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UK back to normal; Bob Moran, 22 Aug 2020

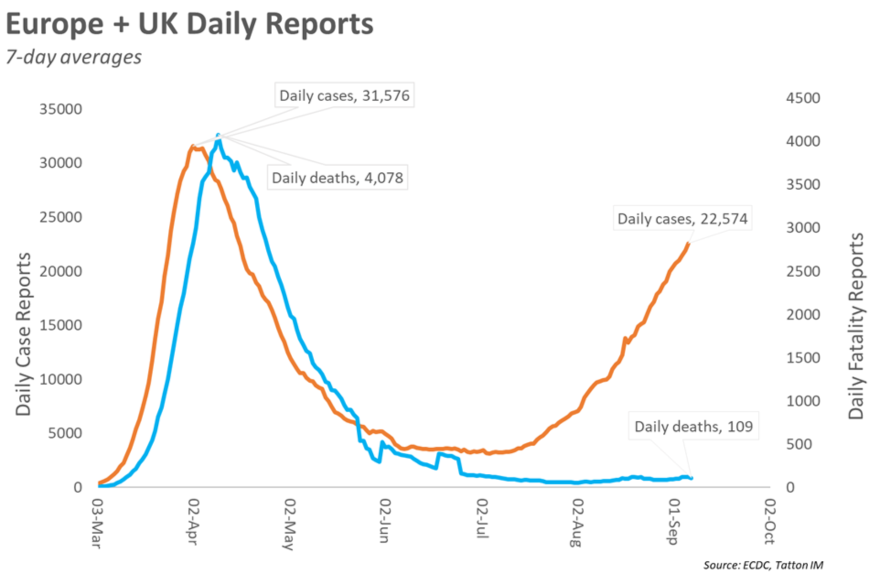
Frictions and contradictions

September has ended what now feels like a 'goldilocks' summer for investors, and political, societal and capital market frictions have returned to the stage with a bang. However, the fact that stock markets have not simply plunged on bad news, but have instead remained surprisingly stable, is a good indication that economic and market dynamics are not quite as simple as they may appear. Following a summer of hopeful yet gradual recovery the second wave of Covid has not prompted a sudden return to depression and decline. The reason for this is most likely that there is a general feeling that we have indeed learned to cope with the virus, even if we have to accept that things will not return to our old normal for some time yet.

Starting with stock market action over the past week, market strategists, who for much of August struggled to make sense of the upward surge in the top US tech stocks, appeared to have found the culprit and cause. Enter Softbank, a Japanese technology investment house that suffered substantial losses over its hapless backing of 2019 tech darling WeWork. Softbank appears to have spurred markets and whipped-up the recent froth through large derivative positions in tech stocks – with the aim of winning back of what had been lost. But while humans have a tendency to embrace the straightforward explanations over the more comprehensive ones, reality tends to be multi-factored rather than mono-causal.

It would seem that Softbank's speculative investments was one element, but as is often the case, sharp market moves are based on a coincidence with other factors: some reports point to perhaps millions of small US retail investors who (in their boredom of COVID activity constraints) had put some of their government support windfall cash to work – and this not only through straight forward cash equity investments but also options, i.e. geared. Now that the US government has halved its generous support payments to $300 per week, many are starting to worry whether they will indeed be returning to gainful employment as quickly as first expected. As a result, this massive burst of incremental investment liquidity is disappearing – and with it some of the unhealthy exuberance built up in US tech stocks. Given the wider monetary and fiscal support spectre that was behind the swift market recovery in Q2, it is perhaps not surprising that the stock markets at large have held up rather better.

Staying with capital markets, but turning towards the virus-driven expectation set, it would appear that recovered levels are perhaps not just all dependent on the combination of near-term vaccine hopes and central bank liquidity injections. Back in May, we would have expected AstraZeneca's halting of their vaccine trial – on the back of an unexplained but serious neurological inflammation that one of their patients suffered – to send stock markets into free-fall. That it did not happen last week might well have to do with the observation that Europe's relapse in infection rates back to April's levels appears to have astonishingly little impact on public health when compared with the first wave (see chart below).



