THE **CAMBRIDGE** WEEKLY

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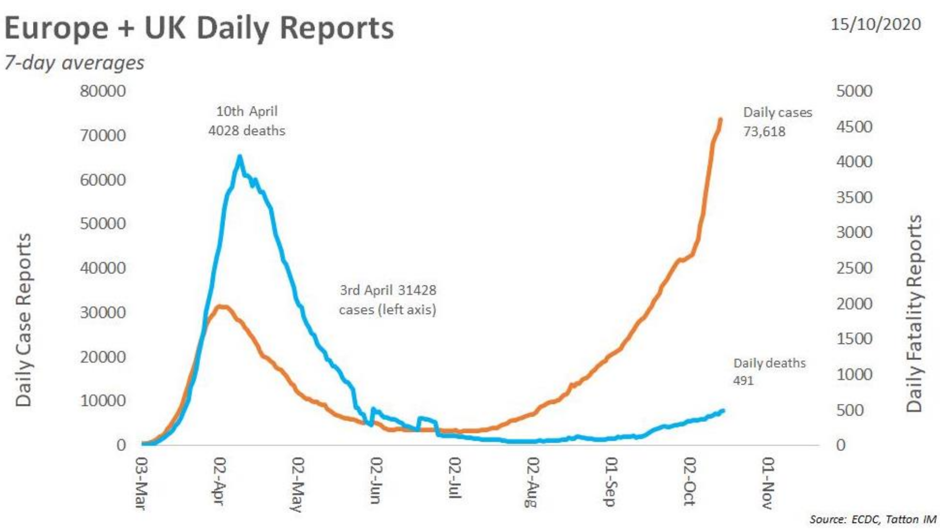
London Lockdown, Bob Moran; 16 Oct 2020

Watching and waiting

A noticeable winter chill is in the air. The threat of fresh lockdown measures has become reality, with renewed restrictions coming into force not just in the UK, but across most of continental Europe as well. But unfortunately, the UK – once again – is faring particularly badly in virus terms.



At the same time as this bleak news, Brexit negotiations have once again turned sour. Boris Johnson's self-imposed 15 October deadline has come and gone. Latest reports point to more than stalling in talks, after Johnson told the nation on Friday to "get ready" for a no deal Brexit – except that capital markets appeared utterly unconvinced – rallying throughout the day as if a deal is very close. The Prime Minister's chief negotiator David Frost claimed to be "disappointed" with the outcome from last week's European Council meeting. Among other things, fishing rights remain one of the big sticking points, with Johnson and French President Macron apparently digging into their respective sides.

It would be quite astonishing if a destructive result for both sides came about because of what is ultimately only an insignificantly small part of both British and French economies. But Macron's hard line shows little sign of letting up, and Johnson is reportedly trying to force a crisis in talks with the European Union (EU). The government claims that EU negotiators are dragging their feet, and Johnson is set to continue to emphasise the possibility of a "no deal" Brexit on the 1st January.

We can take some heart from the fact that France's obstinate position is losing support even among usual allies. The German press last week was surprisingly sympathetic towards the UK, with media outlets blasting Macron's inconsistent demands. The French Premier will no doubt come under significant pressure to temper his approach. And, while the current Brexit rumblings are disconcerting, we must once again point out the immense incentive for both sides to reach a deal. With the pandemic decimating economic activity in the UK and across the continent, the worst thing for both sides would be an acrimonious split from a vital trading partner. In the words of Liberal Democrat MEP Andrew Duff (a lifelong European federalist and anti-Brexiteer): "To let this collapse over mackerel would be absurd. Everybody knows there is scope for a deal and that is what will happen".

In the US, things look comparatively better. While the trend in daily cases is on the rise, it has yet to pass its previous peak, and COVID deaths show no sign of increasing just yet. The US economy has also fared somewhat better than Europe – particularly compared to the UK – throughout the pandemic. But US virus numbers lagged those on this side of the Atlantic early on in the pandemic, and it should be little surprise if Americans are in for another spike towards the end of the year.

