Perpetual Investments

THOUGHTS ON THE MARKET

14th September 2020 - The three issues which are holding markets back

SUMMARY

- Global risk markets were quiet on Friday night with the MSCI World Index and regional credit markets unchanged to end the week. Overall, it was a session with did not have any narrative-altering developments although the list of market headwinds continued to grow. In other markets, 10-year US Treasuries fell -1 point to 0.67% with curve flattening, commodities were mixed with oil steady (at USD37.31 per barrel) and gold lower (-0.5% (to 1,941 per troy ounce), and G10 currencies were mixed against the Greenback with the AUD (+0.2% to USC72.87) and the Euro (+0.1%) advancing, the Yen was steady and Sterling dropped sharply (-1.6% and is now -4.8% since its 1st September peak) as hard Brexit fears and COVID-19 case numbers both surged.

- At present, regional sharemarkets are struggling to stabilise after a fast -11% sell off in US tech. While many have attributed this to the beginning of a value rotation, I'm not convinced as the tech underperformance is occurring at a time when bond yields are flat (instead of rising) and cyclical equity market sectors are also lower (ditto), which suggests that growth concerns and geopolitics are also at play. Indeed, since the tech peak 12 days ago, US 10-year Treasuries are only +2 basis point higher and the curve has steepened only +1 point, cyclical US equity sectors such as energy (-7.3%), financials (-3.1%), industrials (-2.9%) and US small caps (-6.0%) have all declined, and commodity currencies (AUD and CAD) have underperformed defensive ones (USD, JPY and EUR).

  Growth and geopolitical risks seem to be emanating from three broad thematics. Firstly, while nearly all economic face some degree of fiscal consolidation in 2021, the US fiscal cliff comes earlier than all and can become a material risk to markets if it intersects with a contested US election in November. If we don't get a CARES 2 package legislated soon then US growth could dip to a sub-trend pace in the December quarter and the market is likely to be characterised by heightened volatility. Secondly, the risks of a hard Brexit are now real, even if not base case, underpinned by ideology (the Johnson government seems to value sovereignty over the mutual benefits from trade), complexity (given recent views that the UK would breach international law in a "specific and limited way" by introducing legislation around the Irish protocol) and a tight timeline (the agreement must be finalised by end-October to give legislators time to pass required bills through Parliament).

  A no-deal outcome is a major headwind for the UK economy in 2021, a headache for Europe and a non-event for global GDP growth given the size of the UK economy. Lastly, accelerating virus cases in Europe is a concern and they have implemented surgical-like social isolation policies which suggests that reversing the curve will take time and weigh on confidence and potentially spending. Their situation seems as manageable as the recent US case surge, but seasonality is becoming less favourable coming into year end.

- The number of global cases of COVID-19 is 28.9 million with another +221.7k cases so far (but Mexico, Colombia and 6 US states have not reported their numbers) which means that Sunday was the 55th consecutive day where daily increases are greater than 200k. At present, 10 countries have more than 500k cases, 22 countries have more than 200k cases (Indonesia joined this group overnight) and 33 countries have more than 100k cases. It took 73 days to record 1 million cases, and after this each subsequent million has taken 13 days, 11 days, 12 days, 10 days, 11 days, 8 days, 8 days, 7 days, 6 days, 5 days, 5 days, 5 days, 4 days, 5 days, 3 days, 4 days, 4 days. 4 days, 4 days, 4 days, 4 days, 4 days, 4 days and 4 days. More importantly, the growth rate of daily confirmed cases (+1.1% since Thursday) is steady. Meanwhile, deaths stand at 922.2k and the death rate was steady at 3.19% although the number of daily deaths remains elevated.

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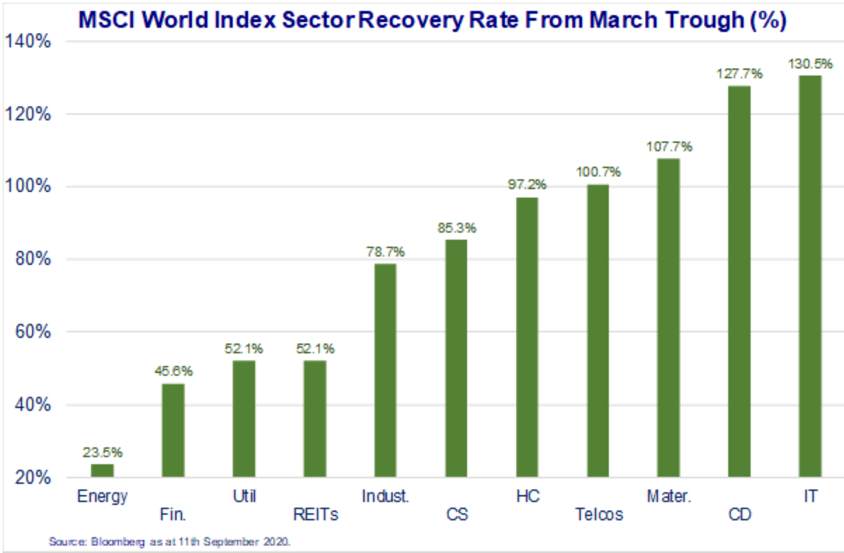
FINANCIAL MARKETS

