THOUGHTS ON THE MARKET

16th September 2020

The US tech recovery continues, but will China's activity rebound lead to a premature tightening in policy?

SUMMARY

- Global risk markets posted modest gains overnight as a recovery in tech shares outweighed a solid decline in US financials as pressure on net interest margins seemed to intensify. Although the Fed is expected to maintain is dovish stance at its policy meeting tonight and there remains massive amounts of liquidity sitting on the sidelines, recent volatility and more evidence of bubble characteristics in growth sectors makes it hard to envisage a strong rally before the US election result is known, unless there is a sustained break through on the COVID-19 vaccine. In the end, the global sharemarket has had a large increase in the past five months and it's hard to know if earnings will catch up with prices, or prices will adjust to earnings, but either way market's seem unlikely to add to their 2020 gains until next year.

  In other markets, 10-year Treasuries declined one basis point to 0.68% with modest curve steepening, commodities were higher with oil (+2.7% to USD38.48 per barrel) outperforming gold (+0.5% to USD1,955 per troy ounce), and G10 currencies were mostly higher against the Greenbank with gains in Yen (+0.5%), AUD (+0.4% to USC73.02) and Sterling (+0.1%), whereas the Euro (-0.1%) defied the broader trend and closed factionally lower.

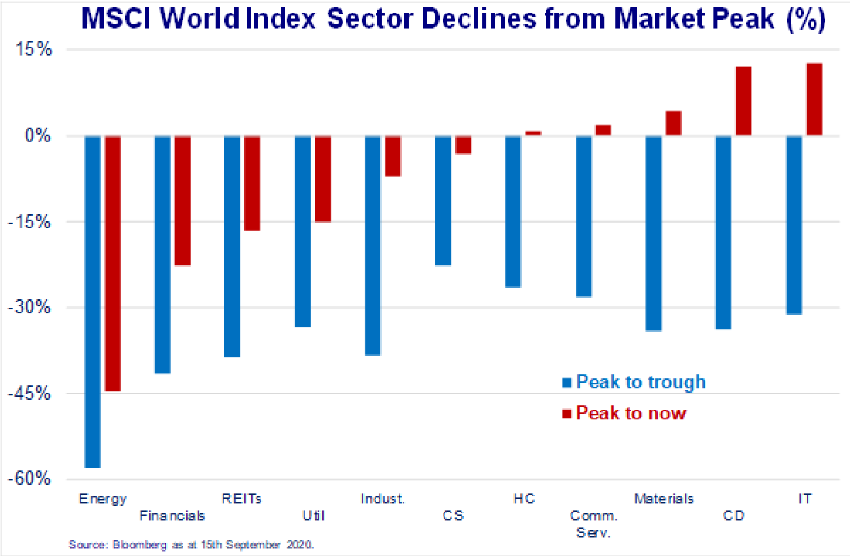
- Economic data overnight was constructive with China's round of old economy activity reports logging their best results since the coronavirus shock in January with retail sales returning to positive annual growth, industrial production making further gains and fixed asset investment improving although it remains just in contraction territory in 2020. A key question for investors and markets is what are the implications of the activity rebound, and I suspect that policy will remain neutral for the time being, but late in the December quarter support will be lessened given China's propensity to over-tighten from the last cycle likely to be repeated even though the bar for aggressive tightening is higher than before given the sustained uncertainty of the health crisis and the continued geopolitical tensions with the US.

- The number of global cases of COVID-19 is 29.1 million with another +222.1k cases so far (but Brazil, Mexico, Colombia, Pakistan and 3 US states have not reported their numbers) which means that Tuesday was the 57th 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 and 33 countries have more than 100k cases. More importantly, the growth rate of daily confirmed cases (+0.8% since Saturday) is steady. Meanwhile, deaths stand at 931.3k and the death rate was steady at 3.18% although the number of daily deaths remains elevated.

FINANCIAL MARKETS

- **EQUITIES**
  - **The MSCI World Index closed +0.5% higher overnight with advances led by communication services (+1.5%)** underpinned by strength among FAANG and large cap media names. Meanwhile, a strong rise in Amazon (+1.7%) supported consumer discretionary (+1.2%), but there were some notable drags in department stores, homebuilders and leisure names. Meanwhile, IT (+0.9%) outperformed on strength in semis and software, and Materials (+0.5%) was in line supported by higher industrial metal prices. Meanwhile, energy (-0.2%) continued its recent losing streak (20 declines in the past 24 days) and financials (-0.9%) were at the tail end of the field with banks lagging, particularly Citigroup (-6.9%) which built on its -5.5% decline

yesterday, with JPMorgan (-3.1%) and Bank of America (-1.8%) also on the defensive given sustained pressure on net interest margins. There was no material change in the sector peak to now chart below.

