CAMBRIDGE
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Struggles with the universal staying at home order; Graeme Keyes, 1 April 2020

Unprecedented quarter or calm before the storm?

Last week marked the end of the first quarter of 2020. Rarely if ever does it happen that one news story swamps all else as much as the coronavirus pandemic has, but in the future we probably will not remember much else about the last three months. The economic and financial news stories and outlook pieces at the beginning of the year hardly seem relevant now, but it is worth looking back – if only to put this crisis (and what might happen when it subsides) into context.

Even before the first case of coronavirus made headlines, the global stock markets were in a precarious position. Global growth slowed notably in 2019 and, while there were some promising early signs of a recovery, we were still waiting for tangible improvement. This was in stark contrast to the mood in capital markets, which seemed to be banking on the renewed monetary push from central banks of Q4 2019 and a steadily rebounding global economy showing up in the economic data flow. Easing trade tensions between the US and China, plus the manufacturing sector coming out of its third midcycle slowdown of the past decade, had many investors decidedly bullish. As a result, the equity rally that had been building since the Autumn continued, despite corporate results not (yet) living up to lofty expectations.

This led to concerns that if rebound expectations were delayed, then equity valuations (price-to-earnings-ratios) were becoming quite stretched and vulnerable to corrections. As has repeatedly been the case in recent years, this was coupled with a general anxiety that the longest business cycle ever had to end sooner or later, bringing down the ten-year bull market with it. We, like others, pointed out that economic cycles do not die of old age: they end because of central bank action (either forced or through error) or external shocks. As long as the business environment remains stable, and markets have enough liquidity, growth keeps on going.

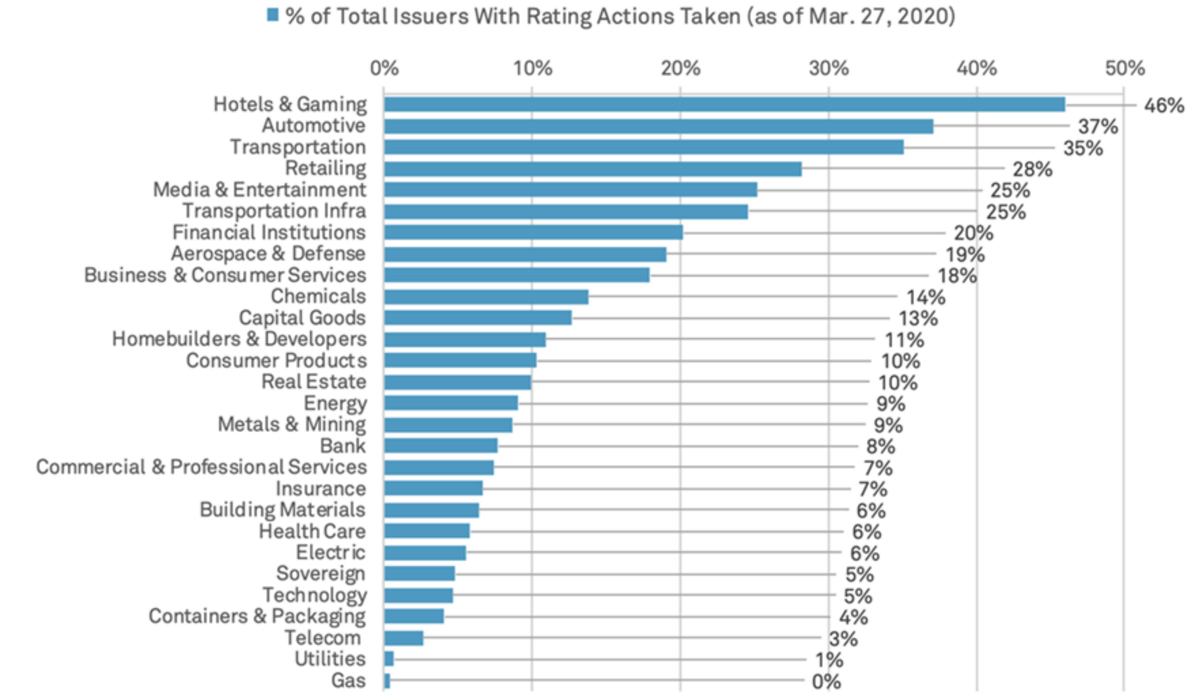
At Cambridge, we took a cautiously optimistic stance, keeping portfolios broadly in a neutral position, but with a 3% overweight towards Emerging Markets and in particular China, where a massive fiscal stimulus package was being put together.