- **EQUITIES**
  - **The MSCI World Index was flat on Friday which closed out two consecutive weekly declines for the first time since mid-March.** On the sector front it was a strange session in that while tech led the pace of declines led by IT (-0.7%), communication services (-0.2%) and consumer discretionary (-0.1%), the traditional value sectors were mixed with the advances led by industrials (+0.9%) with machinery leading the gainers, and financials (+0.3%) ended higher (although gains in banks, life insurers and consumer finance were modest), but energy (-0.1%) continues its awful recent run with the sector down for the 18th occasion in the past 22 sessions during which it has fallen by -13.7% even though the crude price has been only slightly lower over that period. While, value sectors oscillated between gains and losses, the defensive names outperformed with advances in utilities (+0.3%), consumer staples and healthcare (both +0.5%). Moves over the week saw lower recovery rates in energy (23.5%), financials (45.6%), REITS (52.1%), communication services (100.7%), consumer discretionary (127.7%) and IT (130.5% - see chart).



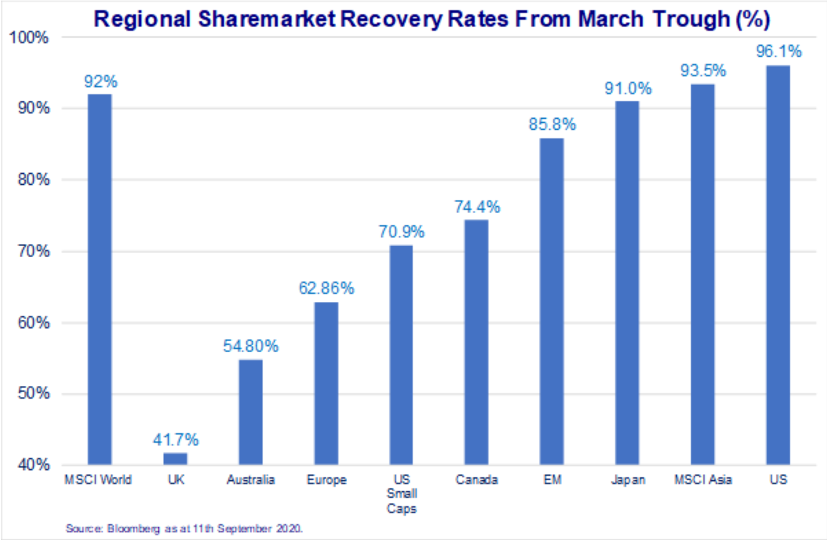
  - **There were modest gains in all regions, led by Asia where the MSCI Asia Pacific Index rose +0.5%. It was a very quiet session with little incremental news on the macro, policy or corporate front, but nearly all indices ignored another weak lead from Wall Street to close higher.** Japan was upbeat as Tokyo lowered its virus alert level where infections have subsided enough to be included in the national tourism campaign. Meanwhile, Cov-19 cases continue to decline in Asian hotspots with South Korea infections at a three-week low and Victoria's 50 cases continued a slow trickle lower ahead of looming easing of restrictions in regional areas. By the closing bell, regional gains were led by Mainland China (+1.0%), Hong Kong (+0.8%) and Japan (+0.7%), whereas India (+0.04%), South Korea (+0.01%) and Taiwan (-0.1%) where little changed, with Australia (-0.8%) had the only large decliner of the session.

    Meanwhile, European shares closed slightly higher (+0.1%) in choppy trading although, like Asia, there was nothing incremental to move the market dial. On the macro front there were a couple of final inflation reads for August which were in line with the flash estimates, and on Brexit the European Commission said it will consider its next steps after September. However, there was brighter news in that the UK and Japan concluded a free trade agreement which means 99% of the former's exports to Japan trade will be tariff free. Meanwhile, Coronavirus remained at the forefront as European cases continues to push higher on Friday with the R-factor at 1.23 relative to the US at 0.85, and the UK rose to 1.78. By the closing bell, regional performance was mixed with gains in Switzerland (+0.5%), the UK (+0.5%) and France (+0.2%), whereas Italy was unchanged and Germany (-0.1%), Sweden (-0.1%) and Spain (-0.8%) closed lower.

