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Delta scare, Hedgeye, 19 July 2021

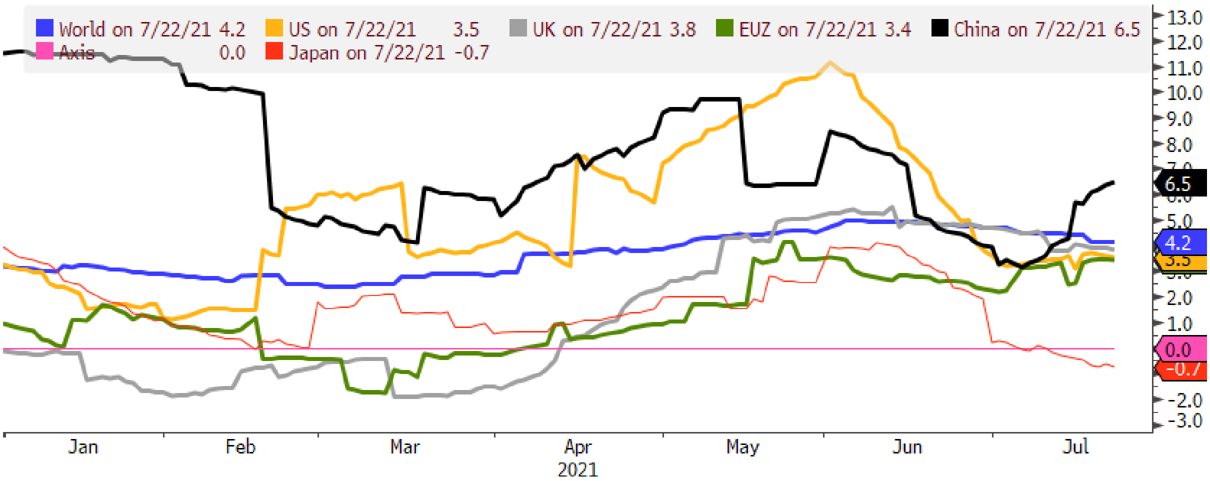
Markets wake up to living with the virus

It has been a week of ups and downs. Last Monday saw sunshine and relaxation as so-called 'Freedom Day' COVID restrictions were lifted in England. Investors did not join in the party, though, as major equity indices sold off around the world. Markets recovered most of those losses later into the week, but the episode marked an unwelcome return of volatility. Unfortunately, that market volatility has been matched by uncertainty in the underlying economy, as the spread of the virus continues to pose a threat to global activity.

Like everyone, we had hoped rapid vaccination programmes would bring some stability and respite to the world. Only a few weeks ago, markets seemed so convinced of this narrative that the main question for investors was not the virus but what comes after, namely how would the world economy fare through the transition and, indeed, what are we even transitioning too? Unfortunately, a global surge in the Delta variant has put that question on hold. Virus concerns are still ever-present in decision-making, for governments, businesses and individuals.

