

# THOUGHTS ON THE MARKET

16<sup>th</sup> November 2020

The COVID-19 vaccine is just what the doctor ordered, but there are sizable problems to resolve

## SUMMARY

- **Global risk markets rallied strongly last week** in response to the Pfizer announcement of a COVID-19 vaccine which was 90% effective in its stage 3 trials. That news certainly bolstered confidence that the world can finally break the nexus between virus containment and social mobility and if that proves the case, 2021 is likely to be a year of global reflation given the likely combination of above-trend growth, ultra-loose monetary policy and large scale operational leverage in corporate structures, given recent cost-out drives. However, the governing dynamic of this embryonic cycle is that things change fast and timing portfolio adjustments is much more difficult than it was after the GFC, for example, where valuations were 10x earnings – today they are 23x earnings and the combination of surging virus numbers in the US and Europe, a lack of an immediate US fiscal impulse (most likely until March 2021) and already high valuations are set to create rising market volatility into year's end and early 2021.

**Consequently, the optimism that the global economy can move past the COVID-19 crisis next year has to be balanced against a significant growth drag in the months ahead and also the massive logistical issues centred around inoculating around 5.8 billion people which will be required for global herd immunity.**

Pfizer's COVID-19 vaccine drug is being manufactured in both Michigan and Belgium and the key issue centres around storage and distribution as the drug needs to be stored and transported at around -70 degrees Celsius which is the temperature at the South Pole at the extremes of Winter. This will require large investment in transportation capability which may not exist at present, and this is something that could require a more extended timeframe to roll out the treatment. In addition, there is a current dry ice shortage in the US and there are also limits of how much of this key input can be used on a plane as it releases carbon dioxide – this suggests that transportation and storage will be key issues moving forward. In addition, hospitals and pharmacies will also need to find ways to store large vials of the vaccine until they're needed as doctor's clinics can't take the volume of vaccine vials which are planned to be distributed in lots of 1000 units (with five shots per unit). These issues are not insurmountable, but they could delay distribution and make controlling the virus's spread a longer process which could have consequences for growth risks which are not priced into markets.

**Even if the virus fades from the scene in the second half of next year, permanent job losses and cumulative income declines indicates that the COVID-19 pandemic will leave lasting damage on the global macroeconomic landscape.** The income hit is the first round effect, then there's the change in corporate and household behaviour in the wake of such a large historic shock – household savings rates are likely to remain above pre-COVID-19 levels, investment is likely to diminish, firms will look to simplify supply chains and could trade simplicity over margins, and there is likely to be permanently higher unemployment as firms work their costs harder. So, risks are significant that we have another weak cycle ahead of us which is not being priced into markets and when the euphoria diminishes, prices may have to adjust.

- **Another area of lasting consequences is inflation and our view, which has been well stated for several months, is that despite considerable volatility across regions and massive stimulus, the virus and its aftermath is set to produce lasting disinflation.** We are now starting to see this in the data in October where US headline and core inflation was flat, China's core and headline inflation rate (both +0.5% y/y) declined to its lowest level ex-GFC, European core inflation is already at a record low (+0.2% y/y) and Japan (-0.3% y/y) is already back in deflation territory. The challenge here is that goods sector inflation is starting to ease and the pandemic is hitting the services sector in a very persistent and protracted way, and price there remain very weak and are likely to remain so over the medium term. In terms of a policy response, with rates at zero it is clear that central banks don't have the tools to fix this problem, which is why fiscal support is so critical but this

is collectively being unwound in 2021. While central banks can do more QE, but this will not turn water into wine.

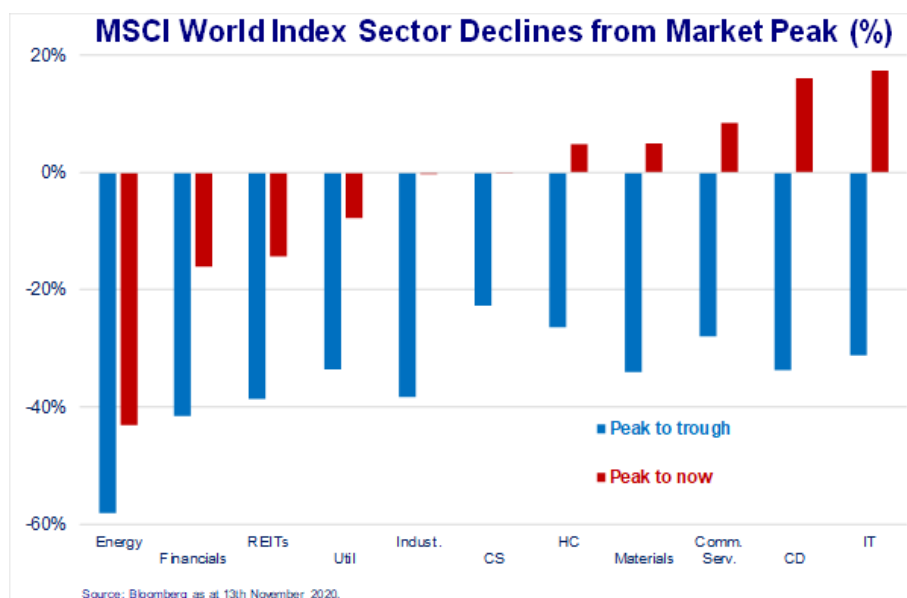
- **In other markets, 10-year US treasuries recorded capital losses** with yields up +8 points to 0.90% with curve steepening, commodities were mixed with oil up strongly (+8.1% to USD40.13 per barrel) but gold declined (-3.2% to USD1,889 per troy ounce) and G10 currencies were mixed against a weaker Greenback with gains in both Sterling (+0.3%) and AUD (+0.2%), and declines in the Euro (-0.3%) and Yen (-1.2%).
- **The number of global cases of COVID-19 is 54.3 million with another +370k cases so far overnight** (but Brazil, Colombia, France, Mexico, Pakistan, Spain and Sweden and 20 US states have not reported their numbers) which means that Sunday was the 118th consecutive day where daily increases were greater than 200k. At present, 20 countries have more than 500k cases, 36 countries have more than 200k cases and 57 countries have more than 100k cases. More importantly, the growth rate of daily confirmed cases (+1.1% since Thursday) is slightly higher. Meanwhile, deaths stand at 1.32 million and the death rate was steady at 2.42% although the number of daily deaths remains elevated and hit an all-time high on Wednesday.