Of course, we all quickly learned that the mother of all external shocks was just around the corner. After initially brushing off coronavirus as a problem on the other side of the world, which was based on the historical experience of the first SARS virus outbreak in 2003, on 20 February, markets realised the potential gravity of the situation. Over the next month, the S&P 500 lost 34% of its value, and all the world's major equity indices entered official bear market territory (defined as a stock market decline in excess of 20%). Government orders shuttered the global economy, ending the longest expansion cycle in history, and plunging us all into a deep recession.

To make matters worse for markets, two of the world's largest oil producers – Saudi Arabia and Russia – decided they could no longer deal with the supply glut that had been building through production cut compromises – resulting in a hugely untimely price war. This sent crude oil into free-fall and left energy producers (who usually provide market support through large capital expenditures) uncertain about their ongoing ability to service their capital, be it debt or equity. It resulted in crude oil's worst quarterly performance on record, as shrinking demand was met with burgeoning supply – almost maxing out storage capacity. We cover this in a separate article below.

Initially, the market reaction could have been described as rational, stock markets fell by around 10% as investors revised their expectations. Safe-haven assets like gold and government bonds initially shot up, with bond yields (the inverse of price) sinking to historic lows. But the sell-off worsened, which led to a self-perpetuating downward spiral. When shoppers began panic-buying staples such as toilet paper and hand sanitiser out of a natural urge to 'do-something', investors fell victim to a similarly irrational 'sell anything that is liquid' cash-grab mentality. For a while, even the safe havens suffered losses – the complete opposite of the 2008/2009 sell-off. Most sectors of the economy were now feeling the pain – though far from equally. The chart below shows the sectoral breakdown of companies facing ratings downgrades.

Sector Impact of COVID19 and Oil Price War



Source: S&P Global Ratings. Data as of Mar. 27, 2020

At the point when policymakers were weighing up the costs of a global economic depression and a virus death toll comparable only to the 50 million deaths caused by the 1918-1920 Spanish Flu pandemic, governments and central banks stepped in to make clear they would "do whatever it takes" to prevent such an outcome. Central banks acting as the unlimited 'buyer of last resort' in capital markets decisively ended the 'dash-for-cash' spiral. Fears that capital markets would saddle global society with a financial crisis on top of the health crisis were decisively quelled.

In combination with government support measures aimed at preventing the unintended consequences of a complete economic shutdown, this calmed investors' fears of a complete and lasting economic meltdown. While corporate earnings prospects for 2020 remain dire or at least completely uncertain, the likelihood of a collapse of the corporate debt markets now appears more limited.

In terms of recovery hopes, the main shining light has been the sheer size of the support measures undertaken. The US Federal Reserve led the way by lowering overnight rates to zero and pledging virtually unlimited funding for buying government debt and even private sector credit, which is a novum for the US. An international USD shortage was addressed by extending USD swaps to the central banks of 14 countries. Other central banks took similarly unprecedented measures and, crucially, governments took the opportunity to unleash a wave of fiscal bridging support and stimulus for the time when economic activity restarts.

In the UK, emergency government spending measures will cost around 2.5% of GDP (depending on the uptake of the furloughed worker scheme). A further £330 billion of business guarantees and loans should help steady the ship for the rough ride ahead. In the US, the Senate passed an emergency response bill of just over USD 2 trillion, equivalent to 9% of GDP.

The European Union (EU) has yet to settle on a coordinated fiscal response, but most major economies, including Germany, announced substantial measures to see workers and businesses through. These measures are almost entirely to be paid for by government borrowing, which itself can be 'monetised' by central banks' extraordinary measures if required to keep interest rates and longer terms yields steady. In effect, central banks have been authorised to print/create money for governments to use in short-term emergency spending. That may indeed cause problems further down the line, but as global policymakers have almost all realised, right now, there is simply no other choice.

