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US having a bad double pandemic; KAL – 31 May 2020

Markets are enjoying an uncomfortably benign pandemic

May 2020 will be remembered for many things. For most of the world, it was when lockdown measures began to ease and people filtered back out into the sunshine for the first time in weeks. It was also when the size of the economic problem facing us become abundantly clear. US unemployment numbers released for April showed the number of jobless Americans at its highest on record, although that decline has been tempered somewhat by the announcement last Friday that the US economy added 2.5 million jobs in May (even so, an unemployment rate of just above 13% is still incredibly high for US standards). Big companies have rolled out global restructuring plans to cut employees and costs, and the depth of this government-directed recession has grown clearer by the day. The policy problem facing governments – how to balance equally enormous health and economic concerns – was a constant concern throughout the month.

Politically, May was fractious as ever. The Chinese government moved to effectively end Hong Kong's autonomy, dramatically heightening tensions between China and the US. And at the end of the month, tragically, yet another unarmed black American was killed by those meant to protect him. Widespread protests across the US – and indeed the world – kicked off, and the public anger, and heavy-handed response from authorities, has led to scenes that none of us expect to see in a democratic nation.

And yet, for investment professionals, May will be remembered for entirely opposite reasons. Despite the turmoil, equity markets continued to soar. In sterling terms, UK stocks were up 3.3%, while Japanese, European and US equities shot up 8.1%, 7.8% and 7.1% respectively. Oil prices, languishing during April, had their best ever month – climbing 45.8%. These moves have left stock valuations at eye-watering levels. From an investment perspective, perhaps the word that best sums up May 2020 is 'disconnect'.

Asset Class	Index	May	YTD	12 months	2019
Equities	FTSE 100 (UK)	3.3	-18.2	-11.8	17.3
	FTSE4Good 50 (UK Ethical Index)	3.1	-18.7	-13.7	13.9
	MSCI Europe ex-UK	7.8	-7.1	1.3	20.0
	S&P 500 (USA)	6.9	1.8	15.0	26.4
	NASDAQ (US Technology)	9.1	13.8	31.2	31.4
	Nikkei 225 (Japan)	8.1	-0.5	9.1	15.0
	MSCI All Countries World	6.5	-2.7	7.5	21.7
	MSCI Emerging Markets	2.8	-9.9	-2.5	13.8
Bonds	FTSE Gilts All Stocks	0.0	9.5	12.0	6.9
	£-Sterling Corporate Bond Index	0.9	1.2	6.4	11.0
	Barclays Global Aggregate Bond Index	2.5	9.4	7.7	2.7
Commodities	Goldman Sachs Commodity Index	18.7	-35.1	-33.0	13.1
	Brent Crude Oil Price	45.8	-38.6	-37.8	17.9
	LBMA Spot Gold Price	2.6	21.4	35.7	14.2
Inflation	UK Consumer Price Index (annual rate)*	-0.2	-0.1	0.6	1.3
Cash rates	Libor 3 month GBP	0.1	0.4	0.9	0.9
Property	UK Commercial Property (IA Sector)*	-1.8	-2.4	-2.7	-0.8

Data sourced from Morningstar Direct as at 29/05/20. * to end of previous month (30/04/20). All returns in GBP

From an outside perspective, it might look like capital markets are in their own fantasy world, blissfully unaware of the chaos that surrounds them. But markets are not just running on hot air. First, the unprecedented support measures from governments and (particularly) central banks have left the financial system awash with liquidity. The abundance of capital to spend has drastically lowered the risk premium (the return investors demand for a given level of risk) across all asset classes – with equity still offering one of the highest. Second, we have seen a substantial increase in demand for capital investments from retail investors. The public is putting its lockdown savings to work in capital markets, adding further to global liquidity.

These factors change the way we look at markets. While the pulse of the global economy is indeed slowing, we must remind ourselves that it is doing so because governments are putting it into an induced coma – which is temporary. Most businesses around the world have taken a huge hit to their earnings and balance

sheets, but this is true for (almost) everyone, so few have a competitive advantage. At the same time, governments have made it their mission to ensure companies and individuals do not go bust as a result of the pandemic. And since the threat of systemic and widespread bankruptcies appears removed for now, the question appears not to be "should I invest?" but "where should I invest?" This is why assets that offer even a mildly better return prospect beyond the next few months – that is, equities – are doing so well. It also explains why the growth-intensive US technology sector has performed so well – posting a 9.1% gain in sterling terms last month.

