Perpetual Investments

THOUGHTS ON THE MARKET

17th September 2020

Achieving its employment and inflation targets is now out of the Fed's hands

SUMMARY

- Global risk markets declined overnight as a selldown in megatech stocks pulled regional indices lower after Fed Chair Powell remarked about the uncertain nature of the economic rebound. It was a whipsawing night with markets initially jumping as the FOMC signalled through its dots that it would keep rates on hold through 2023, but the optimism fizzled out after Powell noted in his press conference that he was not sure if the stronger-than-expected recovery will continue, with the US unable to control the virus or provide more fiscal stimulus.

  As such, the net net of the meeting was that the Fed provided more long-term certainty with more near-term uncertainty. I continue to believe that by its use of forward guidance (which only confirmed what the market had already factored in with 5-year US Treasuries at 0.27%) and with official rates and yields both close to zero, the Fed has acknowledged that its policy tool box is close to empty. Accordingly, if the Fed gets knocked by fiscal policy becoming less supportive, then the tools to lift growth and inflation is limited to a doubling down of what they have already been doing with QE and (now) forward guidance, with the committee not excited about yield curve control or negative rates, which is fair enough.

  Consequently, **the Fed's mantra of allowing inflation overshoots and remaining behind the curve only works if you can actually get behind the tightening curve in the presence of reflationary forces**, but if you don't have reflation and you don't have co-ordination with fiscal policy or the tools to push beyond what is already a very low and flat yield curve, there is very little than can help push the economy towards full employment growth and 2% inflation. So, they now have an asymmetric policy tools which can't materially help them achieve their goals, but which create highly dangerous and distorting asset bubbles.

  In other markets, 10-year Treasuries rallied +2 points to 0.70% with curve steepening, commodities were mixed with oil surging +4.9% to USD40.08 per barrel) on lower US inventories whereas gold was marginally lower (-0.5% to USD1,960 per troy ounce), and G10 currencies were mixed with the Yen (+0.6% to 104.95 which is its lowest level since early March) and Sterling (+0.5%) appreciating, whereas the AUD (-0.4% to USC73.07) and the Euro (-0.7%) both declined.

- Economic data was in minimal supply overnight but **US headline retail sales rose +0.6% m/m** in August but the control group fell -0.1% m/m, and downgrades to the July result saw the annual growth rate at +2.6% y/y. While nearly all economists attributed the control group decline to expire enhance unemployment insurance, I would characterise it as a normalisation in goods spending which is already above its pre-pandemic level. The expiration of $600 per week of additional unemployment benefits translates to a $70billion per month hit to incomes, or about 6% of total monthly spending. However, the US household savings rate is very high (17.8% of disposable income) and provides a temporary cushion and $300 per week of benefits (back dated to August 1st) are now being paid out which should raise incomes again in September. **Overall, we thought it was a solid report which provides me with more confidence that things are slowly normalising, with emphasis on slowly as much as normalising.**

- The number of global cases of COVID-19 is 29.7 million with another +160.3k cases so far (but Mexico, Colombia, India and Pakistan and 5 US states have not reported their numbers) which means that Wednesday is likely to be the 59th 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 Sunday) is steady.

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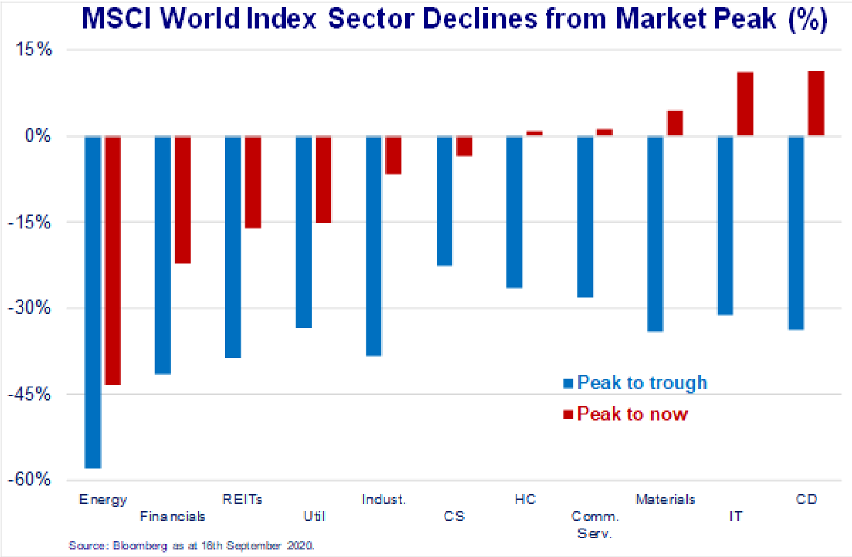
Meanwhile, deaths stand at 937.5k and the death rate was steady at 3.16% although the number of daily deaths remains elevated.