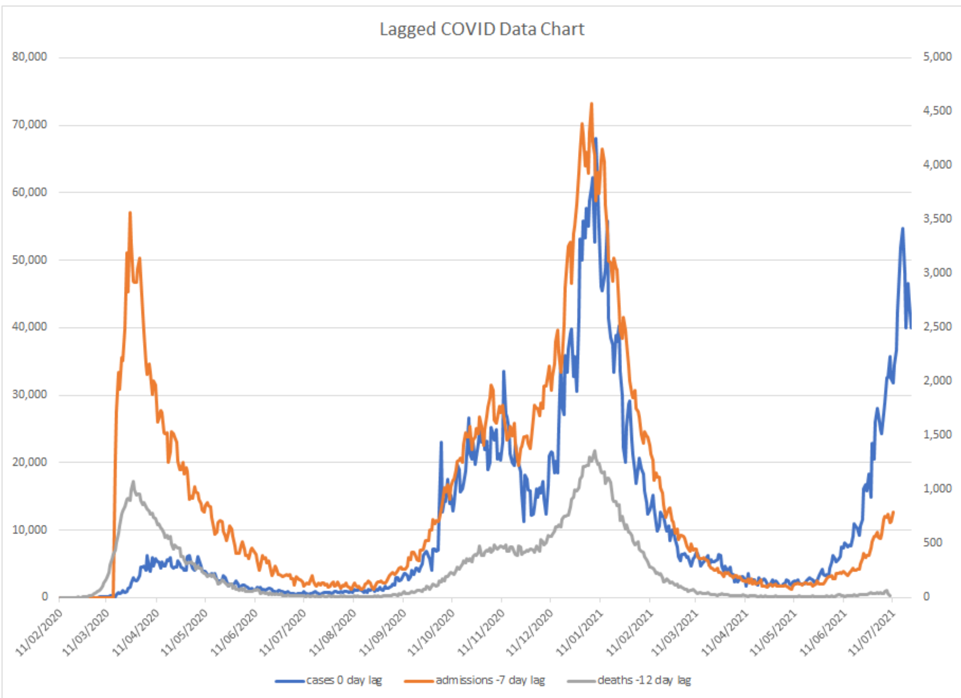
We can see this in the latest economic data – the so-called 'nowcasting' from JPMorgan. It is a measure of the current growth rates in the world's major economies, and estimates a snapshot based on the latest available data, adjusting for seasonal effects (so, without distorted base effects that can skew more traditional growth measures). As seen in the chart below, we saw a significant drop in growth throughout June. This was particularly pronounced in the US, which followed astronomical levels in the spring to a much more muted summer, and in Japan, which is now estimated to have sunk to a mild contraction.

JP Morgan Nowcasts YTD
Smoothed Monthly



Source: Bloomberg, Tatton IM, JP Morgan: G498
JNOWGLSM Index (JPMorgan Global Smoothed Monthly Nowcast (SMN)) JPM Nowcasts ytd Copyright© 2021 Bloomberg Finance L.P. 22-Jul-2021 20:10:25

Fears of continued restrictions or a health catastrophe are clearly weighing down economic sentiment. However, we note that the current virus spread within highly vaccinated populations still seems different from the negative impact of earlier in the pandemic. The chart below confirms hospitalisation rates in the UK are picking up, but for now at a slower pace than in previous phases. And, most importantly, the death rate is much lower (note that the data series flattens towards the end of the chart as the data lags). Should this continue, we expect economies to operate in a less restricted way while the virus still circulates. Another cautiously optimistic sign is that the case number displays some signs of peaking. Were this peak to come in the next few weeks, markets would certainly be pleased.



Source: https://coronavirus.data.gov.uk/details/cases, TattonIM.

For us, the primary concern had been that in such context – when societies find their way to live with the virus – policymakers may end the intense monetary and fiscal support too soon, choking off the recovery. But central banks have been at pains to reassure everyone of their dovish intentions. The US Federal Reserve (Fed) has been key in calming those market nerves, but support from the European Central Bank (ECB) has been equally important. Therefore, last Thursday's ECB's policy update was probably the event of the week.

ECB President Christine Lagarde offered clearer guidance (compared to previous updates) that interest rates will stay at current levels, or lower, until it sees progress in growth forecasts for the Eurozone. Officials also stated that the outlook for Eurozone inflation must reach 2% "well ahead of the forecast horizon". In other words, policy tightening would not happen just because the ECB foresaw inflation rising in two or three years' time. The revision in guidance was backed by an overwhelming majority of the ECB Governing Council, and it was taken as a dovish sign by news outlets.

We should point out a few things about the ECB release. First, its guidance was conditional rather than absolute, stressing that policy would have to be reactive to incoming data. Reports that the ECB is pursuing a "lower for longer" policy are therefore a little wide of the mark. If growth suddenly came in much stronger, the ECB is resolved to act quicker. Second, the change in forward guidance only concerns interest rates. There was no real discussion of the ECB's other policy tools, and Lagarde was coy on what undershooting the target might mean for its various support schemes. Third, Lagarde underlined that the ECB Council will use its own judgement when assessing the need to change policy, which means there is no automatic data or forecast-driven policy reaction function. That is not particularly new, but it is telling that Lagarde thought it worth emphasising.

For now, the ECB is looking ahead to the September projections for policy clues. No one knows what those will say, but they "will certainly have an impact going forward", according to Lagarde. Ultimately, the bottom line is that the ECB will allow inflation to run hotter than its target rate before it considers tightening policy. Even if that makes little change right now, it is significant that the central bank is moving to a reactive approach rather than a pre-emptive one. Officials at the Fed made the same pledges last year, to the warm approval of capital markets.