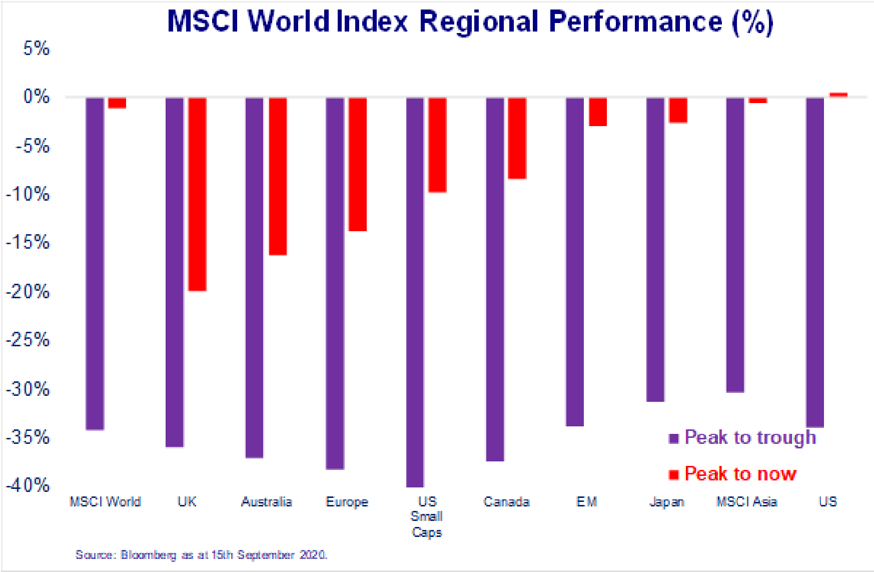


- **Among the regions, the pace of gains was set by the US equity market (+0.5%) which posted a third consecutive advance and this enabled the index close at a six-day high.** The market opened strongly given positive leads in Europe and Asia but it progressively softened as the session progressed but the early rise in tech was enough to outweigh a late decline in financials. It was reasonably quiet session from a headline perspective with no big directional drivers in play. Among macro data a consensus miss on August US industrial production was partially offset by a better-than-expected September read from the Empire manufacturing index which came in at its second-highest reading since November 2018. Meanwhile, there was nothing incremental on the fiscal stimulus front with the Republican-Democrat stalemate continuing despite apparent pressure from moderates on both sides, but Senate Democrats are now reportedly backing away from their earlier position to quickly reverse President Trump's tax cuts if Biden wins the November election. By the close of trading, all indices closed higher (although only just) with advances led by the NASDAQ Composite (+1.2%), S&P 500 (+0.5%), Russell 2000 (+0.1%) and the Dow Jones Industrial Average (+2 points, +0.01%, 27,996).

  European equities closed higher (+0.5%) for a third straight session with regional sentiment enhanced by a positive ZEW survey in Germany, but this was tempered a bit by sustained weak inflation prints in Italy and France for August. In politics, UK PM Johnson's bill to breach the Brexit treaty was passed at its first hurdle in Parliament by 340-263 votes, which meant that press reported of a rebellion among Conservative MPs was wide of the mark, although the bill has to be passed at a second reading next week. In Cov-19 news there were plenty of headlines around rising regional case numbers and the R-factor being above 1, but this did more to fill content than worry investors. Meanwhile, the EU is preparing to offer its banks an 18-month extension on access to London's crucial market infrastructure as it seeks to prevent a jolt to financial stability when the UK's Brexit transition period expires at the end of 2020. By the close of trading, all regional bourses closed higher led by the UK (+1.3%), Spain (+1.2%), Sweden (+0.9%), Italy (+0.8%), Switzerland (+0.6%), France (+0.03%) and Germany (+0.2%).

  Asia equities finished higher on Tuesday with the MSCI Asia Pacific Index up by +0.3% as new age stocks outperformed. The regional tech strength was underpinned by positive August macro data in China which created a constructive market backdrop supported by Apple's new product reveal. There wasn't much in the geopolitical front and Cov-19 numbers around the region were about -10% below recent levels. By the time regional bell was rang Mainland China (+0.8%) South Korea (+0.7%), Taiwan (+0.5%) and Hong Kong (+0.4%) posted moderate gains, while Australia (-0.1%) and Japan declined (-0.4%).