## FINANCIAL MARKETS

### • EQUITIES

- **The MSCI World Index closed +2.4% higher last week, with gains in all regions and most sectors.** Overall sentiment was dominated by the Cov-19 vaccine announcement from Pfizer which sparked a violent sector rotation out of growth and into value/cyclicals. At the sector level, energy (+14.9%) led the pace of advances given its low recovery rate, higher oil prices and hopes that the vaccine would end the COVID-19 negative impact on the recovery. Financials (+8.2%) also rallied strongly as yield curve slope increased although this impact lessened as the week progressed and REITs (+5.2%) and industrial (+4.7%) were also buoyant as investors sought sectors which had struggled under the pandemic. At the other of the return spectrum, tech sectors underperformed with communication services (+1.0%), consumer discretionary (+0.4%) and IT (-0.5%) recording the three weakest weekly price movements.

By the end of the week's trading only energy (-43.1% with a recovery rate of 26%) remained in bear market territory, with financials and REITs (-16.0% and -14.4%, and 61% and 63%, respectively) promoted into correction territory. Meanwhile, healthcare (+4.7%, 118%), materials (+5.0%, 115%), communication services (+8.5%, +130%), consumer discretionary (+16.0%, +148%) and IT (+17.4%, 156%) have recorded complete recoveries (see chart).



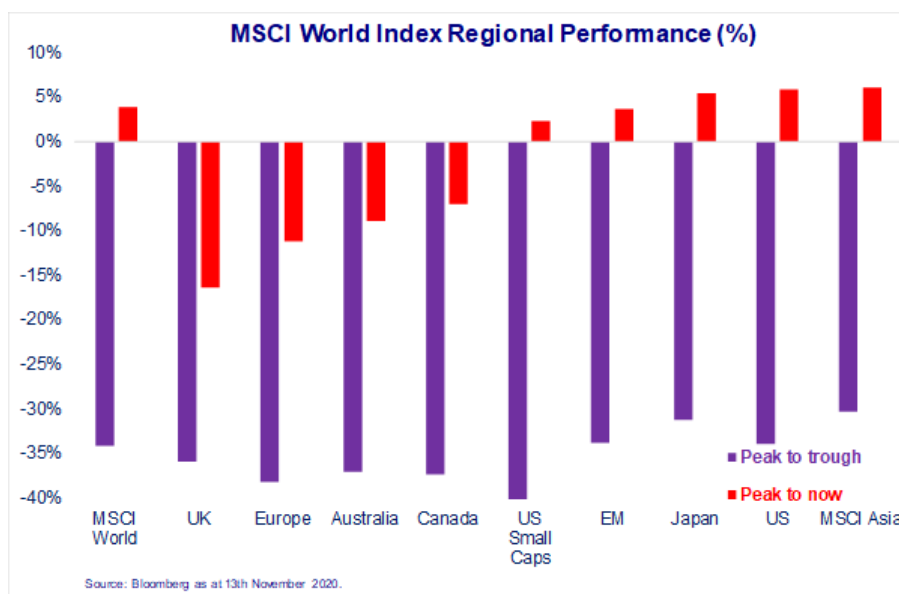
- Among the regions, the pace of was led by Europe (+7.1%) which benefited from a modest flattening in its COVID-19 curve (although this could just be noise) and its value composition which sparked large gains in financials from the steepening yield curve and energy from higher crude prices. Although there

were questions about how long the vaccine's protection will last and how fast large parts of the population can be immunised the news was welcomed by all. Economic data was minimal with the second estimate of regional Q3 GDP growth in line with its predecessor, but industrial production (-0.4% m/m in September against the street at +0.8% m/m) came in well below expectations. Meanwhile, the ECB President expressed optimism over a vaccine boost, but continued to see uncertainty ahead as the Northern Hemisphere winter approaches. By the end of trading for the week, regional gains were largest in countries with the most stringent lockdowns including Spain (+13.3%), France (+8.5%), the UK (+7.0%), Italy (+6.2%), Germany (+4.8%), Sweden (+4.3%) and Switzerland (+1.6%).