FINANCIAL MARKETS

- **EQUITIES**
  - **The MSCI World Index declined -0.2% in an oscillating trading session where investors sentiment underwent several changes.** Overall, the market was pulled down by weakness in growth and momentum plays, but the downside was cushioned by a rally in value and cyclical stocks. IT (-1.3%), consumer discretionary (-0.7%) and communication services (-0.7%) were the three worst performing sectors on weakness in FAANG, software, semicaps and video game groups. In contrast to recent weeks, the traditional value/cyclical sectors bounced led by energy (+2.1%) which liked the sound of a 5% rise in crude prices, industrials (+0.5%) which was supported by gains in airlines, and financials (+0.5%) which saw investment banks recover some of their recent losses. By the close of trading, there was little change in our peak-to-now positioning with energy (-43.3%) and financials (-22.2%) still in bear market territory, but consumer discretionary (+11.3%) is now the top performing sector since the February peak (see chart).



  - **Among the regions the pace of declines was led and limited to the US, where the market had a whipsawing session which ended down -0.5%.** Growth and momentum stocks underperformed as investors digested Chair Powell's press conference and the FOMC statement in which they said the recoveries sustainability is uncertain, but rates will remain on hold through 2023. However, there is still a lot of doubt about how the Fed can create reflation especially if fiscal policy is reduced. On this topic, President Trump told Republicans to go for higher numbers on a stimulus deal, but there was nothing incremental from House leader Pelosi. Meanwhile, macro data was mixed, as August retail sales missed street estimates and July was revised lower, but on a bright note some services spending (i.e. restaurants) showed some constructive signs. By the closing bell at the NYSE, the losses were largest in the NASDAQ Composite Index (-1.3%), the S&P 500 (-0.5%), whereas the Dow Jones (+0.1%, +37 points, 28,032) and Russell 2000 (+0.9%) both closed higher.

    In contrast, European equities closed +0.2% higher in a session which was a case of "*let's sit on the sidelines and listen to what Jerome has to say*". In dataland, August UK inflation came in at the lowest level in nearly five years (+0.2% y/y) amid the government's discount to help the restaurant sector, and the European trade balance rose to €20.3 billion in a nothing-to-see-here report. In other news, European Commission President von der Leyen doubled down on action to protect climate and digital revolution in her State of the Union address and in Brexit news, it was leaked that last week Britain offered tentative concessions on fisheries last week just as it was threatening to breach the divorce deal. There wasn't much else and by the market close, most indices were higher led by Sweden and Spain (both +1.1%), Germany and Switzerland (both +0.3%), France (+0.1%) and Italy (+0.04%), whereas the UK (-0.4%) was the sole market to retreat.