It is too early to conclude that the virus has 'burnt itself out' and will gradually disappear as a threat. The very different paths of the graph above could have a number of explanations, not all of them encouraging. Nevertheless, the slightly contradictory market reaction seems to indicate that markets no longer assume the second wave will hold back the economic recovery enough to derail expectations of a rebound of longer-term earnings growth.

Many will have – like ourselves at Cambridge – registered with dismay that the UK government found it necessary to restrict our range of social interactions once again. As we wrote last week, any return of higher levels of activity restriction and fear are going to increase the damage for the economy. On reflection, it may be a necessary – but hopefully only temporary – step to reiterate the public health message that this epidemic is not yet over and stress the importance that people limit the spread of the virus until a more permanent solution becomes available. Despite qualifications over the flattening of the public health impact curve mentioned above, it is possible that if the trend nevertheless continues for another month, activity restrictions may become unenforceable and indeed less called for – even before a vaccine can be deployed for the vulnerable and elderly. In the meantime, governments may be faced with increasing frictions between the frustrated and less-affected young and the more vulnerable (ruling) old.

Given these virus-related political pressures, it is unclear why the UK's government chose last week to further increase political stresses by announcing their planned breach of the European Union Withdrawal Agreement. The decision has only served to undermine the nation's standing as a contractual counterparty in the international political arena in an unprecedented way. It appears most likely to be a combination of political actors lacking relative experience, paired with a certain gung-ho attitude to shake things up for the better of the country. But, as with the previous disconcerting negotiation moves, this one should probably not be taken as seriously as it was by currency markets, which responded with a distinct mark-down of £-Sterling. At the end of the day, it remains – now even more than before – in the very best interest of both sides to achieve a mutually beneficial trade deal, rather than falling out with their biggest trading partners at the very point that economic headwinds would be most destructive. Just as the government's 31st July deadline passed without any further mention, we would not be surprised to see the 15th October pass in the same way. The real deadline to watch is the summit of European heads of state in early December. Our expectation is that the final outline of the future arrangements will only come together then – after a few nights of gruelling debate.

Credit where credit is due

Central bankers have played a vital role throughout the COVID crisis. With the global economy in the grip of its deepest-ever recession, the world's central banks have had to inject huge amounts of liquidity into the financial system and government coffers to stop the health crisis turning into a financial catastrophe. The US Federal Reserve (Fed) has been the chief protagonist of the crisis response. It has massively expanded its asset purchase program, rolled out a number of emergency lending facilities and, most recently, has effectively committed to a 'lower for longer' policy on interest rates.

These huge liquidity injections have been one of the key factors in keeping the US economy and financial system rolling through the global economic shutdown. But recently, the pace of those injections has actually slowed somewhat. The Fed is still regularly pumping out substantial amounts of capital, but at a level closer to the 'regular' quantitative easing we saw over the last decade than the emergency levels we saw from March until the summer.

This is, to a certain extent, to be expected. Desperate measures should be reserved for desperate times and, with the US and global economies opening up, a steady return to normality is nothing to be afraid of. The Fed is still running multiple support initiatives, including its corporate lending facility, municipal liquidity facility and its Main Street Lending Program. As long as credit markets and the wider financial system are functioning properly, these measures combined with asset purchases should be sufficient backstops.

The crucial question, then, is how well are things really functioning? We can see from the relatively low (compared to past recessions) bankruptcy rates so far that the Fed's priority – pumping-in liquidity to prevent mass default – has been reasonably successful. But for some of its other measures, it is not yet clear whether the mechanisms for getting capital to those requiring it are working properly. Take the Main Street Lending Program, for example. This is designed to help small and medium-sized businesses, including non-profit organisations, affected by the pandemic, and to support corporates that were unable to access other corporate support programmes (such as the Paycheck Protection Program). So far it has made $600 billion in loan facilities available to employers who were in good financial standing pre-pandemic and, while the loans are administered by private banks, the Fed promises to buy 95% of new or existing loans handed out.

Clearly, it is designed to encourage banks to get money to those who need it. And, though there have been some problems reported about unwilling lenders, which would also be in line with tightening lending conditions reported in the senior loan officer survey, we suspect most of the reluctance is on the demand side. In any case, the recorded take-up of these loans from businesses has been very low, with firms either unwilling or unable to access the funds.