    Elsewhere, US markets were marginally higher (+0.1%) in an up and down session which saw the major indices post their second consecutive weekly loss which last occurred in mid-March. It was a quiet session on the headlines front with macro data revealing US inflation had increased to a five month high of 1.3% y/y which was a bit higher than expected but still below target. Meanwhile, House Democrats blocked the GOP's USD500 billion stimulus plan and the US Treasury detailed a record budget deficit of USD3 trillion with one month to go in the US fiscal year. By the closing bell at the NYSE, advances were led by the

Dow Jones (+0.5%), with the S&P 500 (+0.05%) scraping together a daily rise in the last minute of trading, but the NASDAQ 100 (-0.6%) fell for the fifth time on the past six sessions, as did the Russell 2000 (-0.7%).

The close of trading saw Europe (+2.7%) close out a weekly advance, whereas Asia (-0.2%), Australia (-1.1%) and the US (-2.5%) all declined which pulled the recovery rates from the February peak down in the process.



- **Futures markets suggest a subdued opening in Asia** with Australia (+0.1%) and Japan (+0.1%) priced for gains, whereas Hong Kong (-0.5%) appears set to open lower at the bell.

- **What to make of the recent equity market decline?**
At present, it appears that regional sharemarkets are struggling to stabilise after a fast -11% sell off in US tech. While many have attributed this to the beginning of a value rotation, I'm not convinced as the tech underperformance is occurring at a time when bond yields are flat (instead of rising) and cyclical equity sectors are also lower (instead of higher), which suggests that growth momentum concerns and geopolitics are also at play. Indeed, since the tech peak 12 days ago, US 10-year Treasuries are only +2 basis point higher and the curve has steepened only +1 point, and cyclical US equity sectors such as energy (-7.3%), financials (-3.1%) and industrials (-2.9%) and US small caps (-6.0%) have declined, and commodity currencies (AUD and CAD) have underperformed defensive ones (USD, JPY and EUR).

  There appears to be strengthening headwinds/more questions in three broad areas:

  1. **The US fiscal cliff** - The US fiscal cliff can become a material risk to US markets if it intersects with a contested US election in November. Almost all economies face some degree of fiscal tightening over the next year if support measures are not extended, but the US is facing its cliff earlier than others due to the expiration of enhanced unemployment benefits in July. Most market analysts see this issue as a manageable risk as the US economy had strong momentum coming into the event; there was Republican/Democratic common ground around a USD1 trillion package and investor equity positioning was below average.

     However, if we don't get a CARES 2 package through then US growth will dip to a sub-trend pace in the December quarter and the market is likely to be characterised by heightened volatility. When this is overlayed potentially with a contested election, like what occurred in 2000, volatility is likely to spike higher. There are some similarities to 2000 as a tech bubble was deflating, but there are also stark differences as the US economy in 2000 was heading into recession whereas 20 years later they are just coming out of it. Nonetheless, during the Bush-Gore saga, which went on for more than one month, US shares declined -7% from their pre-election level, the US dollar declined (see chart) and US investment grade and high yield spreads widened 20bp and 100bp, respectively, but admittedly it is difficult to distinguish the recession influence from the political uncertainty.

     The path in 2020 is harder to envisage as the political issues could be resolved by a middle of the road solution to the fifth stimulus bill impasse and this would see equities at worst stabilise. In contrast, the path for the US Dollar is more one-sided relative to other reserve assets like JPY, EUR,

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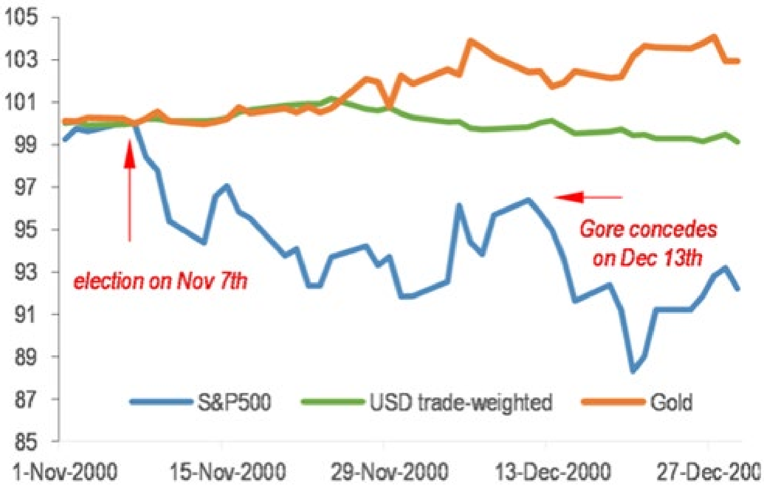
CHF and Gold, given that the currency is now amongst the global low-yielders now compared to its high-yield status in 2000.