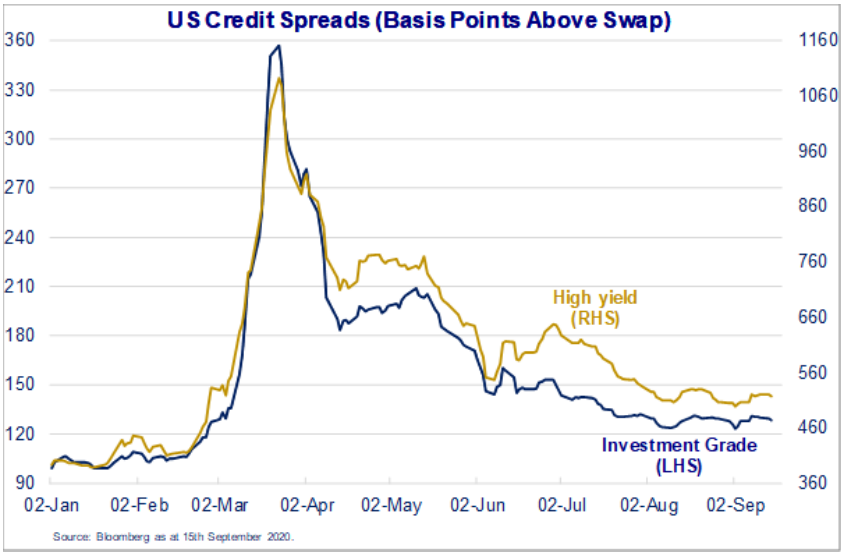
  The overnight moves saw some changes in our peak-to-now chart with the UK just out of bear market territory, the US going back above its February peak for the second time this year, but the MSCI World is just short of that mark (see chart).



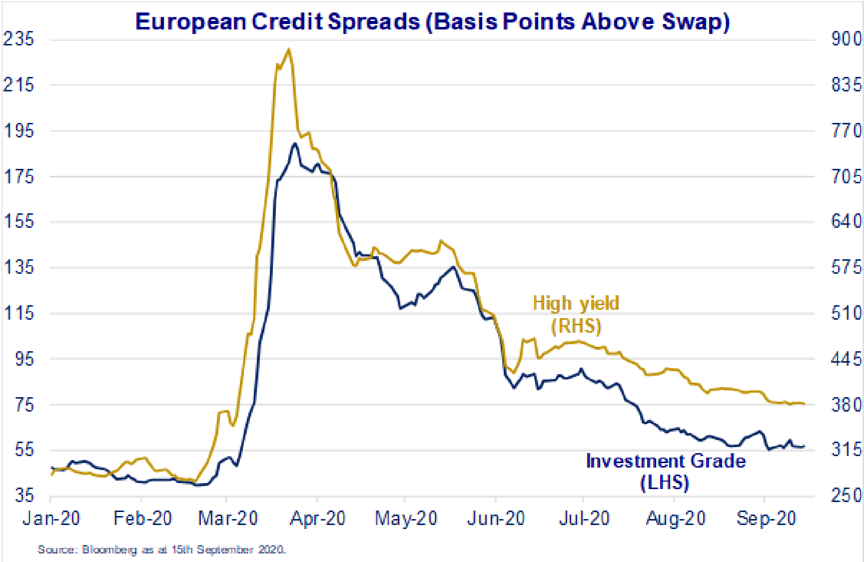
- **Futures markets suggest a mixed opening in Asia** with Australia (+0.7%) and Hong Kong (+0.3%) slated to advance at the bell, whereas the higher Yen has Japan (-0.1%) priced to retreat.

• CREDIT MARKETS

- **Regional credit indices were little changed, again, with spreads in the US investment grade space down -1 point to +128 bpts, which lifted the recovery rate one notch to 90%.** There was a bit more action on the spread front relative to recent days/weeks, but still no sector moved more than two basis points, but all sub-sectors recorded lower spreads for the first time in nearly two weeks. In the high yield universe, spreads declined -2 points to +518 bps, which kept the recovery rate at 84%. Seven of the 11 sub-sectors recorded capital gains led by industrials (-10 points, +624 bps, 59%) which rallied for a second consecutive day, with consumer discretionary (-4 points, +485 bpts, 77%) also among the leaders, whereas energy (+4 points, +820 bpts, 97%) went the other way.

