THE **CAMBRIDGE** WEEKLY

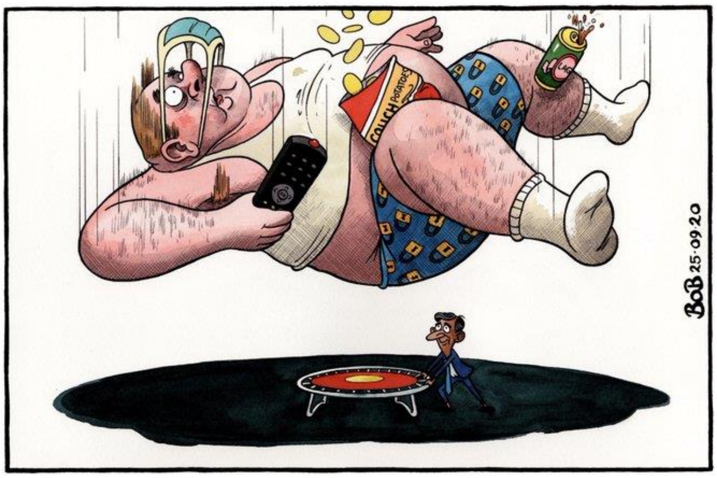
28 September 2020

Lothar Mentel

Lead Investment Adviser to Cambridge

CAMBRIDGE INVESTMENTS LIMITED

28th September 2020



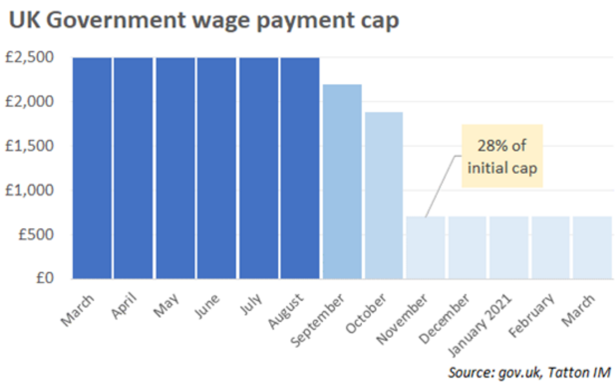
So unfair! But perhaps necessary; Bob Moran, 25 September 2020

A recovery on hold

September continues to bite equity markets. Stocks everywhere wobbled again last week and even though they bounced back, the S&P500 is down around 8% in US Dollar terms for the month. UK investors might notice less of a fall, with global equities down just 1% in sterling terms. This is partly due to the fall in sterling itself, with the pound suffering yet again from adverse Brexit news.

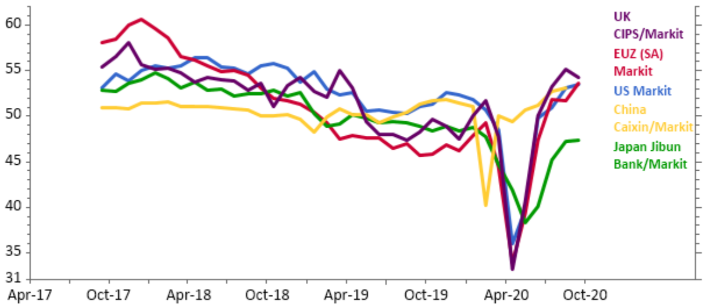
Despite the drama in stock markets, bond markets have been eerily calm. Government bond yields have been stable – not falling amid stories of the impending economic slowdown, but likewise not rising in disapproval when governments around the world issue vast amounts of new debt. This inert response has good and bad implications. Immovable bond yields allow governments to borrow at practically non-existent rates indefinitely, helping them reflate their lagging economies through fiscal action. But from an investment perspective, flatlining yields break the inverse relationship between bonds and equities. That hinders the risk offset that bonds provide investors, making multi-asset portfolios riskier, at least in the short-term.

Still, in the deepest-ever recession, governments having fiscal free rein is an economic positive. And politicians look happy to exercise that freedom. Last Thursday, UK Chancellor Rishi Sunak announced a new work support scheme, set to replace furlough. The top-up pay scheme was praised (though not universally) for its similarity to those in Europe – particularly the German Kurzarbeitergeld (translated as "short-time work allowance") programme. Nevertheless, under current plans, the cap in government wage payments will be just 28% of what furlough originally provided.



