THE **CAMBRIDGE** WEEKLY

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Quite a COVID catch, Christian Adams; 2 Oct 2020

A question of time horizons

A US presidential debate that nobody would want to watch twice was followed by reports that COVID reality has finally caught up with a US president who insists that only he can determine what is real and what is fake has made for a dramatic October start. The UK's domestic perspective was not much less unnerving, with public divisions over the most appropriate reaction to the second COVID-19 wave growing by the day, while economic pressures are doubled up by the seemingly never diminishing uncertainties over a 'deal-or-no-deal' Brexit.

If there is one thing capital markets investors dislike, it is uncertainty, which we have in abundance. On balance, however, we can see improvements in what will drive economic and market fortunes beyond the immediate short-term time horizon. The noises coming from Westminster that negotiation progress with the European Union (EU) is being made, reconcile with our observation that 1) both sides have an even bigger economic interest in reaching amicable economic divorce terms than before, given the imperative of swift economic recoveries on both side, and 2) because of the UK's regrettable underperformance – both in terms of public health and economic damage sustained from the epidemic – there should be less appetite from the UK government to risk a crash Brexit scenario.

Similarly, for the US, an increasing number of market strategists are beginning to update their economic outlooks and view a Joe Biden presidential election win in a more positive light. Economic growth – rather than return of decline – is therefore increasingly what we expect as the most likely scenario for 2021.

With continued substantial fiscal support from governments around the world coming into sync with central banks' monetary support policy measures, the argument that the so-called 'reflation trade' will lead the world back to economic expansion (and thereby improving corporate earnings) is gaining validity. If the US is able to change political direction, and regains its former status as the world's preeminent growth engine, this will increase the possibility of a meaningful upswing in the global trade cycle – overcoming the weakness in demand that characterised and marred the decade that followed the financial crisis.

This may sound like a very bullish scenario for stock markets, and to a certain extent it is. However, investors must not forget that much of the effectiveness of recent monetary policy has been to bring forward future capital return potential from yielding assets by suppressing the yield of the secure alternative investment – fixed interest bonds. While it is entirely reasonable to expect an economic rebound would prompt a further upward movement in share prices, the really substantial moves are more likely to be found when investors begin to rotate their interest from the darlings of the low growth past – that profited most from the low yield environment – to those that benefit most during cyclical recoveries and perhaps even rising yield expectations. September's return landscape has provided a first glimpse of what may be to come.

Taking stock of market returns up to September

Against all expectations, and despite considerable intramonth volatility, September turned out to be decidedly dull for investors. After a five-month rally had left global stock indices around or above their pre-pandemic highs, the turn of Autumn sent a chill through capital markets.

Asset Class	Index	September	YTD	12 months	3-yr rolling annualised
Equities	Nikkei 225 (Japan)	4.6	1.8	1.9	1.7
Bonds	Barclays Global Aggregate Bond Index	3.2	8.3	1.3	5.4
Equities	MSCI Emerging Markets	1.9	1.3	5.4	2.4
Bonds	FTSE Gilts All Stocks	1.5	7.6	3.4	5.7
Equities	MSCI Europe ex-UK	0.6	-1.4	-0.5	1.2
Bonds	£-Sterling Corporate Bond Index	0.4	4.5	4.3	5.0
Commodities	LBMA Spot Gold Price	0.4	27.5	21.4	-
Equities	MSCI All Countries World	0.2	3.9	5.3	7.1
Inflation	UK Consumer Price Index (annual rate	0.0	0.1	0.5	-
Cash rates	Libor 3 month GBP	0.0	0.5	0.7	0.7
Property	UK Commercial Property (IA Sector)*	-0.1	-3.4	-4.3	-N/A
Commodities	Goldman Sachs Commodity Index	-0.2	-31.7	-31.2	-9.5
Equities	S&P 500 (USA)	-0.4	8.2	9.8	13.7
Equities	FTSE 100 (UK)	-1.5	-20.2	-18.1	-3.5
Equities	NASDAQ (US Technology)	-1.7	28.4	34.4	21.0
Equities	FTSE4Good 50 (UK Ethical Index)	-1.9	-21.6	-20.3	-5.6
Commodities	Brent Crude Oil Price	-3.2	-34.3	-31.9	-9.4

Data sourced from Morningstar Direct as at 30/09/20. * to end of previous month (31/08/20). All returns in GBP.