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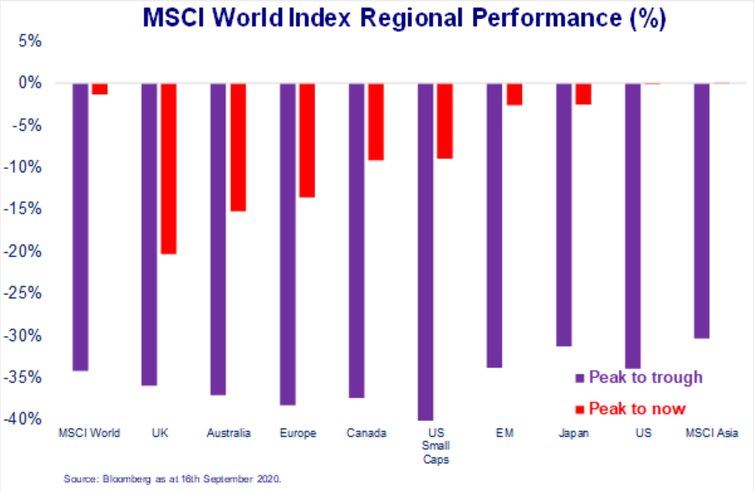
Asian equities finished +0.6% higher thereby closing out five consecutive days of price gains, which is the region's longest win streak since early June. The macro calendar had little of note with only Japanese August trade data showing exports continued to contract at an annual double-digit pace, and in geopolitics, Japan's new LDP leader Suga was formally voted in as prime minister. Interestingly, there was no notable follow-through from Apple product launches -- new Apple Watches, refreshed iPad Air, and Apple One subscription bundle. Attention was also on the upcoming September FOMC meeting in which investors on the whole expected reaffirmation of dovish stance and a downbeat economic assessment. By the closing bell, performance was mixed with Australia (+1.0%), India (+0.6%) and Taiwan (+1.0%) outperforming the regional tape, with Japan (+0.1%) recovering from a sluggish open, but Hong Kong (-0.03%), Korea (-0.3%) and Mainland China (-0.7%) weighed on the regional index.

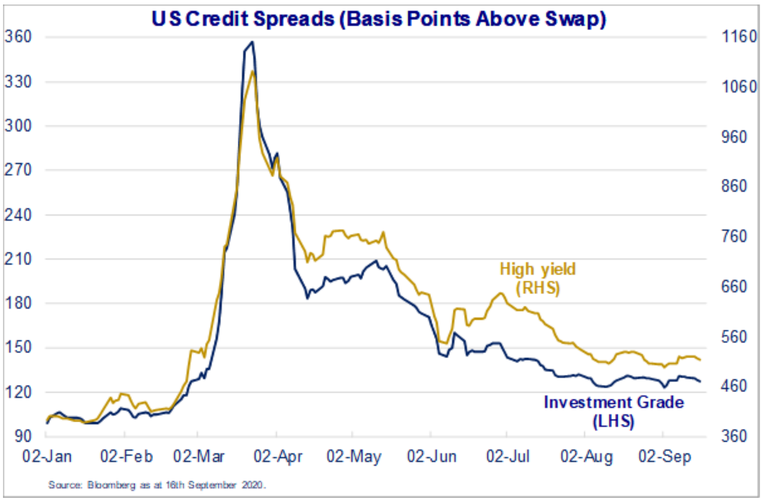
The rally in Asian shares means the region has now closed out a complete recovery with the US just -0.1% from its February peak, but it has crossed the level already twice and has not been able to sustain that level. In contrast, the UK (-20.3%) went back into bear market territory overnight (see chart).