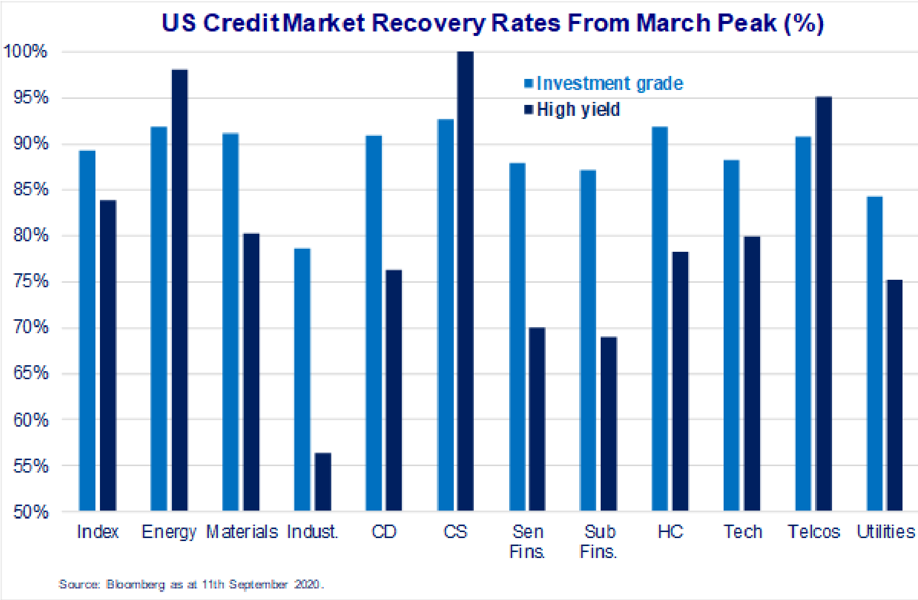
Source: J.P. Morgan

2. **Brexit negotiations –** While forecasting the outcome of trade discussions between Europe and the UK is always hard, the risks of a hard Brexit are now real, even if not base case. The decent odds of no-deal are underpinned by ideology (the Johnson government seems to value sovereignty over the mutual benefits from trade), complexity (especially given recent views that the UK would breach international law in a "specific and limited way" by introducing legislation around the Irish protocol) and a tight timeline (things must be agreed be end-October to have enough time to be legislated). A no-deal outcome is a major negative for the UK economy and could take three percentage points off UK GDP in 2021 (which would halve it to about 3.25% after a -9% decline in 2020) and result in further Sterling depreciation and BoE QE, with an outside chance of the Bank cutting policy rates below zero. Conversely, the hit to European area might be about -0.5% off GDP (to +5.7% in 2021 from -6.75%) given the relative importance of bilateral trade. However, given the size of the British economy, the impact on global GDP growth is negligible.

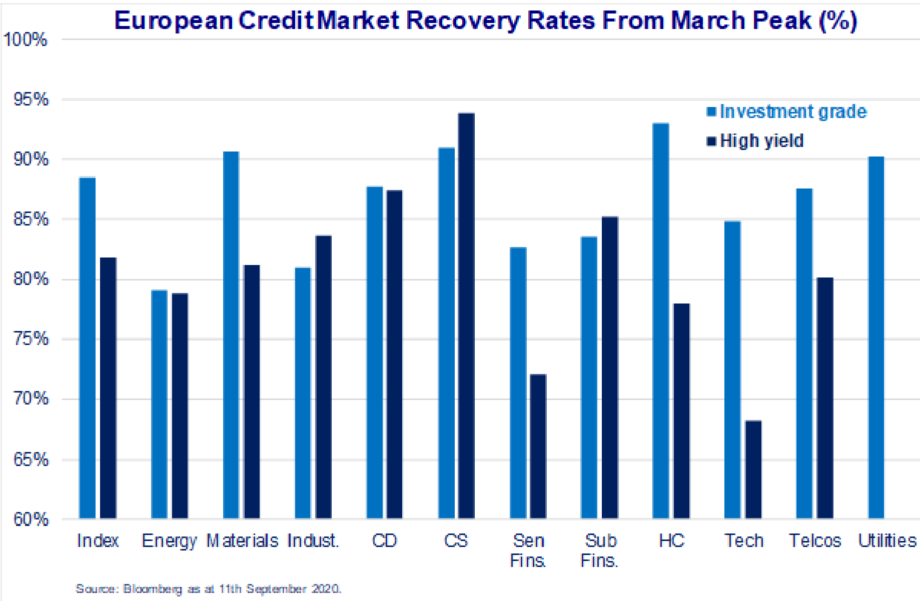
3. **The accelerating virus cases in Europe -** Europe's second wave is accelerating, and the region has implemented surgical-like social isolation policies which suggests that reversing the curve will take time and weigh on confidence more than anything else. Their situation seems as manageable as the recent US one which is now producing considerably lower case growth, but the daily cases there are still well above zero.