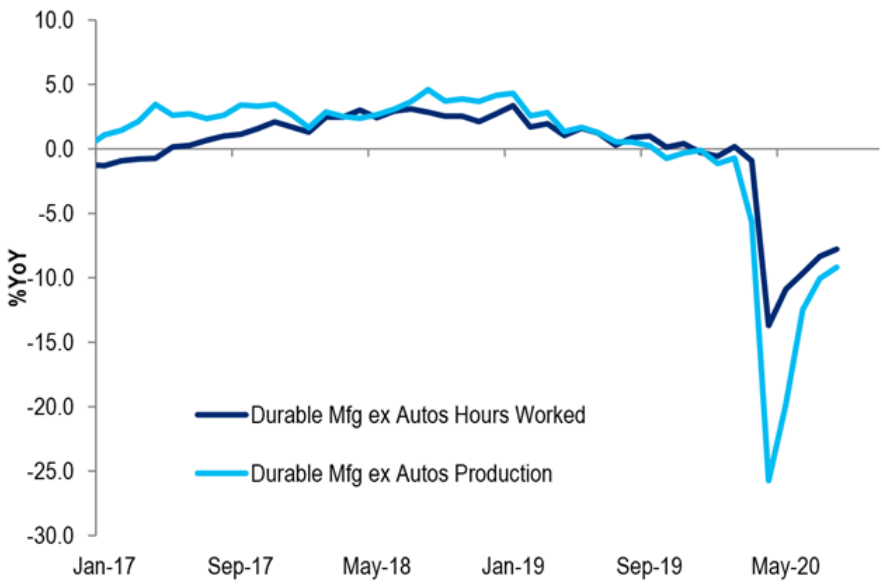


- **European credit markets were also quiet with spreads in the investment grade universe steady at +57 points, which left the recovery rate at 89%.** While nine sub-sectors recorded capital losses, none was by more than a basis point. In the high yield universe, spreads declined -1 point, with 6 sectors recorded capital gains led by energy (-6 points, +475 bpts, 79%) and consumer discretionary (-5 points, +419 bpts, 88%), whereas spreads in tech (+5 points, +333 bpts, 67%) increased despite a solid rebound in their regional equity peer (+0.3% d/d).



THE GLOBAL ECONOMY

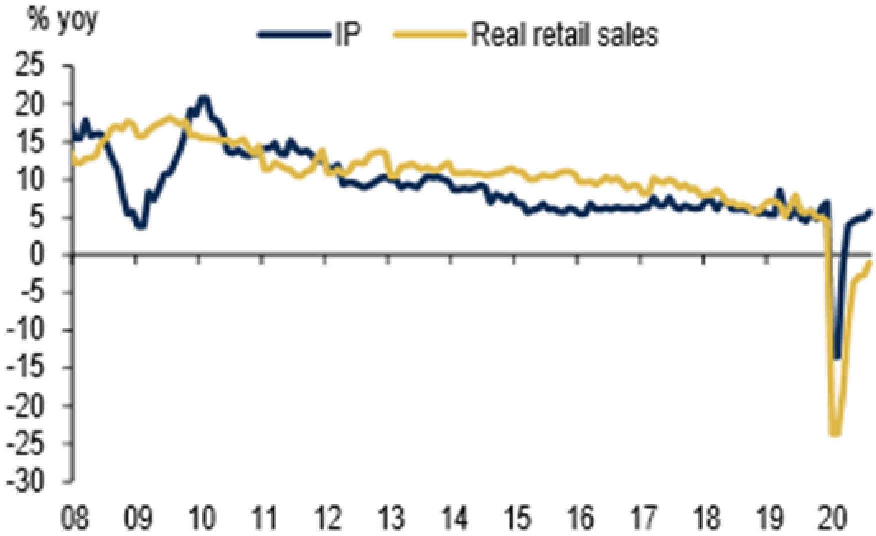
- **US industrial production for August slowed sharply to just +0.4% m/m which was well below the street (+1.0% m/m),** underpinned further strength in non-auto production (+1.4% m/m) and some pullback in auto manufacturing (-3.7% m/m, after production returned to its pre-pandemic levels in July). This meant US industrial production is down -7% from its pre-Cov-19 levels but this completely contradicts the dollar-value of factory shipments which had already shown a faster rebound than that by July, with a small part of the difference accounted for by prices (which are now recovering). I would argue that factory shipments are a cleaner measure on activity as they are measured directly, whereas IP is estimated via employment levels, energy usage and therefore can be revised heavily in subsequent months. Overall, the rebound in factory shipments reflects temporary inventory rebuilding and that growth should begin to slow soon, which will flow through to lower industrial production growth, but this was not evident in overnight's stronger Empire State measure (+13.3 points to +17.0) for September – the timing pf the IP moderation appears to be too early.



