THE **CAMBRIDGE** WEEKLY

14 April 2020

Lothar Mentel

Lead Investment Adviser to Cambridge

United we stand; Patrick Blower – 6 April 2020

Fading threat of financial crisis re-opens old divides

These "strange times we live in" are even stranger for those of us working in and around capital markets. Despite the COVID-19 death toll rising to horrifying and previously unthinkable highs, stock markets staged another phenomenal recovery week. At the same time, while economic data flow has only just begun to show the global economy's 'medically-induced coma' (since lockdown only began mid-March) it has already hit depressed levels never seen in our lifetimes. The very real pain felt by people most exposed to the economic shutdown is now starkly visible. Companies are warning everywhere about the risk of defaulting, corporate earnings expectations are in freefall, and we can only draw comparisons with the breadlines captured during the Great Depression era of the 1930s.

Yet stock markets have recovered somewhere between one-third and half of their late March losses. Did they overreact previously? And, as reality catches up with prior market expectations, are things turning out not to be quite as bad as originally feared?

Well, it is a bit more complicated.

What stock markets fear even more than lower corporate profits are corporate bankruptcies (defaults). These do more than just lower the expected return-on-capital; they put the return-of-capital in its entirety at highest risk. That is why we saw sheer market panic in the middle of March, which forced central banks to step in with all their might to prevent the virus crisis causing an all too unhelpful financial crisis on top. Effectively, the central banks' objective was to allay fears of mass corporate defaults by intervening in the debt markets to an extent that substantially lowers the risk of widespread defaults. At the same time, injecting vast amounts of additional liquidity helped satisfy the urge of so many to hold more of their capital in cash while the uncertainties of the virus crisis reign.

As we wrote before, this, together with government's fiscal support pledges, has put a safety net underneath capital markets. The sense of universal crisis has eased and markets are seemingly indicating – and forecasting – to the public and politicians that the collateral damage to the economy will indeed be quite limited. However, the extent of this ongoing recovery is quite possibly overshooting what authorities deemed necessary to prevent capital markets from disrupting society's attempts to contain the loss of life from COVID-19.

The issue is that nobody can know and the recovery in risk asset markets is most likely not suggesting a benign impact either. Markets are merely reacting to the double boost of much reduced default risks emanating from bond markets and plentiful liquidity from central banks.

Given we know the shutdown will end eventually, at which point the economy can be revived from its 'coma', it does indeed appear rational to buy those business assets at still much marked down prices, rather than be stuck in negatively yielding government bonds, especially when inflation is becoming a real possibility again.

So, here is the investment dilemma. Due to central bank pledges, markets have possibly attained a resilience to short-term bad news that is normally not part of the market valuation and investment behaviour equation. On the other hand, we may be experiencing a bout of artificial calm and exuberance in stock and bond markets, which underestimates what the true medium-term damage from the COVID-19 'economic coma' will be. If the pain to the economy drags on and the negative news-flow becomes overwhelming, while authorities simply execute what they have already announced without introducing ever new superlatives, then stock markets may well re-assess their fast-rising valuation levels against the backdrop of ever-faster falling earnings outlook expectations.

While I always like to end on a positive, it is difficult at the start of this week. Not only in face of the mass loss of human lives every day, but also because the recovering asset markets are creating frictions and opening up new divides which could become unhelpful. If wider society no longer feels that we are 'in this together' – because capital owners once again turn out to be the relative winners – then authorities will find it much harder to continue in their aim to protect the wider economy through fairly blunt but effective measures. There is also a real risk that last week's rise of political finger-pointing and lack of international cohesive action will deteriorate into an 'everyone for themselves' frenzy. In the short-term at least, all eyes are on the European Union's ability to agree an act of fiscal solidarity to heal some of the divisions that have arisen between countries of the less affected north and the truly virus-ravaged south. We dedicate a separate article to this issue below.

European Fiscal Policy is seldom EZ

The one shining light throughout the coronavirus crisis has been policymakers' willingness to commit to substantial and decisive economic measures. Central bankers were among the first officials to put their heads above the parapet and ensure the financial system had enough liquidity to see it through this economic hibernation. The US Federal Reserve (Fed), European Central Bank (ECB), Bank of England and Bank of Japan have all effectively written blank cheques to their respective governments – by pledging the monetary firepower needed to keep yields and short-term lending rates stable. For the most part, governments have begun to cash in those cheques. In Britain, China and the US, politicians have promised billions – or even trillions – in fiscal spending to stave off the economic disaster that would otherwise come with the lockdown.

