Perpetual Investments

THOUGHTS ON THE MARKET

1st September 2020 - Is European credit sending us a message?

SUMMARY

- It was a quiet night on the macro front with a fairly short list of activity releases, but that didn't stop the global sharemarket snapping its recent run of record highs, but the overall losses did not amount to much. That said, the selldown was broad with all three regions simultaneously lower for the first time in the past four weeks after China threw a spanner into US company plans to buy TikTok. However, that was not enough to prevent the US sharemarket from recording a 7% monthly advance in August which is a 34-year high, and with bond yields also up 0.2% over that period, it is clear that traders have taken comfort in the global economy's recovery and continued stimulus support. However, the market is now priced for perfection, and there are many risks which could trip up investors from the virus, to early policy withdrawal, geopolitical tensions, the US election and so on. Yet on the other side, there is a wall of liquidity which is buttressing the market, but central bank liquidity has not prevented a -2.5% selloff in Europe in the last three sessions, but the rise in credit spreads in European financials is the real worry as these capital losses in the past two weeks are starting to mount.

  In other markets, 10-year US Treasuries rallied with yields down another -2 points to 0.70% with curve flattening, commodities were up with gains in energy (+0.6%) to USD42.86 per barrel) stronger than those for gold (+0.1% to USD1,967 per troy ounce) and G10 currencies mostly rallied against a weaker Greenback with gains led by the Euro (+0.3%), AUD (+0.2% to USC73.78) and Sterling (+0.1%), but the Yen defied the trend and closed lower (-0.5%).

- Macro releases were scant overnight but the China August PMI had mixed results with the manufacturing gauge down slightly to 51.0 as a surprising decline in production outweighed higher new orders, but employment was little changed, which was a disappointment. Meanwhile, the non-manufacturing index rose further in August as a decline in construction was outweighed by a strong rise in services as social mobility restrictions were further eased, thereby supporting activity. So overall, the economic recovery remains on track even though it is not overtly robust.

- The number of global cases of COVID-19 is 25.35 million with another +117.0k cases so far (but Brazil, Colombia,, India, Mexico and 6 US states have not reported their numbers) which means that Monday is set to be the 44th consecutive day where daily increases are greater than 200k. At present, 8 countries have more than 500k cases, 21 countries have more than 200k cases and 29 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 (+1.0% since Friday) is once again coming down. Meanwhile, deaths stand at 848.4k and the death rate has declined to 3.33% although the number of daily deaths remains elevated.

FINANCIAL MARKETS

- ### EQUITIES
  - **The MSCI World Index closed lower (-0.1%)** and took a breather from its run of recent record highs. Seven of the 11 GICS sectors closed lower in a poor day for traditional cyclical stocks. Energy (-1.6%) led the pace of losses despite another rise in the crude price with the overnight decline taking the sector's losses over the past 13 sessions to -7.9%. Financials also returned their past two days of advances with losses prevalent among banks and insurers, and industrials (-0.6%) were weighed down by airlines. In contrast, consumer discretionary (+0.8%) was the top performer with strength from Amazon (+1.5%) outweighing broader losses in other subsectors, and Tech (+0.4%) also beat the tape with support from Apple (+3.4%) after its stock split. The overnight moves saw materials (with a peak to now decline of -0.4%)