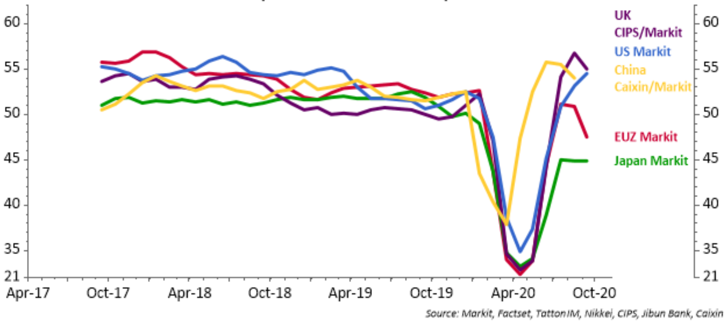
Meanwhile, Europe's economic recovery has stumbled, and may have even temporarily reversed. After a spike in coronavirus cases, business sentiment for the services sector has been particularly disappointing. Thankfully, European government support measures are stable. Manufacturing PMIs and other indicators remain positive, such as the Germany IFO Business Climate, which rose from August's 92.6 to September's 93.4.

Manufacturing PMIs



Services PMIs

Smoothed over 3 months apart from last data point



Markets have already shown they are happy with fiscal expansion. The main issue for markets is rather the opposite: The wider public's jeers of 'how do we pay for it' have already begun. Politicians are worried about the cost of their fiscal support and have started cutting incomes in response. At the same time, the continued second wave of virus cases is scaring both governments and the public away from normal economic activity. Many no longer want to go about their routines of work, spend and leisure, and those that do are limited by re-imposed government restrictions. That means businesses will be facing much lower levels of demand. And, with governments now only providing limited support, firms will have to find some way of cutting costs. As usual, wages will be the first costs cut. At least some increase in unemployment is inevitable.

In the US, the situation is also worrying. The political chasm between the Republicans and Democrats means that, despite both sides agreeing further stimulus is needed, getting a bill passed is near-impossible. The US Congress last week did manage to pass a bill avoiding a government shutdown at the end of the year – an unfortunately common occurrence – but it is virtually insignificant in the face of this economic crisis. Without another round of fiscal support, the US economic outlook is beginning to look bleak.

As we wrote when this crisis first set in, questions of how the support is paid should not get in the way of the fact that it is needed. Rory MacQueen, principal economist at the UK's highly regarded National Institute for Economic and Social Research (NIESR), points out: "Now is not the time to be talking about scare stories about government debt." MacQueen notes: "There is no indication whatsoever that the current approach is causing any problems or any question marks to appear over the sustainability of government debt". Recent bond market moves suggest he is right.

Last week, the UK's Debt Management Office sold £6.5 billion of 40-year(!) bonds at a yield of just 0.66%. The amount of orders (demand) that investors put in massively overshot supply when they came in at about $50 billion. This is a clear-as-day signal from capital markets that, if higher debt levels are what is needed to stave off a classic recession, then higher debt levels it is. Markets are practically giving money away to governments, but governments are hesitant to take it.

Politicians are clearly worried about the long-term cost of the emergency measures. However, what we can read from last week's equity sell-off is that stock markets are much more worried about the short-term cost of an avoidable recession. Fortunately, no politician pays attention to the stock market quite like Donald Trump does. He seems to see stock prices as the measure of his presidency, and will no doubt be concerned about September's sell-off. Even if Congress cannot pass any fiscal support, the President can use executive orders to "repurpose" funds toward unemployment support. Given that this could paint him as a saviour of markets and the economy – with just 39 days till an election – he can be counted on to do so.

Capital markets can be fickle, sometimes ignoring bad economic conditions to see light at the end of the tunnel, and sometimes reacting massively to news that brings short-term uncertainty. Clearly, this year we have seen both. September's market declines are still on the 'long view' side, as it is becoming clear that the initially steep V-shaped recovery after the government-imposed recession is levelling off towards more of a  or inverted square root sign.

Clearly, the relative calm of the summer has given way to a choppier sideways market trend, just as our lives have once again been interrupted by the second wave of COVID-19. Markets have had to readjust their expectations, with so much now hinging on politicians. Should governments falter in their ongoing fiscal policy support while COVID restrictions are still in place, there are bound to be short sharp bouts of market volatility, as we experienced last week.

However, compared to March, the health impacts of Coronavirus are significantly less uncertain. Not only have health services been able – so far – to better treat those most at risk, but also those who are vulnerable are this time likely to be better shielded. In the best case, this means COVID-19 has lost much of its fearsome public health impact and no longer leads to a higher excess mortality than usual flu epidemics. At worst, our ability to cope better buys time, which gets us ever closer to an effective vaccine. This is increasingly seen as coming forward from 'sometime in 2021' to 'towards the end of 2020'. Markets are therefore probably right to temper their optimism, while also not falling back into panic about the medium-term future.