Selling pressure built up early in the month, as COVID cases spiked around the world once more. The fear was that we were in for a repeat of March, where the spread of the virus and ensuing global economic shutdown sent markets into a panicked frenzy. But this time, level heads prevailed. While asset prices traded either sideways or down throughout the month – depending on the region and currency basis –no 'sell everything' fever took hold.

In sterling terms, the best regional performer – by some distance – was Japan. Japan's Nikkei 225 climbed 4.6% in September, with the MSCI Emerging Market index the next-best performer at 1.9%. US equities, having done so well in the recovery rally from April, fell 0.4%. Most interestingly, Technology (the market darling of the last few years) was the worst-performing US sector. The tech-heavy Nasdaq index fell 1.7%, as investor optimism for the all-conquering mega-caps began to wane. Still, even after letting off a bit of steam, US tech remains up 28.4% year-to-date.

Looking deeper into the tech world, The big five – Microsoft, Facebook, Amazon, Apple and Alphabet (Google) – are up an average of 39.7% year-to-date, while the median US stock has fallen 6%. Those five companies now account for a record 23% of the entire value of the S&P 500.

UK stocks, meanwhile, continue to lag behind their global peers. The FTSE 100 once again had a rough month, down 1.5% in September and now negative 20.2% year-to-date. The double whammy of a significant economic and public health crisis – worse than any other G7 country – and damaging Brexit risks is hampering businesses. How and when these two factors will stop weighing on Britain is difficult to say, but investors should at least be consoled that, as globally diversified investment portfolios, UK assets do not constitute the predominant part of their overall investments. It is global growth – and global asset markets – that are far more important.

Overall, September's price moves look more like the consolidation of a strong run than the flight of frightened investors. Nevertheless, market jitters were far more prominent than over the summer, with far larger price swings. As we wrote recently, commodities have been at the head of this bout of volatility – with Bloomberg's commodity index losing nearly all its August gains last month. A substantial part of this fall was driven by oil prices, which fell 3.2% in September and are now 31.9% lower year-to-date. Gold, on the other hand, is still the second-best performing asset among those we track, up 27.5% in 2020.

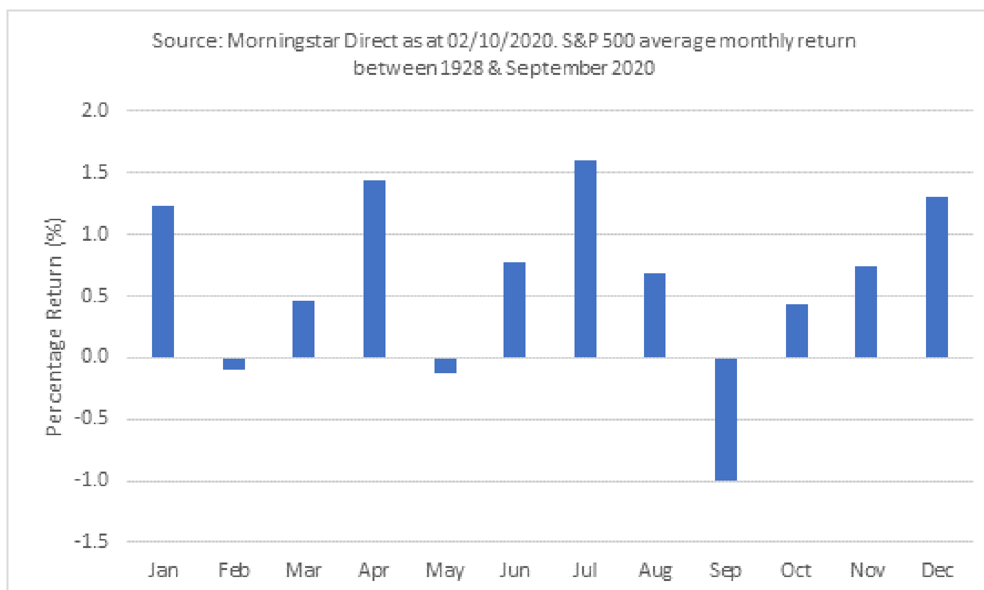
Volatility goes hand in hand with the 'wait and see' narrative coming through in capital markets. The hopes of a swift V-shaped economic recovery that drove markets over the summer have been dashed by second wave fears, diminishing fiscal support from governments and a generally slowing rebound. The jury is still out on how long lockdown restrictions will need to last, and how quickly a vaccine – which would save lives rather than restrict social activities - can be produced and rolled out at scale.