The G20 meeting a week ago talked of a "coordinated response". In one sense, the responses are coordinated. They are generally similar monetary and fiscal measures, happening at the same time, and all agree that the measures are necessary.

The Fed and the ECB have been acting with a broad remit in mind. The ECB crosses national boundaries because of the Euro's nature. The Fed has a responsibility foisted on it by the US dollar's role as the main currency for international trade and finance.

However, there is little evidence that the separate nations are acting to help each other. For the European Union (EU), the current circumstances question its very existence. All EU member states have pledged their own response packages for the pandemic. And yet, faced with an insidious alien threat, surely this is the moment of greatest union, of greatest solidarity?

However, despite the EU finance ministers talking for two weeks, at the time of writing, a unified response has yet to be achieved. There are two overarching problems. The first is directly political.

For years, incumbent European politicians have spoken of unity and common purpose. They have personally committed, to each other to build solid EU structures. Yet their electorates are not so sure. In the nations with historically less fiscal discipline, those commitments were made by people who currently have no influence. The EU structure of relying on national politicians for its decision making is destabilised by national democracy. And, even if they agreed to borrow money together and to spend it on the areas that needed it when they needed it, they didn't build any mechanisms ahead of time. A legal framework is yet to come together to allow mutualised debt or fiscal union, and so is political will to slog through making one.

Earlier this week, the Eurogroup – a group of finance ministers from Eurozone members – carried a virtual meeting through the night into Wednesday morning, but could not come to an agreement on emergency spending measures. The key dispute (reportedly between Italy and the Netherlands) is over what conditions should be attached to emergency loans from the European Stability Mechanism (ESM). But without an agreement on that front, no overall joint plan for the crisis and post-pandemic recovery can be agreed.

The Eurogroup is currently reconvening and may well have come to agree a proposal by the time you read this. We expect they will. But the fact that no joint plan could be agreed – despite most of the continent having been in lockdown for weeks – speaks volumes about European political disarray. French finance minister Bruno Le Maire was candid about the lack of progress: "As we are counting deaths by hundreds and thousands, ministers of finance are playing on words and adjectives. That's a shame for finance ministers, a shame for the Eurogroup and a shame for Europe."

The ESM has a €500bn bailout fund ready to deploy, but Dutch and Italian ministers were at loggerheads over how loans from the fund should be structured. Italy wants emergency funding with no conditions on further economic reforms down the line, while the Netherlands has made it clear they will not accept this. Both sides have a point. The Hague wants emergency measures to be done within the existing framework to ensure long-term stability and avoid the risk of fiscally prudent members like themselves being on the hook for the past profligacy of others. Rome wants to avoid a situation where taking emergency loans now puts their entire economy and political system at the mercy of the troika further down the line.

Indeed, what makes the lack of progress so frustrating is that both arguments are understandable – because they have been around since at least the inception of the euro. It is a tired routine: one side (usually Italy, Spain or Portugal) wants some form of minor fiscal collectivisation or debt mutualisation so bond investors do not need to differentiate in their pricing between stronger and weaker EU member states which keeps the interest they have to pay low. Meanwhile, the other side (usually Germany or the Netherlands) says there is no hope of agreeing to the proposals, after which the situation descends further into gridlock until some other emergency measures (usually from the ECB) have to be put in place to stabilise things. Rinse and repeat.

In the early stages of this week's meeting, Italy demanded that the word "coronabonds" – debt mutualisation just for this crisis – be explicitly mentioned in the agreement. The Dutch minister rejected this suggestion out of hand. Even previous holdouts have agreed that something must be done to break the logjam. German minister Olaf Scholz urged that credit lines from the ESM "shouldn't mean that commissars come to your country, or the troika, and develop programmes for the distant future, like ten years ago". Meanwhile, the EU's budget commissioner told the press this week he wants to change the bloc's multiannual financial framework so as to allow the commission to raise more debt in capital markets.

We wrote before that this crisis could be the one that finally ushers in a European fiscal union, the crucial and undermining omission when the monetary union was set up. But from what we have seen in negotiations so far, it looks unlikely that any comprehensive arrangement will be reached. Some of the fiscally prudent northern countries do appear more willing to compromise, but whatever deal is reached will likely be more focused on easing stringent budgetary rules for member states – even if only temporarily.

Just like the Eurogroup itself, any emergency coronavirus measures taken by the EU will likely be a fudge of new and existing policies rather than anything comprehensive. This will, unfortunately, leave many of the old structural problems right where they are. But it should remove the biggest economic tail risk of all of this – a dissolution of the EU itself. Besides, fudge agreements are in many respects all the EU has ever been: The 'ever-closer union 'integrates one crisis at a time.