This highlights a real problem for the Fed. In any crisis, when credit conditions tighten and the effective money supply gets constricted as businesses tighten their payment terms, a central bank can do its part to increase the supply of credit. But the actual demand for credit is beyond their control. Ultimately, even at generous rates and conditions, businesses will be uneasy about being saddled with more debt when the prospects for finding their feet are still so uncertain. Borrowing to stay afloat when you have no idea when or if the business will be viable again is not an attractive idea. The Fed can provide liquidity, but it is the economy that assures solvency.

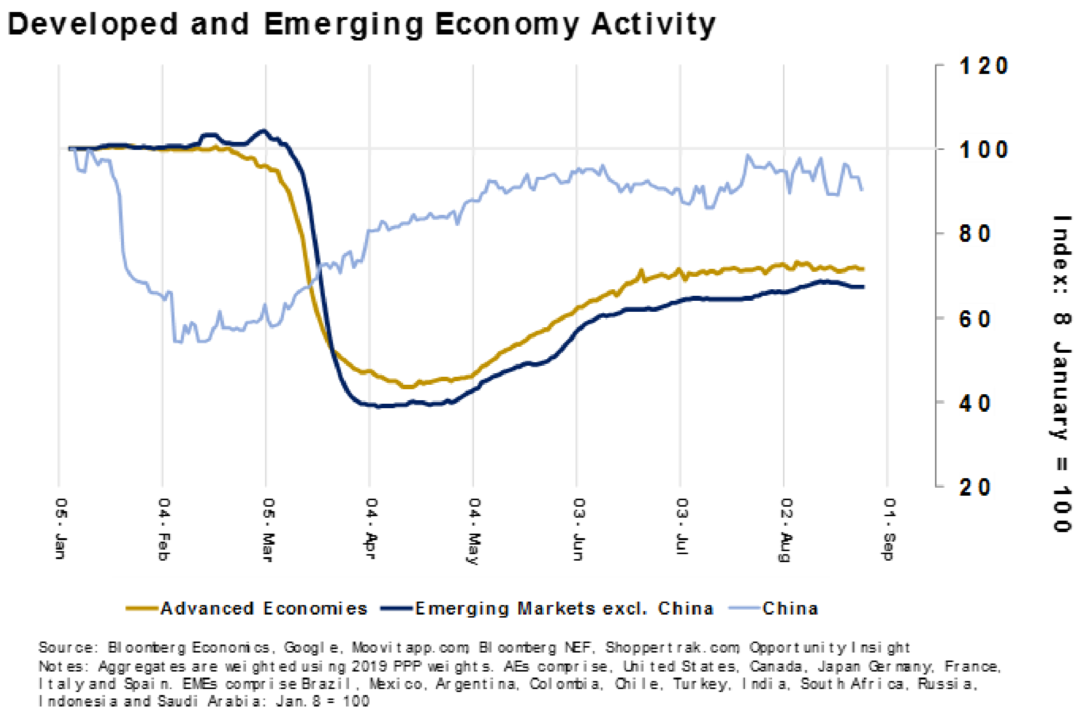
Unlike some of the government's fiscal measures, loans through Main Street – by their very nature – cannot be turned into grants or forgiven by lenders. As such, both the lender and the borrower have to assess the loan's viability. Even though the bank's liability for the loan is small, the fact it has any liability at all means it has to make a risk-based decision. That the loan must be paid back means the business has to assess whether it should take on more debt. With the threat of a second wave or increased lockdown still hanging over the economy, both of those things are extremely difficult to assess.

For the moment, the Fed seems to be hoping that demand for Main Street loans will naturally pick up. This is not an unreasonable expectation. We are already seeing a bounce-back in US economic activity. The fact that bankruptcies among smaller businesses have been relatively contained so far is a big positive. But there are complications. Along with the Fed's liquidity provisions, the government's fiscal measures have been crucial in preventing widespread defaults. However, most of these programs are either expired or expiring – with unemployment support currently being extended only through an executive order from President Trump. These direct support schemes are arguably more beneficial as they are not mediated by the banking system. Banks, by their nature, lend to make profit. But these emergency loans are currently primarily for survival, not for profit, and in times of financial trouble, risk-based decisions can be a hindrance to economic support. For Main Street loans to work effectively, and the banking system to be helpful in providing economic support, the prospect for making money needs to be there – and that has been the problem so far.