**The US market (+2.2%) recorded its second consecutive weekly advance, but overall performance was weighed down by its tech bias which saw the NASDAQ record its third decline in the past four weeks.** Like all other markets, sentiment was dominated by the vaccine developments which provided a boost on top of reduced election risk which lifted traditional value sectors. The rally, however, came against a worsening COVID-19 backdrop and falling expectations that the US Congress can enact a stimulus bill in the lame-duck period between the election and when elected members sit in the legislature. Meanwhile, it was a fairly mild week of economic data with weekly jobless claims coming in better than expected, and October headline and core inflation was flat (the street was at +0.2% m/m), which was below the street and there was plenty of Fed speak although most of this was commentary with nothing incremental about further support. By the bell at the NYSE on Friday afternoon NY time, the Russell 2000 index (+6.1%) had recorded by far the strongest weekly advance, with the Dow Jones (+4.1%) and S&P 500 (+2.2%) also piecing together another constructive price rally, but the NASDAQ Composite Index (-0.6%) recorded a modest decline.

**Asia (+1.4%) lagged the performance of other regional markets reflecting its high price base (in that the regional gauge had already recorded a complete recovery of its COVID-19 losses) and with low cases in most countries, the macro outlook did not change much with the vaccine news.** There wasn't much macro data also although Chinese consumer and producer inflation did come in below the street which may worry investors if this trend is not reversed, and Japanese core machinery order (a good lead indicator for investment) came in well below consensus in a sign that all is not rosy in the land of the rising sun. There was nothing much also from regional central banks and by the closing bell in Mumbai on Friday night AEDST, there was broad-based gains but they were generally smaller than those in regions led by India (+3.7%), Australia (+3.4%), South Korea (+3.2%), Japan (+2.7%), Taiwan (+2.3%) and Hong Kong (+1.7%), whereas China (-0.6%) was one of the few regional markets to decline.

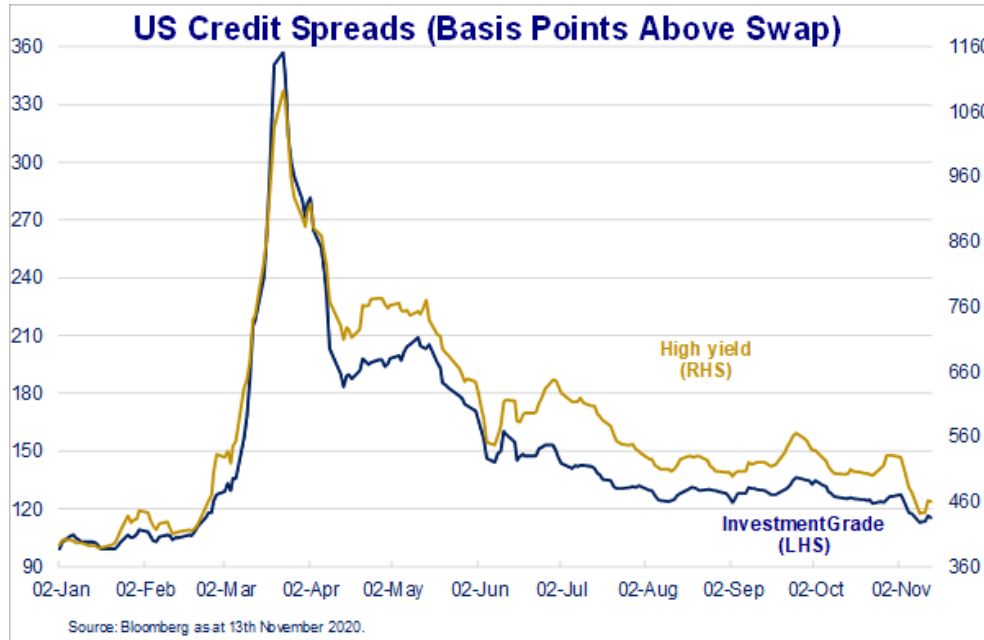
**By the close of trading, there were some sizable changes in our peak-to-now chart with no bourse in bear market territory anymore,** and only the UK (-16.4%) and Europe (-11.2%) in correction territory, with US small caps (+2.3%), EM (+3.6%), Japan (+5.4%), US (+5.9%) and MSCI Asia (+6.0%) having all recorded a complete recovery (see chart).



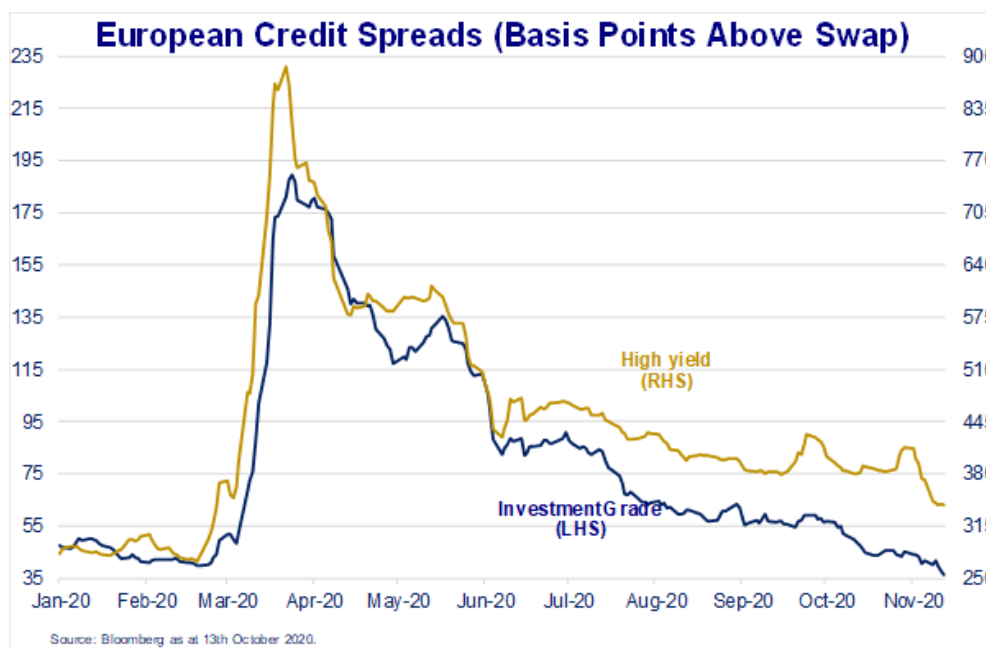
- **Futures markets suggest a positive opening in Asia** with Japan (+1.2%), Australia (+0.8%) and Hong Kong (+0.4%) and all set to open higher at the bell.

