot support the US economy single-handedly, but it is doing all it can to maximise the chances of a healthy recovery.

Less can be said for fiscal policy. Many of the government's emergency support measures – including federal contributions to unemployment benefits – expire at the end of July. With cases still spiking across the US, lawmakers from both parties are well aware that renewal of these measures is vital. What they do not agree on, however, is how that should be done.

The HEALS (Health, Economic Assistance, Liability protection and Schools) bill proposed by Republican Senate Majority Leader Mitch McConnell contains a number of support schemes amounting to an extra $1 trillion in new stimulus. If the bill passes, American households would receive another $1,200 from the government in stimulus checks, insurance and unemployment benefits would be extended and schools

across the country would receive $105 billion in funding, with an additional $15 billion earmarked for virus testing.

The changes to unemployment benefits are perhaps the most controversial. Under the Republican bill, jobless Americans would see their benefits immediately slashed from $600 a week to just $200. This reduced amount would continue until individual states are able to transition to a system where the unemployed are paid 70% of their previous wages. Crucially, just 20% of that would come from the federal budget, with the remaining 50% coughed up by local state governments. While we may have less of a problem with unemployment support being lowered at some point (even if the timing may be less fortunate), we are more than puzzled with the idea that federal states would have to fund the bulk of the new arrangement.

Compared to the US Treasury – with its huge tax receipts and vast borrowing power – state governments have extremely limited funds at their disposal. Many have balanced budget rules which prevent them from spending more than they receive in taxes, and those states that can run deficits are forced to borrow at much higher interest rates. Lumping local governments with such a big expense could be disastrous, pushing many of them to cut back on spending and choking off economic recovery before it has begun.

We should note straight away that Senator McConnell's plan faces substantial opposition – even within the Republican party, opinions are divided – and may not get enough support to pass through the Senate. If it does, it will almost certainly not pass through the House of Representatives in its current form. The Democrat-controlled House has proposed its own bill much closer to the $3 trillion stimulus plan passed back in May. With an election only a few months away, some political back and forth is inevitable, and the end result will likely be somewhere in the middle of the two parties' plans.

Nevertheless, it is highly likely that state contributions towards benefit spending will have to increase. That is bad news for state legislators and for the economy itself, given how slow state spending procedures tend to be. If that happens, Fed policymakers will be scratching their heads. Central bankers do what they can, but if political process or obstinance blocks recovery measures when needed most, rescuing the economy becomes a nigh-impossible task.

However, there may be some room for manoeuvre. As part of its emergency pandemic response, the Fed has already created a $500 billion Municipal Liquidity Facility (MLF) for directly buying up state and local government debt. The MLF is designed only to stabilise the municipal bond market – and does not have the power to finance state budgets as it can Federal ones. As it stands, direct aid to states needs to be authorised by the US Congress, but the Fed is not averse to bending the rules when economically necessary.

Some in the Republican party have tried to paint state crises as political mismanagement, with Mitch McConnell even suggesting that states should be allowed to go bankrupt to stop federal bailouts of Democrat-run states. But dwindling budgets is not a partisan issue. All 50 US states are struggling with revenues, and if those struggles are allowed to continue it will hit Republicans and Democrats alike. As such, Republican politicians are unlikely to block emergency state aid – particularly if done through the Fed's technical wizardry rather than extensive legislation.

Time is already up for the government's previous emergency support package, and there are serious political barriers to passing another. The end of the $600 per week payments has come, with nothing to immediately replace it. The US politicians go into their summer recess at the end of this week and brinkmanship has returned to derail the initially positive consensual program. This is yet another example of political risk getting in the way of economic upside for the US. The Fed is doing its part to steady the ship, but as we head into the last few months before the election, we should expect more of the same.

Earnings season round-up: plenty for markets to mull over

Although stock prices have come down recently, the ratio of price to earnings remains high enough to make investors squeamish. As such, eyes are now turning to the recent slew of earnings reports from the second quarter. Q2 was, of course, dominated by virus news, global lockdowns and a record slump in economic activity. And even though these figures can only tell us where we have been rather than where we are headed, now that we have passed the halfway point of the earnings season, it is worth taking stock - especially now that the megacaps, which have largely been propping up the rest of Wall Street, have published their 'beating' earnings reports.

All regions have been hit economically by the global pandemic, but not equally so. In Europe, sales figures disappointed analyst expectations, but actual earnings posted a positive surprise. We should distinguish between the 'surprise' figures on earnings and the actual earnings growth figures themselves. As we have written before, companies have come to learn that surpassing expectations often wins you a bump in stock price – and so consistently post overly-pessimistic forecasts only to clear the low bar later on. Sure enough, overall European equity earnings came in just over 17% above analyst forecasts, but this was still a 15% fall from a year earlier. Likewise, European company sales were 5% below the expected figure, but 26% down from the same period in 2019. And to make a point that macro and micro can match: eurozone GDP (real) also contracted by 15% year-on-year.