When looking at the numbers, comparisons to the financial crisis – or even the great depression of the 1930s – are not hard to find. But rather than reeling off scary statistics, the key question is: how bad will the damage be? The answer to that depends on how long this forced hibernation lasts, and what the authorities do in response.

While China's re-emergence after barely eight weeks of social distancing and shut-down are encouraging, neither the US and Europe has reached the 'peak' of the virus and may not for some time. However, the quick and decisive economic response from governments is encouraging. In an ideal scenario, measures would be perfectly timed and targeted to get just enough money to keep businesses and individuals tied over so they can resume their usual spending patterns once the lockdown is lifted. In that ideal case, we would see a sharp V-shaped recovery, where growth returns exactly as before.

Of course, in the real world, perfect timing and targeting are not possible. Some businesses will suffer irreversible damage, bankruptcies will rise and so too will unemployment. If the collateral damage proves too much, a prolonged 'U-shaped' recession could set in (or, in the extreme case, the dreaded 'L-shaped' permanent deterioration). But given the measures already in place, there will be winners too. The emergency fiscal and monetary measures may last longer than the lockdown itself, after which the added stimulus could lead to a strong rebound – particularly if pent-up demand comes out all at once. As outlined before, in that case an overshoot on growth and inflation seems more probable than a prolonged downturn.

Or in other words, monetary and fiscal policy can play a crucial role in limiting the collateral damage, but pandemic and virology science will determine the timing and success of the recovery. Whatever the case, the determination to avoid economic disaster is clear among policymakers. There are certainly challenges to overcome on that front (Germany and the Netherlands' blocking of the Eurozone 'coronabond' being a prime example).

'Tumultuous' would be an understatement when describing the first quarter of 2020, 'unprecedented' captures reality more adequately, but is also a frightening adjective.

Asset Class	Index	Q1/2020	2019	3-yr rolling annualised	5-yr rolling annualised
Equities	FTSE 100 (UK)	-23.8	17.3	-4.1	0.6
	FTSE4Good 50 (UK Ethical Index)	-23.7	13.9	-6.1	-2.7
	MSCI Europe ex-UK	-17.5	20.0	-2.3	-1.0
	S&P 500 (USA)	-14.1	26.4	5.4	10.6
	NASDAQ (US Technology)	-4.2	34.1	14.1	13.8
	Nikkei 225 (Japan)	-11.1	15.0	-0.1	-0.3
	MSCI All Countries World	-16.0	21.7	1.5	2.8
	MSCI Emerging Markets	-18.4	13.8	-1.6	-0.4
Bonds	FTSE Gilts All Stocks	6.3	6.9	4.6	4.7
	£-Sterling Corporate Bond Index	-5.6	11.0	1.8	3.2
	Barclays Global Aggregate Bond Index	6.5	2.7	3.8	6.4
Commodities	Goldman Sachs Commodity Index	-38.4	13.1	-13.3	-12.8
	Brent Crude Oil Price	-57.3	17.9	-21.0	-14.1
	LBMA Spot Gold Price	12.6	14.2	8.9	6.4
Inflation	UK Consumer Price Index (annual rate)*	0.1	1.3	-	-
Cash rates	Libor 3 month GBP	0.2	0.9	0.6	0.6
Property	UK Commercial Property (IA Sector)*	0.4	-0.8	2.0	2.2

Data sourced from Morningstar Direct as at 31/03/20. * to end of previous month (29/02/20). All returns in GBP

The table of asset class returns for the quarter isn't pretty, but it conveys the pain that investors have endured since the year began. However, the three and five year annualised figures also show that the longer-term investment time horizons that our portfolio investors base their planning on have not been disproven, in spite of the first quarter's events. The returns also illustrate why diversified investment portfolios, made up of holdings across many asset classes, generate significantly less extreme returns when compared against single asset class investments.

The levels at which the crash left stock market valuations at quarter-end reflect investor uncertainty and negative expectations around both the global economy and corporate results in the near term. However, compared to the lower levels plumbed just a week before the quarter ended, concerted actions taken to protect economies and private households have created something like a 'safety net', which appears to have been accepted as averting the very worst outcomes – including a full-blown financial crisis.

For now, capital markets have stabilised and there is a healthy improvement of sentiment based on the good that can come from the sheer size of intervention packages over the longer term. That said, even the boldest policy actions cannot prevent the misery that the coming weeks and months will bring – not only to those affected by the virus itself, but also in the economic collateral damage brought in by the social distancing measures aimed at limiting the loss of human life.