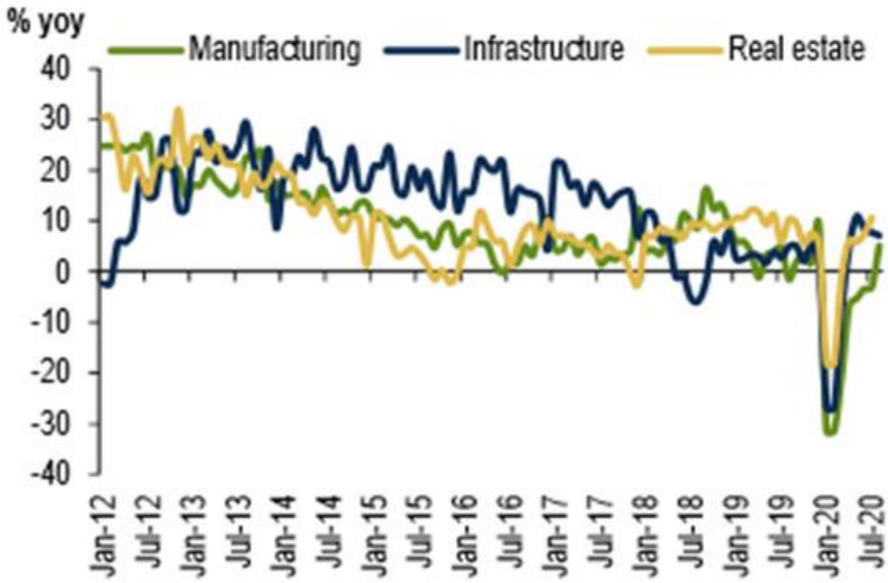
- **China's round of old economy activity reports was better than expected, logging their best results since the coronavirus shock in January. Among the releases:**
    - The main highlight was retail sales which rose back into positive territory (+0.5% y/y) for the first time in 2020 although real retail sales remained in negative territory (+1.6% to -1.1% y/y - see chart). The Chinese consumer had lagged other cyclical indicators which had underpinned previous

concerns about the recovery in domestic demand, but this report suggests things are improving. Among the sectors, goods sales rose +1.3% to +1.5% y/y with the decline in catering (the primary drag until now) lifting to negative single digits (+4% to -7.0% y/y) suggesting that even the most impacted sectors from COVID-19 are showing a positive impulse, with most other major category groups showing incremental improvements led by communication equipment (+13.8% to +25.1% y/y), cosmetics (+9.8% to 19.0% y/y) and gold & jewellery (+7.8% to +15.3% y/y).

- **Manufacturing sector growth also picked up steam with industrial production up +5.6% y/y** with mining and utility IP growth lifting strongly, (+3.0% to +1.6% y/y, and +4.1% to 5.8% y/y), whereas manufacturing IP growth was steady (at 6.0% y/y).



- **Meanwhile, the Fixed asset investment contraction narrowed to -0.3% (from -1.6% in July)** underpinned by a pickup in real estate where aggregate nominal sales turned positive for the first time this year, and manufacturing (+8.1% to 5.0%) also lifting and with infrastructure was solid (at +7.1%).



A key question for investors and markets is what the implications of the activity rebound is? Although the data points to a stronger than expected recovery in domestic demand, I still believe that policy will remain neutral for the time being, but late in the December quarter support will be lessened. In the end, I expect policy complacency and China's over-tightening bias from the last business cycles to be repeated even though the bar for aggressive tightening is higher than before given the sustained uncertainty of the health crisis and the continued geopolitical uncertainty with the US.