## • CREDIT MARKETS

- **Regional credit market continued to rally, but low spreads are limiting the level of any advance.** Spreads in the US investment grade sector declined -2 points to +115 bpts, which increased the recovery rate one notch to 94% with ten sectors recording lower spreads. However, gains were limited with only energy (-7 points, +176 bpts, 92%) and consumer discretionary (-5 points, +120 bpts, 96%) of note. In the high yield sector, spreads contracted -14 points last week, to +461 bpts, which increased the recovery rate two notches to 90%. Gains in the subsectors were strongest in the cyclical areas of the market with energy (-29 points, +736 bpts, 98%) responding positively to another week of high oil prices, with industrials (-22 points, +511 bpts, 75%) and consumer discretionary (-21 points, +436 bpts, 83%) also improving.



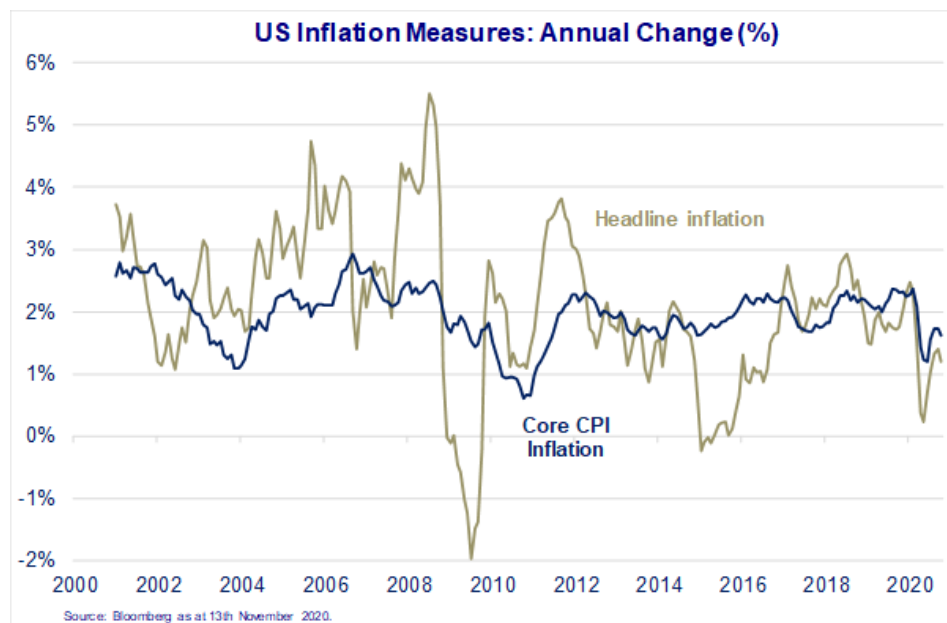
- **Meanwhile, in Europe spreads in the investment grade universe came in -5 points to +36 bpts, which means that the market has recorded a complete recovery from its COVID-19 blowout.** All 11 subsectors recorded lower risk premiums led by the cycles including consumer discretionary (-10 points, +45 bpts, 100%), subordinated financials (-9 points, +119 bpts, 94%) and industrials (-8 points, +28 bpts, 100%). In the high yield universe, spreads came in -31 points to +342 bpts, which increased the recovery rate another 5 notches to 89%. All 11 subsectors rose led by energy (-64 points, +471 bpts, 80%), consumer staples (-50 points, 432 bpts, 100%) and industrials (-42 points, +359 bpts, 95%).