We continue to closely monitor whether politicians are playing their part in preventing lasting scarring on those sectors of the economy most affected by the continued restrictions. Central banks and capital markets have done their bit in providing the funding, but as the saying goes, you can only lead a horse to water. Depending on politicians' fiscal resolve – and *how* they spend their money – the default risk of previously-viable businesses will either continue to be contained or begin to rise. The same applies to unemployment. At the moment, credit markets are telling us that default risk is rising, and parts of the equity markets are telling us that the short-term consumer demand outlook is falling. Nothing too dramatic yet, but a clear deterioration from the summer.

We are beginning to reach the point where we must hope the impact of the second wave causes the least negative economic impact, before the responsibility for 'saving lives' can be handled by vaccination rather than restriction of freedoms. This pivotal moment may not be that far away, and is one that many are not yet fully factoring in. So, while last week felt decisively gloomy compared to the summer's recovery period, we see the return of increases in restrictions more as a pause to the recovery rather than the end.

FinCEN files - don't bank on banks?

Given the roller-coaster week it has been for markets, the economy and everything else, you would be forgiven for missing a story about bank reports. But last week's release of the FinCEN files – so called after the US Financial Crimes Enforcement Network – contained plenty of intrigue, from fraud and money laundering to Russian oligarchs and terrorist bank accounts. Leaked documents covering the period from 2000 to 2017 show that the world's biggest banks allowed at least $2 trillion of suspicious transactions to go ahead, in what investigative journalist Fergus Shiel called an "insight into what banks know about the vast flows of dirty money across the globe".

The usual suspects all made appearances, with JP Morgan, Barclays, HSBC and Deutsche Bank all involved in reporting fraud, money laundering or breaking international sanctions – among many others. Regrettably, the City of London also had many mentions in the files, with over 3,000 UK companies named in the suspicious activity reports – more than any other country.

Still, the leak highlights a global banking flaw, at an inopportune time for policymakers. Throughout the pandemic and economic shutdowns, central banks and governments have been intent on making liquidity available to businesses and individuals. Through its extensive asset purchase programme, the US Federal Reserve (Fed) has injected huge amounts of liquidity into the financial system, with no sign of letting up. But without an effective banking system to get that money where it is needed, central bank liquidity will remain central.

As such, central bankers have also tried to loosen restrictions on banks to get them lending more. Through his tenure – and especially from the onset of the current crisis – Fed Chair Jerome Powell has overseen a slight, but steady, easing of regulation built up since the financial crash. To make sure more loans are made, capital cushions and risk requirements have been eased. This is a natural and expected reaction to a recession as deep as this one – particularly one caused by an entirely external shock. But stories like the FinCEN files underline the danger in doing so.

What's more, in spite of the relaxed restrictions, and the resolve of central banks – in the US and elsewhere – to introduce emergency funding measures and favourable loans for businesses, we have seen many reports of banks still hesitant to lend. The decision to lend – and the risk that comes with it – ultimately rests with the bank. Recently, the US senior loan officers survey revealed that some lenders are unwilling to take on this risk, through fear that borrowers will be unable to pay it back.

Again, this is to be expected. Banks are, by their very nature, pro-cyclical. When the economy is booming and profits are strong, lending is easier to do. But in a recessionary environment – especially one where government rules might prevent businesses trading at any time – lenders will be more wary. As we have written before, these transmission problems make the policy response difficult for governments and central banks.

In any crisis, when policymakers want to get money out to the economy, banks are the first port of call. But they may not be the best port of call. Direct fiscal action – transfers, discounts or tax cuts rather than loans – are often more effective in crises precisely because they bypass transmission problems. In the UK, that steady fiscal flow looks set to continue. But in the US, largely because of its fractious political environment, the outlook for fiscal stimulus is much more uncertain.

Nevertheless, there are alternatives to directing funding through banks. Cleveland Fed President Loretta Mester spoke last week about how it can utilise a 'digital dollar' to get cash to where it is needed faster. In general, the economic importance of banks – as the lender of first resort – has been diminishing for years. This is particular true in the US, where corporate loan markets have received a great deal of attention from fund managers, but the rise of new financial technology firms has made transactions, deposits and loans more available everywhere, without having to go through traditional banks.

None of this is to understate the importance of an effective banking system for the economic recovery. Indeed, the pandemic has shown banks are still essential in getting liquidity out to the economy. But issues like these make it difficult to rely on banks alone, and highlight how important fiscal action is in seeing us through the crisis.