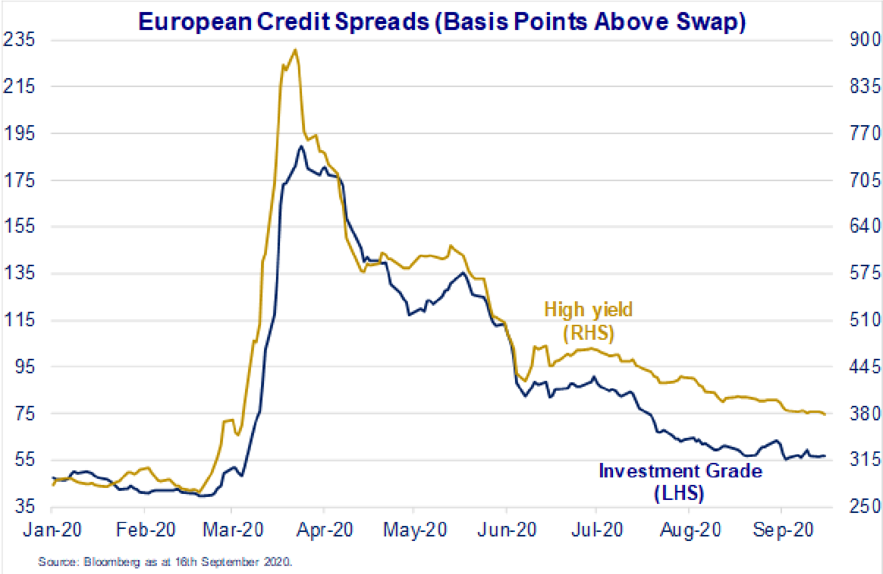
- **Futures markets suggest a negative opening in Asia this morning** with Australia (-0.2%), Hong Kong (-0.2%) and Japan (-0.1%) all set to open slightly lower at the bell.

- ## CREDIT MARKETS

  - **Regional credit indices recorded modest capital gains overnight.** Spreads in the US investment grade universe declined -1 point to +128 bpts, but the recovery rate was unchanged at 90%. Six of the 11 sub-sectors recorded capital gains but all were capped at or below -2 points, with no noteworthy movements. Meanwhile, spreads in the high yield universe declined -4 points (two-week low) to +514 bpts, which was enough to have the recovery rate increase one notch to 85%. The spread declines were led by the cyclical sectors which rallied in line with their equity peers led by industrials (-23 points (best in ten weeks), +600 bpts, 63%) and energy (-10 points, 809 bpts, 98%) but there wasn't much else.



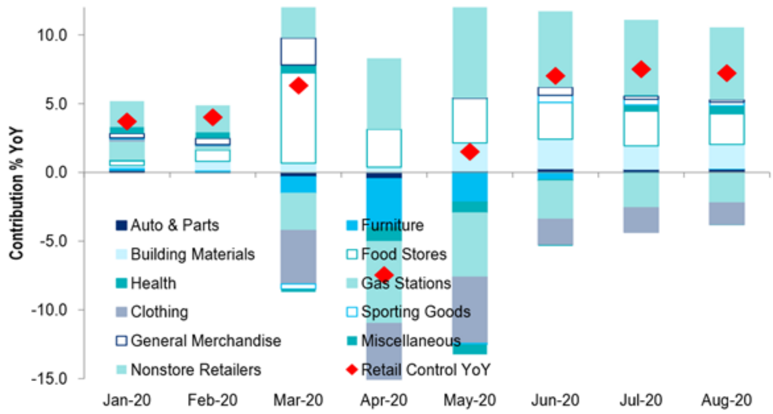
- **European credit markets were little changed** with spreads in the investment grade universe steady at +57 bpts and the recovery rate at 89% with no subsector moving by more than a basis point. In contrast, spreads in the high yield market declined -2 points, to +379 which was enough to lift the recovery rate one notch to 83%. Six of the 11 subsectors rallied overnight but gains were capped with the largest being energy (-6 points, +476 bpts, 79%) and consumer discretionary (-5 points, +416 bpts (lowest since late February), 88%).



THE GLOBAL ECONOMY

- **Headline US retail sales increased +0.6% m/m in August, and the control group (which is used to estimate the national account's consumer spending) fell -0.1% m/m, both of which were well below consensus** (+1.0% m/m and +0.3% m/m, respectively). There were also downgrades to the July result (-0.3% to +0.9% m/m) which saw the annual growth rate rise to +2.6% y/y on base effects. Interestingly, auto sales (+0.2% m/m) were close to flat on the month (+4.5% y/y) as were online sales (+22.4% y/y) suggesting some easing in goods demand (+0.1% m/m) from its strong pace since April. In contrast, traditional discretionary items improved including furniture (+1.6% m/m), building materials (+2.0% m/m) and clothing (+2.9% m/m). The decline in the control group was underpinned by sizable falls in categories such as sporting goods (-5.7% m/m) and grocery stores (-1.6% m/m), but in a positive sign that hard-hit restaurant industry continues to recover (+4.7% m/m, -15.4% y/y (but this was -52.4% y/y in April).