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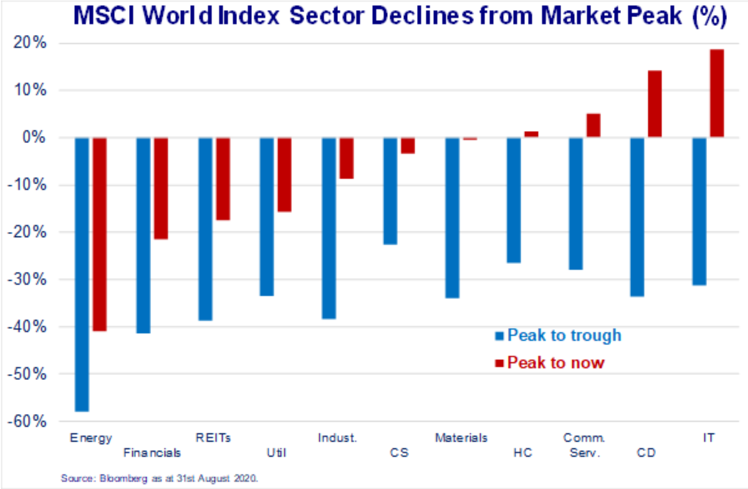
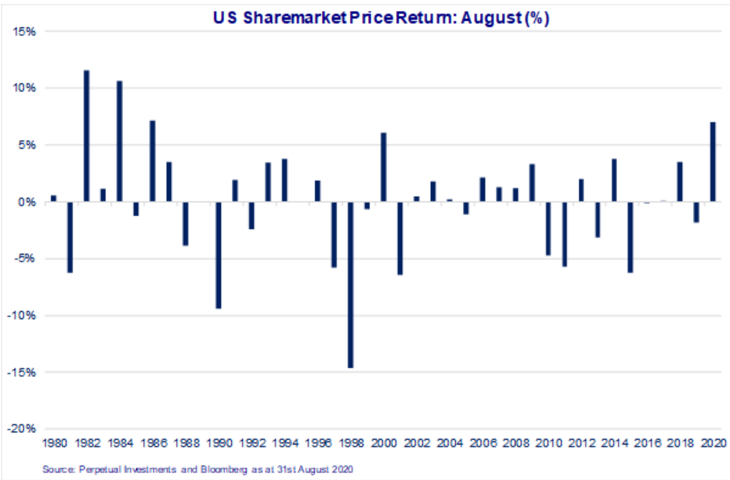
move out of the complete recovery group, whereas energy (-40.9%) continues to decline with its recovery rate now at just 29.4% and its peak-to-now losses at -40.4% (see chart).



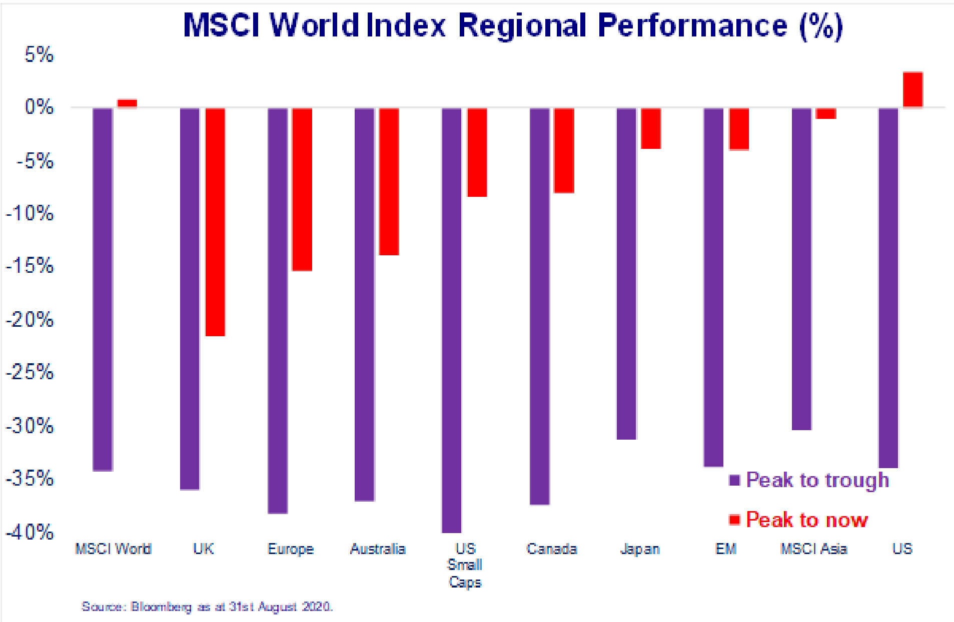
- **Among the regions, losses** were led by Europe (-1.3%) which opened positively but the lack of macro data and a poor run of COVID-19 case numbers saw the market come off its intra-day peak, and a weak opening on Wall Street saw all regional indices head into the red. Regional case numbers rose to +31.2k which is the highest daily increase in five months with France declaring that the wearing of masks will be mandatory for companies with groups working in close proximity, while wire services reported German Finance Minister Scholz, saying that exceptional spending must remain in place because "the crisis won't be over before by the end of this year" and "if everything goes well, the worst will be behind us by end of next year". In politics, The London Times reported that Treasury officials are drawing up plans for a £30 billion tax raid on the wealthy, businesses, pensions, and foreign aid - to plug a hole in the nation's finances caused by the virus. In economic data, German inflation fell to -0.1% y/y in August, Italy (-0.5% y/y) and Spain (-0.6%) remained deeper in deflation territory. By the closing bell, the region recorded its largest decline in the past 7 sessions with losses led by Spain (-2.3%), France (-1.1%), Italy (-1.0%), Germany (-0.7%), Sweden (-0.6%) and Switzerland (-0.3%) with the UK closed for a bankers holiday.