If a vaccine which protects those most at risk can be achieved before the end of the year – or if the public health risks from the 'second wave' are not as great as what we saw during the first bout of COVID (which the experiences of Spain and France suggest) – we should expect the economic recovery to resume. Even in that case, activity is unlikely to rebound as quick as we might hope – with reluctance of the more fearful to return to their former lifestyles not necessarily outweighed by gushing spending and activity increases by the demob happy young and fearless.

That realistic outlook makes the second prong of the recovery – policy – all the more important. With consumers and businesses struggling to survive, central bank and government support has been vital. Central bankers have seemingly now committed to doing their part: keeping rates low and liquidity flowing for the long haul. But the fiscal side has recently left a little to be desired. Support is being handed out with less zeal than earlier in the crisis, and in some cases not handed out at all, which could drastically slow the recovery.

Unfortunately, the longer restrictions must remain in place, the more opportunity there is for a policy error. The biggest danger of this is in the US – where bitter political divisions seem to be hampering the progress of getting fiscal support to those who need it. We can take some comfort in the fact that both presidential candidates are likely to give some level of fiscal stimulus, but it is needed sooner rather than later. Thankfully, we can bank on Donald Trump going to any length to secure his re-election, and if that means further spending measures in the next few weeks, that is what we should expect. If none are forthcoming, there is a real danger that this forced recession could turn into a 'classic' downturn – driven by widespread corporate defaults and rising unemployment.

Finally, we end with a note on historical monthly returns. While last month's market returns were a little disappointing, they were normal by historical standards. Interestingly, September is on average one of the worst months for market returns, dating all the way back to 1928. Perhaps investors prefer to take their profits after having taken stock of their investment over the course of their summer holidays.



Source: Bloomberg, Tatton IM, 2 Oct 2020

US election market impact – not straight forward

By any standard, last week's US Presidential debate was ugly. With just over a month until Americans head to the polls, the Trump/Biden clash was packed with pithy insults, but exceedingly light on policy. President Trump characteristically tried to steamroll his challenger, constantly interrupting Biden by attacking his political record and his personal faculties. The Democratic nominee, on his part, managed to avoid any of the big gaffes that have plagued his campaign, and even managed to deliver the night's most memorable soundbite: "Will you shut up, man!?"

Judging from the betting markets, it was Biden who walked away from the fight in better shape. Betfair Exchange puts the odds of a Biden victory at around 60%, up a meaningful 5%. Indeed, the polls on candidates' policies and performance also point to higher marks for Biden. But talk of him 'winning' this debate may be a little hasty. Nobody really won here, and it is unlikely that the showdown did much to change anyone's mind decisively.

That in itself is a positive for the former vice president, however. Biden did not *have* to win the battle of bluster; he just had to not lose. Trump trails his opponent 6-8% in national opinion polls, and by a slightly smaller (though still tangible) margin in the all-important swing states. Despite the polls, Trump's sizable re-election probability was likely in part down to the expectation of a late surge – spurred by Biden taking a bruising in debates. That did not happen, and Trump's bulldozer performance seems to have done little to gain him support – even if it did not lose him any. Friday morning's news that Trump has contracted COVID-19 and gone into self-isolation is unlikely to turn things around for him, given he has always portrayed the danger of the virus as exaggerated and often refused to wear a mask. Given this now also robs him of about one-third of the remaining campaign time, the only way this could slightly play into his hands is if his course of infection turns out to be very mild.

