CAMBRIDGE
INVESTMENTS LIMITED

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China's president Xi – playing games; Morten Morland – 24 May 2020

May ends with optimism and promises of more stimulus

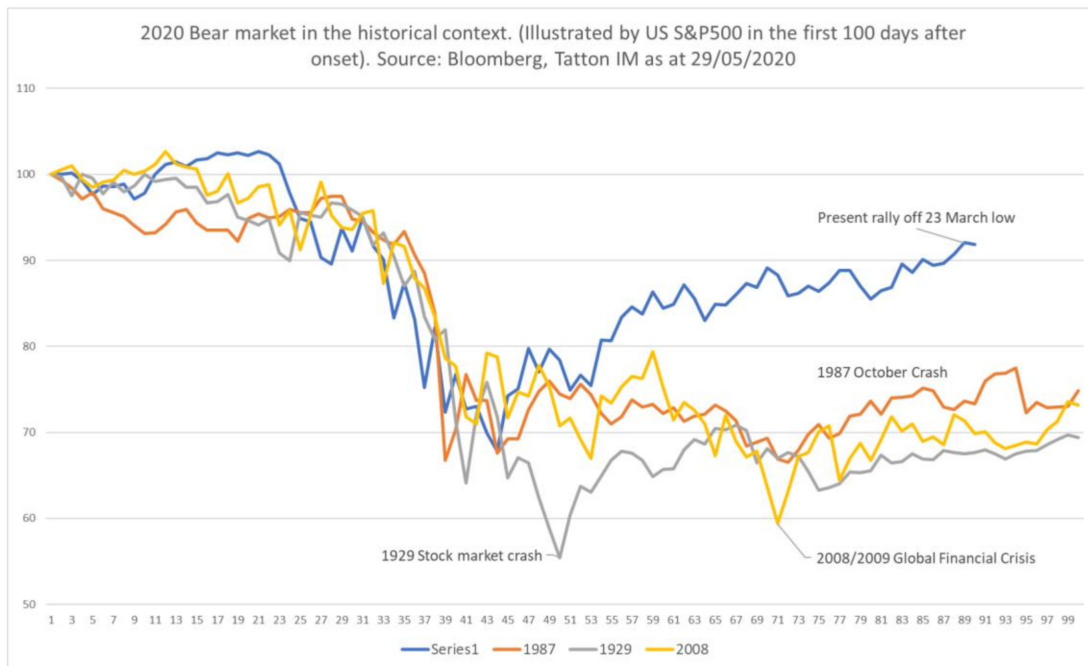
The stock market recovery that started on 23 March – and was widely regarded as little more than a soon-to-falter bear market rally – consolidated further over the last week of May. By now it is either the most pronounced bear market rally in history, or we have indeed already witnessed the turning point of the equity bear market that accompanies recessionary periods (see chart further down). In this context, it was notable that the recovery broadened over the past week, with small cap stocks, markets beyond the US and cyclical stocks all finally enjoying a day in the sun as well.

With the cost of corporate credit remaining stable, despite the sobering readings of economic output in freefall, there was real optimism in the air that with the gradual and persistent reopening of western economies, the worst may be over and a strong recovery in sight.

But what has happened to concern over a second wave of COVID infections in the autumn, and the extraordinary economic damage the lockdown has already inflicted? We observe that a market consensus appears to be forming that even if a second wave was to occur, a second round of lockdowns to the extent we just witnessed would be unlikely. Either a vaccine will be available – at least to those groups shown to be most vulnerable – or a South Korea-style Track, Trace and Isolate regime will prevent the excessive damage of a full economic lockdown having to be repeated.

Some may regard this as delusional optimism, but there is some logic in the argument, given a) the working age population has only been marginally affected, b) much-improved defence mechanism are introduced

every week and c) there may just simply not be the necessary public support for a second round of total lockdown.



Regarding the economic damage, compared to the last world-wide recession caused by the Global Financial Crisis of 2008/2009 this time there are – beyond the obvious – a number of variables which are following a very different playbook. On the one hand, European countries (including the UK) are aggressively pursuing fiscal stimulus to restart and reinvigorate their economies, rather than repeating failed austerity program approaches. On the other, the US is painting the opposite picture. Instead of effective political leadership uniting global efforts to fight the issues (as occurred under the Bush and Obama administrations), Donald Trump is mishandling the domestic response to the crisis, in politically destructive ways that would have been unimaginable only a few years ago.