And what of banks themselves? In last week's market sell-off, banks all over the globe had a particularly torrid time. Some of this could have been down to the FinCEN scandal, and the possibility of some renewed regulatory attention on the sector, but most of the nosedive was caused by markets' economic pessimism. With interest rates pegged at zero for the foreseeable future, the short-term outlook for bank profits is limited – particularly if we do not see more fiscal action in the US.

When debtors are happily paying interest, banks are fine. When those debtors break the conditions on the loans, stop paying interest or fail to pay the money back, banks are under strain. Of course, that's what their reserves are for and the question is always "have the banks already got enough reserves"? The good news is that the Western world's banks are generally well capitalised. With perhaps the exception of some of Europe's weaker small banks, the system is as stable or perhaps in better shape than at any time in the past 30 years. If anything, the aftermath of the global financial crisis has meant banks have had to carry significantly more capital than might have been thought necessary. The restriction on dividends and the impact of government guarantees for emergency corporate funding has meant many of these banks are likely to remain healthy even in the face of a possible "double dip".

So, the current economic crisis is not a financial or banking crisis. Whereas previous downturns were brought on by reckless lending, banks had done a great deal to minimise their risk exposures before the pandemic. And, even if COVID risks did prove overwhelming – which looks unlikely – governments would almost certainly not allow a banking collapse to pile onto the current crisis.

Let us return to the FinCEN issue and add some perspective to this latest bank 'scandal'. Barclays, HSBC and Standard Chartered were said to have had £2 trillion of suspect payments over the past two decades. This sounds a lot, but the UK banking system on its own currently processes £2 trillion of payments approximately every four days (according to Bank of England Real-Time-Gross-Settlement system data). Meanwhile, Oliver Wyman analysis from 2017 reckoned that at least 90% of suspect payments activity warnings were false positives.

And, as Wirecard has shown, banks are easier for a regulator to regulate than the largely unknown Fintechs. We should not be surprised that criminals are everywhere, and we should want them to have the hardest time getting funds laundered as possible.

Finally, given its low starting point and sensitivity to the global economy, the banking sector stands to offer significant upside when fortunes do eventually turn around. More fiscal action, the development of a vaccine or a quicker-than-expected rebound in sentiment are all possibilities that could prompt a quicker economic recovery. Even with all the headwinds and negative news stories, we suspect that any further sell-offs will be limited. From here, banks stand much to gain.

Reflation reality check

As rain and wind flush out the heat of the last few months, there's a noticeable chill in the air for capital markets. For investors, things looked bright between June and August. The economy was finding its feet again, lockdown restrictions continued to lift, and central bankers were committed to indefinite monetary accommodation. As such, the 'great reflation trade' looked on. A rebounding global economy with practically unlimited monetary backing, and a healthy dose of fiscal support, caused inflation expectations to climb back up from their lows – taking US equities past their record peak. So far though, September has been one long reality check for those expectations.

To some extent, the sell-off in asset markets over the last few weeks may be an exercise in profit-taking for investors who have enjoyed impressive gains for the last five months. But headwinds have undoubtedly parched market optimism: an uptick in virus cases and resumed restrictions in the UK and Europe, as well as an increasingly uncertain political landscape in the US, have left investors wondering if they got ahead of themselves. In contrast to the downturn in equities, bond yields have stayed virtually flat, despite a pick-up in real (inflation-adjusted) interest rates. This signals a decline in inflation expectations.

In line with those falling inflation expectations, gold prices have fallen after a strong run. Some of that will be due to the pick-up in the value of the dollar, but overall commodity prices have fallen markedly throughout the month.

Due to their tight link to global economic activity, commodities were a central part of the reflation trade – nosediving throughout March's sell-off fever but gradually rebounding as economic sentiment improved. The Bloomberg Commodity Index chart below shows that commodity prices have already lost nearly all their August gains.

Global commodity price development over 12 months. Source: Bloomberg

After a significant rally over the summer, precious metals have been particularly hard hit, with platinum and silver (down 21% since the end of last month) faring even worse than gold. Not all metals have joined in the sell-off, however. Copper, often used a proxy for infrastructure spending, has held its value, and the same is true for steel and iron, with both barely changed from the end of August. That is almost certainly to do with China.

In a bid to aid its economic recovery, the Chinese government has unleashed a significant amount of fiscal stimulus – particularly into large infrastructure projects. According to research from Citibank (the US bank), Chinese steel demand is the biggest swing factor for iron ore prices. Due to renewed building demand, Citi now expects iron ore prices to be on the up for the rest of the year and into 2021.