Barring any more October surprises, a Biden victory has become a reasonable base case. At first glance, that seems like a negative for capital markets. Trump has made deregulation and tax cuts a central part of his economic policy, while Biden's plans involve an estimated 12% hike in the effective corporate tax rate – roughly back to where it was under President Obama.

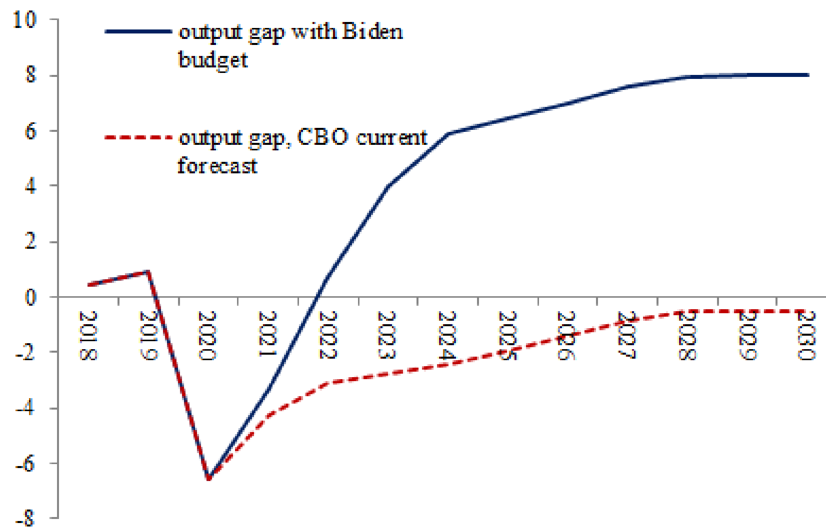
Even if Biden was to win of course, implementing his proposals unchanged would be extremely unlikely, as the Republican Party is still favourite to retain control of the Senate. But over the last four years, Trump has shown the immense policy power of the executive order – something we expect to become a permanent feature whatever the election result, given the partisan logjam in Washington. And yet, US equities have been stable over the week, even rallying somewhat on Wednesday following the debate. Why are equity markets so sanguine about this probable tax rise?

Obviously, there is far more to equity values than a country's tax regime. A potentially larger effect from Biden's plans could come from the sizeable fiscal boost on offer. Biden plans to spend significantly more than his opponent in aiding the US economic recovery. Compared with the current plan from the Congressional Budget Office (CBO), Biden is expected to add a 1% fiscal boost next year, followed by two years with a 3% boost, and another year at 1.5%. The calculations involve only 'first round' effects but, nonetheless, give an idea of the extent of stimulus. Tim Bond of Odey Asset Management has produced

the chart below, which shows the difference in output gap between the CBO's current forecast and Biden's plans. The stark difference would lead to a significant growth spurt for the US economy.

Whether that is a positive for equities is a little more complicated. Throughout the pandemic – and long before – one of the main market underpinnings has been the unprecedented support provided by central

US output gap trajectory, as forecast by CBO and with Biden fiscal easing



Source: Haver, author calculations

banks. By keeping interest rates pegged at zero and injecting vast amounts of capital into the financial system, monetary policy has drastically lowered the 'risk-free' return of real (inflation-adjusted) government bond yields. With returns vanishing in the bond market, investors have nowhere to go but equities.

The US Federal Reserve (Fed) has recently committed to a 'lower for longer' policy on interest rates, going as far as saying it is willing to let inflation run above its 2% target for some time to aid the economic recovery. But if Biden can boost medium-term growth with his fiscal plans, it could create upward pressure on inflation. If so, the Fed could rethink its tolerance for overshooting inflation – tapering back its bond purchases and possibly even raising interest rates sooner than expected. If this led to a sharp spike in bond yields, it would likely cause a re-rating of equity prices, pushing down risk premia (the amount investors are willing to pay for a given level of risk). Equities would become less attractive compared to fixed income investments – put simply, the government bond yield would have become more attractive again compared to the equity yield. This could put downward valuation pressures on equities if investors felt that the economic growth only led to higher government yields, but not also improved earnings on the corporate side.