The current capital market mood stands in stark contrast to a few months ago, when investors were selling everything not nailed down in a panicked frenzy. By contrast, markets now definitely seem to be in a 'risk-on' phase, despite there being a plethora of risks around. Emerging market debt, for example, returned 4.6% during May. This makes sense given the above factors, but it makes for uncomfortable reading, nonetheless. Just as the sell-off from late February quickly spiralled lower than could be justified by reasonable economic expectations, the higher the current rally goes the more detached it becomes from economic reality.

There are, thankfully, reasons to be positive about the global economy over the medium term. These are mostly based on the speed at which countries are opening up, but long-term fiscal factors – such as the German government's plan announced last week – are also a huge part. Even if few European countries are able to churn out fiscal support at the same scale as Germany, a pan-European response is also in the making. Joint fiscal plans are being proposed and stubborn political barriers being broken faster than we have seen in years – all pointing to genuine progress on the horizon. The US, on the other hand, is grappling with damaging civil unrest and fractious politics at the time it could do the most harm.

Crises tend to provide catalysts for change as underlying problems bubble to the surface. Back during the global financial crisis of 2008/2009, Europe's structural weaknesses were exposed, and European countries suffered as a result. The US, on the other hand – under decisive leadership – executed swift interventions and constructive financial reform, and ultimately fared much better relative to its global peers in the West. In this crisis, we are seeing the reverse. In Europe, there is genuine political will to pull together and find a way around the inherent weaknesses of the European edifice (i.e. little fiscal co-operation across countries) – and we are seeing progress that looked impossible only a few months ago. In the US, deep-seated inequality, racism and division are becoming plain to see.

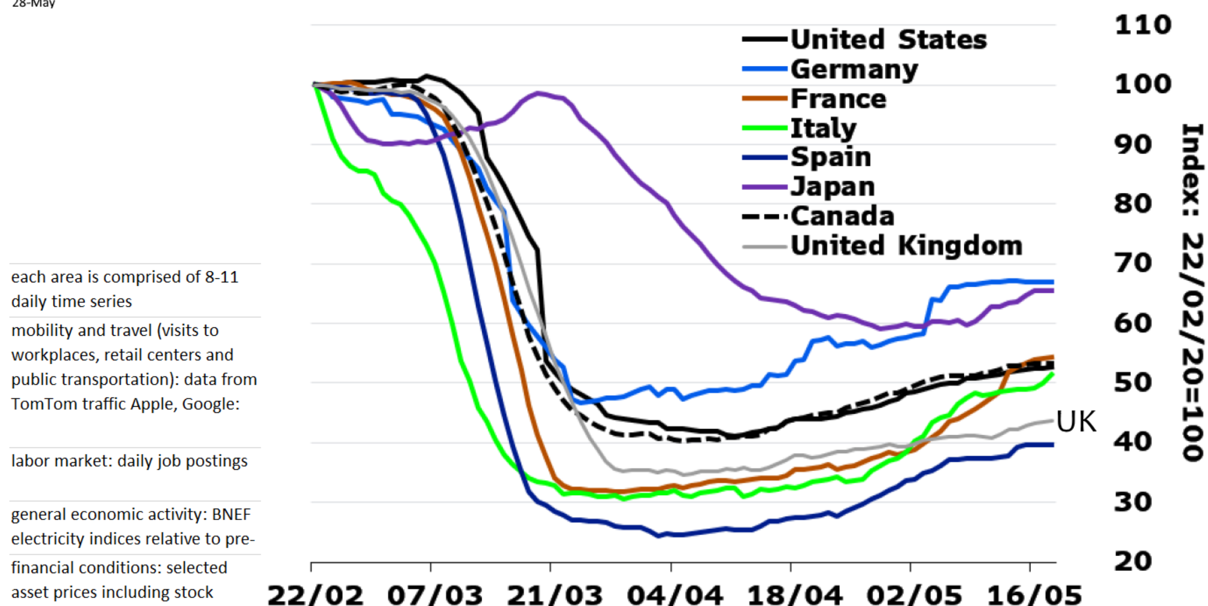
This makes the European case look stronger by comparison. But we should not get carried away. There are reports that the US government may commit an additional $1 trillion in fiscal stimulus soon, and as quickly as November the political situation may look entirely different. Nevertheless, it seems clear that this pandemic has been a catalyst for deep tensions. While we welcome capital markets' forward-looking and optimistic stance, which certainly could be deemed justified under 'normal' circumstances, we would hope that that the catalyst for change that has sprung up will be mostly for positive change which speedily re-establishes that 'normal' which markets appear to be counting on.