- **Looking ahead, goods spending is likely to fall further as other spending on other items resumes and is not a problem.** While many economists attributed the control group decline to expire enhance unemployment insurance, I would characterise it as a normalisation in goods spending which is already above its pre-pandemic level. For example, grocery store sales should continue to moderate as consumers begin purchasing a larger portion of their meals at restaurants and it must be remembered that about in normal times, the purchase of services is around 65% of consumer spending. The expiration of $600 per week unemployment benefits translates to a $70 billion per month hit to incomes, or about 6% of total monthly spending. However, the savings rate is high at present and provides a temporary cushion and $300 per week benefits (back dated to August 1st) are now being paid out which should raise incomes again in September. Overall, I thought is was a solid report which provides me with more confidence that things are slowly normalising, with emphasis on slowly as much as normalising.



POLICY

- **The September FOMC meeting held rates** (just above 0%) and QE (USD120 billion per month) at current levels and signalled (through the dots) that rates are expected to remain unchanged for at least three years, until the US gets back to maximising employment and 2% core inflation. However, while the average dot signalled rates are on hold, four officials of the 16 pencilled in at least one hike in 2023 (Kaplan and Kashkari were among the four and are voters).

  The meeting was the Fed's first step in its new strategy which was unveiled last month with laid the groundwork for inflation to be able to rise beyond 2% without necessary triggering policy tightening. Indeed, in his press conference, Chair Powell's most important point was that the Fed will keep policy highly accommodative for as long as it takes to bring back the hardest hit workers.

  In an updated statement of economic projections, the Fed upgraded 2020 growth from -6.5% to -3.7% and lowered its December end-2020 unemployment rate forecast to 7.6% (from 9.3% - see table below). A couple of points around this:

  - Although the US economy has recovered faster than the Fed forecast at the outset of the COVID-19 crisis, at his press conference Chair Powell stated that the recovery is still far from complete and remain highly vulnerable to the uncertain health outlook and darkening clouds around fiscal policy; and

  - The better 2020 outlook is somewhat, although not fully, at the expense of the estimates for 2021 and 2022, and the core PCE inflation is not expected to be above the 2% target by the end of 2023 and thereby the Fed is expected to remain on hold during this time.

Table 1: Median FOMC forecast in September 2020

Variable		2020	2021	2022	2023	Longer run
Real GDP	Sept 2020	-3.7%	4.0%	3.0%	2.5%	1.9%
	June 2020	-6.5%	5.0%	3.5%		1.8%
Unemployment	Sept 2020	7.6%	5.3%	4.6%	4.0%	4.1%
	June 2020	9.3%	6.5%	5.5%		4.1%
PCE inflation	Sept 2020	1.2%	1.7%	1.8%	2.0%	2.0%
	June 2020	0.8%	1.6%	1.7%		2.0%
Core PCE inflation	Sept 2020	1.5%	1.7%	1.8%	2.0%	
	June 2020	1.0%	1.5%	1.7%		
Fed Funds Rate	Sept 2020	0.1%	0.1%	0.1%	0.1%	2.5%
	June 2020	0.1%	0.1%	0.1%		2.5%