## THE GLOBAL ECONOMY

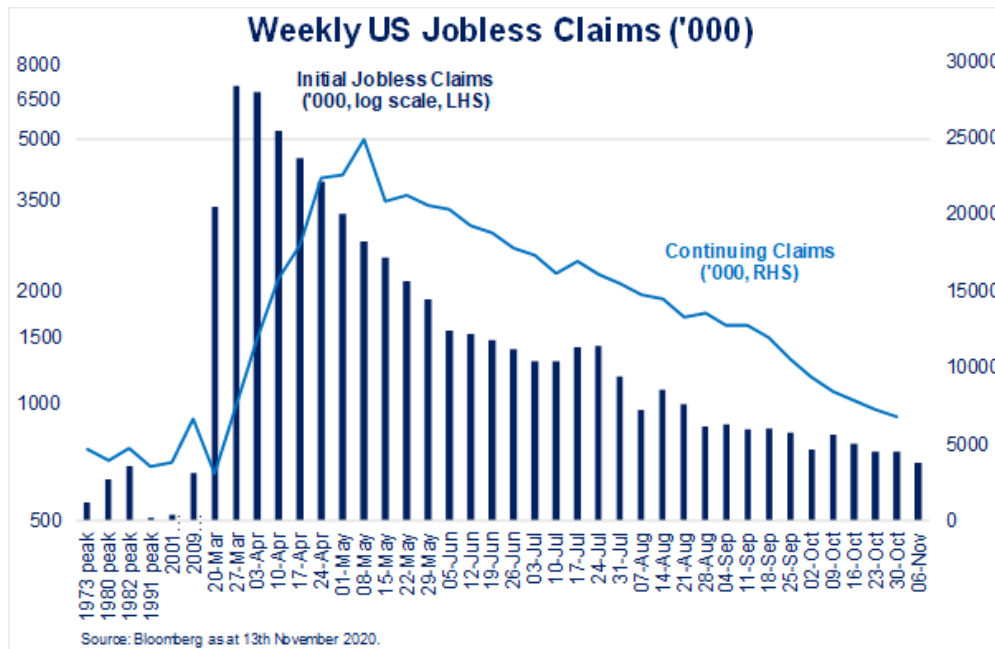
- **US inflation gauges for October were subdued with both headline and core CPI flat for the month which saw annual rates both decline to +1.2% y/y and +1.6% y/y, respectively, both of which were slightly below the street.** Among the components, energy (+0.1% m/m, -9.2% y/y) and food (+0.2% m/m and +3.9% y/y) both recorded modest increases and when these were excluded goods price inflation (-0.2% m/m) recorded its first decline in six months, whereas services (+0.1% m/m) remained very subdued given large excess capacity. Meanwhile, used car prices declined slightly (-0.1% m/m, +11.5% y/y) in October after propping up the core CPI with outsized increases in the past few months, and this allowed the recent lack of strength in the other core components to show through and the only thing that prevented a negative reading was a large rise in tenants' and owners' equivalent rent (both +0.2% m/m) whose strength is likely to prove temporary, as the spring declines in listing rents for new leases have yet to have fully filtered into the CPI's measure of current rent payments.

Looking ahead, we suspect that there is likely to be very little inflation in the next three months as services remains characterised by unused capacity and inflation for items such as used cars, medical equipment and shelter rents return to modest increases. This will see headline inflation decline to around +0.6% y/y in January and core to decline to +0.8% y/y. Meanwhile, the results for the US PPI for October (+0.3% m/m for headline and +0.2% m/m for core) suggests that the core PCE inflation is likely to be flat in October, which will lower the annual rate to just +1.4% and this is also likely to decline to a sub-1% level in the months ahead.

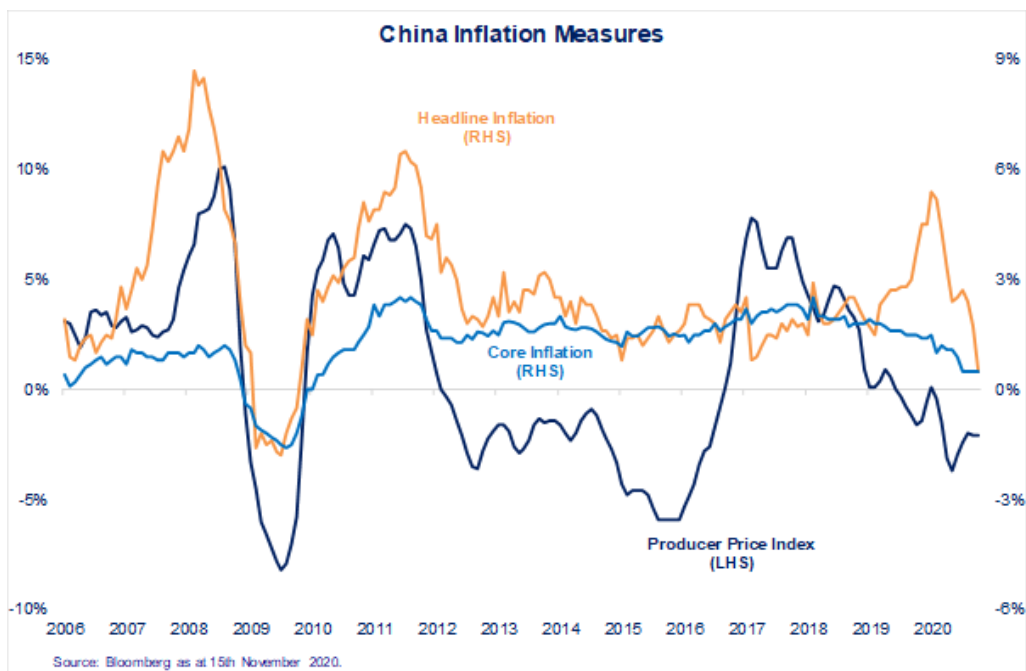


- **US jobless claims this week improved with both gauges showing a continual recovery with less churn.** Initial claims fell by -48k this week to +709k which is the fourth straight week of sub-800k which was a surprise and the medium state reading of a +4% w/w drop in non-seasonally adjustment claims show the improvement was broad-based and less correlated with COVID-19 cases than in the previous week. Meanwhile, continuing claims for the week ending Oct. 31 fell by -436k to 6.8 million with the prior week's data revised lower by -63k. Importantly, the pace of implied outflows has slowed, and the latest week's -1.1 million reading is now -0.5 million below the prior 4-week average reflecting a mixture of slower rehiring and fewer expiring benefits and this suggests that labour market recovery is continuing, but slowing, and it is important to remember that initial claims are still above the peak levels of the past six recessions (see chart).