Europe looks to be winning the race towards recovery – for now

The first priority of a government, we are told, is to protect its citizens. The speed at which lockdown measures were imposed around the world in the wake of this pandemic (even by those relatively slow-to-react countries) is a testament to that. But as case rates start to fall across most of the world, 'protection' gets a little ambiguous. As policymakers are well aware, maintaining people's livelihoods can be just as important as saving lives from the virus. This is why most governments (in the developed world at least) have also embarked on huge stimulus and support programs to see us through the current economic hibernation. It is also why many are now eager to ease lockdown measures and wake the economy up again.

From an investment perspective, tracking the economic recovery is vital. The traditional indicators suggest most of the world's largest economies have started to rebound. For Europe, the US and Japan, the low point came in late March to early April, when sudden and strict limits were put in place. This can be seen in the Purchasing Managers' Index (PMI) business survey data for global manufacturing, which shows an increase in business confidence, albeit still to a low level, signalling ongoing contraction.

But given the unprecedented nature of the pandemic and the economic collapse it has wrought, traditional indicators might not be the best ones right now. Aggregate PMIs, for example, are only released on a monthly basis, and this is a crisis that shifts week-to-week or even day-to-day. Instead, analysts are increasingly using 'high-frequency' data, which, thanks to the wonders of modern tracking technology, gives a more fine-grained picture of economic activity.

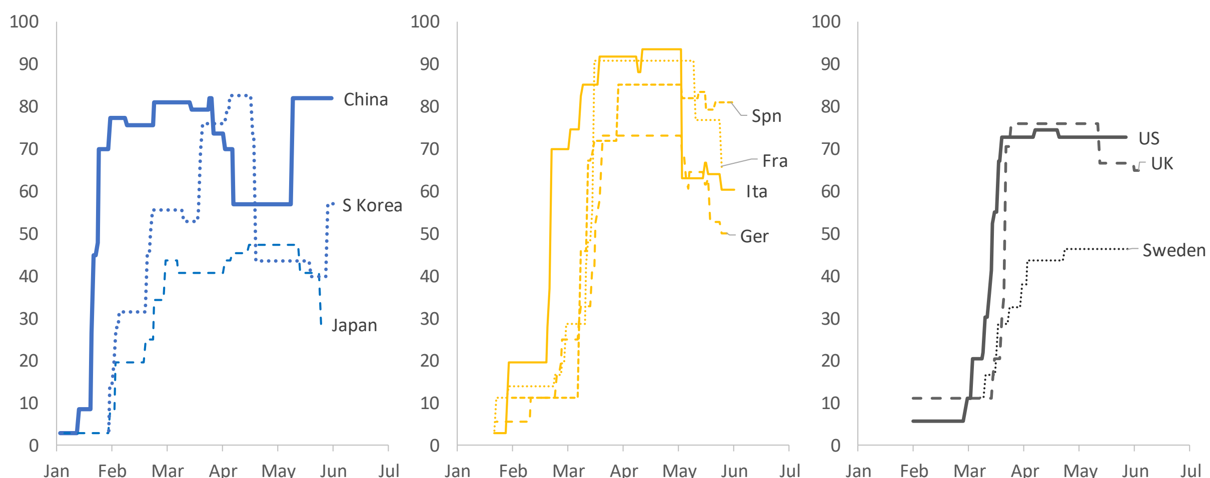


Traffic and smartphone location data, for example, can give an up-to-date reading of overall 'mobility', which can be split into commuters and deliveries. Daily job postings shed some light on labour markets, which in turn tell us about business confidence. Meanwhile, credit card data informs us on consumer demand. Like the PMIs, these indicators also show the global recovery is underway, but that there is substantial regional

variation. In Germany, economic activity fell around 50% from late February to early April, but is now just 35% down from the February peak. France and Italy have also picked up quickly, whereas the UK and Spain are still languishing relative to pre-pandemic levels, as shown in the chart above.