What is more, just as the Brexit deadline looms here, the all-important US election is now less than three weeks away. It was hoped that an agreement on much-needed fiscal stimulus could be reached before then – with Donald Trump spending big to boost his re-election chances – but with the bitter partisan deadlock in Washington, that is looking increasingly at risk.

With a sizable lead in the polls, Joe Biden is now the presumptive winner for capital markets. With an expansive fiscal agenda, that looks to be a positive for growth in 2021 and beyond. But the unfortunate flipside is that we may have to wait until Biden takes office for any more fiscal stimulus – as Senate Republicans seem intent on blocking increased government spending – regardless of their own president's wishes. Going into a potentially arduous winter, if this were to happen it would be a big negative for the US economy. The resilience of the US stock market tells us that they are just as unbelieving of impeding political disaster as the UK stock markets over a last-minute failing of Brexit negotiations.

There is a virtual consensus among economists that substantial fiscal stimulus is needed not just to plug the pandemic output gap, but to invest in a strong economic recovery afterwards. Even the International Monetary Fund (IMF) is now advising governments in developed economies to borrow heavily to fund public spending, assuring them that the growth pay-off will be enough to balance out deficits as early as 2025. Coming from the organisation that helped usher in the age of austerity following the 2008 financial crisis, this is a significant turnaround – and gives politicians a powerful political tool against would-be budget hawks. We dedicate a separate article to this below.

One thing we should note is that, despite last week's doom and gloom, underlying fundamentals are holding up surprisingly well. Pfizer and BioNTech are set to publish the results of their joint COVID vaccine trials later this month, and both companies have already mass-produced vast numbers of vaccine doses since the summer, ready for pinpointed release to the vulnerable and highly virus exposed before year-end. And, while looming COVID restrictions had led many to think that credit conditions would once again struggle under the weight of business closures, another corporate liquidity squeeze looks unlikely. According to a recent report from Goldman Sachs, businesses across the US and Europe are well-prepared for another economic shutdown.

When emergency lending measures were rolled-out at the onset of the pandemic, businesses stocked up with enough cash not just to handle immediate closures but also ones that may come further down the line. As such, the risk of mass defaults is not as high as one may have thought initially, even if further announcements of mass redundancies and corporate collapses will make for depressing reading over the coming weeks.

Altogether, this leaves us in something of a 'wait and see' period. A possible vaccine, a positive US election result and a Brexit resolution are all in the pipeline. And in the meantime, businesses are holding up reasonably well. As downbeat as last week's news may have been, the case for strong growth in 2021 remains quite firmly in place. We need only to make it through intact.

IMF: Austerity is not the answer this time

The International Monetary Fund (IMF) created considerable waves last week with mixed messages in its biannual world economic outlook. IMF economists now expect a decline in economic activity of 4.4% for 2020, with the slight increase from June's forecast owing to better than expected growth in the second quarter of the year. The higher base effect from this year is partly why expectations for next year's growth have tempered somewhat. But downgrades to 2021's growth outlook also reflect the expectation that virus restrictions of some kind will continue to affect our lives well past January.

That sombre note resonates through much of the IMF's findings. Although global growth for this year may not be as bad as one may have thought, the -4.4% is still the most severe contraction since the great depression and puts the -1.7% contraction of 2009, that followed the Global Financial Crisis, firmly in its place. Emergency support from governments has worked to curtail the classic near-term impact of this deep recession in terms of dropping consumer demand from unemployment. But the IMF warns that the virus crisis will cause "lasting damage" to living standards across the world.

Much of the warning is well-known. The IMF pointed out that job losses could become permanent and bankruptcies persist for some time, and restrictions – or long-term psychological scarring – could make entire sectors of the economy unviable. Even after the virus fades, we could be in for a long and arduous recovery, with developed economies 3.5% worse off in five years compared to their expected paths pre-virus. The long-term hit for emerging economies is even worse, at 5.5% of national income. IMF chief economist Gita Gopinath foretold of dire consequences for wider society: "Not only will the incidence of extreme poverty rise for the first time in over two decades, but inequality is set to increase".