China has unfortunately also recently changed direction, and this time cannot be counted on as a strong supporting contributor to recovery as it did back in 2009. Its political calculation to never let a good crisis go to waste – using it as an opportunity to further its own political agenda – may well backfire spectacularly. As we noted last week, the move to end Hong Kong's quasi-independent status in order to finish off the freedom protest movement is likely to make the resumption of economically vital global trade that much harder.

That said, stock markets proved surprisingly resilient on the week's more disconcerting news flow (which included Trump's latest petty grievances against Twitter's attempts to add balance to his most subjective tweets). Once again, it seems capital markets are being overly optimistic about recovery prospects. Or are they simply concluding any missteps during this crisis time will lead to approval of even larger fiscal recovery packages for Hong Kong, China and the US? Given the game-changing developments in Europe's fiscal stimulus position, it is worth looking at this aspect a bit more closely.

As we have said from the outset of the crisis, substantial government and central bank support is crucial in seeing the global economy through the current crisis. And as such, the changing tide of policy is more important than ever to capital markets. On that front, the big news this week came from Europe and Japan.

The Japanese government has approved a second supplementary budget for the fiscal year worth 6.2% of the nation's GDP. That brings Japan's total fiscal deficit for this year to 14.9% of GDP – the biggest stimulus boost in decades. Meanwhile, the European Commission has put forward a plan for a €750 billion (€500 billion grants, €250 billion loans) Eurozone recovery fund. This is notably bigger than the Merkel-Macron plan that had financial news outlets gushing before – with the Commission's plan amounting to 6.2% of Eurozone GDP. Once the previous €540 billion package of April is added in, we are even looking at fiscal stimulus worth up to 10% of GDP.

Fiscal action on the European front is particularly noteworthy because, until now, Europe's political setup has been notoriously obstinate and resistant to the idea of fiscal union. The Commission's offered solution is, as ever, a fudge of various measures rather than a comprehensive reform. But it is promising, nonetheless. The Commission will now be able to call upon each Eurozone country to contribute 2% of its GDP towards a common budget and, crucially, it can use that future revenue as a guarantee to dip into bond markets in the short term.

There are drawbacks. The money raised by the commission will not be available to spend until 2021. And the bureaucratic sleight of hand used in getting these measures past Europe's politicians mean the repayment schemes and exact clauses are somewhat open to interpretation. But while it is just a kicking of the can down the road, it is an almighty kick. Repayments on the debt raised will not start until 2028 and can last until 2058.

From our perspective, this signals that we are moving from fiscal stimulus being just a means to plug pandemic holes in the short-term, to a realisation that the road to recovery is one that will need long-term fiscal investment. Both Europe and Japan's measures are emblematic of this, with a focus on long-term rebuilding, and we saw similar spending measures announced in Britain even before the pandemic hit.

For capital markets, the key thing to watch here is whether the US follows suit. So far, federal spending measures have been focused entirely on keeping businesses and individuals afloat, while the Trump administration has squandered valuable time with playing blame games rather than making plans for a decisive fiscal restart investment program. But with a presidential election in less than six months, commitments to long-term spending are still likely. If that does happen, markets will be more confident of a rebound to strong growth over the next two or three years. The initial support package to see the US economy through the COVID activity suppression void amounted to around 8% of GDP. On that measure, if the US decides to repeat the 'shock and awe' created back in March, there could be some interesting longer-term fiscal support package dimensions in the pipeline.

Superpower predicaments in the 21st century

In normal times, a serious escalation of tensions between the US and China would be front-page news across the world. But as far as we are from normal, the rising conflict between the world's two preeminent powers made little more than a footnote on the BBC news page last week. On Thursday, it warranted an article on the frontpage of the Wall Street Journal, but was still secondary to virus counts and the EU's communal investment proposal.

That lack of coverage hardly diminishes the gravity of the situation though. China's National People's Congress has formally approved a plan to impose national security measures on Hong Kong. If and when

this is put into force, Hong Kong will – de facto – have lost its status of quasi- independence from mainland China.