- **US markets also closed lower (-0.2%)** and while for every stock that rose two declined, the downside to indices was limited by another strong day by tech shares. Nonetheless, the market snapped a 7-day win streak of record highs and closed out a +7.0% rise in August which was the highest since 1986 (see chart). It was a quiet session in terms of data flow with nothing of note on the macro calendar, but geopolitical tensions rose after China threw a spanner into US company plans to buy TikTok which weighed heavily on indices where Microsoft (-1.5%) and Walmart (-1.0%) had a large weighting. In contrast, shares in Apple (+3.4%) rallied strongly after their 4:1 stock split which saw the NASDAQ 100 index trade above 12,000 for the first time. In Fed news, Clarida reiterated that guidance and QE are the best policy tools, but I remain sceptical of the Fed's ability to boost inflation. By the close of trading, the NASDAQ composite index (+0.7%) was the only gauge to advance, whereas the S&P 500 (-0.2%), the Dow Jones (-0.8%, -224 points to 28430) and Russell 2000 (-1.0%) all lost ground.



- **Asian sharemarkets finished lower (-0.8%) despite an upbeat opening following a positive lead from Wall Street over the weekend,** but trading intensified in the afternoon session during which most indices swung into negative territory. In geopolitics, LDP lawmakers scrambled to nominate a replacement for PM Abe with Chief Cabinet Secretary Suga set to declare support from major factions. Suga is closely aligned with Abe and this allayed market concerns about political instability and risks of a big shift in policies. In other developments, economic was a mixed with China's August manufacturing PMI declining but remaining in expansion territory, whereas the non-manufacturing sector recorded modest improvement suggesting some potential upside to H2 2020 domestic demand. Elsewhere, Japan industrial output was stronger than expected in July (+8.0% m/m versus the street at +5.4% m/m), whereas retail sales (-2.8% y/y, after -3.8% y/y in June) disappointed given its broadly based lull in momentum. By the closing bell in Mumbai, losses were widespread led by India (-1.6%), Korea (-1.2%), Taiwan (-1.1%), Hong Kong (-1.0%) all of whom scored century losses, whereas China (-0.6%) and Australia (-0.2%) beat the market tape and Japan (+1.1%) recovered most of its losses from Friday amid news that Berkshire Hathaway had been building long positions in major Japanese trading houses.