Closer to home, personnel changes for the Bank of England's Monetary Policy Committee (MPC) are generating some interest. A couple of weeks ago we mentioned that Andy Haldane's departure might mean others would shift slightly more hawkish. Michael Saunders was the prime candidate and he obliged quite quickly. He joined colleague Dave Ramsden in pointing out the Bank may stop buying bonds "fairly soon", which led to some gilt price underperformance versus other government bond markets.

Another new MPC member is Catherine Mann, who focused on the fragility of recovery in her confirmation hearing to the Parliamentary Committee. Her accommodative tone suggests she will join other dovish MPC members, at least in the near-term. Long-dated gilts outperformed US Treasuries by over 0.5% through the past week.

Central bank support is crucial for markets as economic expectations wane. In a further sign that the outlook is dampening, the US Dollar continued its strengthening against global currencies – usually a signal that investors are looking for safe haven assets. There were a few interesting short-term movements during the past week, and this Dollar strength came mostly at the expense of other developed market currencies like the Euro and Sterling. On the other hand, Emerging Market currencies, which tend to be correlated with risk-on sentiment, had days when they fared better. The Chinese Renminbi held up, but the Japanese Yen was a standout performer after a sharp upward move on Monday and Tuesday.

This fuelled speculation that a big Japanese investor might be reducing exposure to 'foreign' assets in both equities and corporate bonds, or that it might be linked to the woes of Chinese real estate firm Evergrande (touched on in the next article). Worries about contagion from Evergrande potential default have even led to comparisons to Lehman Brothers in 2008. While Evergrande is certainly big enough to cause problems and is comparable to Enron and WorldCom in its potential liabilities, it is far too soon to make the comparison, and Evergrande is unlikely to be anywhere near as systemically important as Lehman Brothers. Furthermore, it is clear the Chinese authorities have an eye on both Evergrande and the broader credit situation in the economy; indeed credit liquidity is a major policy tool in China and hence a negative surprise moment – or even black swan situation – is hard to envisage.

The summer holidays are upon us, and hopefully will mean peace, quiet, and lots of spending on leisure activities. Perhaps the US and EU central bank events in late August and September will be the next major focus. With thinner trading volumes expected, it would be nice not to have deal with anything significant for a few weeks yet.

China's fortunes rebound as property crackdown accelerates

One of China's top property developers is teetering on the edge. Evergrande Group, a Shenzhen based developer that was the world's most valuable real estate company in 2018, saw an almighty sell-off in its share price last week, tumbling to a four-year low on Tuesday. What was once deemed to be one of the company's great strengths is now on the verge of destroying it. A patina of credit quality allowed it to become Asia's largest private issuer of US$-denominated bonds, built up in a huge spurt from 2015 to 2017.

That was then. Now the Chinese government is intent on removing risks to the economy from both public and private sector leverage. Ms. Ruan Jihong, Director of Statistics at the People's Bank of China (PBoC) gave a speech last week in which she said: "We have effectively controlled financial risks in key areas. By the end of the first quarter, the shadow banking assets, non-standard credit assets, and non-standard capital in the financial system dropped by about one-fifth, one-fourth, and one-fifth, respectively, compared to historical records. We have been exploring risk control mechanisms in small- and medium-sized financial institutions, and made progress in installing risk control mechanisms in small- and medium-sized financial institutions with high risks. *We are also improving and establishing long-term financial regulation mechanisms for the real estate sector with a focus on stabilizing land prices, property prices, and people's expectations*" (emphasis is ours).

Authorities have had an eye on Evergrande for a while, especially on its leverage structure. This has now trickled into more concrete action. Last Monday, authorities in Shaoyang (a 'Tier 4' city, some 500 miles north of Hong Kong) halted sales at two of Evergrande's projects due to "a shortage of funds". Buyers of Evergrande's yet-to-be-built flats had paid up-front but the client money account showed only CNY 106 million, not the CNY 290 million expected. Evergrande wired CNY 128 million into the account and promised the rest when banks release their mortgage loans.