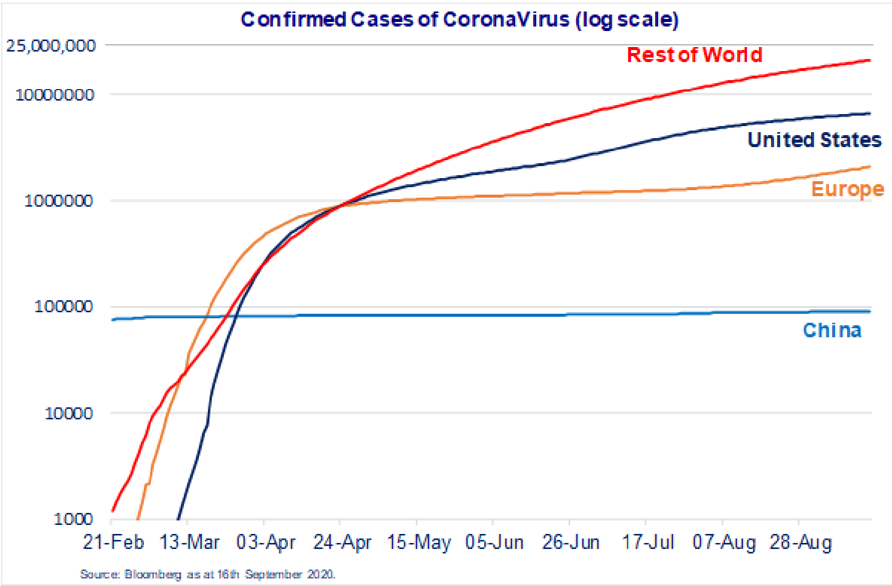
As such, the net of the Fed's new regime is that they provided more long-term certainty with more near-term uncertainty. I continue to believe that by its use of forward guidance and with official rates and yields both at zero, the Fed has acknowledged to itself that the policy toolbox is pretty empty.

Accordingly, if the Fed gets knocked by fiscal policy becoming less supportive, then the tools to lift growth and inflation is limited to doubling down of what they have already been doing with asset purchases and forward guidance, with the committee not excited about yield curve control or negative rates, which is fair enough. Consequently, **the Fed's mantra of allowing inflation overshoots and remaining behind the curve only works if you can actually get behind the tightening curve in the presence of reflationary forces**, but if you don't have reflation and you don't have co-ordination with fiscal policy or the tools to push beyond what is already a very low and flat yield curve, there is very little than can help push the economy towards the low unemployment and 2% inflation targets. So, they now have an asymmetric policy tools which can't materially help them achieve their goals, but which create highly dangerous and distorting asset bubbles.