STXE 600 (EUR) Pr — Range CQ2 Ending: 5/16/2020 - 8/15/2020

Surprise | Growth

Sector (GICS)	Reported	Sales Surprise	Earnings Surprise
11) All Securities	267 / 445	-4.37%	17.02%
12) > Energy	14 / 17	-30.02%	N.M.
13) > Materials	24 / 41	1.42%	31.87%
14) > Industrials	54 / 82	6.19%	-62.29%
15) > Consumer Discretionary	26 / 44	2.51%	13.81%
16) > Consumer Staples	19 / 33	-2.61%	30.60%
17) > Health Care	22 / 43	-2.31%	3.43%
18) > Financials	40 / 71	2.67%	17.99%
19) > Information Technology	20 / 31	1.01%	5.40%
20) > Communication Services	18 / 33	0.01%	-25.05%
21) > Utilities	16 / 24	-15.46%	-7.97%
22) > Real Estate	14 / 26	-2.05%	6.04%

Source: Bloomberg, the horizontal bar is number of companies beating (purple, left half) or missing (green, right half) sales and earnings surprise, the percentage number of sales and earnings beating estimate is in terms of monetary results beating or missing expectations.

Earnings releases give us an early insight into sector performance, while earnings surprises give us an idea of where perceived wisdom in resilience or suffering from the virus fallout may have been a bit misguided (positive and negative). One of the big disappointments for Europe, for example, was the utilities sector, with sales and earnings figures both well below analyst forecasts. Utilities companies are the stereotypical defensive stock – without much growth potential but faring better through downturns. So, the negative surprise here is interesting; even utilities companies have been hit by the pandemic.

The European financial and IT sectors delivered positive surprises, cementing their status as relative winners from the pandemic (or at least not as big losers). Both sales and earnings came in better than expected – and financials achieved positive overall growth compared with the year before. A great deal of that will have been to do with the turnaround in investment sentiment over the last few months, but banks less exposed to capital markets also showed an aggregate surprise compared to earnings expectations. Make no mistake: earnings growth is (in aggregate) deeply in the red for those banks that were not able to benefit from financial market volatility. But the fact that the sector did not undershoot expectations that, at present, the sector is not at the centre of the economic malaise – as it has been in past crises.

Through the pandemic, Europe's banks have benefitted from regulatory relief and government intervention in the real economy – in stark contrast to the financial crisis just over a decade ago. For sure, things could turn sour for financials – particularly if and when the 'second round' economic troubles kick in. But for now they can take comfort. When looking across the Atlantic, a similar picture is apparent: institutions exposed to capital markets outshone their traditional banking counterparts, whose earnings have halved (slightly worse than in Europe).

Now we turn our attention to the US megacaps. There was some market nervousness that an earnings miss could weigh on already valuation-rich markets, but this has not yet materialised. Microsoft and Apple clearly benefitted from the lockdown trend of turning kitchen tables into home offices, and children's bedrooms into schools. Facebook was also able to beat expectations, even if its revenues could not match last year's level. Google (Alphabet) recorded slightly negative (to flat) revenue growth as advertisers tightened their belts (so here a megacap took a hit from the real economy), but this was to a certain extent expected. The big overachiever was Amazon, which beat expectations and its own previous results. Some of this is lockdown-related, as with the tech sector, but retail is also clearly undergoing a structural shift away from the high street.

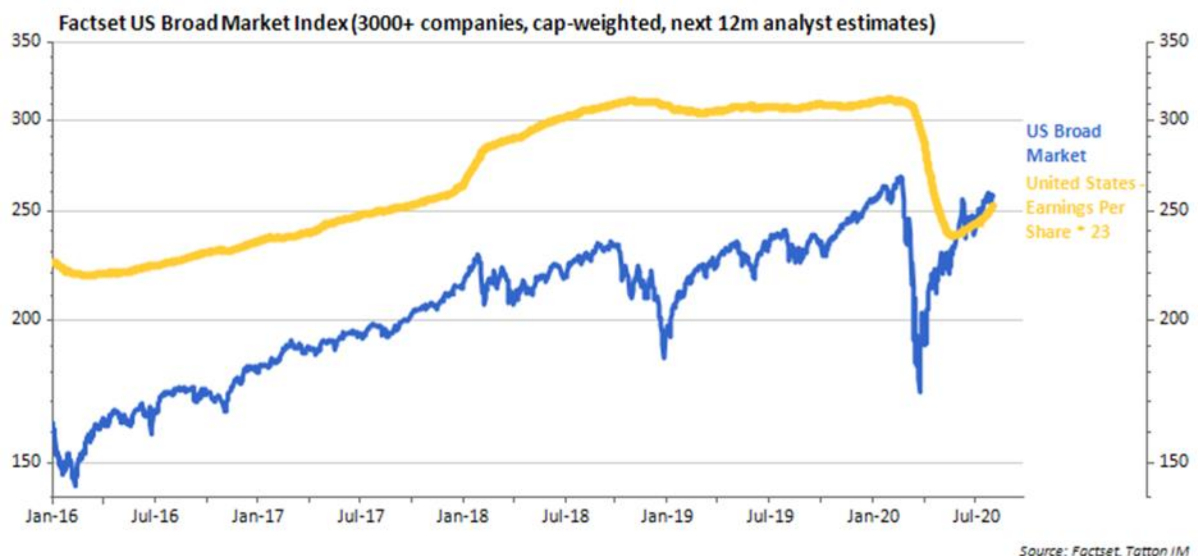
We often underline that while the megacaps are different in terms of the business they operate in – technical innovation versus retail disruption – they have one theme in common: regulators have an eye on them in terms of market dominance and their impact on healthy competition. Although it was noteworthy that Microsoft was not invited to last week's Congressional hearing. Nevertheless, investors will be keeping an eye on the US elections, and the future government-mandated rule changes intended for megacaps.