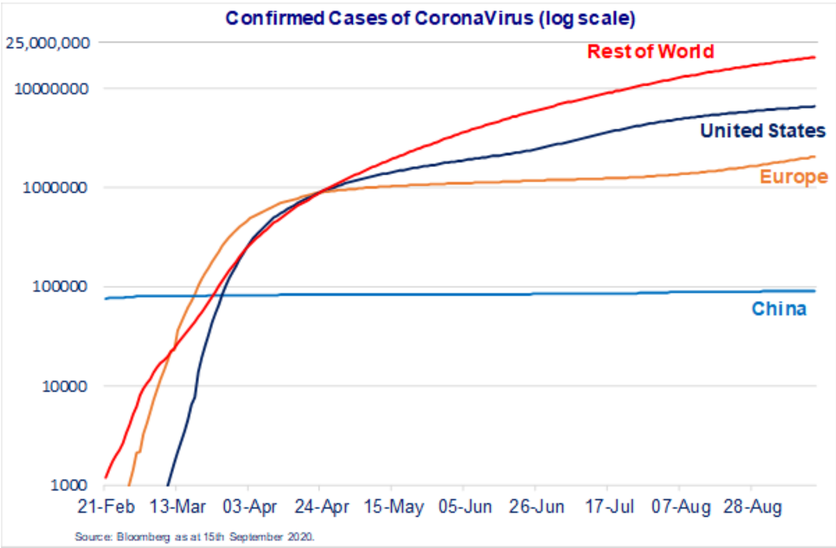
POLICY

- There were no material policy announcements overnight.

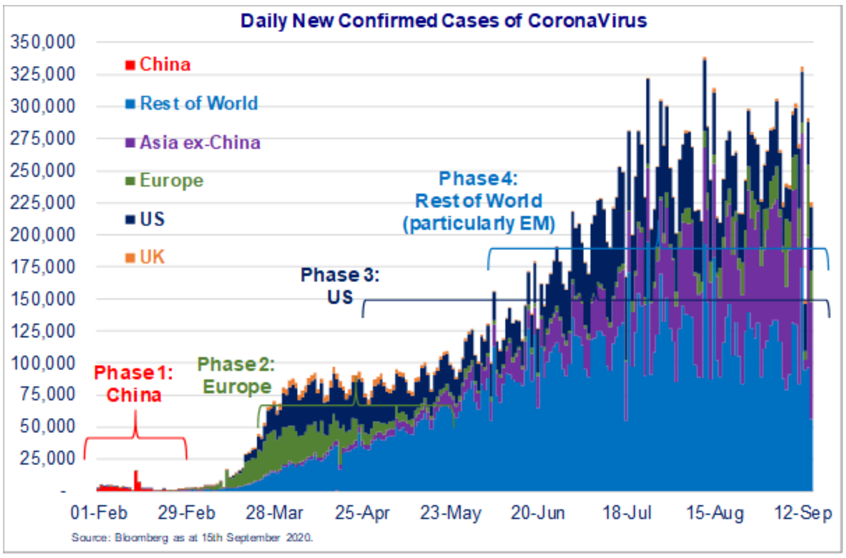
VIRUS UPDATE

- The number of global cases of COVID-19 is 29.1 million with another +222.1k cases so far (but Brazil, Mexico, Colombia, Pakistan and 3 US states have not reported their numbers) which means that Tuesday was the 57th 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 and 33 countries have more than 100k cases.

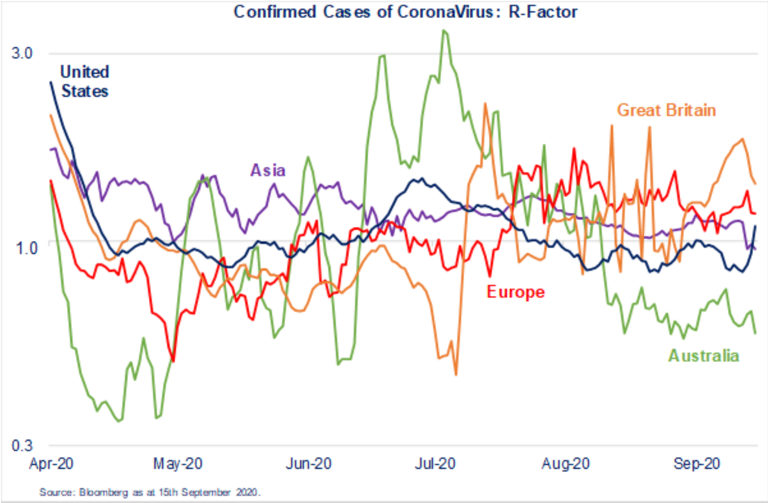
  It took 73 days to record 1 million cases, and after this each subsequent million has taken 13 days, 11 days, 12 days, 10 days, 11 days, 8 days, 8 days, 7 days, 6 days, 5 days, 5 days, 5 days, 4 days, 5 days, 3 days, 4 days, 4 days, 4 days. 4 days, 4 days, 4 days, 4 days, 4 days, 4 days and 4 days. More importantly, the growth rate of daily confirmed cases (+0.8% since Saturday) is steady. Meanwhile, deaths stand at 931.3k and the death rate was steady at 3.18% 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 (+147.5k to 26.6 million) and highest daily new cases (and by a considerable margin) followed by the US (+49.6k (11-day high) to 6.6 million, although 3 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 (+25.0k to 2.07 million - see chart) which is the only region with an R-factor above 1.0 which indicates that the infection rate (1.17 is too high, especially in Britain (1.40).