China proves that where there's a will, there's a way

As the coronavirus crisis deepens across the western world, governments have resorted to increasingly harsh lockdown measures. But in contrast to the pictures of empty streets in Rome, Paris and London, this week we passed a significant landmark on the road to recovery.

On Wednesday, Wuhan – the epicentre of the coronavirus outbreak – emerged from its official lockdown. For 76 days, the Chinese city of 11 million people endured probably the toughest and most extensive quarantine measures in history. From mid-February, citizens were not allowed to leave their homes, not even for essential food or medicine. They had to rely on delivery services.

Now, provided they do not have the virus, residents can emerge from their isolation. After a dramatic drop in new cases of the virus, Wuhan's motorways, airports and railway stations are open again.

It is still early days, but we are beginning to see similar restrictions loosening across China. Most bars and restaurants remain closed, but shops are opening in the major cities and people are being allowed back to work. China was the first country hit by the virus, and its response was quick and drastic. That it should lead the way back to normality should be no surprise, but it is heartening all the same. We know this virus can be beaten, and China provides the roadmap to recovery.

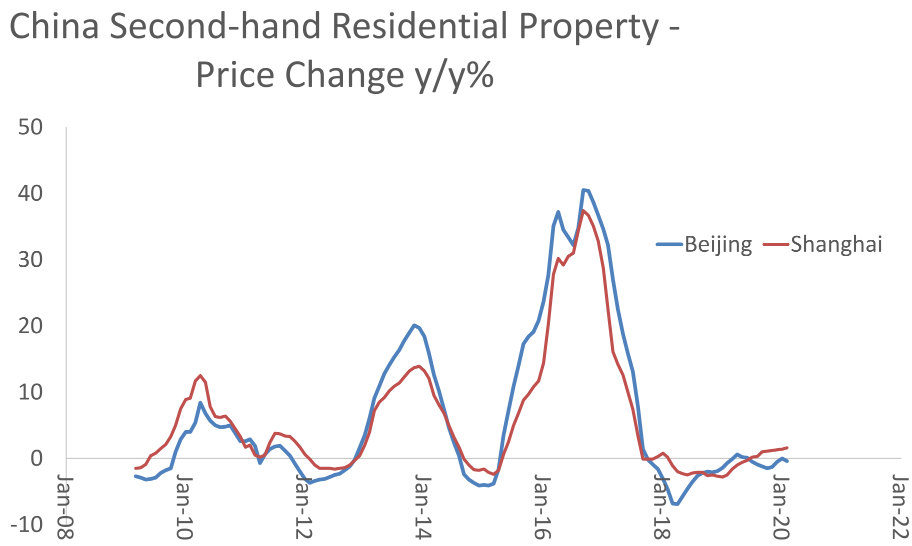
The same is true of the economic effects of the pandemic. Just as western governments have now pledged enormous monetary and fiscal stimulus to prevent a deep and drastic global depression, officials in Beijing ramped up support measures from the moment the lockdown began. The People's Bank of China (PBoC) has been steadily lowering funding costs and easing credit conditions since the beginning of the year, and the Chinese government has introduced a number of measures designed to spur infrastructure investment and domestic consumption.

Crucially, new measures keep coming. With China already opening up its shuttered economy, the PBoC has promised to inject more liquidity by cutting banks' reserve requirement ratios for a third time this year. It is also lowering interest rates on excess bank reserves for the first time since 2008. According to government sources, it plans to use this monetary leeway to complement another huge spur of fiscal spending, expanding the budget deficit for 2020 to a record high.

China's economic policy response has not received as much attention in the international press as its western counterparts, however. In part, this is because of how the Chinese government operates its support measures. Whereas policymakers in the US, EU and UK used 'shock and awe' tactics – promising headline-grabbing stimulus packages all at once – Chinese officials tend to prefer a steadier flow of announcements. Monetary policy gradually gets looser and fiscal policy becomes more active, and so the size of the overall package becomes hard to gauge. It is an approach driven by the knowledge that stimulus measures in China magnify its systemic problems. For many societal reasons, the country has a tendency to run up property and credit bubbles.

The global financial crisis of 2008/09 crashed demand for China's exports and swiftly pushed the government towards stimulus. Meanwhile, a domestic property and construction boom had been taking hold from 2005 (perhaps even earlier). While the stimulus may have helped exporters, it ramped up pressures around urban residential property.