- **Chinese inflation for October contracted -0.3% which took the annual rate down -1.2% to just +0.5% y/y.** The primary source of the declining prices was food which fell -1.8% m/m and +2.2% y/y primarily reflecting trends in pork prices (-7.0% m/m) which dropped on higher supply and this trend is expected to persist in coming months. Elsewhere, non-food inflation increased +0.1% m/m which kept the annual rate at 0.0% y/y and PPI inflation was flat which kept the annual rate at -2.1% y/y. Looking ahead, headline inflation is set to fall into the negative territory within the next two months given falling food prices and a rising base, which is likely to keep policy in place despite recent hawkish rhetoric from the PBoC. Meanwhile, non-food inflation should remain quite muted, but I doubt there will be reduction in either the cash rate or the RRR.



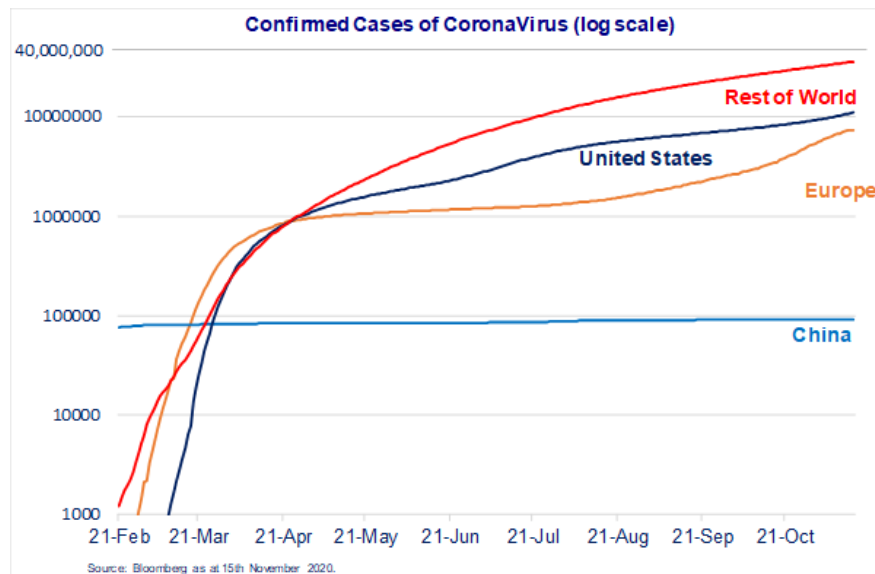
## POLICY

- ECB President Lagarde's stated at the ECB's annual central bank conference that while all policy options are on the table at its December meeting, the Bank will prioritise more asset purchases and ultra-cheap loans as their tools of policy boost, rather than deeper rate cuts into negative territory. Clearly these tools have proven effective during the crisis and can be dynamically adjusted to react to how the pandemic evolves