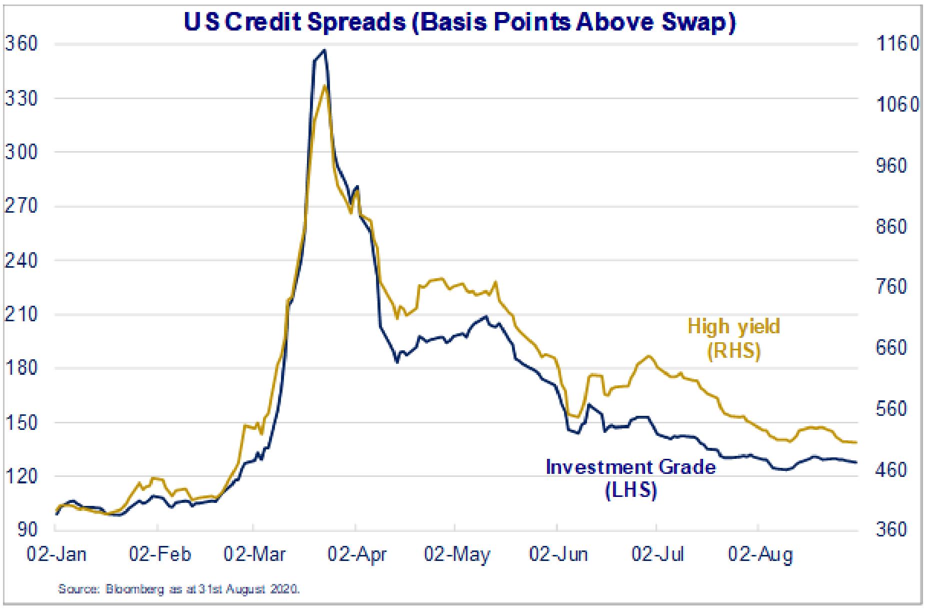
  The overnight moves had no material impact on our regional peak-to-now chart with the UK (-21.5%) the only region in bear market territory, Europe (-15.3%) and Australia (-13.9%) are in correction territory, and the US and MSCI World indices are the only ones to have recovered all of their losses (see chart).



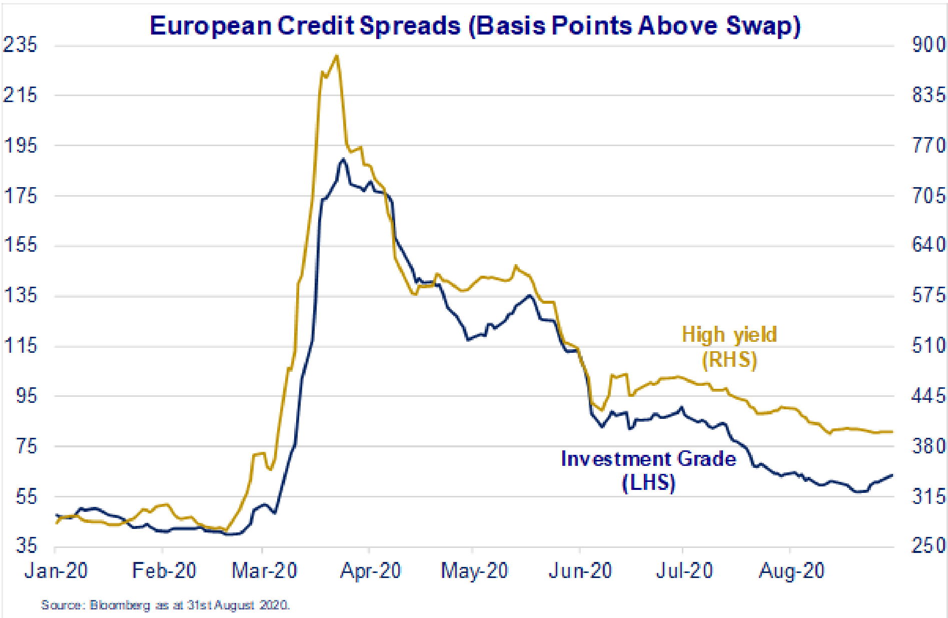
- **Futures markets are pointing to losses at the opening bell in Asia** with Australia (-1.0%), Hong Kong (-0.4%) and Japan (-0.3%) all slated for negative openings.

CREDIT MARKETS

- **Regional credit indices were mixed overnight.** Spreads in the US investment grade universe fell -1 point to +128 bpts, but the recovery rate was unchanged at 90%. All 11 sub-sectors recorded lower risk premiums but only tech (-2 points, +105 bpts, 89%) and subordinated financials (-2 points, +158 bpts, 89%) were more than a basis point. In the high yield universe, spreads were unchanged at +505 bps with the recovery rate idle at 86% with no material moves of note among the sub-sectors.