We should remain realistic and accept that as long as virologic or behavioural science cannot provide a more definitive time frame for the economic suppression, then assessments of the likely economic cost, and thereby justified discount to stock market valuations, remains impossible.

As the shut-down progresses, the economic pain of individual corporate defaults and the 'scaring' from mass-unemployment (and underemployment), are likely to depress market sentiment again. This bear market is therefore likely to progress along the lines of historical precedent, with the crucial difference that if any form of medical advancement is found, forward expectations can improve just as rapidly. Overly active portfolio management in such an unpredictable environment remains challenging, but also carries the prospect of generating long term value.

Cambridge's investment team is therefore decidedly busier than most employees around the world. In our upcoming investment committee meeting we will determine the future course of portfolio activity.

We are satisfied with the way we constructed risk-profiled, diversified portfolios for our clients, and that we held our nerve in what bordered on emotional market chaos around us. Our response ensured clients remained within the boundaries of what their risk profiles suggested to be possible and to be expected. While we are saddened for clients by the overall poor capital market returns, we do hope and believe that this 2020 market crash has born fewer surprises than many clients experienced during the 2008/2009 bear market.

Oil price slump – dangerous or stimulating for economy?

Source: Fabiusmaximus.com, 2012

When markets began their deep and lengthy sell-off at the end of February, fear of the coming global pandemic was the main driving force. But the sell-off deteriorated towards panic when an even more monumental fall in global oil prices took place. Just as lockdown measures began to loom over the world, Russia and Saudi Arabia, the world's two largest oil exporters, engaged in a price war by ramping up production. Saudi Arabia had previously pushed for the OPEC+ agreements on production cuts to be extended and deepened. But Russia's reluctance to do so led the Saudis to opt for a "pump at will" strategy, flooding the market and sending prices tumbling.

During trading on Monday, Brent – the international crude oil benchmark – fell to just $21.76 per barrel, its lowest level since 2002. Meanwhile, US benchmark WTI fell below the $20 mark. To show just how substantial a fall that is, in early January Brent was trading at just under $70 per barrel.

Of course, both equities and oil prices have been shifting because of the collapse in general activity. With the world's major economies in lockdown, near-term demand for oil has collapsed. Traders and analysts are expecting consumption of crude supplies to fall by as much as a quarter next month, as a result of the pandemic.

Over the longer-term, low oil prices should be a boon for other sectors of the economy, giving more room for growth. Surely, one might argue, this ought to be good for companies and share prices in general? Perhaps, but in recent times, the opposite has happened (in the short term, at least). Over the past decade, corporate capital expenditure (capex) has been low and contributed significantly less to economic growth than it has historically. The greatest positive outlier from this has been capex from energy companies, especially in US shale and pipeline developments. The financing for these, however, has come from relatively expensive high-yield bonds and loans, so when oil revenues fall, further development plans are pulled. In addition, the possibility of debt default rises, forcing investors to expect losses and to raise liquidity themselves.

It's not just shale development investors that need financial liquidity. Of the oil-producing nations, Saudi Arabia may have significant financial reserves, but it also has pressing near-term needs to finance the economy. In usual times, Saudi Arabia uses its oil revenues to finance near-term disbursements, keeping reserves in much riskier long-term assets. Indeed, they have been a major investor in hedge funds and similar types of investment. Now, they are being forced to dip into that rainy-day fund, to the detriment of overall market levels as their selling adds to selling pressures of others.

Oil prices and general equities look like moving together for some time, so what should we expect from here? Recent signals point to a potential détente in the price war. President Trump announced on Thursday that talks with Russia and Saudi oil producers would lead to a deal being made within a "few days", sending prices up more than 12%. But competing political interests, and the flimsiness of past agreements, has led to suspicions that prices could get much lower before a sustained turnaround arrives.

With production still expanding, and demand rapidly contracting, oil traders predict we could reach a surplus of 25 million barrels per day next month. That would overwhelm storage capacity – which is already near-full due to the supply overhang from the last few years. According to reports, the cost of hiring large crude tankers has more than doubled over the past week to $229,000 a day. Because of the lockdown, refineries have been cutting back on processing crude. And if producers keep sending them barrels with nowhere to put them, prices could quickly fall to zero or even negative.