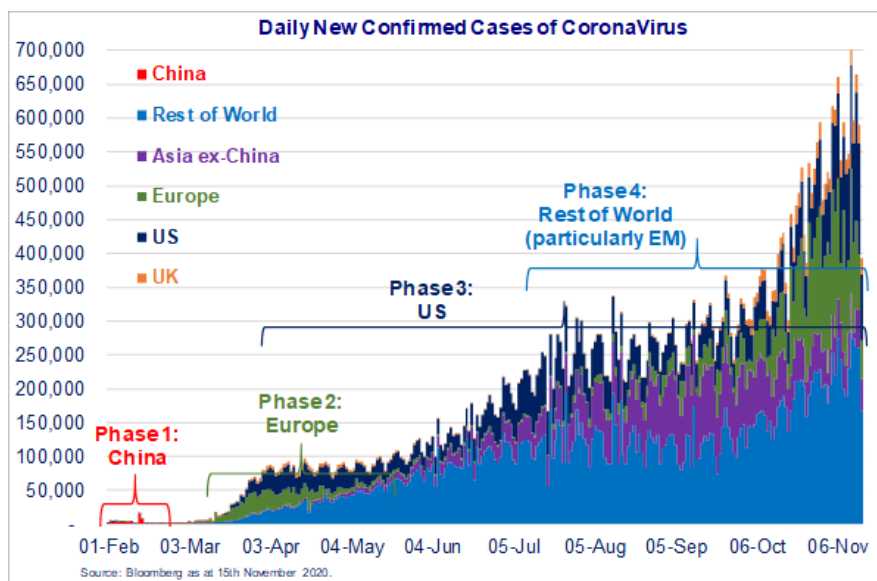
## VIRUS UPDATE

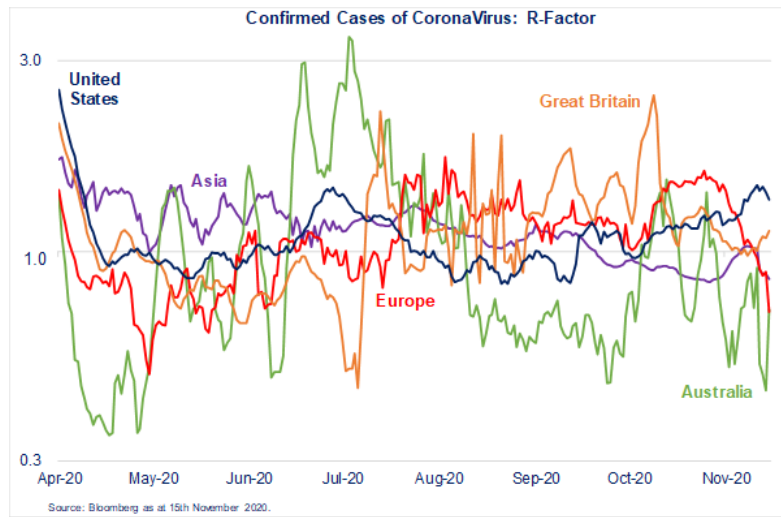
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It took 73 days to record 1 million cases, and after this each subsequent million has taken 13 days, 11 days, 12 days, 10 days, 11 days, 8 days, 8 days, 7 days, 6 days, 5 days, 5 days, 5 days, 4 days, 5 days, 3 days, 4 days, 4 days, 4 days, 4 days, 4 days, 4 days, 4 days, 4 days, 3 days, 4 days, 3 days, 4 days, 4 days, 3 days, 4 days, 4 days, 2 days, 2 days, 3 days, 2 days, 2 days, 2 days, 3 days, 2 days, 2 days, 2 days, 2 days, 2 days, 1 day, 2 days and 2 days. More importantly, the growth rate of daily confirmed cases (+1.1% since Thursday) is slightly higher. Meanwhile, deaths stand at 1.32 million and the death rate was steady at 2.42% although the number of daily deaths remains elevated and hit an all-time high on Wednesday.



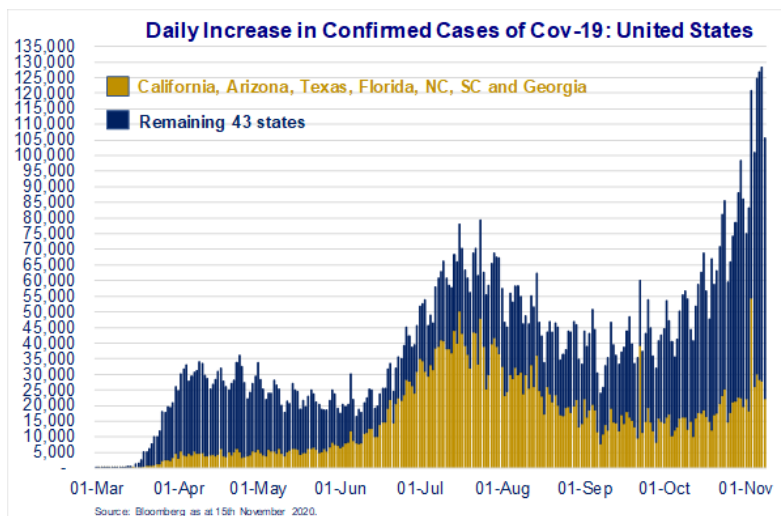
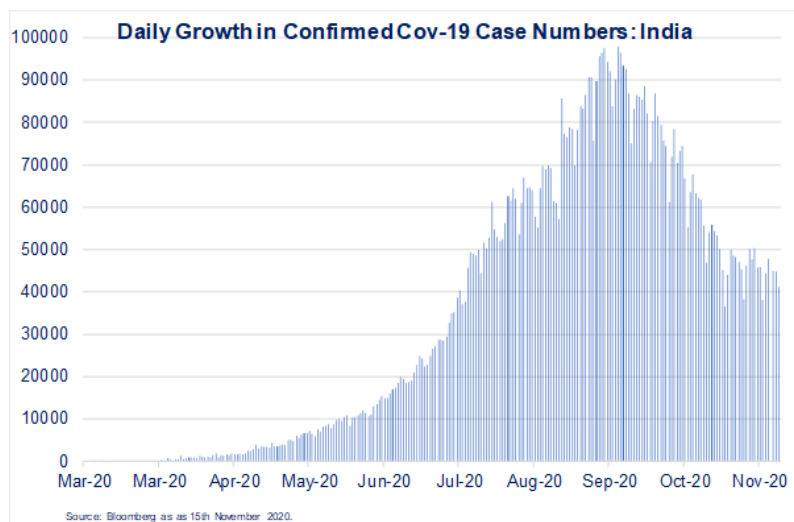
- We break the infections into four groups – the US, Europe, China and ‘others’ and the rest of the world outside the G3 economies now has the most total cases (+214.3k to 46.1 million) and highest daily new cases (and by a considerable margin) followed by the US (+97.2k to 11.00 million, although 20 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 (+57.0k to 7.38 million - see chart) with an R-factor at 0.71 which indicates that the infection rate is now declining, and this is below the UK (1.13), the US (1.35) and Asia (0.86).