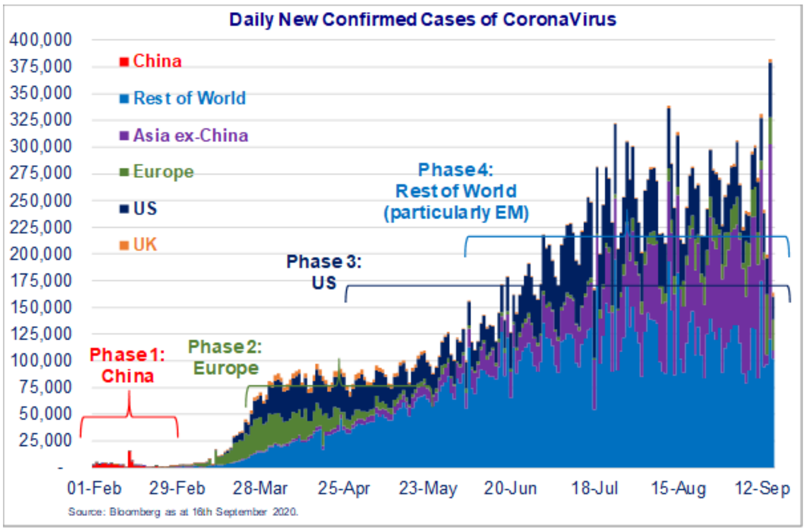
VIRUS UPDATE

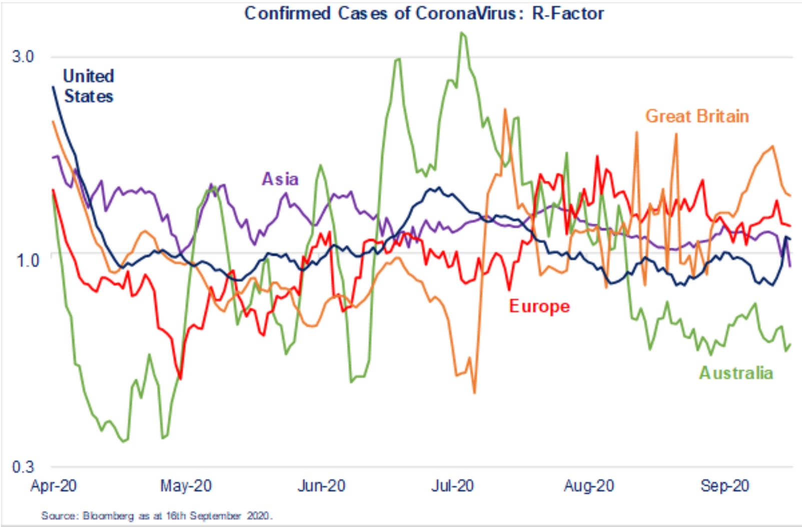
- The number of global cases of COVID-19 is 29.7 million with another +160.3k cases so far (but Mexico, Colombia, India and Pakistan and 5 US states have not reported their numbers) which means that Wednesday is likely to be the 59th consecutive day where daily increases are greater than 200k. At present, 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 Sunday) is steady. Meanwhile, deaths stand at 937.5k and the death rate was steady at 3.16% although the number of daily deaths remains elevated.



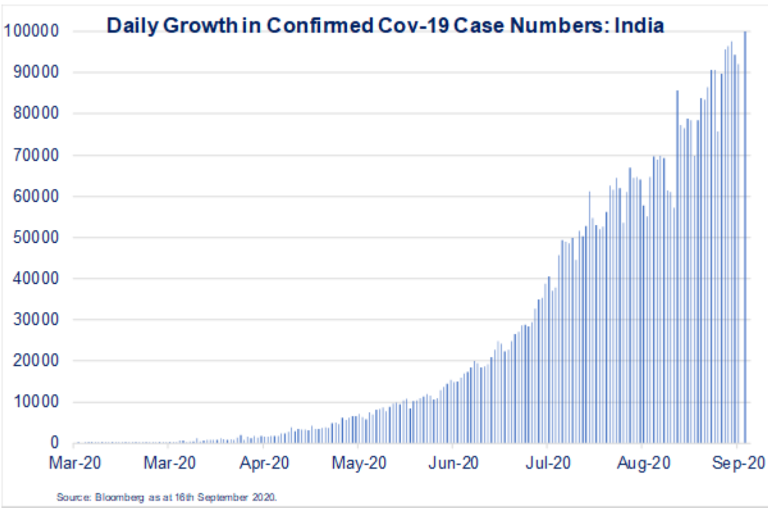
- We break the infections into four groups – the US, Europe, China and 'others' and the rest of the world outside the G3 economies now has the most total cases (+109.7k to 26.9 million) and highest daily new cases (and by a considerable margin) followed by the US (+21.9k (3-month low) to 6.63 million, although 5 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 (+28.8k to 2.09 million - see chart) which is the only region with an R-factor above 1.0 which indicates that the infection rate (1.16 is too high, especially in Britain (1.38).





- Among countries, the most cases are in the US (+21.9k (so far) to 6.63 million, with 5 states yet to report), India (not reported, 5.02 million), Brazil (+36.8k to 4.38 million), Russia (+5.6k to 1.08k), Peru (+4.2k to 738.0k), Colombia (not reported, 728.6k), Mexico (not reported, +676.5k), South Africa (+1.9k to 653.4k), Spain (+11.1k to 614.4k) and Argentina (+12.2k to 577.3k). Australia confirmed cases rose +29 (6-week low) to 26.9k yesterday which placed us 70th in terms of total infections.

  Elsewhere, Singapore recorded +26 new cases to 57.5k most of which are linked to foreign workers who are forced to live in crowded dormitories, but Indonesia (+4.0k to 229.0k) is now on the rise and has the second most cases in the region behind only the Philippines (+3.5k to 272.9k).