Tim Bond sees the case for this. If long-term 30-year rates were to move towards 3.5% from the current 1.48%, and the corporate tax rate were to rise to from the current estimate of an effective 14% to 26%, his view is that it might mean as much as 30% downside for the S&P 500.

We are much more sanguine. In our view, economic growth would drive up corporate profits, and would likely more than offset the effects that tax hikes might have on equities over the medium-term. Even assuming a bullish scenario for growth and inflation, it could take many months before markets question

the Fed's grip. We would expect fixed income bond markets to remain orderly, and therefore a re-rating of equity valuations should not outweigh the benefits of improved profit growth. Indeed, it might mean that real yields move further down, the scenario which has historically been very supportive for risk assets.

JPMorgan is similarly positive on the outlook for US equities and credit markets. It expects the S&P 500 to reach record highs of 3,600 by the end of 2020, with improved corporate earnings this year and next. On this view, a Biden victory is neutral or even slightly positive, rather than the negative equity scenario some are painting.

That said, should US corporate taxes increase while inflation runs hot, US bonds and large cap equities would become relatively less attractive compared to their global peers – pushing down the value of the dollar. That situation – a booming US economy with a weak dollar – has historically been a major boon to the world, even if US equities themselves do not reap a benefit relative to other regions. Emerging market assets would do well out of this, particularly if a Trump loss led to a less impulsive US trade policy.

In particular, the US tech superstars – the big winners of recent years – could face tougher times than most. This is arguably something that needs to happen regardless, and could be seen as a sign of a healthy sectoral rotation. If the Democrats do indeed sweep the election (winning the Presidency, House and Senate) we see better investment opportunities in sectors like materials and industrials – the classical cyclical winners.

The worst-case scenario for equities would be if Trump lost the election but refused to accept the result – no doubt resulting in widespread civil unrest. It is unlikely that he would be successful in challenging the election result, but it is a risk nonetheless. For now, it looks like a Biden victory would, overall, not be negative for US equity markets and indeed may be good news for markets across the rest of the world.

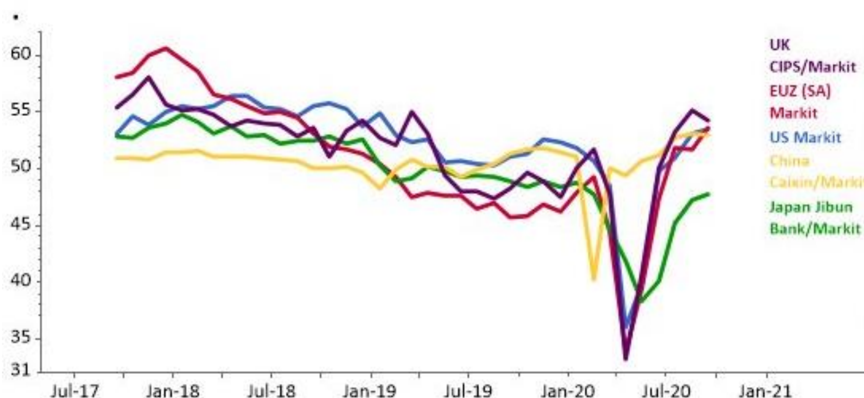
State of the global economy

Throughout the middle of this year, we saw an impressive bounce back in economic activity. While the global economic shutdown had frozen business and manufacturing activity, the opening-up into the summer months suggested we may be on course for a sharp V-shaped recovery. Purchasing Managers' Indices (PMIs) – a survey-based measure of business confidence – showed that firms were indeed optimistic about the speed of the recovery. The numbers for July were all firmly in positive territory, indicating expansion from the lockdown lows.