Palladium – another indicator of economic activity due to its use in car manufacturing – has also held mostly steady. Falls throughout September have been noticeable, but palladium prices are now roughly where they were at the end of August. Again, palladium is a material that depends heavily on Chinese demand. But its supply is usually 'sticky' (mostly immune to changing demand levels) and even the sharp drop in manufacturing activity in March could not sufficiently shift imbalances in favour of sustained lower prices.

Notably, oil – usually the centre of attention in commodity moves – has barely moved through all of this. Given oil prices are usually read as an indicator of global economic demand, this is interesting. The flipside is that, unlike other commodities, oil prices have moved very little over the summer. Without a significant rally beforehand, there was not much to correct for in oil markets.

However, Citi research suggests oil stocks look set to come down, after a substantial build-up through the global economic shutdown. As we enter the winter months, there should be some seasonal effects on oil supply and demand. But Citi suggests most of the outlook for the last quarter of this year and the first quarter of next will be driven by non-seasonal factors. After prices sank earlier in the year OPEC+ (including Russia) producers agreed to substantial supply cuts. While these production cuts have been scaled back in recent months, oil producers are likely to remain sensitive to price action – dialling back production if needed. As such, prices should remain stable.

Interestingly, natural gas has rebounded in the midst of the recent commodity sell-off. Prices have mostly recovered the early September losses, but remain volatile.

Overall, the commodity sell-off has been something of a shake-out from the previous reflation optimism. But the fact that commodities linked to economic activity remain stable is a positive – even if this is mostly down to Chinese demand. Markets seem to be waiting for more signs of optimism before resuming the reflation trade. If (and when) the cavalry arrives – either in the form of additional US fiscal support or a quicker than expected vaccine development – things could pick up again. Optimism has tempered somewhat, which might not be a bad thing; markets are now just waiting for realistic hope.

CAMBRIDGE INVESTMENTS LIMITED

28th September 2020

Global Equity Markets

Market	Fri 14:54	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	5814.1	-3.2	-193.0	⇘	↘
FTSE 250	16923	-3.7	-647.2	⇘	↘
FTSE AS	3245.0	-3.3	-111.1	⇘	↘
FTSE Small	4975.9	-3.7	-189.2	→	↘
CAC	4691.6	-5.8	-286.6	↘	↘
DAX	12385.5	-5.6	-730.8	⇘	⇘
Dow	26771	-3.2	-886.4	⇘	⇘
S&P 500	3235.0	-2.5	-84.5	⇘	→
Nasdaq	10666.7	-1.2	-126.6	⇘	↗
Nikkei	23204.6	-1.2	-270.9	⇗	→
MSCI World	2300.3	-2.9	-67.7	⇘	→
MSCI EM	1057.7	-4.6	-50.8	⇘	⇘

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
Pearson	+10.1	Rolls-Royce	-19.3
Kingfisher	+8.2	M&S	-15.1
Brit-AM Tobacco	+5.5	Int'l Consol Air	-14.6
GVC	+5.1	John Wood	-11.8
Natwest	+2.3	Fresnillo	-11.8

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.272	-1.5	Oil	41.83	-3.1
GBP/EUR	0.915	+0.2	Gold	1861.7	-4.6
USD/EUR	1.16	-1.8	Silver	22.94	-14.4
JPY/USD	105.60	-1.0	Copper	295.8	-5.0
CNY/USD	6.83	-0.9	Aluminium	1740.0	-2.3
Bitcoin/$	10,620	-2.5	Soft Cmdties	361.4	+0.8

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.19	+0.01
UK 15-Yr	0.41	-0.01
US 10-Yr	0.65	-0.04
French 10-Yr	-0.25	-0.03
German 10-Yr	-0.52	-0.04
Japanese 10-Yr	0.01	-0.00

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.1	18.6	19.2	13.7
FTSE 250	2.8	15.8	27.1	14.7
FTSE AS	3.8	17.9	20.5	13.8
FTSE Small	3.7	16.2	-	13.8
CAC	2.4	19.4	23.8	14.0
DAX	2.8	21.4	20.0	12.9
Dow	2.4	21.3	23.3	15.6
S&P 500	1.9	24.1	24.7	16.6
Nasdaq	0.8	34.0	30.6	18.8
Nikkei	1.9	23.6	23.3	17.1
MSCI World	2.1	22.7	23.4	15.7
MSCI EM	2.4	16.6	17.2	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

If anybody wants to be added or removed from the distribution list, please email enquiries@cambridgeinvestments.co.uk

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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.

Lothar Mentel

www.cambridgeinvestments.co.uk | enquiries@cambridgeinvestments.co.uk
Tel : 01223 365 656 | CB1 Business Centre, 20 Station Road, Cambridge, CB1 2JD