Like everything else in these strange times, that would be an unprecedented move. Analysts and politicians have urged some sanity from Russia and Saudi Arabia to stop a total price collapse. But Saudi officials have reportedly told oilfield workers to prepare for a long fight.

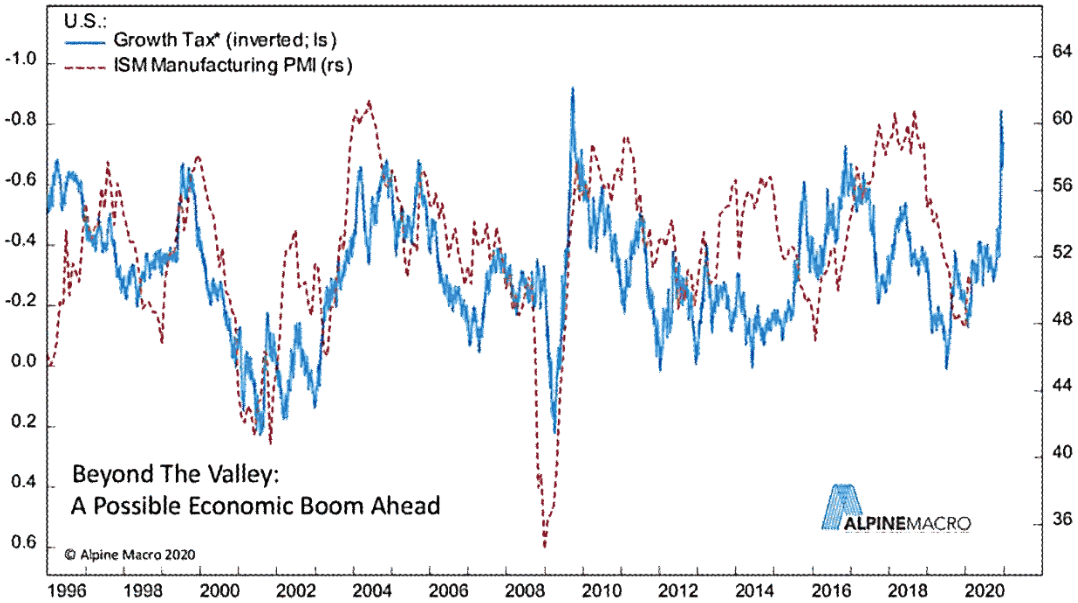
A few things are worth pointing out here. First of all, while pushing prices into negative territory might seem like a stroke of suicidal madness, there is still some incentive for Saudi Arabia and Russia to do so. US shale producers have been a thorn in the side of OPEC+ ever since their emergence some years ago. The Saudis have tried to drown them out of the market and claw back market share, but with limited success. Now, with many shale producers on the verge of bankruptcy and a substantial shortfall of demand, the old oil monopolists might see this as an opportunity to strike. If so, we should not expect a sustained agreement any time soon – despite President Trump's protestations.

Looking even further out, the effect on overall capex is one of the reasons why the energy sector is so important to the US. The other – possibly even bigger – reason why the US shale industry is important to

American politicians is the supposed need for energy security (of which Trump is a strong advocate). The US has only recently become a net exporter of oil and could, in theory, meet all their energy demand with domestic production.

If shale producers started going bust, US energy security would be under threat. It therefore seems likely the current administration would move to support the industry in the face of nosediving oil prices, taking advantage of much-increased intervention powers due to the coronavirus crisis. Such emergency support could help on the capex front, but would only prolong the oil price war.

Over the medium-term, however, that may not be such a bad thing. High oil prices and interest rates are two of the major barriers to global growth, effectively acting as taxes on economic activity.



*Combination of the dollar, oil price and interest rates, standardized and advanced by 9 months

As Alpine Macro show in the above chart, the main positive to take from all this is that with both oil prices and interest rates set to remain low, when the world eventually returns to normal, there should be a solid base for global growth.

Dividend cuts follow yield declines

Companies across the developed world are cutting dividend payments amid the current economic paralysis. For investors – particularly those with income portfolios who rely on regular payouts – this confirms the damaging effects that six weeks of capital market chaos have had on portfolio values.