Such data paints a detailed picture of the restrained economy right now, but for consumers, businesses and markets, the bigger question is what it might look like in the future. For the short-term at least, this is almost entirely dictated by government lockdown measures rather than actual economic activity. Researchers at Oxford University have compiled an index tracking the strength of lockdown measures across the G20 (weighted by GDP) ranging from 0 to 100. At the beginning of this week, lockdown stringency across all 20 countries was at 68.9. Again, this is a clear improvement on a global scale from early April, but regions differ quite substantially. It's interesting to note that the previous coronavirus recovery 'leaders', South Korea and China, have increased their stringency recently, after a resurgence in the rate of diagnosed cases in some localities. However, it is important to note that for the Oxford-Blavatnik measure shown below, should one region or a sub-national level in a country increase its stringency, this is applied to the country as a whole. This approach can lead to a misleading impression for a big country such as China where a small region has a diminishing impact on the country overall.

Oxford-Blavatnik Stringency Regional Indices



Source: Oxford Uni, Tatton IM

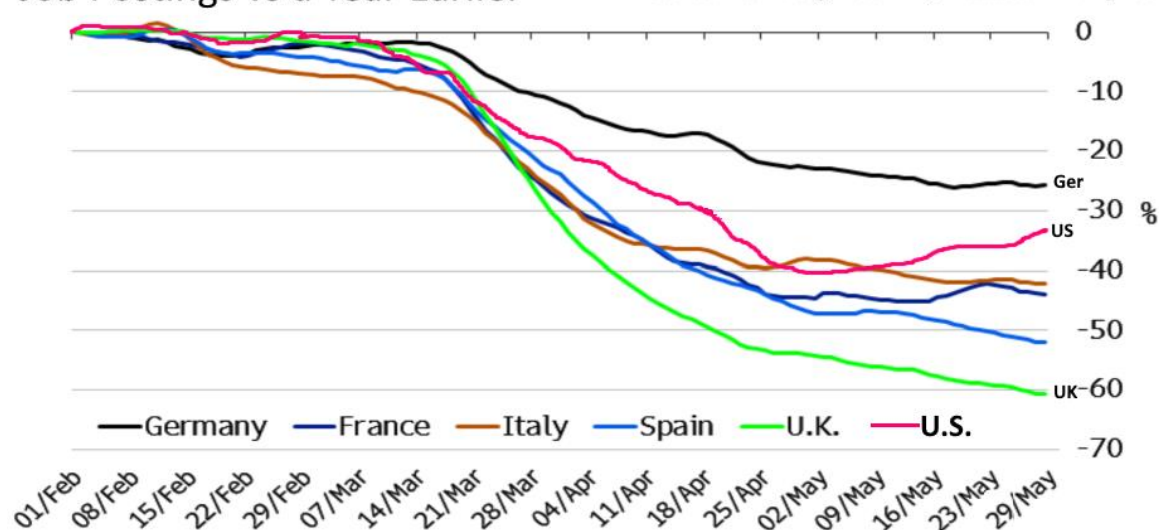
The recession we are now in is the result of government-ordered measures, and the message is that social distancing and travel restrictions will remain in place for the foreseeable future. But those actions will have a huge economic impact for as long as they are around. For example, even mild restrictions will drastically reduce operating capacity for most travel and leisure companies (as we detailed in last week's article on the travel sector). Hospitality providers have noted that maintaining a two-metre distancing rule would mean they would only be able to serve customers at 25% of pre-pandemic levels.

So far, governments and central banks in the developed world have been good at plugging the gap created by the lockdown shortfall. Few think that the furlough and emergency loan and grant support schemes should be ended while the restrictions remain in place, as many businesses and employees are currently reliant on these measures for survival. But even with incentives to keep employees on the payroll, some

businesses have started cutting jobs and hiking prices in anticipation of lasting changes in consumer behaviours.

Labour market structures and government support policies differ across the world. US unemployment, for example, has already skyrocketed to its highest level on record. Those out of work are still mostly receiving some form of government support. In Europe, the rise in unemployment looks more limited, with furlough schemes much more the norm.