Faced with unaffordable housing in its major cities, China's State Council applied what it felt to be measured constraints. House prices fell. The cycle of stimulus and constraint started again in 2012. The 2015/16 episode substantially worsened these aspects.



Source: Bloomberg, Tatton IM, China National Bureau of Statistics

House prices in Tier 1 cities (Beijing, Shanghai, Shenzhen, Guangzhou) are already some of the least affordable anywhere in the world. Meanwhile, corporate debt levels in China are among the highest globally, leaving some policymakers fearful of adding fuel to the fire.

The world's second largest economy slowed in 2018 and 2019, after Beijing's attempt at deleveraging its debt-laden corporate sector. This left the country in a credit crunch, forcing the government to ease credit conditions. Towards the end of last year, it looked like this plan had been working, but when the coronavirus crisis set in, officials were forced to double down on their support measures.

And Beijing is aware, like governments around the world, that drastic measures are needed to stave off a lengthy depression. The State Council has shown it is prepared to use every tool in its arsenal to see the country through this crisis. Long before the pandemic set in, it was already enacting big stimulus packages to boost the Chinese economy.

Officials may be fearful of overstimulating the property market, but doing so has long been a way of stimulating domestic demand in China. And even though it may create problems later on, it looks as though they are again making that trade-off – as we can already see in the speed at which China's top property developers are now snapping up land.

In the short or medium term, that decision should benefit the global economy. Back in 2016, Chinese stimulus helped to end the global growth slump, and the country's importance has only grown since then. When the rest of the world eventually comes out of lockdown, there will already be significant demand from China – helping businesses out of their forced hibernation.

China should experience many benefits from being the first nation to emerge from the pandemic crisis, but taking the lead is not without some downsides. Chinese firms will not be able to capitalise on global demand while the rest of the world is still in economic suspended animation. And even when the rest of the world starts moving again, there is always the danger of a political backlash similar to the damaging US-China trade war. But bringing back production (re-shoring) of critical goods production will take time and only strengthen Beijing's resolve to spur domestic demand. With the rest of the world in lockdown, China will look to bolster its domestic economy.

All of this adds to the already strong investment case for Chinese assets. Of the major economies, it has led the world both in terms of its response to the virus and its economic stimulus. We should, therefore, expect strong capital flows into China, most likely resulting in a strong Renminbi. And, the more landmarks the country passes on its road to recovery, the more investors will take notice.

Returning to politics briefly, while some politicians are quick to point the finger at China to deflect from their own crisis management failings, it is also entirely possible that China has indeed underreported the number of COVID-19 cases and fatalities (and is still doing so). However, it is harder to suppress fatalities and details of the overwhelmed hospitals that emerged when the virus ravaged through Wuhan. The reason? Masses of dead cannot be hidden from their families and those families will grieve through social media – as witnessed during the Wuhan outbreak. The same applies for lock-down measures.

China's recovery is therefore real. And, as long as they have learned how to keep the virus from taking hold again (which they clearly appear, given the easing of restrictions), we should be prepared to learn the lessons they can teach us (including the necessity of imposing lengthy and harsh lockdowns), rather than joining in the blame game.

Note: TS Lombard, one of our economic research partners, produced a list of the various policy measures enacted by Chinese authorities over the past two months (as of 7 April). The language is technical, and we don't seek to explain it all here, but the main consideration is the sheer length of the list.

Fiscal policy (total 3.6% of GDP):

- Frontloaded local government special purpose bond issuance.
- Eased funding leverage restriction for local government financing platforms.
- Mandated higher proportion of local government bond proceeds spent on infrastructure projects and prohibits usage for land and property activities.
- Part of social security tax waived: 5 months for SMEs and all firms in Hubei, 3 months for large firms ex-Hubei.
- Waivered toll road fees from 27 February.
- VAT exemptions for small-scale taxpayers in Hubei between March and June, VAT for small-scale taxpayers outside Hubei lowered from 3% to 1%.
- Electricity prices for businesses cut by 5%.
- Infrastructure stimulus. The National People's Congress will hike the quota for special bond issuance by local governments to RMB 3.1 trillion (US$450 billion), up from last year's RMB 2.15 trillion.
- New quota of central government special purpose bonds. The quota will be between RMB 1.5-2 trillion, proceeds to be spent on infrastructure and property construction.

- The central budget deficit is likely to surpass the 3% of GDP threshold for the first time, with an increase of at least 20 basis points (bps) over 2019 level of 2.8% of GDP.
- Property stimulus. To cope with unemployment, China will launch a national property construction stimulus. Financed by policy lending and bond issuance.
- Cheaper car loans and lower auto purchase tax. Larger car license plate quotas.