Now that summer is over and we are approaching the final quarter of the year, renewed efforts to resolve this credit impasse could prove crucial. Due to seasonal effects, Q3 is usually the lowest quarter for bankruptcies. As such, some analysts expect a spike in default rates towards the end of the year. To us, it is hard to say whether the lower take-up of loans recently is a sign of stability or not – given the demand issues mentioned above. However, if we do see a pick-up in loan demand from now until the end of the year, we would view this as a positive, as it would suggest businesses or individuals see the potential to make profits – the sign of a healthy economy. But it is likely that the Main Street Loan Program and other emergency lending schemes will need to be extended – by whoever is in the White House at the time. We have had the emergency intervention from the Fed, now we need to see that liquidity getting into the real economy.

Politics get in the way of Chinese investment

In economic terms, China is one of the best placed of any major economy to recover from the pandemic. The first country to suffer heavily from Covid was also the earliest to emerge from lockdown, with life now well on its way back to normal in the world's second largest economy. Wuhan, a city of 11 million people and the original epicentre of the virus, is now the focus of a PR campaign from the Chinese government – encouraging tourists and international businesspeople from all over to come see the "reborn" city. From the latest economic data, it looks as though China has pulled off nearly a complete V-shaped recovery in the third quarter of 2020. This is while developed and emerging markets the world over are languishing – as shown in the chart below.



Historically, China's post-2000 rise was closely linked to undercutting prices in international goods markets, holding back inflation for the rest of the world. But as we wrote last week, it is worth noting that export prices are currently much higher than what would be suggested by the pronounced slump in international trade. Rather than undercut competitors to pull off an export-led recovery, Chinese export inflation is increasing just as global trade inflation falls. Overall, China's exporters have fared reasonably well through the pandemic – not only sellers of Covid-related goods (protective equipment, medicine, etc.) but producers of intermediate goods too.

But how is the domestic side faring? Earlier in the year, the pick-up in homegrown activity was somewhat disappointing. Chinese citizens seemed less willing to go out or return to work than their global counterparts – perhaps due to the scarring effects from the government's tight lockdown measures. But there are signs that caution is receding – with domestic tourism picking up and offices slowly welcoming back workers.

To be clear, this is not the booming Chinese growth we saw over the last couple of decades. But overall things are going reasonably well: signs of a natural pickup in demand are coming through, supported by the government's substantial fiscal measures.

Financially speaking, China's handling of the crisis has been markedly different from its global peers. While the government has kept fiscal policy supportive, monetary policy has not followed suit. Unlike central banks around the world, the People's Bank of China (PBoC) has not injected huge amounts of liquidity into the system, and indeed has recently allowed interest rates to go up. Even short-term deposit rates are now back to where they were before the virus hit.

This could be down to the government's longstanding efforts to wean the economy off cheap credit (deleveraging). But this is where the other oddity of Chinese policy comes in: policymakers have been easing up the banking system. Authorities are now allowing – indeed, actively encouraging – banks to take on more risk. Local government bond issuance, through which China runs and finances its infrastructure projects, keep coming though (even if issuance had been frontloaded in response to the Covid crisis). This means that, despite the PBoC constricting base money supply, the government is increasing the overall effective money supply through loosening credit conditions, thereby increasing the turnover of money.

All in all, this is positive for China. Barring a second wave of virus cases, domestic demand – supported by fiscal policy – should hold up well, while the external side of the economy benefits from the global rebound. That economic positivity makes a strong investment case for China.

The problem for international investors is – as always with China – politics. Tensions with the US are well-known, and there is little sign of de-escalation even if Donald Trump loses office in November. Rhetorically, Chinese officials have matched the Twitter-happy US President blow for blow, but in actual trade policy terms have remained reasonably accommodative and open to negotiation. The biggest danger for the US-China relationship is that the growing cold war turns hot, and spills over into accidental or intentional conflicts. That would be a big problem for the whole world, not just China and the US. Thankfully though, China's economic and cultural integration with the US and the rest of the developed world make that somewhat less likely.

However, China's political problems are not just on the international scene. Since becoming paramount leader eight years ago, President Xi Jinping has slowly broken down the system of informal checks and balances constructed by the Chinese state since Deng Xiaoping stepped down in 1992. Xi is now the head of the Communist Party, the state council, the military and, most recently, the police. Those positions are now effectively his for life, after his removal of constitutional term limits in 2018.