We think the first two issues are larger market disruptions than the last one.

- **CREDIT MARKETS**
  - **Regional credit indices were quiet yet again with spreads in the US investment grade space unchanged at +130 bpts with the recovery rate at 89%.** Although seven of the 11 sub-sectors recorded lower spreads, none of them was more than half a basis point and this was the same story over the past week when investment grade spreads increased +2 points, but no sector saw of increase of more than five points which meant recovery rates were mostly unchanged over the past week (see chart). Meanwhile, spreads in the high yield universe increased +1 point to +521 bpts, with the recovery rate steady at 84%. Although ten of the 11 subsectors recorded higher risk premiums the largest was +3 points in another quiet day for investors. However, over the past week spreads increased +14 points and recovery rates declined a couple of percentage points in energy (98%), utilities (75%) and industrials (56%).

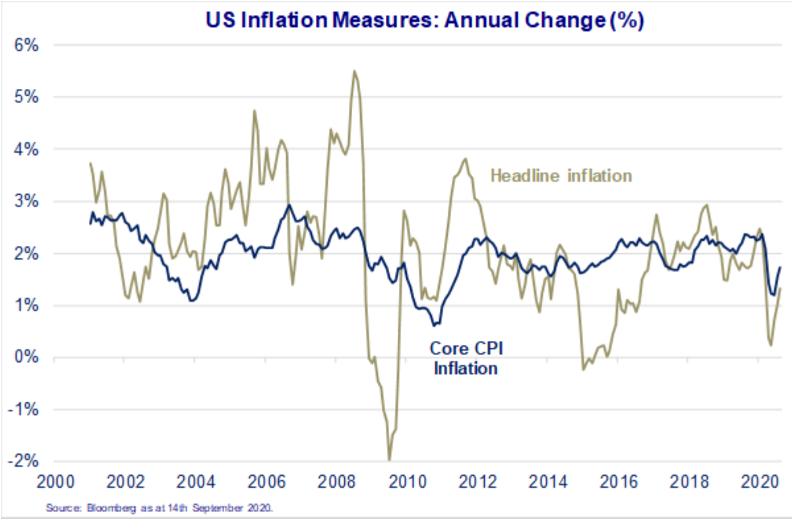


- **European credit markets were also quiet with investment grade spreads declining -2 points to 57 bpts,** which increased the recovery rate to 88%. In many ways Friday was a reversal of Thursday in terms of spread movement and sector trends, with no sector recording an increase of more than +3 points which meant that over the past week recovery rates were unchanged. In the high yield universe, spreads ended +3 points higher at +383 bpts but that was not enough to alter the recovery rate which remained at 82%. The defensive sub-sectors recorded the largest increase in spreads led by communication services (+8 points, +309 bpts, 80%) and consumer staples (+7 points, +498 bpts, 94%) but these were just the swings and round-abouts of daily volatility with recovery rates for the week mostly steady (see chart).



THE GLOBAL ECONOMY

- **US headline CPI inflation rose +0.39% m/m in August** which was below the +0.6% surge that we saw in both June and July, but an elevated number nonetheless, which took the annual rate up to +1.3% (see chart). The August increase was underpinned by a +5½% rise in the volatile used car category which accounted for almost 40% of the August price increase. Among other sectors, energy prices (+2.0% m/m) also increased solidly but food prices (-0.1% m/m) fell.



Removing the impact of both food and energy saw the remaining core CPI rise +0.39% m/m which took the annual rate up to +1.7% y/y which is nearing the Fed's target range. The outsized core CPI increase was again driven by used cars (yes the pun was intended) but when this item is removed the remaining core CPI increase was just +0.22% m/m. Among the remaining components, strong rises in prices for household furnishings, airfares, lodging away from home and recreational items, were largely offset by weakness in tenants' and owners' equivalent rent and the smallest increase in medical services prices in more than a year and a half. So the increase in the US CPI inflation over the past three months has been driven by the goods sector (+4.0% q/q annualised) whereas services inflation is more dormant.

Combining the CPI and PPI results from last week, suggests that the August core PCE will be around +0.3% m/m which is likely to see the annual rate increase to about +1.65%. These levels are up about ¾ of a percentage point from the April low, but this rate is likely to peak soon as the price impact of reopening fades, and excess capacity sees inflationary pressures ease over the subsequent 6 months.