While Shaoyang allowed Evergrande to restart sales, some of the developer's banks are now trying to stop it withdrawing deposits. Meanwhile, a local court froze the deposits of Evergrande subsidiary Hengda, after the latter missed several debt payments. Then on Wednesday, four of Hong Kong's biggest mortgage providers (including Bank of China and HSBC) stopped lending to buyers of the group's unfinished apartments. The latest twist is that HKMA – Hong Kong's de facto Central Bank – questioned this move, and authorities now seem intent on avoiding a broader credit crunch emanating from Evergrande

In many ways, Evergrande is a symbol of China's rapid economic ascent over the last few decades. Stellar growth in the world's second-largest economy has been accompanied by mass urbanisation and some of the quickest and most intense property development ever seen. Evergrande has been a key beneficiary of this, specialising in upscale city apartments for China's growing upper-middle class. The group even owns its own football team in Guangzhou, a further symbol of the country's newfound riches. Evergrande's business model is a reflection of modern China: it used client money paid upfront for future developments as collateral, leveraging that cash to fund expansion at breakneck speed.

Evergrande's role in China's boom made its chairman Hui Ka Yan an influential figure, and one of the richest men in the world. But recent years have been less kind. As a result of China's burgeoning corporate debt pile, Beijing is now more concerned with economic stability than rapid growth. While the rest of the world's central banks slashed interest rates and poured cash into their financial markets through the pandemic, Chinese authorities were some of the few among major economies to tighten liquidity provisions – just as they abandoned strict growth targets for the first time.

The Chinese government has been reining-in excessive debt for years, but last summer it decided to clamp down on highly leveraged property developers by bringing in balance sheet metrics known as "three red lines". This move led to fears over Evergrande's ability to refinance its bloated debt pile which, at $88 billion, stands at 224% of its shareholder equity.

A potential Evergrande collapse might be a problem for the banks, and for the wider Chinese economy, given how deeply it is woven into the wider corporate fabric. President Xi Jinping has repeatedly affirmed his commitment to deleveraging and reining-in corporate excess. On a deeper level, over the last few years the Communist Party has shown its eagerness to clamp down on private companies or individuals considered as too big or powerful. We saw this last year when officials cancelled the initial public offering

(IPO) of fintech firm Ant Group. More recently, officials launched a cyber security probe into ride-hailing company Didi mere days after its listing on the New York Stock Exchange. The investigation caused Didi's share price to plummet from its IPO level and sent many of China's tech start-ups scrambling to reconsider their foreign stock listings.

There are many parts to this story. For China's tech sector, it means a tightening of regulations and a closing-off of loopholes that allowed for foreign financing and rapid expansion. For the financial system, it signals a reorientation away from overseas financing towards domestic investment. And for corporate China, it is yet another reminder that The Party comes first and will not hesitate to step in when private actors become too big for their boots.

These factors all play into one another. Chinese companies' reliance on overseas funding is a consequence of its heavy restrictions on domestic investment – which make it extremely difficult for firms to raise cash through equity sales. That also pushes businesses to load up on debt rather than list their shares in the mainland.

Many companies have chosen to borrow from shadow banks rather than the commercial banks whose processes are not unresponsive. As mentioned earlier, the PBoC is trying to change this, but its 'stick' looks a bit bigger than its 'carrot'. It will be vital to establish a functioning corporate funding system such that corporates can thrive. The growing tensions between the US and China give an extra urgency to the situation. Beijing wants to fund its economy without inflating the credit bubble or selling off its assets abroad. The best way to do that is to utilise its citizens' household savings, but that will require significant structural changes, which takes time. In the meantime, the Chinese economy needs an extra boost of impetus.

Sure enough, that is now exactly what we are seeing. Despite the relative policy tightness in China throughout the pandemic – in terms of monetary policy and corporate clampdowns – authorities now seem to be easing conditions. Reserve requirement ratios for banks were cut in the last few weeks, while China's total social financing (a measure of how much liquidity the financial system provides to the economy) in June was its highest since the beginning of the year. In fact, after having been a laggard in liquidity injections among the world's central banks, China now appears to be stepping on the pump while others might be easing off.