For many, the choice to cut dividends is out of their hands. Earlier this week, British banks were told by the Bank of England to jump before they were pushed on slashing shareholder payouts. HSBC, Barclays, RBS, Lloyds and Standard Chartered all cancelled payments of their 2019 dividends on Tuesday, and announced they were withholding 2020 dividends and buybacks. UK bank shares plunged in value after their announcements, but given the unprecedented global crisis, this is hardly surprising.

In the US, companies are cutting dividends at a rate not seen since the 2008/2009 Global Financial Crisis, with 21 companies in the S&P 500 index trimming payouts. Meanwhile, those borrowing from the government will not be allowed to pay a dividend nor opt for share buy backs. In Europe, insurers as well as banks have been told to stop dividends.

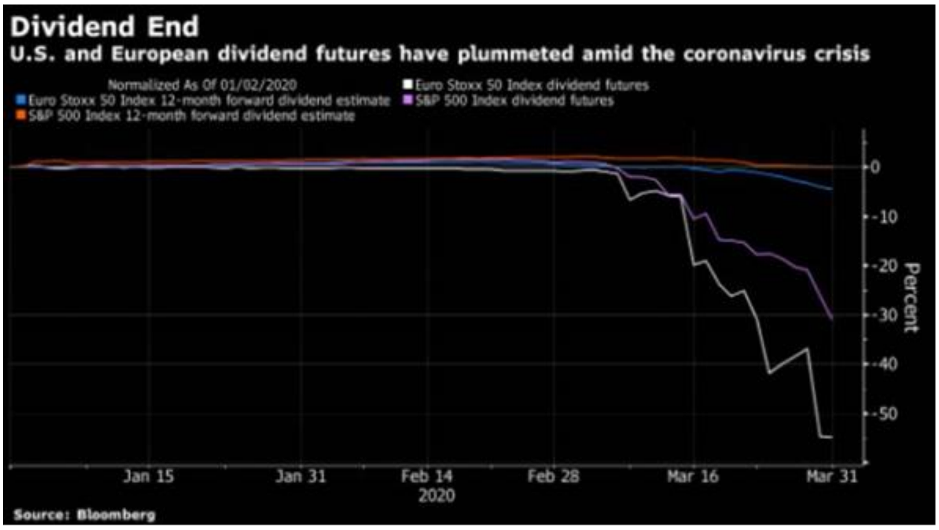
When a crisis hits, shareholders are behind debtholders and workers in the queue to be paid – understandably, given their role is to provide capital and take on a certain level of risk. Even if companies have surplus profits, the authorities can stop them from being handed out, as we are seeing now. Such is the trade-off that companies now face for relaxed regulation (in the case of banks) or state aid (for businesses receiving grants or guarantees).

Not all businesses cutting dividends are being told to, however. Slashing payments is also a way for companies to preserve their balance sheets for the economic hibernation ahead. Future cash flow, like everything else right now, is deeply uncertain – meaning that companies need to reserve cash on hand to pay their debt obligations or staff. While this is a negative for equities (since it means withholding dividends) it may be a positive for credit (since companies are less likely to default).

Looking beneath the headline figures, Europe is more exposed to dividend issues than the US, since the sectoral makeup of Europe is more skewed towards dividend-paying companies, such as financials or utilities. In the US meanwhile, high-growth but low yielding stocks – the big tech mega-cap names like Google and Amazon – have dominated the stock market for years.

In this highly unusual recessionary environment, many of the traditional high yielding sectors are more exposed. British banks may have slashed shareholder payouts, but the energy and property sectors are facing similar problems too. Not all high yield sectors are in danger however, with healthcare currently in very high demand.

These effects can also be seen in the difference of dividend yields that major European and US stock markets have traditionally paid. For the S&P 500, the dividend yield from 2016 to 2018 settled around 2%, whilst the Eurostoxx 600 yielded 3.5%. Given these factors, markets are already pricing in more dividend cuts in Europe than in the US. Expectations of future dividends are far from rosy anywhere but, as the chart below shows, more European companies are likely to slash dividend payouts than their American counterparts.