In response, the US announced that it no longer considered Hong Kong autonomous enough to warrant 'special status'. That status has permitted visa-free travel, US support for Hong Kong's separate representation on global bodies such as the World Health Organisation. Most importantly, it has allowed trade to be much easier than with mainland China.

A little context is needed here. The protest movement in Hong Kong – still ongoing more than a year after it began – started in response to a bill in the city's legislature that was intended to allow Hong Kong residents to be extradited to mainland China. Protestors considered the bill a violation of the 'one country, two systems' law, and a major erosion of Hong Kong's civil liberties – eventually forcing its removal by the administrative government. But the Chinese government's current plan makes that previous bill look timid by comparison. If enacted, it will be the first time that Beijing has directly implemented criminal law in Hong Kong, completely bypassing the Special Administrative Region's lawmakers. Pro-democracy activists and international observers suspect that the Chinese Communist Party is using the pandemic crisis as a pretence to stamp out human rights.

Two 'strongmen' at work*; KAL – 28 May 2020*

That is why the US administration has issued the most striking political response from any western nation, declaring Beijing has effectively ended 'one country, two systems'. But this is only the latest escalation between the US and China. American lawmakers from both parties have been pushing for President Trump to enact sanctions against China. And Trump – himself a longstanding China critic – has been piling pressure on The People's Republic whenever he can. The world's two largest economies have been locked in trade wars and technological arms races for many years

There is no sign of tensions slowing anytime soon. Americans take to the polls later this year, and both the Democrat and Republican parties recognise that being tough on China is a vote winner. Trump made China-

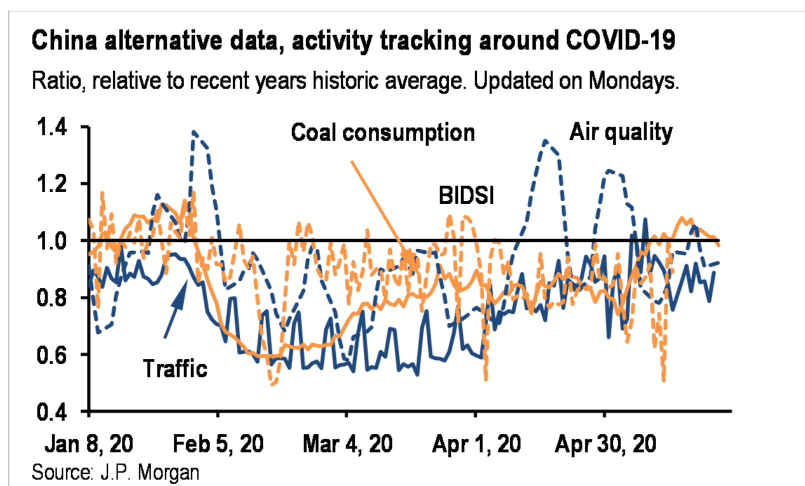
bashing a key part of his 2016 campaign and his first term in office. But Democratic Challenger Joe Biden is now trying to out 'tough' Trump, labelling the President soft on Beijing in the early stages of the pandemic. Even in the US Congress, recent anti-China bills have passed with near-unanimous support.

Across the Pacific, the rhetoric from top officials has been slightly more composed. At the National People's Congress, Premier Li Keqiang claimed China rejected a "Cold War mentality", declaring: "Decoupling between the two economies will do neither side any good". But we should not mistake diplomacy for weakness. Under President Xi, China has become increasingly confident on the world stage. Beijing has responded aggressively to criticisms of its handling of the COVID-19 outbreak, and there seem to be few avenues for de-escalation. According to Richard McGregor, author of a book on China's communist party: "under Xi, China is programmed not to take a backward step".

Economically speaking, China should be in a strong position relative to the (admittedly dire) rest of the world. The world's second largest economy went through its virus crisis quick and early, and led the world in opening up from lockdown, with well-targeted fiscal and monetary stimulus behind it. But tensions with its largest trading partner present a formidable obstacle to China's recovery. China's exporters already expect global demand to be weak for the foreseeable future, and being hit by further tariffs or sanctions could be disastrous. Meanwhile, domestic demand has been increasing in the post-lockdown period in a rather patchy fashion, with signs that smaller businesses have not re-employed their workers to the levels that had been expected.