It may not have come as a complete surprise, but that quick rebound tempo has slowed since. Survey numbers for September – while still in expansionary territory – have slipped, suggesting the road back to normal may be longer than it looked over the summer months. JPMorgan's all-industry composite PMI for developed economies came in nearly one point below its August levels. But the September declines were not equal across sectors. Most notably, the global manufacturing PMI improved to 52.3 (+0.5pts). The chart below shows the comparisons between manufacturing and services sectors in the different major economies. To note, a PMI of above 50 indicates expansion, while a reading below 50 indicates the opposite.

In the US, the ISM Manufacturing PMI came in at 55.4 for September, down only modestly from August's 56.0. Most of that decline was driven by a fall in new orders, which fell to 60.2 from August's spectacular 67.6. This suggests inventory levels are low for manufacturers, pointing to some potential inflation in the price of goods.

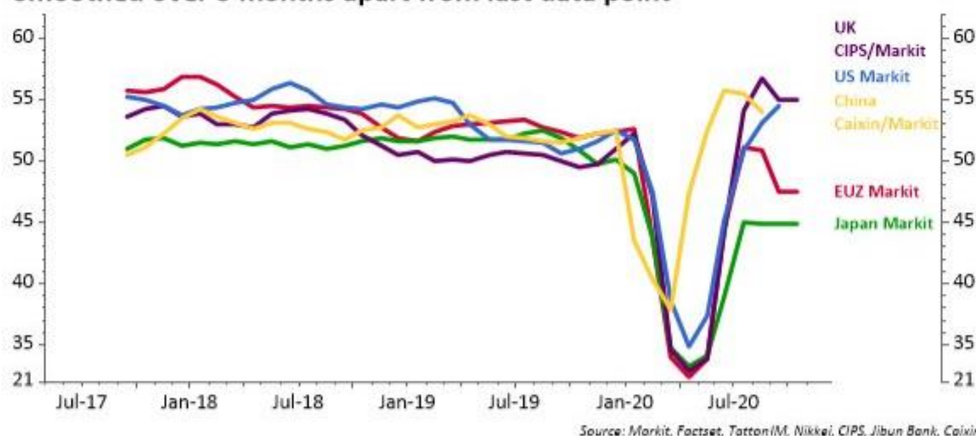
Manufacturing PMIs



Overall, the picture is reasonable, albeit a little disappointing given the previous V-shaped recovery hopes. What is particularly concerning, however, is the fall back in the services sector, which has shown a clear deterioration from the summer.

Services PMIs

Smoothed over 3 months apart from last data point



Economic surprise indices show a similar slowing of the recovery. Again, indices are still positive across all major regions, but have dropped from the July and August highs. This has also been reflected in capital market moves. Having regained all of the losses from March, US equities reached new highs in August, only to come off those highs throughout September. In fact, after excluding the US mega-cap technology stocks the capital market rally had already begun to wane over the summer. Small and medium-sized companies were seeing little upside relative to the top dogs once it became clearer that government restrictions and ensuing economic weakness would be with us for a while longer.

To see more upside from here – both for the economy and for markets – we will need to see further signs of positivity. As we have written before, this could come from an earlier-than-expected vaccine rollout – signalling a quick end to restrictions. Or, more likely, it could come from another boost to fiscal policy. We have already seen additional fiscal expansion in Europe and the UK – even if the furlough replacement scheme has proven somewhat disappointing relative to its predecessor – but the key market mover would be further fiscal action in the US.

Unsurprisingly, the political stalemate between the Republican and Democratic parties complicates things. Both sides agree that more spending is needed, but the details – and bitter political differences – keep getting in the way. Whatever the outcome of next month's election, we will almost certainly get another fiscal package (possibly even before, if Trump tries to boost his re-election chances). But the stronger and sooner the support the better – something the Trump administration will be well aware of.

Without a fiscal boost in the short-term, things could get difficult over the coming months. The capital market rally we saw from April onwards was in large part down to a huge influx of investment from consumers, who, unable to spend their money on much else, put their savings to work in markets. With fiscal support measures now dwindling, individuals have begun drawing down their savings – pulling liquidity out of the system. This is happening just as economic positivity is also tailing off. These two factors combined – in the absence of a significant fiscal boost – would be bad news for investors.