So, bad news for income portfolios, which could translate into a big hit to pension payouts. It is worth pointing out, however, that the poor performance of equities since the end of February has also been accompanied by a sharp fall in government bond yields, even if they have risen somewhat in the 'capitulation' phase of the current bear market. Since yields are the inverse of price, bonds (which make up a high proportion of income portfolios) have done relatively well. But in terms of what this means for investment strategy, we are left with two key considerations: Do lower bond yields mean that investors will accept lower equity dividends? Will investors, once again, turn towards dividend-yielding companies?

A reduction in 'risk free' government bond yields towards zero and below should increase the attractiveness of equities, even if the payouts are lower, especially once some earnings uncertainty can be removed. And, looking at the last five years, this seems to be the case. As yields for government bonds with ten years to maturity rose in 2016 (so the opposite to now), the MSCI world headline index outperformed its high dividend counterpart.

The current situation is of course very specific, as social distancing measures produce an unusual pattern of corporate winners and losers. This means the jury is still out on whether investors in aggregate will display a preference for big corporates with stable earnings outlooks but low yields (tech, FANG). In any case, it is important to keep in mind that income-seeking investors also face lower government yields, which takes away some of the pain related to the current dividend cuts – but only in relative, not in absolute terms.

Meanwhile, although it is undoubtedly painful to forego today's dividends, it should mean dividends being paid later. If the shoring up of cash reserves helps build confidence in the robustness of companies, investors should be rewarded for their patience.

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6th April 2020

Global Equity Markets

Market	FRI 16:49	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	5406.2	-1.9	-104.2	↘	↘
FTSE 250	14101	-4.5	-668.7	↘	↘
FTSE AS	2953.7	-2.3	-68.2	↘	↘
FTSE Small	4122.4	-0.3	-11.5	↘	↘
CAC	4153.1	-4.6	-198.4	↘	↘
DAX	9526.3	-1.1	-106.2	↘	↘
Dow	21011	-2.9	-625.9	↘	↘
S&P 500	2493.8	-1.9	-47.6	↘	↘
Nasdaq	7520.2	-0.9	-68.1	↘	→
Nikkei	17820.2	-8.1	-1569.2	↘	↘
MSCI World	1803.1	-1.3	-24.1	↘	↘
MSCI EM	838.5	-0.5	-4.0	↘	↘

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
Imperial Brands	18.8	Carnival	-37.6
Hikma Pharma	14.9	Rolls-Royce	-31.2
Royal Dutch Shell	14.1	Melrose	-29.0
Royal Dutch Shell	13.7	Legal & General	-23.9
Brit-AM Tobacco	13.5	Informa	-21.9

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.221	-2.0	Oil	32.94	32.1
GBP/EUR	0.883	1.2	Gold	1613.3	-0.9
USD/EUR	1.08	-3.2	Silver	14.33	-1.0
JPY/USD	108.60	-0.6	Copper	219.6	-0.1
CNY/USD	7.09	0.1	Aluminium	1491.0	-2.9

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.31	-0.06
UK 15-Yr	0.55	-0.02
US 10-Yr	0.57	-0.10
French 10-Yr	0.08	+0.13
German 10-Yr	-0.44	+0.03
Japanese 10-Yr	-0.01	-0.03

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	5.9	15.4	11.7	13.3
FTSE 250	5.5	15.2	10.4	14.2
FTSE AS	5.8	15.9	11.4	13.4
FTSE Small	5.4	-	-	13.8
CAC	4.4	15.1	12.7	13.5
DAX	4.3	16.5	12.5	12.5
Dow	3.0	14.9	15.3	15.1
S&P 500	2.4	16.4	16.1	16.1
Nasdaq	1.2	23.1	21.0	18.1
Nikkei	2.4	15.8	13.9	16.9
MSCI World	3.0	15.9	15.0	15.3
MSCI EM	3.3	11.8	11.4	11.9

UK Mortgage Rates

Mortgage Rates	Feb	Jan
Base Rate Tracker	2.50	2.48
2-yr Fixed Rate	1.48	1.49
3-yr Fixed Rate	1.65	1.66
5-yr Fixed Rate	1.71	1.72
10-yr Fixed Rate	2.61	2.61
Standard Variable	4.26	4.24

* 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

For any questions, as always, please ask!
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enquiries@cambridgeinvestments.co.uk

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