The 'alternative data' economic indicators from JP Morgan show that the economy's steady improvement has stalled at around 90-95% of the yearly averages (BIDSI is a shipping/freight index):

China is at a crucial juncture. The government still has much to do, and as such would much prefer issues



like Hong Kong, Taiwan and the mass internment of Muslim Uighurs in the Xinjiang Province to fade into the backdrop. Perhaps officials thought that, with the world focused on controlling the pandemic, they would be allowed to quietly implement control in Hong Kong – or perhaps the 2019 riots in Hong Kong were too much of an affront to the party's power to let lie.

Whatever the case, the response from US voters and politicians has made it abundantly clear that "something must be done about China". With both sides helmed by authoritarian 'strongmen', their

positions are hardening, setting the stage for what could become a protracted and economically-damaging fight.

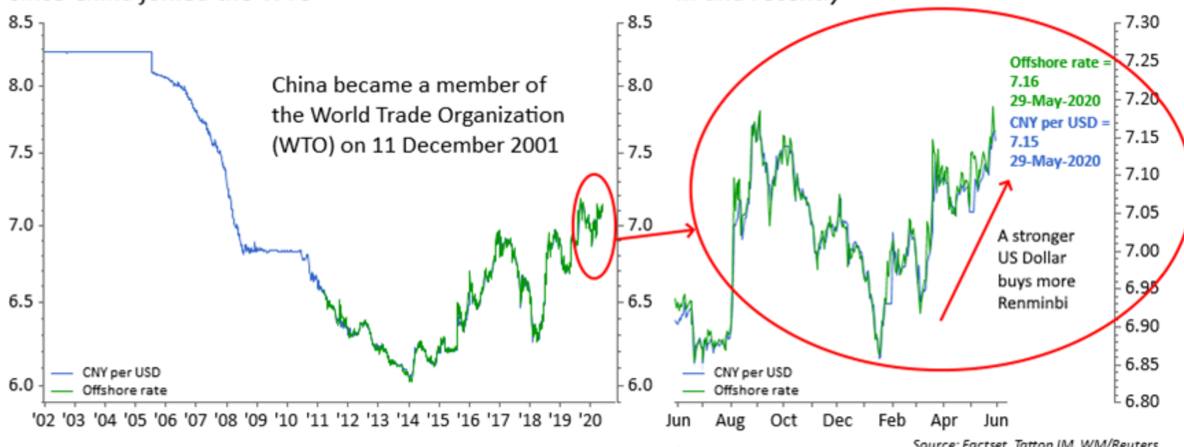
Even before the news about China's treatment of the people of Hong Kong, there were measures under way to bring pressure to bear on the Chinese administration.

On the capital markets side, concerns about Chinese company governance were brought to a head by Luckin Coffee's collapse in early April amid fraud allegations. While many have pointed out there was already a requirement to apply international accounting standards (GAAP in the US, IFRS in the EU) to any Chinese company seeking a listing in US markets, the rules were not enforced adequately. A new bill passed the US Senate last week (the S.945 Bill) which requires the Public Company Accounting Oversight Board to review audits of US-listed Chinese companies. This has been unacceptable to the Chinese government, perhaps because of the close involvement of the state in private companies.

On Wednesday, the House of Representatives passed the Senate's bill calling for sanctions to be imposed because of the treatment of the Uighur people. Trump has 180 days to establish a list of responsible Chinese officials. He has some leeway, but experience suggests he will want to be seen to be tough. The Chinese have said they will retaliate if sanctions are forthcoming.

Trump also has a 'nuclear' option, one which would impact financial markets hugely in both countries. It is possible that the Hong Kong Monetary Authority might be restricted in accessing the US dollar clearing system. This could become a wider restriction on Chinese banks' access to US dollars. Such a move would inevitably threaten the sale of Chinese holdings of US Treasuries (within a few dollars, equal to Japan's vast trove) so one would think such a move unlikely. However, it's possible that politicians might propose it.