Because lower growth inevitably leads to smaller tax revenues, a prolonged slump would result in substantially higher national government debt – a trend we have already seen in virtually all advanced economies. But the IMF advises against cutting public expenditures in response. Rather than opting for austerity to balance the budget, it recommends that governments in developed nations borrow heavily to offset weak growth.

Interest rates in advanced economies are extremely low and even negative in many countries in Europe (which means, as a reminder, that the investor pays the government for being allowed to park money in the jurisdiction), and are expected to remain that way for some time. As such, the IMF's head of fiscal policy Victor Gaspar advised that: "Policymakers that have a choice would be well-advised to be very gradual and to maintain fiscal support until the recovery is on a sound footing and the long-run scarring impacts from Covid-19 are perceived to be under control".

Again, the advice itself is not new. Through anchoring interest rates and injecting huge amounts of liquidity into the financial system, central banks around the world have effectively written governments blank cheques to avert short-term catastrophe and a long-term slump. Politicians have thus far been mostly happy to use this money for emergency measures in the short-term, but throughout the crisis economists have urged that long-term investment for a sustained recovery need to replace direct handouts when the immediate pandemic ends. As we have written before, questions of how this gets paid for should not get in the way of the fact that it is preferable to a balanced budgets approach, on the basis that the eventual size of the 2020 COVID crisis bill for future generations of taxpayers will depend on how quickly economies recover – and tax revenues in their wake.

What will appear new to many is where this advice is coming from. In the aftermath of the Global Financial Crisis, the IMF led the chorus of national debt fears, advising governments to substantially cut back spending. Back then, it warned that fiscal stability, rather than growth, should be the main concern. In the eyes of some, this earned the IMF some blame for the decade of austerity, sub-par growth and stagnant living conditions that followed. Indeed, its own internal auditor has since concluded it was too quick to advocate austerity in 2010-11. In the IMF's defence, one can underline that the years of 2008 to 2012 were 'payback time' for past exuberances – be it subprime activity in the US household sector, or in the Eurozone, where years of low interest rates allowed for the build-up of substantial imbalances between member states. At the moment, the major cause of this recession remains the virus, even if one could find several areas in economies with room for improvement.

Another aspect catching the eye of international policy communities is that the social impact of austerity measures had a more adverse impact on broader policy dynamics (such as the rise of populist extremism in the West) than in the past and therefore deserve closer consideration this time round. Specifically, in which areas is austerity an expression of increasing efficiency of an economy (e.g. cut red tape and corruption, generate goods and service more efficiently) and hence lower the waste of resources, or where could it exacerbate social disparity and push parts of the population into poverty?

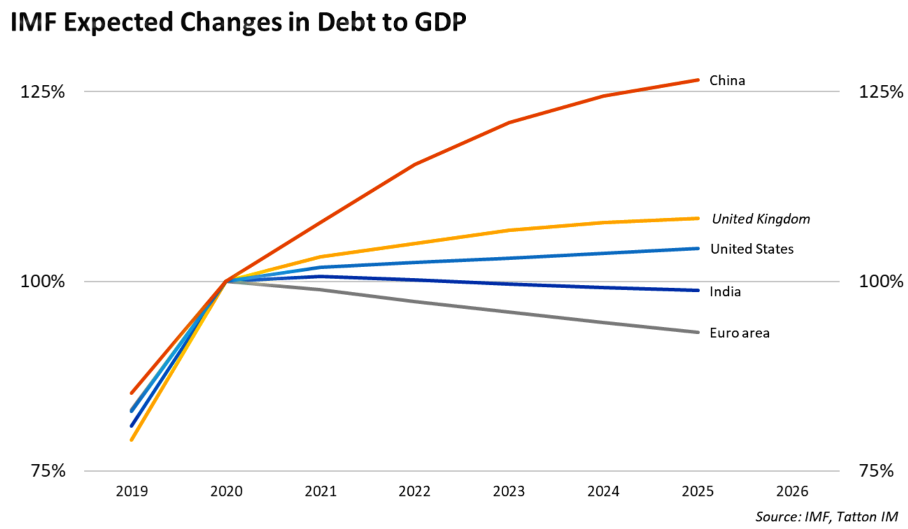
Back to the current situation, according to the IMF's current guidance of focusing on stimulating growth through deficit spending, most developed nations should be able to stabilise their public debt by the middle of the decade, without any significant spending cuts. By borrowing heavily and investing it into the economy, overall government deficits in 2025 are predicted to be roughly where they were projected to be before the pandemic.