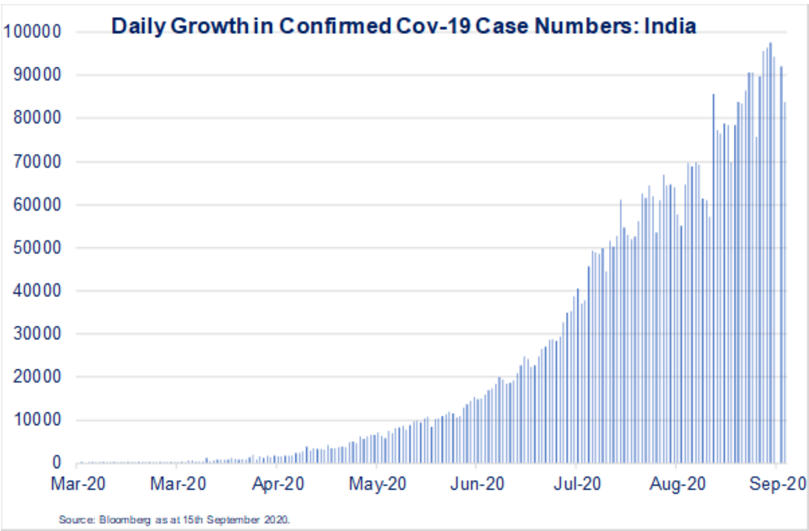


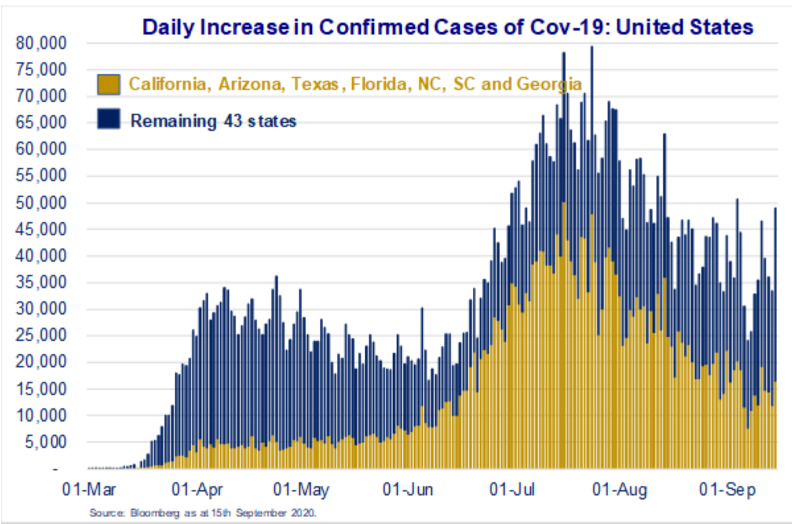
Perpetual



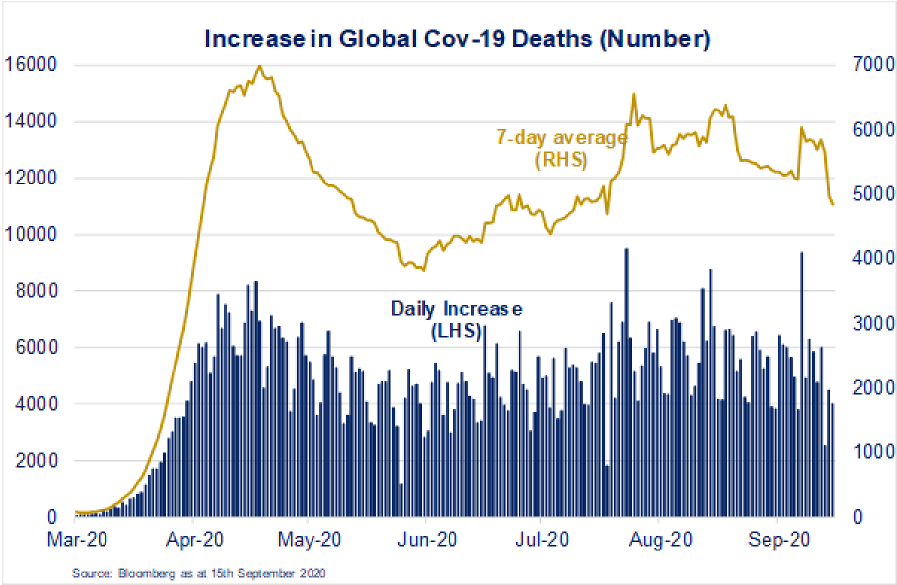
- Among countries, the most cases are in the US (+49.6k (so far) to 6.60 million, with 3 states yet to report), India (+83.8k to 4.93 million), Brazil (not reported, 4.35 million), Russia (+5.4k to 1.07k), Peru (+4.2k to 733.9k), Colombia (not reported, 721.9k), Mexico (not reported, +671.7k), South Africa (+0.8k to 651.7k), Spain (+9.4k to 603.2k) and Argentina (not reported, 565.5k). Australia confirmed cases rose +41 (6-week low) to 26.8k yesterday which placed us 70th in terms of total infections.

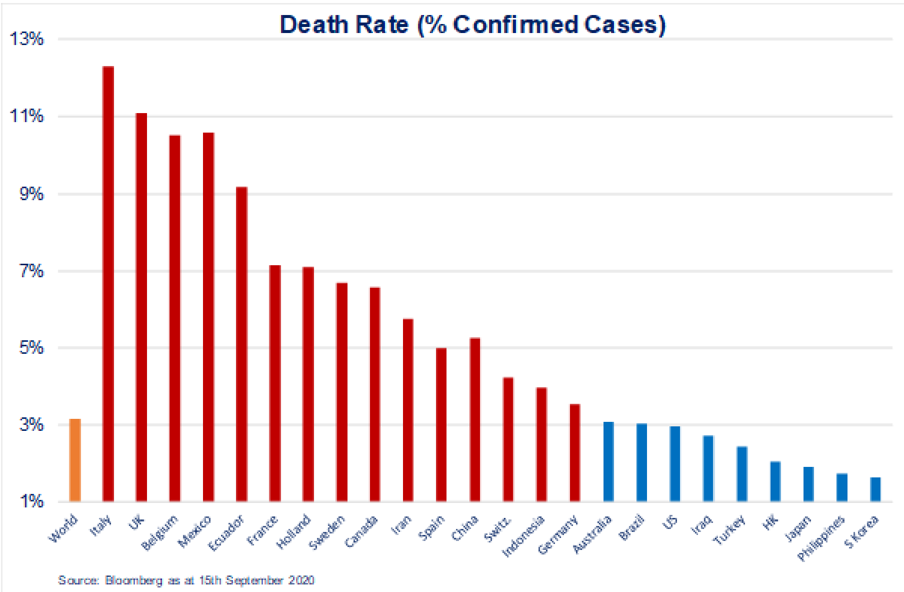
  Elsewhere, Singapore recorded +34 new cases to 57.5k most of which are linked to foreign workers who are forced to live in crowded dormitories, but Indonesia (+3.5k to 225.0k) is now on the rise and has the second most cases in the region behind only the Philippines (+3.5k to 269.4k).





- Although final numbers are not in until 1pm AEST, the global death rate was steady at 3.18% with the global total to 931.3k after another +4.0k deaths overnight, so far, which indicates the daily average deaths is stabilising again (see chart). The US (+1.2k so far) has the most deaths at +195.7k, with Brazil (not reported, 132.0k), India (+1.1k to 80.8k), Mexico (not reported, 71.0k), the UK (+27 to 41.7k), Italy (+9 to 35.6k) and France (+49 to 31.0k) all over +30k. The death rate is highest in European countries where the health systems had collapsed led by Italy (-0.1% to 12.3%), the UK (steady at 11.1%), Belgium (-0.1% to 10.5%), France (-0.1% to 7.2%), the Netherlands (-0.1% to 7.1%), Sweden (steady at 6.7%) and Spain (-0.1% to 5.0%). 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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