For us, one of the key signs to gauge the balance between further escalation and potential for de-escalation is what happens to China's currency. Currency devaluation has been a Trump talking point since before he was elected, and – to their credit – Chinese officials have tried to counteract a weakening of the Renminbi's value against the dollar throughout the trade talks of the last few years – as a show of good faith to US negotiators. However, in the last two weeks, that faith has seemingly been absent, with the Renminbi falling steadily throughout May (I.e. the US$ rises in value relative to the RMB - see chart on next page).



Regular readers will know that positivity on China's economy was one of our investment calls for the post-pandemic recovery. The underlying bases – its early recovery and measured policy boost – are still there for the most part. But, following last week's news, Chinese and Hong Kong equity markets took a major bruising, despite a wider rally in Asian and emerging market stocks. This is a story we are watching closely, but without the urge to jump to rash conclusions and actions. Both sides desperately need a strong economic recovery to maintain public support. This recovery would be severely hampered by a flaring up of trade tensions in the near-term and therefore remain mutually undesirable.

Headwinds for travel and leisure

Of all the industries hit by the pandemic and subsequent global lockdown measures, none have been hit harder than travel and leisure. Flights and holidays have been put on hold for the foreseeable future, and while businesses are starting the slow process of opening up, tourism and international travel are seen by governments as the last stop on the road back to normal.

Airlines, which rely on regular traffic, are hobbling forward with little clue when they will be able to resume business in any form, let alone at pre-crisis levels. Many have sought to take advantage of employee furloughs or emergency loan schemes, as well as requesting extraordinary bailouts. The British public seemed to feel a little schadenfreude (along with a heavy dose of outrage) at the sight of Richard Branson asking for a bailout for Virgin Atlantic last month. But there is no denying that travel companies are facing existential risks. EasyJet announced last week that it plans to cut 30% of its 15,000-strong workforce. This comes after British Airways, Ryanair and Virgin Atlantic all announced similarly large layoffs.

Crucially, EasyJet said it does not expect flight demand to return to normal levels until 2023. Others are a little more sanguine about the issue. Ryanair boss Michael O'Leary told Reuters that the budget airline's flight bookings were at 40% of capacity for July, and the company planned to run 60%-70% of its regular flights by September. Wizz Air was even more optimistic, saying it expects to be running 70% of its flights by July and August. But EasyJet CEO Johan Lundgren believes his company's projections were made on "a conservative but still realistic basis." On differing opinions among airlines, Lundgren was frank: "Truth of the matter, nobody knows".

Indeed, nobody does. But the uncertainty surrounding the virus underlies a deeper fear for travel companies – that the pandemic may provoke longer-term changes in people's behaviour, ensuring travel demand stays lower for longer. Infection fears could linger in the collective consciousness for some time, which is bad news for an industry premised on scattering people all over the world.

We should, straight away, temper any apocalyptic predictions for the travel industry. "Things will never be the same again" is a well-worn phrase in crises, and rarely holds true. But some changes seem probable, over the medium-term at least. We have heard anecdotally that companies are incredibly nervous about planning any form of business travel in the foreseeable future, since sending employees abroad could make firms liable for a host of complications (virus spread, employee safety complaints, flight cancellations, etc.). And while there may be no replacement for a beachline sunset, video-call services have shown there are plenty of (much cheaper) alternatives to a boardroom. Business travel is a significant source of demand for airlines, travel planners and the hospitality industry, so travel-shy companies could pose a real problem.

There are also longer-term trends to consider. There has been much media discussion about the rising number of 'staycations' taken by Britons over the last few years – usually explained by austerity measures or economic uncertainty over Brexit. The data shows this trend has been exaggerated (the number of Britons taking *only* staycations is decreasing). But it is easy to see how virus fears or economic fallout could accelerate this trend.

The other side of the equation is policy. From 8 June, the UK will be forcing incoming travellers to quarantine for 14 days – a proposal which has gained traction in many countries around the world. Spending a fortnight cooped up indoors either side of a holiday would surely dissuade many travellers from taking a trip overseas. Michael O'Leary is dismissive of the quarantine measures, however, suggesting: "The UK will either quietly drop them or drop them as another easing measure in the next week or two. I am confident of that".

We are a little less confident. The key concern many health experts have highlighted during this pandemic is the possibility that countries could see a second wave when things start to return to normal. COVID-19 is a global health crisis, but not every country is going through it at the same time or the same rate. In China, where new domestic cases have dropped to near zero, the biggest fear is that – since other countries are still in the throes of their fight with COVID – the virus could be reintroduced and move through large sections of the population all over again. Governments seem to agree that travel restrictions are a key part of avoiding hotspots flaring up and then spreading continuously.