At the same time, while developed world economies have come off the boil, we have seen several positive surprises in China's economic data. Total social financing for June rebounded by quite a lot more than was expected, even taking into account the usual seasonal jump. While comparisons with last year still make the growth level relative to GDP (known as the credit impulse) look negative, the authorities appear to be allowing relative credit growth to resume in comparison to 2019 levels. This is backed up by PBoC liquidity injections into the money market and lower short-term money market rates.

China's recent equity market has improved – even outperforming the Eurozone – despite the problems at Evergrande and the crackdown on Chinese tech, suggesting investors have become more confident this marks a turn in China's medium-term economic outlook.

Over the longer term, the loosening of domestic investment restrictions should add to this positivity. Government clampdowns are a caveat to this, but we should expect those to be focused on China's large and powerful private companies, while its small and medium-sized firms could thrive by comparison.

Restructuring the Chinese economy could become a great secular growth story, but in the meantime, it may be wise to focus on the cyclical development.

The first signs of an improved growth outlook come just as market optimism may be waning in the western world. From a broader viewpoint, this shows an interesting disconnect between China and the world's other major economies – to the extent that Chinese assets could act as a tool for diversifying investments. For cyclical assets like emerging markets, this is a positive sign. Politics might make problems for big Chinese companies, but the overall outlook is good.

26th July 2021

Global Equity Markets

Market	Fri 14:19	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7021	+0.2	+13	→	↗
FTSE 250	22840	+1.7	+373	→	↗
FTSE AS	4021	+0.5	+18	→	↗
FTSE Small	7310	+0.6	+43	→	↗
CAC	6555	+1.5	+95	→	↗
DAX	15665	+0.8	+125	→	↗
Dow	34823	-0.5	-164	→	↗
S&P 500	4367	+0.2	+7	⬀	↗
Nasdaq	14685	+1.0	+141	↗	↗
Nikkei	27548	-3.7	-1060	↘	↗
MSCI World	3047	+0.7	+22	→	↗
CSI 300	5089	-0.1	-6	⬂	↗
MSCI EM	1326	-1.0	-14	⬂	↗

Top 5 Gainers

Company	%
3i	+11.2
Next	+8.4
Burberry	+6.7
Intermediate Capital	+6.6
Taylor Wimpey	+6.5

Top 5 Decliners

Company	%
Unilever	-5.7
Avast	-5.6
Fresnillo	-5.0
Reckitt Benckiser	-4.4
Polymetal International	-3.8

Currencies

Pair	last	%1W
USD/GBP	1.376	-0.0
GBP/EUR	0.855	+0.3
USD/EUR	1.18	-0.3
JPY/USD	110.53	-0.4
CNY/USD	6.48	+0.0
Bitcoin/$	32,449	+2.5

Commodities

Cmdty	last	%1W
Oil	73.59	+0.0
Gold	1800.9	-0.6
Silver	25.21	-1.8
Copper	438.1	+1.1
Aluminium	2483.0	-1.4
Soft Cmdties	443.7	-1.7

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.4	19.2	13.1	14.1
FTSE 250	2.3	17.3	24.3	15.7
FTSE AS	3.2	18.7	14.1	14.3
FTSE Small x Inv_Tsts	1.7	17.2	-	15.3
CAC	2.2	25.7	17.5	14.8
DAX	2.3	17.1	15.0	13.4
Dow	1.7	20.2	19.6	16.3
S&P 500	1.3	26.7	22.6	17.4
Nasdaq	0.6	33.8	33.8	22.6
Nikkei	1.6	17.0	18.2	17.6
MSCI World	1.7	24.1	20.5	16.5
CSI 300	1.7	17.6	15.5	12.5
MSCI EM	2.0	14.6	14.0	12.5

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.60	-0.02
UK 15-Yr	0.90	-0.05
US 10-Yr	1.31	+0.02
French 10-Yr	-0.07	-0.05
German 10-Yr	-0.40	-0.05
Japanese 10-Yr	0.02	-0.01

UK Mortgage Rates

Mortgage Rates	Jul	Jun
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.37	1.43
3-yr Fixed Rate	1.64	1.69
5-yr Fixed Rate	1.60	1.65
10-yr Fixed Rate	2.57	2.57
Standard Variable	3.62	3.62

* 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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CAMBRIDGE
INVESTMENTS LIMITED

26th July 2021

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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