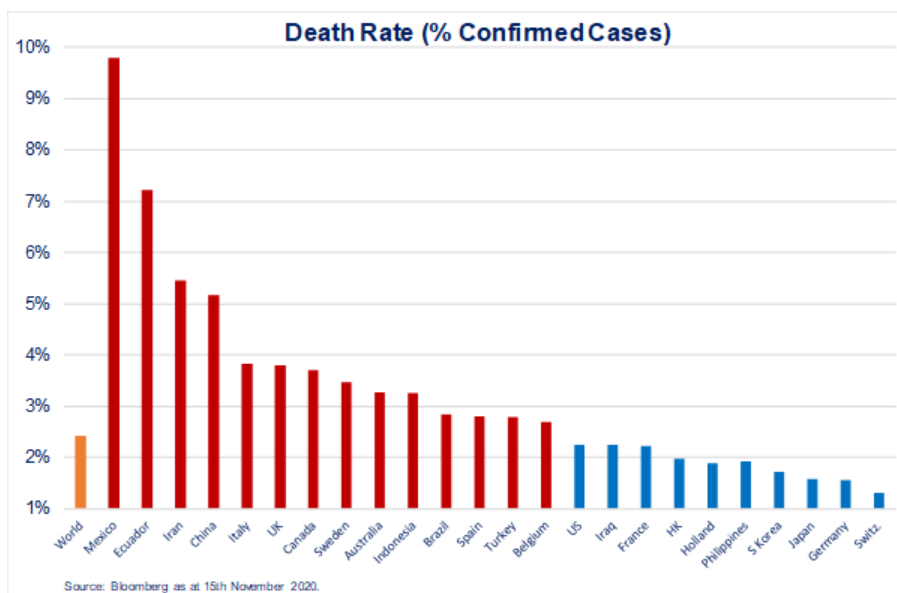
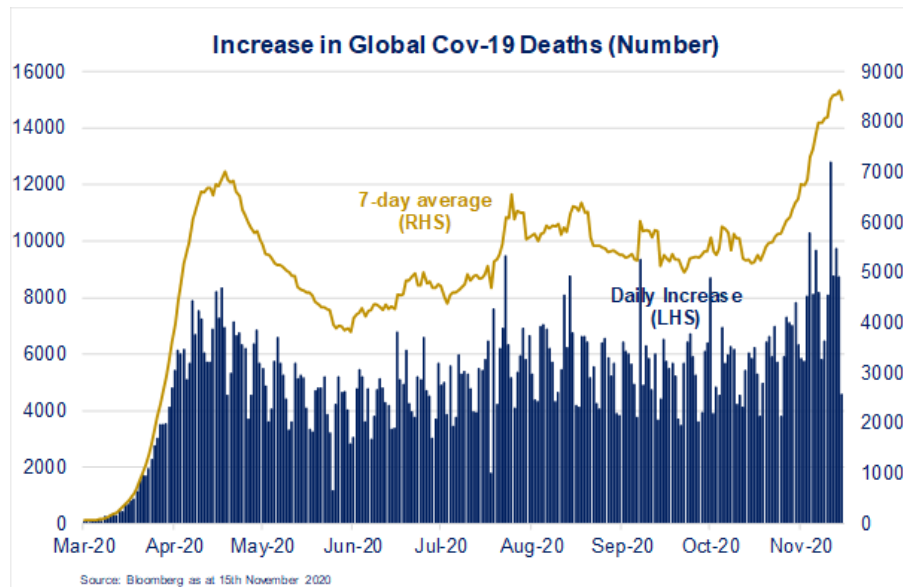
- Among countries, the most cases are in the US (+97.2k (so far) to 11.00 million, with 20 states yet to report), India (+41.1k to 8.81 million), Brazil (not reported, 5.85 million), France (not reported to 1.92 million), Russia (+22.3k to 1.91 million), Spain (not reported, 1.46 million), UK (+25.0k to 1.37 million), Argentina (+9.7k to 1.30 million), Colombia (not reported, 1.19 million) and Italy (+34.0k to +1.17 million). Australia confirmed cases were +29 yesterday at 27.7k yesterday which placed us 94th in terms of total infections.

Elsewhere, Singapore recorded +3 new cases to 58.1k most of which are linked to foreign workers who are forced to live in crowded dormitories, but Indonesia (+4.1k to 467.1k) is now on the rise and has now surpassed the Philippines (+1.5k to 407.8k) to be the most infected country in South East Asia.





- Although final numbers are not in until 1pm AEST, the global death rate declined to 2.42% with the global total to 1.32 million after another +4.6k deaths overnight, so far, however, the 7-day average is at 8.4k which is close to a six month high. The US (+0.4k so far) has the most deaths at +246.0k, with Brazil (not reported, 165.7k), India (+0.5k to 129.6k), Mexico (not reported, 98.3k), the UK (+168 to 52.0k), Italy (+546 to 45.2k) and France (not reported, 42.6k) all over +40k. The death rate in advanced economies is highest in European countries where the health systems had collapsed led by Italy (-0.2% to 3.8%), the UK (-0.1% to 3.8%), Canada (-0.1% to 3.7%), Sweden (-0.1% to 3.5%), Australia (-0.1% to 3.3%), Spain (-0.1% to 2.8%), Belgium (-0.1% to 2.7%) and the US (-0.1% to 2.2%). However, several emerging markets are now on the leader board including Mexico (steady at 9.8%), Ecuador (-0.1% to 7.2%), Iran (-0.1% to 5.4%), China (steady at 5.2%), Indonesia (-0.1% to 3.3%) and Brazil (steady at 2.8%).



Yours sincerely,



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