Overall, the picture emerging from this earnings season is that things are bad, but perhaps not as bad as expected. Clearly, consumer spending has been compressed throughout the global lockdown, but people still need to eat, drink and buy televisions. Looking forward, one of the most important considerations is, of course, the expectations for future earnings – the Q2 season is by definition a thing of the past. The chart below shows that 12 months ahead expectations have started to recover. Again, to a certain extent,

this is natural, as people are positive that the global community is going to be able to deal with the COVID-19 outbreak as we move through 2021. This increase in earnings expectations has also allowed P/E ratios to stabilise.

But this also means that any unexpected slowing of activity (perhaps from a perceived setback in vaccine development or a wave of bankruptcies) could have a significant impact on the earnings that one is able to discount into today's stock price.

But so much can – and will – happen between now and 12 months' time. For now, markets will have to content themselves with keeping track of coronavirus statistics, second-guessing fiscal and monetary policy, and keeping an eye on the US election now less than 100 days away.



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Global Equity Markets

Market	Fri 15:00	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	5959.6	-2.7	-164.2	↘	↘
FTSE 250	17065	-1.2	-199.7	→	↘
FTSE AS	3314.0	-2.4	-80.9	→	↘
FTSE Small	4946.6	-1.1	-54.5	→	↘
CAC	4851.8	-2.1	-104.6	→	↘
DAX	12454.1	-3.0	-383.9	↗	→
Dow	26277	-0.7	-192.5	↗	→
S&P 500	3252.7	1.2	37.1	↗	↗
Nasdaq	10686.0	3.1	322.8	↗	↗
Nikkei	21710.0	-4.6	-1041.6	↘	→
MSCI World	2304.0	0.5	12.4	↗	→
MSCI EM	1082.1	2.0	21.6	↗	↗

Top 5 Gainers

Company	%
Next	7.0
Land Securities	6.5
Smurfit Kappa	5.8
Centrica	4.7
Segro	4.3

Top 5 Decliners

Company	%
Int'l Consol Air	-16.2
Melrose	-15.9
easyJet	-14.1
TUI	-11.9
Rolls-Royce	-10.5

Currencies

Pair	last	%1W
USD/GBP	1.316	2.9
GBP/EUR	0.898	1.4
USD/EUR	1.18	1.4
JPY/USD	105.68	0.4
CNY/USD	6.98	0.6
Bitcoin/$	11,155	15.8

Commodities

Cmdty	last	%1W
Oil	43.22	-0.3
Gold	1965.8	3.4
Silver	23.95	5.2
Copper	288.7	0.2
Aluminium	1720.0	1.1
Soft Cmdties	350.4	2.9

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.5	31.2	18.8	13.5
FTSE 250	3.0	29.3	25.1	14.5
FTSE AS	4.3	31.4	19.6	13.6
FTSE Small	4.0	13.3	-	13.8
CAC	2.3	32.5	23.6	13.8
DAX	2.6	25.6	19.6	12.7
Dow	2.5	20.6	23.6	15.4
S&P 500	1.9	24.3	25.6	16.4
Nasdaq	0.8	34.6	31.4	18.5
Nikkei	2.0	27.1	21.6	17.0
MSCI World	2.2	25.1	23.6	15.5
MSCI EM	2.5	18.1	17.7	12.0

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.10	-0.04
UK 15-Yr	0.33	-0.04
US 10-Yr	0.56	-0.03
French 10-Yr	-0.19	-0.04
German 10-Yr	-0.52	-0.08
Japanese 10-Yr	0.02	+0.00

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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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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