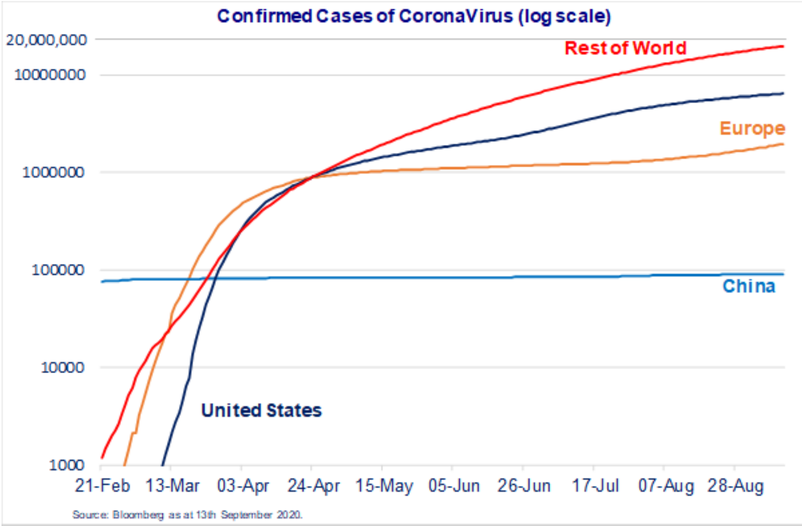
POLICY

- There were no material policy announcements on Friday or over the weekend.

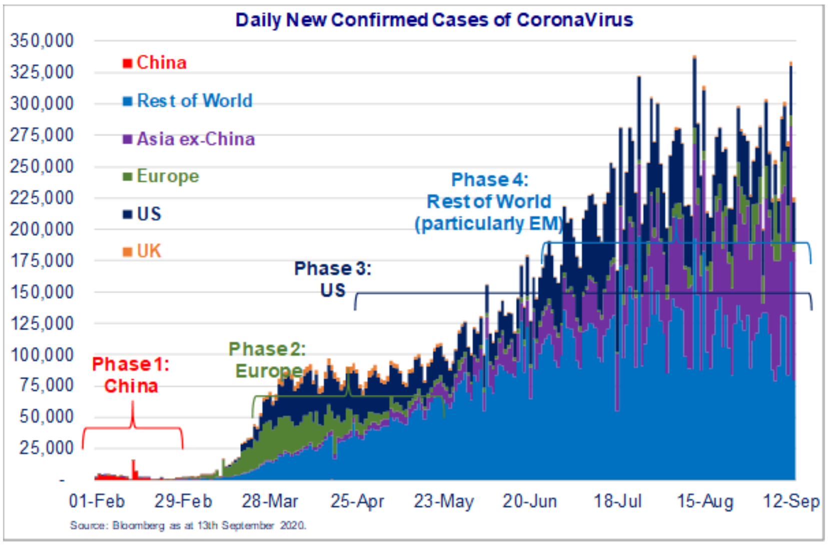
VIRUS UPDATE

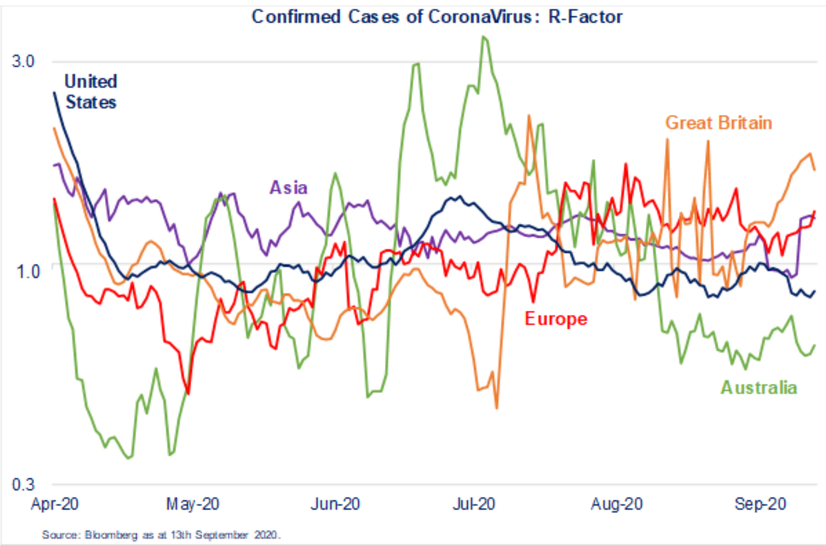
- The number of global cases of COVID-19 is 28.9 million with another +221.7k cases so far (but Spain, Mexico, Colombia and 6 US states have not reported their numbers) which means that Sunday was the 55th consecutive day where daily increases are greater than 200k. At present, 10 countries have more than 500k cases, 22 countries have more than 200k cases (Indonesia joined this group overnight) and 33 countries have more than 100k cases.