Monetary policy:

- Compliance with new asset management regulations delayed to end of 2021. The postponement allows banks to grow shadow banking assets.
- PBoC, CBIRC, and CSRC issue joint statement calling for forbearance and flexibility in debt collection up to 30 June.
- 50-300 bps of targeted RRR *(reserve requirement ratio)* cuts across large and small banks. Only small commercial banks will qualify for the full 300 bps cut. The reserve reductions are conditional on banks meeting strict SME *(small and medium enterprises)* lending targets.
- Interest on excess reserves cut by 35 bps.
- 1y Marginal Lending Facility rate cut 10 bps. Loan Prime Rate cut 10 bp for 1y, 5 bps for 5y.
- Banks allowed to delay NPL *(non-performing-loan)* recognition by 180 days.
- RMB300bn special purpose re-lending provided to banks.
- Increased re-lending + re-discounting rate for small commercial lenders by 25 bps to 2.5%.
- MoF announced subsidies of up to 50% of interest rate payments for companies impacted by the virus.
- Re-lending facility changed dictating banks must not issue loans above 4.55% - 50 bps above the LPR and 205 bp above that charged to small banks.
- State-owned large commercial banks to achieve 30% yoy loan growth to SMEs in H1.
- Extend debt repayments for SMEs and all firms inside Hubei to Q2.
- Coronavirus bonds and WMP *(Wealth Management Products)* issued to support bank and corporate capital.

Stimulus expectations:

- 100 bps more RRR cuts.
- 20 bps MLF and 30bps LPR cuts.
- Pledged supplementary lending to policy banks.

CAMBRIDGE
INVESTMENTS LIMITED

14th April 2020

Global Equity Markets

Market	Thu 17:02	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	5842.7	6.6	362.4	↘	↘
FTSE 250	16408	13.7	1971.1	↘	↘
FTSE AS	3233.2	7.8	234.7	↘	↘
FTSE Small	4607.1	10.6	439.9	↘	↘
CAC	4506.9	6.8	285.9	↘	↘
DAX	10564.7	10.4	993.9	↘	↘
Dow	23883	11.5	2469.4	↘	↘
S&P 500	2799.4	10.8	272.5	↘	⇘
Nasdaq	8166.6	9.1	679.3	↘	⇗
Nikkei	19345.8	8.6	1527.0	↘	↘
MSCI World	1940.1	7.6	137.0	↘	↘
MSCI EM	873.9	4.2	35.3	↘	↘

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	5.5	16.8	13.8	13.3
FTSE 250	4.6	17.8	12.8	14.2
FTSE AS	5.3	17.5	13.5	13.4
FTSE Small	4.8	11.5	-	13.8
CAC	4.0	16.4	15.9	13.5
DAX	3.8	18.3	14.7	12.5
Dow	2.7	16.8	18.2	15.1
S&P 500	2.2	18.4	18.9	16.1
Nasdaq	1.1	25.4	23.6	18.1
Nikkei	2.2	17.2	15.2	16.9
MSCI World	2.8	17.1	16.9	15.3
MSCI EM	3.2	12.4	12.2	11.9

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
Carnival	59.6	BP	-5.0
GVC	49.5	RSA Insurance	-3.6
easyJet	37.0	J Sainsbury	-2.2
Melrose	35.8	Royal Dutch Shell	-2.1
John Wood	30.5	Admiral	-1.7

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.245	0.4	Oil	33.38	11.5
GBP/EUR	0.878	-0.3	Gold	1683.3	4.3
USD/EUR	1.09	0.6	Silver	15.37	6.1
JPY/USD	108.42	-0.5	Copper	225.8	1.8
CNY/USD	7.04	0.6	Aluminium	1465.5	-2.3

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.31	-0.03
UK 15-Yr	0.48	-0.08
US 10-Yr	0.72	+0.13
French 10-Yr	0.11	+0.05
German 10-Yr	-0.35	+0.09
Japanese 10-Yr	0.02	+0.02

UK Mortgage Rates

Mortgage Rates	Mar	Feb
Base Rate Tracker	2.30	2.28
2-yr Fixed Rate	1.42	1.41
3-yr Fixed Rate	1.55	1.55
5-yr Fixed Rate	1.66	1.67
10-yr Fixed Rate	2.61	2.61
Standard Variable	4.09	4.13

* 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!

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

CAMBRIDGE
INVESTMENTS LIMITED

14th April 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.

Lothar Mentel