The International Air Transport Association (IATA) released analysis two weeks ago, showing that the damage to air travel from COVID-19 extends into the medium-term, with long-haul / international travel being the most severely impacted. Quarantine measures on arrival they saw as particularly damaging for confidence in air travel.

IATA's forecast for 2021 air passenger traffic is that it will be about 25% below 2019 levels, based on a phased reopening of travel through the second half of this year. 2019 levels will take a further two years to be surpassed. The key takeaway is that the current industry has between 10% and 20% overcapacity.

Of course, this does not amount to a death sentence for the travel industry. We know that, however long it takes, we will come through the pandemic and consumers will be desperate to catch up on their travel and leisure activities. When demand returns, travel companies that have survived (or indeed, new ones

that spring up) should be able to take full advantage. But surviving until that point is the difficult part. Even with extraordinary government support, we are likely to see an increase in companies going out of business. The recent bankruptcy filing by car rental company Hertz is testament to this – and to the potential credit fallout these problems could bring. As for "nothing will ever be the same", well, nothing ever is. Industries face threats all the time; those that can adapt and survive are left to take advantage.

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1st June 2020

Global Equity Markets

Market	Fri 16:32	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	6084.8	1.2	69.6	↗	↘
FTSE 250	17091	4.3	705.2	↗	↘
FTSE AS	3368.8	1.7	57.4	↗	↘
FTSE Small	4859.8	3.5	166.4	↗	↘
CAC	4715.4	6.1	270.9	↗	↘
DAX	11630.3	5.0	556.4	↗	→
Dow	25167	2.8	692.5	↗	→
S&P 500	3013.4	2.2	64.8	↗	→
Nasdaq	9348.6	0.7	63.7	↗	↗
Nikkei	21877.9	7.3	1489.7	↗	⬀
MSCI World	2148.3	3.7	76.4	↗	→
MSCI EM	925.3	2.2	20.1	↗	⬂

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.7	21.3	18.0	13.4
FTSE 250	3.3	20.2	18.5	14.3
FTSE AS	4.5	22.2	18.0	13.4
FTSE Small	4.3	14.3	-	13.8
CAC	3.1	18.7	20.1	13.6
DAX	3.2	21.9	19.2	12.6
Dow	2.6	18.7	23.0	15.2
S&P 500	2.0	21.0	24.1	16.2
Nasdaq	0.9	29.2	28.6	18.3
Nikkei	2.0	25.5	19.9	16.9
MSCI World	2.4	20.9	22.1	15.4
MSCI EM	3.0	14.4	14.5	11.9

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
TUI	49.0	HSBC	-7.0
Melrose	25.0	Prudential	-6.1
easyJet	20.1	Stan Chartered	-4.6
Whitbread	18.7	London Stock Exch	-4.2
British Land	16.4	Imperial Brands	-3.3

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.234	1.3	Oil	34.92	-0.6
GBP/EUR	0.901	-0.6	Gold	1734.5	-0.0
USD/EUR	1.11	2.0	Silver	17.81	3.5
JPY/USD	107.75	-0.1	Copper	241.5	-1.5
CNY/USD	7.14	-0.0	Aluminium	1537.0	1.6
Bitcoin/$	9,384	2.2	Soft Cmdties	332.3	-0.7

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.18	+0.01
UK 15-Yr	0.37	-0.00
US 10-Yr	0.66	+0.00
French 10-Yr	-0.08	-0.04
German 10-Yr	-0.45	+0.04
Japanese 10-Yr	0.01	+0.01

UK Mortgage Rates

Mortgage Rates	Mar	Feb
Base Rate Tracker	2.30	2.28
2-yr Fixed Rate	1.40	1.41
3-yr Fixed Rate	1.63	1.58
5-yr Fixed Rate	1.67	1.66
10-yr Fixed Rate	2.61	2.61
Standard Variable	3.67	3.77

* 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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1st June 2020

Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet and is only valid for the publication date of this document.

The value of your investments can go down as well as up and you may get back less than you originally invested.

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