Politically, many will see the IMF's guidance as a greenlight for deficit spending, even over the long-term. There are two crucial assumptions on which the fund's expectations rest, though. First, in order to balance budgets by the middle of the decade without cutting spending, we will need to see a strong economic recovery that spurs tax revenues. That is certainly easier to achieve with fiscal investment than without it, but should still not be considered a given. The second, and more decisive, factor is borrowing costs. Due to depressed economic expectations and substantial support from central banks, government bond yields are pegged at historic lows – even over the long-term.

For the IMF's scenario to play out, debt servicing costs will need to remain well below growth levels for the foreseeable future. In developed nations, this is plausible. The US Federal Reserve (Fed) has already committed to a 'lower for longer' monetary policy, stating its willingness to let inflation run well beyond its 2% target over the medium term. Most other central banks seem to be following suit and, as such, few expect any upward movement in bond yields any time soon.

For the emerging market (EM) nations, this will be much harder to achieve. They have limited access to financial markets, and domestic growth spurts are usually accompanied by a spike in borrowing costs. As such, Mr Gaspar warned that their governments will need to be much more careful about their fiscal strategies. This is one of the major reasons why under the IMF's forecasts EMs are set for a worse post-pandemic period (compared to pre-pandemic projections). If this is true, it would likely cause greater inequality on a global level – with austerity for the worst-off and free borrowing for the best-off. We are not completely convinced by this part of the IMF's assessment, because historically, sustainable growth in the smaller developing nations has been driven more by the global trade cycle (and lately demand from China) than domestic fiscal stimulus. To look at it from a different perspective, all things being equal, a strong fiscal boost in the developed world is better for EMs than austerity in leading advanced economies.

Even in developed nations, however, uncertainty persists. If, as many would hope, growth and inflation



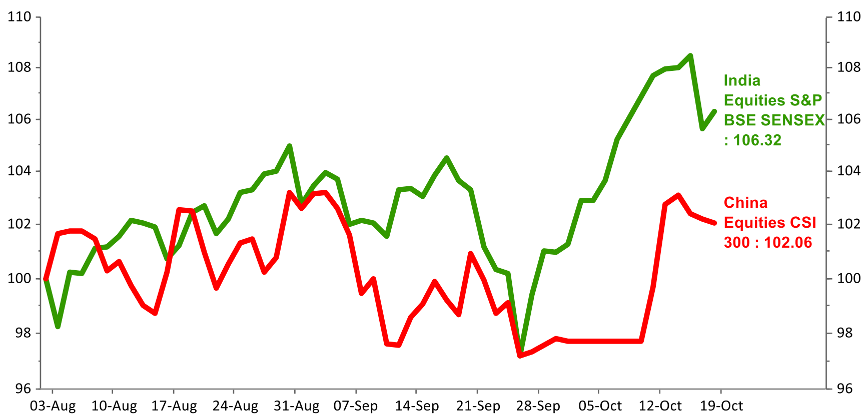
return strongly in 2021 once the virus fades, then a partial reversal in central bank policy and an uptick in bond yields would be a natural reaction. Expectations of a slow recovery would be one of the main reasons why yields are where they are, even without central bank intervention. If the recovery is indeed turning strong, we could see that changing over the long-term and central banks really being put to task to keep rates for governments' long term borrowing low. Indeed, we believe central banks should – just as many of them have promised - hold their nerve, keep yields suppressed in the initial phase of the recovery (and, almost certainly, well beyond), and make sure that economic momentum is firmly back on track. To avoid exuberances, e.g. malinvestment leading to asset bubbles, regulation would probably have to work in the background.