  It took 73 days to record 1 million cases, and after this each subsequent million has taken 13 days, 11 days, 12 days, 10 days, 11 days, 8 days, 8 days, 7 days, 6 days, 5 days, 5 days, 5 days, 4 days, 5 days, 3 days, 4 days, 4 days. 4 days, 4 days, 4 days, 4 days, 4 days, 4 days and 4 days. More importantly, the growth rate of daily confirmed cases (+1.1% since Thursday) is steady. Meanwhile, deaths stand at 922.2k and the death rate was steady at 3.19% although the number of daily deaths remains elevated.



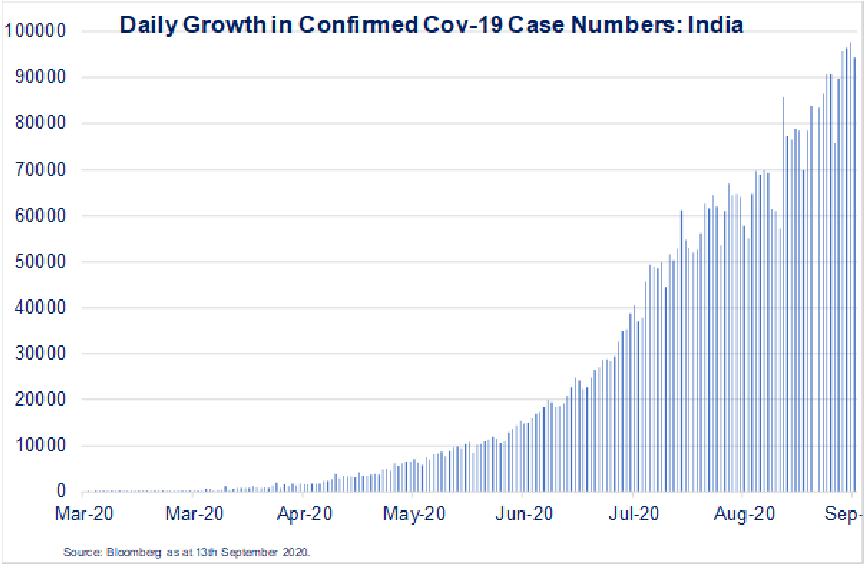
- We break the infections into four groups – the US, Europe, China and 'others' and the rest of the world outside the G3 economies now has the most total cases (+182.1k to 26.0 million) and highest daily new cases (and by a considerable margin) followed by the US (+33.8k to 6.52 million, although 6 states are yet to report). The issue for the US is that they never flattened their curve which means economic opening has not been associated with lower case numbers, and rising case numbers are also evident in Europe (+5.9k to 1.98 million - see chart) which is the only region with an R-factor above 1.0 which indicates that the infection rate (1.33 is too high, especially in Britain (1.67).