Xi's tenure has seen multiple crackdowns on his perceived political enemies, and reports suggest another may be on the way. According to the *Nikkei Asian Review*, Wang Xiaohong – the head of China's secret service bureau and close ally to Xi – has written an article calling for increased political discipline. His particular targets are "two-faced people", who feign loyalty but secretly denounce the party or its leader. This is a clear reference to Xi's rival factions and detractors, indicating that we could see another purge of the party ranks or wider society.

This is not good news. Aside from devastating human rights abuses, Xi's increasingly tight grip on power has caused a great deal of friction in the country. Anti-corruption purges have often led to capital flight from China – with the purged trying to quickly get their money out – and instability in affected private companies. It has also clearly acted as a deterrent for international investors, as crackdowns highlight the inherent instability of China's centralised power.

This, as we see it, is the biggest headwind to the otherwise improving investment case in China. Even though the economic fundamentals are present, the risk is that political developments could quickly get in the way of the return of capital – without any recourse if they do. Unfortunately, with Xi's grip on party, state and military institutions only set to tighten, this is looking unlikely to improve and will require ongoing close monitoring for confirmation or disproval.

14th September 2020

Global Equity Markets

Market	Fri 16:04	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	6027.5	+3.9	+228.4	→	↘
FTSE 250	17601	+1.4	+246.9	→	↘
FTSE AS	3365.2	+3.4	+111.1	→	↘
FTSE Small	5122.0	+1.1	+55.4	⇗	⇘
CAC	5034.2	+1.4	+69.1	→	↘
DAX	13201.8	+2.8	+359.1	⇗	→
Dow	27799	-1.7	-494.0	↗	→
S&P 500	3363.8	-2.6	-91.3	↗	⇗
Nasdaq	10999.7	-4.0	-458.4	↗	↗
Nikkei	23406.5	+0.9	+201.1	⇗	→
MSCI World	2367.8	-1.3	-31.8	⇗	→
MSCI EM	1085.3	-1.3	-14.2	⇗	⇗

Top 5 Gainers

Company	%
Aviva	+11.1
Experian	+10.1
Scot Mtge Inv Trust	+10.0
Ashtead	+9.6
Unilever	+9.2

Top 5 Decliners

Company	%
Int'l Consol Air	-10.8
easyJet	-9.4
Whitbread	-7.8
M&S	-6.4
Wm Morrison	-5.2

Currencies

Pair	last	%1W
USD/GBP	1.279	-3.7
GBP/EUR	0.925	-3.6
USD/EUR	1.18	-0.0
JPY/USD	106.21	+0.0
CNY/USD	6.83	+0.1
Bitcoin/$	10,315	-2.8

Commodities

Cmdty	last	%1W
Oil	40.12	-6.0
Gold	1949.4	+0.8
Silver	26.97	+0.2
Copper	303.2	+2.5
Aluminium	1789.5	+0.5
Soft Cmdties	347.1	-2.0

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.18	-0.08
UK 15-Yr	0.42	-0.09
US 10-Yr	0.67	-0.05
French 10-Yr	-0.19	-0.01
German 10-Yr	-0.48	-0.01
Japanese 10-Yr	0.03	-0.01

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.9	97.2	19.5	13.6
FTSE 250	2.7	46.2	28.0	14.7
FTSE AS	3.7	114.1	21.0	13.7
FTSE Small	3.7	125.4	-	13.8
CAC	2.2	46.6	26.1	13.9
DAX	2.6	41.3	21.6	12.9
Dow	2.3	23.9	24.2	15.5
S&P 500	1.8	26.2	25.7	16.6
Nasdaq	0.8	36.5	31.6	18.8
Nikkei	1.8	38.0	23.1	17.1
MSCI World	2.1	28.8	24.1	15.7
MSCI EM	2.3	19.9	17.8	12.1

UK Mortgage Rates

Mortgage Rates	Aug	Jul
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.59	1.49
3-yr Fixed Rate	1.81	1.75
5-yr Fixed Rate	1.79	1.74
10-yr Fixed Rate	2.39	2.39
Standard Variable	3.64	3.64

* 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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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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