In any case, this highlights how crucial borrowing conditions are for the economic outlook. While the IMF's viewpoint here is nothing new, the fact it is reiterating it now, is significant. The vanguards of international capital are telling politicians to bridge the gap between now and normal, no matter the cost. That should make them more likely to listen and overcome orthodox thinking when faced with this unprecedented challenge.

India revisited

Indian equities have been on a roll. Since the global sell-off through the end of February and March, Indian stocks have recovered over 40%. That still leaves the Indian market down around 2% year-to-date, but compared to other emerging markets, India is faring well, outrunning China particularly over the past couple of weeks. One of the most impressive features of the recovery is its consistency. India is now one of the best-performing emerging markets when measuring on a one month, three-month or six-month basis.

India outshines China



Source: Factset, Tatton IM

From the titbits of news we see here, this may come as something of a surprise. The world's second-most populous nation was deemed at huge risk from COVID; its densely-packed conurbations, and less-developed healthcare infrastructure, make it an unfortunate place to be in a pandemic. Sure enough, in absolute terms the country has suffered heavily in the last six months. Over seven million virus cases have been reported in total, and more than 111,000 people have lost their lives to the disease – although, relative to its vast population, this still means that they have been less affected than for example Germany.

More recently, however, things have been improving. India experienced the worst of its epidemic much later than the rest of world, with the highest seven-day averages for both daily cases and deaths coming in September. Since then, both daily figures have been steadily declining, while the US and western Europe experience sharply rising second waves.

With the peak now seemingly behind it, the Indian government has begun slowly easing restrictions and life is gradually returning to normal. On latest estimates, economic activity in India is now at 93% of its pre-pandemic levels. Business sentiment is improving too, with surveys for both the manufacturing and services sector showing a positive outlook. A new spurt of infections is an ever-present risk, but the hope is that consumer demand will improve over the last quarter of the year. There is still some way to go, but while much of the developed world continues to struggle with virus cases and new restrictions, things look comparatively more under control in India.

The recent equity rally no doubt has a lot to do with the economic restart. But in many respects, the risk associated with India for capital markets is not so much to do with the virus. For international investors, the key issue is what it has always been: the ease, or lack thereof, of doing business. India has long had significant barriers to trade and investment, owing to its fractured legal system (where laws and regulations vary dramatically from state to state), bureaucracy and widespread corruption.

Policy is therefore a key part of any outlook for India. Narendra Modi's premiership is now into its seventh year, and while he has been harshly criticised for his sectarian and authoritarian policies, he has made economic reform a central part of his premiership. His government's reforms have sometimes been harshly criticised for how they were handled – such as the demonetisation of large banknotes and sudden introduction of a standardised sales tax. But implementation issues aside, most agree that these changes needed to be made, and the hope is that they will prove beneficial further down the line.

That reform drive seems to be ongoing. Even with significant COVID disruptions this year, the government has made significant regulatory changes designed to streamline business operations. But the process clearly still has a long way to go. India is still one of the harder countries in the world to do business in, and the overarching problems – corruption and fractured political structure – are still very much there.

Other aspects of policy also leave a lot to be desired. While most major economies have pushed through significant fiscal packages during the pandemic, India's fiscal response has been timid. Last week, the government announced a second round of fiscal stimulus worth $6.4 billion – about 0.2% of India's expected real GDP in 2020. It brings India's overall fiscal spending on coronavirus-related measures to 1.2% of GDP, well below the average for major economies. In such testing times, fiscal stimulus is crucial, so the government's modest spending is disappointing.