The "Jobs Postings" data from Indeed.com (and its research economists at the Hiring Lab) show a more balanced picture of the global labour market. Germany shows relative strength, but the US picture is not far behind and improving. The UK is struggling.



The main fear is that, after lockdown measures have largely subsided, the economy might spiral into a 'classical' recession. If bankruptcies and job losses become widespread, business and consumer sentiment could sink to the point where demand is too weak to support a recovery to pre-pandemic levels over the medium-term. Hopes for a V-shaped recovery would be replaced by at least a U shape.

Meanwhile, it is easy to see how this would lead to huge job losses across the hospitality sector which, as a big employer, would feed back into reduced general consumption.

The clearest way to make this point is to compare the current scenario to the pre-crisis economy. Even if measures were eased such that economic activity reached 98% of its pre-pandemic levels – which, to be clear, we are no way near reaching in the short-term – that would still amount to a 2% fall in global GDP from where we were at the beginning of 2020. In normal circumstances that would be a disastrous outcome, leading to widespread falls in living standards. Even during the recession prompted by the global financial crisis, annual GDP growth 'only' slowed to roughly 0%.

Of course, we are far from normal circumstances. But this highlights how vital it is that governments' economic interventions move from 'plugging the gaps' to 'pump priming' for a strong recovery through long-term investment. On that front, we can take positivity from Germany's announcement last week of

an extra fiscal stimulus boost designed not just to see its citizens through the pandemic but also to encourage them to spend on the other side. That it came after the European Commission's own announcement of spending measures last week is another good sign, and we have already heard similar encouraging plans from the UK. The US, on the other hand, appears fully occupied dealing with spreading civil unrest, and the absence of any post-Covid fiscal stimulus program announcements remains worrisome. That said, Washington keeps mulling another fiscal response, even if the election campaign could complicate the consensus-building process in the House of Representatives. What we can be sure of is that, without these measures, citizens around the world might need more protection from the economic fallout than from the virus.

How ethical can ethical investing be?

Ethical investment has grown substantially in popularity over the last decade. This can be seen from the sector-wide figures, but we have also seen it in the growing recognition of our own ethical portfolios. We launched our first ethical portfolio strategy in 2014. Six years on, we are glad to say our ethical portfolios now cover the risk spectrum and have grown in assets to represent a meaningful portion of the total investments we manage on behalf of UK investors.

Ethical investing comes with its own practical difficulties, but the most fundamental issue is determining what counts as 'ethical' in the first place. This question often comes down to a personal level, so recently we contacted our clients to ask about what investors want from an ethical portfolio.

One of the early insights from our survey was that a majority of investors are particularly concerned about animal welfare. Among our clients, opinions on issues like nuclear power, oil and gas, alcohol, and chemicals industries appear to be more divided than the investment restrictions we apply. But divestment from the fur trade and companies that use animal testing for cosmetics were two common priorities. Unfortunately, even on seemingly clear-cut issues like animal testing, putting these concerns into practice can be challenging. As such, we thought it would be helpful to give some insight and background into how investors' exposure to such industries is managed in ethical funds that are available to us for the construction of ethical portfolios.

It is important to note here that there are different approaches fund managers take to ethical investing in general. For example, if a company – even to a small extent – deals in goods or services deemed unethical, some managers look to exclude those companies entirely, while others think taking a stake in a company and driving change through engagement is a more appropriate use of capital. Some also try to reward the 'best' companies in controversial sectors, as a way to promote clients' preferred outcomes. In our survey, all of these methods received significant support from our clients as ways to include ethical considerations in an investment process.

One of the first things we look for with prospective funds are their so-called 'negative screens' – the ways in which they exclude businesses from their potential investment list. For example, most of the funds in our ethical portfolios exclude companies that use animal testing, either for cosmetic use or altogether. However, as alluded to above, this approach would not be appropriate if the fund manager was trying to generate change through engagement.