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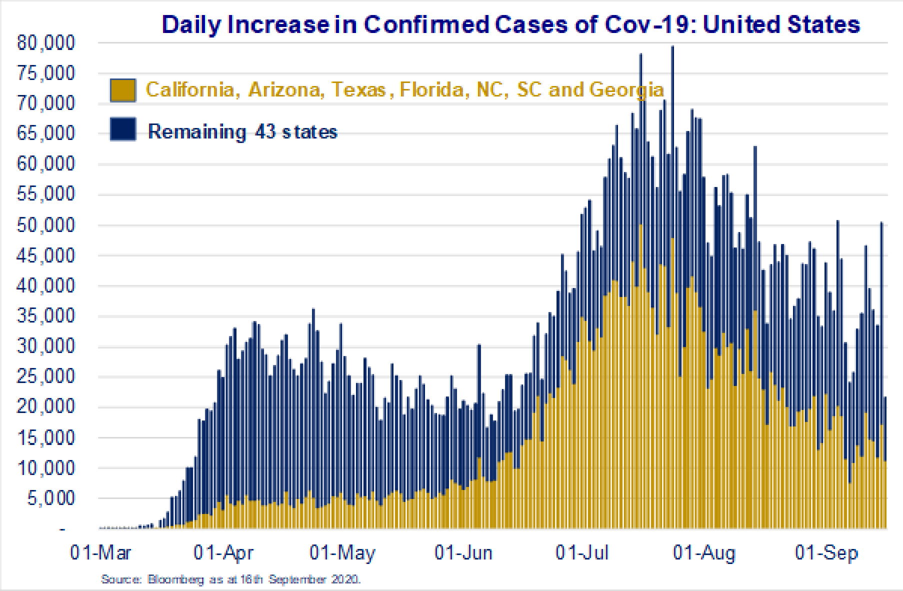
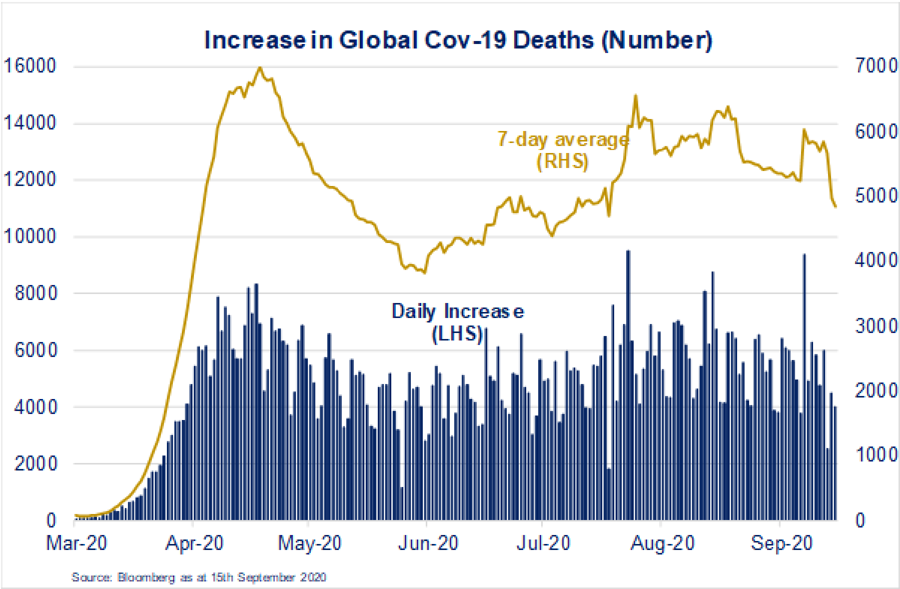


- Although final numbers are not in until 1pm AEST, the global death rate was steady at 3.16% with the global total to 937.5k after another +5.0k deaths overnight, so far, which indicates the daily average deaths is stabilising again (see chart). The US (+0.9k so far) has the most deaths at +196.7k, with Brazil (not reported, 133.1k), India (+1.2k to 82.1k), Mexico (not reported, 71.7k), the UK (+20 to 41.8k), Italy (+12 to 35.6k) and France (+49 to 31.1k) 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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