It highlights how constrained Modi's government is in tackling India's economic problems. One of the reasons other nations have been able to spend big through the crisis – while their central banks poured huge amounts into the financial system – is because both inflation and government bond yields around the world are pegged at near zero. In India, things are different. Headline inflation is still at concerning levels despite the economic shutdown, and interest rates are consequently higher than anywhere in the western world – with the ten-year yield hovering above 6% since the onset of the pandemic.

Given the government's dwindling revenues, borrowing to fund fiscal stimulus should be a priority. This will be extremely difficult while interest rates and bond yields are still comparatively high. But there are thankfully some signs that inflation may be coming down. This would be a positive, as it would give the Reserve Bank of India reason to cut interest rates – thereby giving the government some much needed fiscal headroom.

At the moment, the lack of fiscal stimulus drive remains one of the key obstacles for India. As such, we hesitate to say whether the rally in its stock market can continue. If this obstacle can be overcome, the outlook for India would look much brighter. The Prime Minister's reform drive – controversial as some measures may be – is clearly working to improve the ease of business. And with virus cases now looking more under control, there are reasons to be optimistic. For now, with the difficulties that remain, India's outlook is finely balanced.

Global Equity Markets

Market	Fri 16:19	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	5920.9	-1.6	-95.7	→	↘
FTSE 250	17840	-1.3	-234.0	→	↘
FTSE AS	3327.0	-1.5	-51.4	→	↘
FTSE Small	5196.0	-1.0	-55.0	→	↘
CAC	4948.4	+0.0	+1.5	→	↘
DAX	12930.8	-0.9	-120.4	→	↘
Dow	28756	+0.6	+169.0	→	→
S&P 500	3507.2	+0.9	+30.1	→	↗
Nasdaq	11740.3	+1.4	+160.3	→	↗
Nikkei	23410.6	-0.9	-209.1	↗	→
MSCI World	2435.9	-0.5	-11.8	→	→
MSCI EM	1120.5	-0.2	-2.0	→	→

Top 5 Gainers

Company	%
Scot Mtge Inv Trust	+4.9
Experian	+4.3
Ocado	+4.2
SSE	+3.3
Admiral	+3.1

Top 5 Decliners

Company	%
Carnival	-12.9
TUI	-10.5
Hargreaves Lansdown	-8.4
Assoc. Brit. Foods	-8.3
easyJet	-8.2

Currencies

Pair	last	%1W
USD/GBP	1.292	-0.9
GBP/EUR	0.907	-0.0
USD/EUR	1.17	-0.9
JPY/USD	105.40	+0.2
CNY/USD	6.70	-0.0
Bitcoin/$	11,328	+2.6

Commodities

Cmdty	last	%1W
Oil	42.95	+0.2
Gold	1902.4	-1.5
Silver	24.31	-3.3
Copper	306.5	-0.6
Aluminium	1852.0	+2.6
Soft Cmdties	362.8	-0.3

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.18	-0.10
UK 15-Yr	0.41	-0.12
US 10-Yr	0.74	-0.03
French 10-Yr	-0.35	-0.08
German 10-Yr	-0.62	-0.10
Japanese 10-Yr	0.02	-0.01

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.8	19.0	19.3	13.7
FTSE 250	2.5	15.4	23.6	14.8
FTSE AS	3.6	18.0	20.1	13.8
FTSE Small	3.4	15.3	-	13.7
CAC	2.2	20.4	25.6	14.1
DAX	2.8	22.3	19.6	13.0
Dow	2.1	21.4	24.0	15.6
S&P 500	1.7	25.9	26.0	16.7
Nasdaq	0.7	36.9	32.2	18.9
Nikkei	1.7	23.5	23.3	17.1
MSCI World	2.0	23.9	24.2	15.8
MSCI EM	2.2	17.5	17.9	12.1

UK Mortgage Rates

Mortgage Rates	Sep	Aug
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.74	1.65
3-yr Fixed Rate	1.86	1.83
5-yr Fixed Rate	1.92	1.85
10-yr Fixed Rate	2.45	2.42
Standard Variable	3.50	3.54

* 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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19th October 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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