This stands in stark contrast to the other side of the Pacific. In China, the government has repeatedly shown its fiscal resolve throughout the crisis, and shows no sign of letting up. Interestingly, unlike all other major world markets, monetary policy in China has not been particularly loose. Nevertheless, the recovery in the world's second largest economy is going strong, aided by a generous fiscal drive and a surprisingly positive global trade environment. What's more, a strong China is clearly boosting other emerging markets in Asia, with export demand greatly benefitting manufacturers.

China's economic recovery – particularly the growth in exports – is significant. At the onset of this crisis, there was much talk about the threat that COVID posed to global supply chains, and how this would affect economic policy going forward. The virus has undoubtedly laid bare the dangers of globalisation: by relying on foreign industries for goods or vital services, nations can find themselves cut off in times of crisis. And yet, the supposed shift away from global trade towards greater self-reliance is not playing out in the data – if China's export figures are anything to go by at least.

This is somewhat to be expected. Even if governments want to localise supply chains in future, the immediate problem is the recovery from the world's deepest-ever recession. And, when businesses and consumers are struggling for solvency, they will opt for the cheapest option, regardless of where it comes from. The prophesised reversal of globalisation may indeed be one of the long-term effects of this pandemic, but while the global economic recovery is ongoing, this scenario it is unlikely to play out.

The status quo benefits China's exporters, and indeed manufacturers around the world. The fact that manufacturing has held up well – despite the apocalyptic warnings at the onset of the pandemic – is a good sign. But manufacturing strength cannot compensate for weakness in services. As we have written before, positive signs – a vaccine or fiscal firepower – will be needed from here.

CAMBRIDGE
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5th October 2020

Global Equity Markets

Market	Fri 15:30	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	5866.0	+0.4	+23.3	↘	➘
FTSE 250	17298	+1.5	+253.5	↘	➘
FTSE AS	3281.8	+0.6	+19.9	↘	➘
FTSE Small	5054.8	+1.3	+66.2	→	➘
CAC	4805.3	+1.6	+75.6	↘	➘
DAX	12641.4	+1.4	+172.2	↘	↘
Dow	27623	+1.7	+449.4	→	→
S&P 500	3358.6	+1.8	+60.1	→	↗
Nasdaq	11237.0	+3.0	+323.4	↗	➚
Nikkei	23029.9	-0.8	-174.7	→	→
MSCI World	2380.0	+2.3	+53.2	→	→
MSCI EM	1084.8	+2.4	+25.7	→	→

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
StanLife-Aberdeen	+13.1	Rolls-Royce	-30.0
DS Smith	+10.0	DCC	-9.1
ITV	+9.9	BP	-8.5
Mondi	+9.7	Royal Dutch Shell	-8.2
Legal & General	+9.5	Royal Dutch Shell	-7.6

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.294	+1.5	Oil	39.42	-6.0
GBP/EUR	0.906	+0.7	Gold	1904.1	+2.3
USD/EUR	1.17	+0.7	Silver	24.11	+5.3
JPY/USD	105.36	+0.2	Copper	294.8	-0.9
CNY/USD	6.79	+0.3	Aluminium	1739.5	-0.0
Bitcoin/$	10,531	-1.7	Soft Cmdties	357.9	-1.0

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.25	+0.06
UK 15-Yr	0.49	+0.08
US 10-Yr	0.69	+0.04
French 10-Yr	-0.26	-0.00
German 10-Yr	-0.53	-0.01
Japanese 10-Yr	0.02	+0.01

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.9	18.9	19.2	13.7
FTSE 250	2.6	14.9	22.1	14.8
FTSE AS	3.7	17.9	19.9	13.8
FTSE Small	3.6	17.5	-	13.8
CAC	2.3	19.8	24.5	14.0
DAX	2.9	22.1	20.0	12.9
Dow	2.2	21.9	23.6	15.6
S&P 500	1.8	25.0	25.0	16.6
Nasdaq	0.8	35.6	30.8	18.8
Nikkei	1.7	23.3	23.0	17.1
MSCI World	2.0	23.5	23.8	15.7
MSCI EM	2.3	17.1	17.6	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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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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