Even when companies pass these negative screens, they remain subject to our ongoing monitoring. Unfortunately, this is not as simple as categorising a portfolio by geography or sector. The more nuanced styles of investing – ethical, ESG (environmental, social and governance), positive impact and others – have become more popular over the years, and thankfully this has increased the quality of data. But even so, the available research on bonds, and even some smaller-sized stocks, leaves a lot to be desired. Here, we use a combination of third-party tools to get as much information as we can. Our research has indicated that within both ethical portfolios and the broader investment universe, around 70% of "animal testing" companies are pharmaceutical, with the remaining 30% classed as non-medical. This is the number which we use to estimate exposures at the portfolio level.

However, even this number must be taken with a pinch of salt. Many companies falling into that 30% are legally required in many regions to test their goods on animals. In some regions, animal testing is banned (such as in the EU, UK, India, New Zealand, and others), but in many large markets, such as Japan, the US and Canada, this is not the case. In some instances, testing is legally required for product approval, China being the prime example. Most negative screens and data providers look at the percentage of revenues derived from products or services which engage in, for example, animal testing, but this too creates difficulties. Is it fair that a company which doesn't test on animals globally, but is forced to in China, is excluded just because the Chinese product lines have been popular? Equally, should a non-pharmaceutical company that also produces active ingredients for use in drug development that must be tested on animals be classified as 'non-medical animal testing'? In ethical investing, these questions are easier to come by than their answers.

We know from our conversations with advisers and clients (including the recent survey) that one person's ethical priorities are slightly different from the next person. However, our survey also showed that every aspect we cover through our negative (sin) screens as well our positive (impact investing) screens are important to a large enough a group to matter.

Ethical portfolio strategies need to serve and satisfy a fair number of investors whose standards are directionally aligned but have individually different focal points. Therefore, we will keep working towards reporting enhancements that demonstrate how much less 'bad' and how much more 'good' investment exposure from an ethical standpoint is, particularly when compared against unconstrained approaches. Hopefully, as industry data standards improve so will the information we can provide to clients.

Global Equity Markets

Market	Fri 15:52	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	6453.4	6.2	376.8	↗	↘
FTSE 250	18169	6.6	1126.2	↗	⬂
FTSE AS	3573.3	6.2	209.6	↗	↘
FTSE Small	5112.2	5.1	247.5	↗	⬂
CAC	5157.4	9.8	462.0	↗	⬂
DAX	12758.3	8.3	977.2	↗	⬀
Dow	27067	6.6	1683.9	↗	→
S&P 500	3180.1	4.5	135.8	↗	⬀
Nasdaq	9782.7	3.1	292.8	↗	↗
Nikkei	22863.7	4.5	985.8	↗	↗
MSCI World	2218.5	3.3	70.6	↗	⬀
MSCI EM	988.8	6.3	58.4	↗	→

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
Int'l Consol Air	40.5	Hargreaves Lansdown	-11.4
Carnival	33.7	Hikma Pharma	-8.9
Rolls-Royce	30.7	Fresnillo	-8.7
easyJet	29.8	Reckitt Benck	-4.9
John Wood	27.3	Ocado	-4.2

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.272	3.1	Oil	42.09	19.1
GBP/EUR	0.889	1.2	Gold	1673.1	-3.3
USD/EUR	1.13	1.9	Silver	17.24	-3.5
JPY/USD	109.77	-1.8	Copper	255.6	5.4
CNY/USD	7.09	0.7	Aluminium	1570.5	2.2
Bitcoin/$	9,699	3.0	Soft Cmdties	348.3	4.8

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.36	+0.18
UK 15-Yr	0.57	+0.20
US 10-Yr	0.92	+0.27
French 10-Yr	0.03	+0.11
German 10-Yr	-0.27	+0.18
Japanese 10-Yr	0.05	+0.05

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.4	22.7	19.6	13.4
FTSE 250	3.0	22.5	20.6	14.3
FTSE AS	4.2	23.8	19.7	13.5
FTSE Small	4.0	15.1	-	13.8
CAC	2.3	20.5	22.3	13.6
DAX	2.8	25.1	21.0	12.6
Dow	2.4	20.1	24.7	15.2
S&P 500	1.9	22.1	25.4	16.2
Nasdaq	0.9	30.3	29.6	18.3
Nikkei	1.9	26.6	20.8	16.9
MSCI World	2.3	21.4	22.9	15.4
MSCI EM	2.7	16.0	15.8	11.9

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!

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

8th 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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