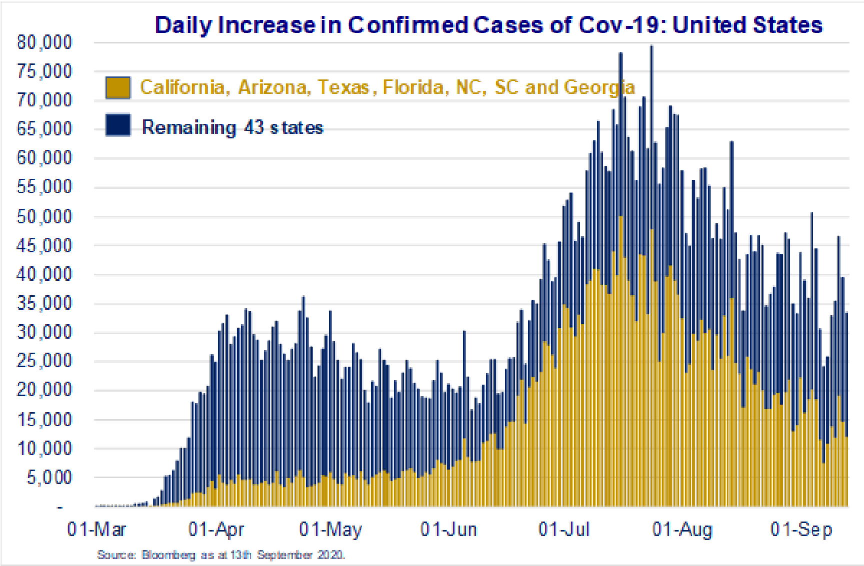




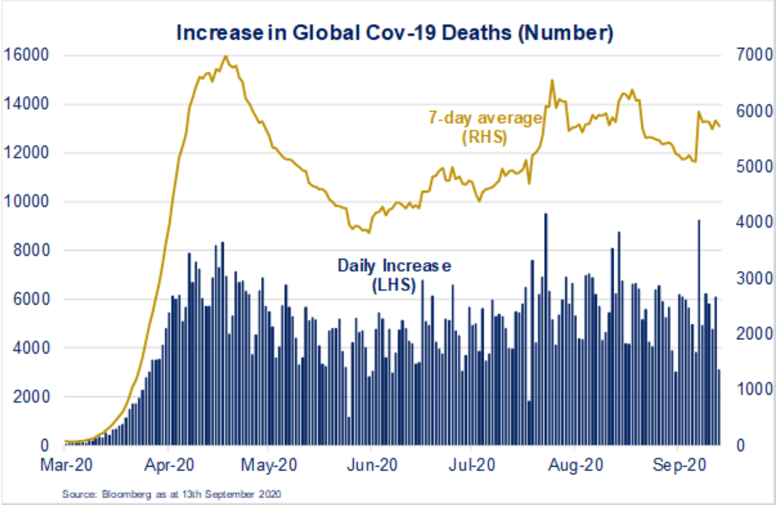
- Among countries, the most cases are in the US (+33.8k (so far) to 6.52 million, with 6 states yet to report), India (+94.4k to 4.75 million), Brazil (+14.7k to 4.33 million), Russia (+5.4k to 1.06k), Peru (+6.2k to 722.8k), Colombia (not reported, 709.0k), Mexico (not reported, +664.0k), South Africa (+1.6k to 649.8k), Spain (not reported, 566.3k) and Argentina (+10.1k to 555.5k). Australia confirmed cases rose +35 (6-week low) to 26.7k yesterday which placed us 68th in terms of total infections.

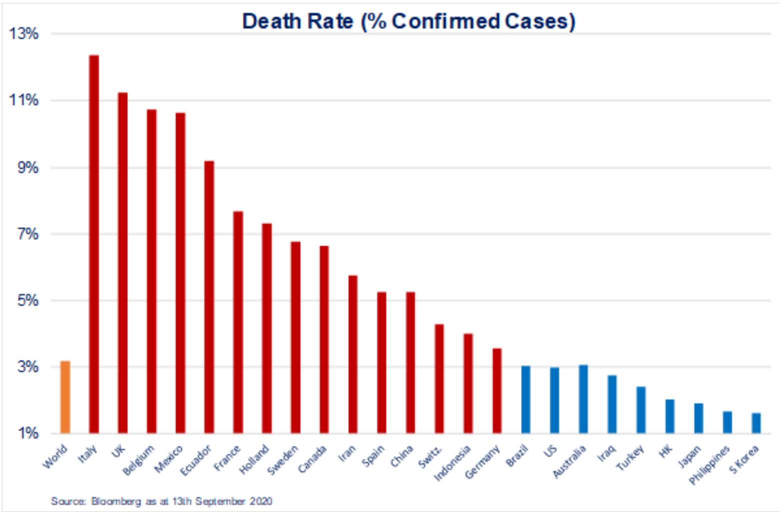
  Elsewhere, Singapore recorded +49 new cases to 57.4k most of which are linked to foreign workers who are forced to live in crowded dormitories, but Indonesia (+3.6k to 218.4k) is now on the rise and has the second most cases in the region behind only the Philippines (+3.4k to 261.2k).





- Although final numbers are not in until 1pm AEST, the global death rate was steady at 3.19% with the global total to 922.2k after another +3.1k deaths overnight, so far, which indicates the daily average deaths is stabilising again (see chart). The US (+0.4k so far) has the most deaths at +194.0k, with Brazil (+0.4k to 131.6k), India (+1.2k to 78.6k), Mexico (+0.2k to70.6k), the UK (+5 to 41.7k), Italy (+7 to 35.6k) and France (+1 to 30.9k) all over +30k. The death rate is highest in European countries where the health systems had collapsed led by Italy (-0.1% to 12.4%), the UK (steady at 11.3%), Belgium (-0.1% to 10.7%), France (-0.1% to 7.7%), the Netherlands (-0.1% to 7.3%), Sweden (steady at 6.8%) and Spain (-0.1% to 5.3%). However, several emerging markets are now on the leader board including Mexico (+0.1% to 10.6%), Ecuador (-0.2% to 9.2%), Indonesia (steady at 4.0%) and Brazil (steady at 3.0%).





Yours sincerely,

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MORE INFORMATION

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