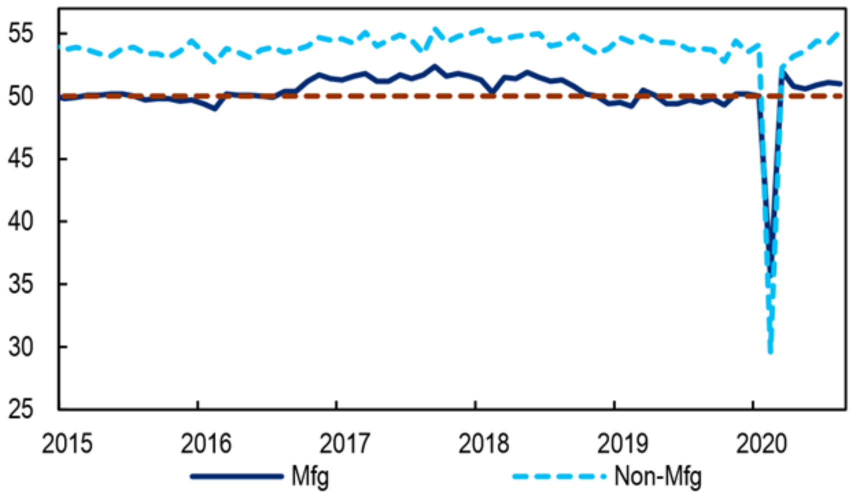
- **European credit markets** were marginally lower with spreads in the investment grade space rising another +2 points to +64 bpts, which lowered the recovery rate one notch to 84%. This means that over the past six session's the region's recovery rate has declined by 5 percentage points which is notable. Overnight, all eleven sub-sectors recorded higher spreads, but there was another rise in subordinated financials (+3 points, +152 bpts, 80%) after their +11-point rise on Friday, but no other sector recorded a rise of more than one basis point. In the high yield universe, spreads were steady at 400 bpts, with the recovery rate at 79% with the largest increases being in tech (+7 points, +335 bpts, 66%) but there was little outside of this. Interestingly, the sharp +45 bpts rise in senior financials on Friday night was not recovered overnight as was the case in July when spreads widened by a similar amount.



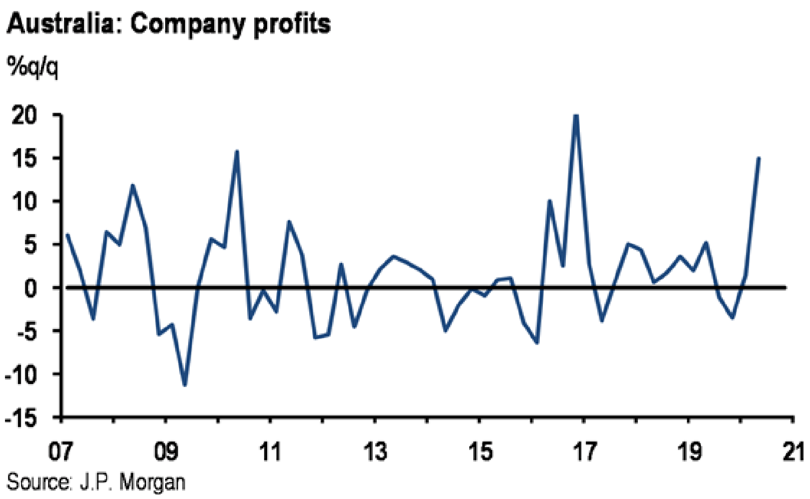
THE GLOBAL ECONOMY

- **The Chinese recovery remains on track, but momentum has softened at the margin with the August manufacturing PMI down -0.1 to 51.0.** Among the components the report was mixed with the overall index held down by a decline in production (-0.5 to 53.5) which was surprising considering the supply disruption from floods, with firms drawing down inventories (-0.5 to 47.1). However, new orders rose (+0.3 to 52.0) and new export orders also improved (+0.7 to 49.1) which suggests the supply side of the economy will be stronger in the December quarter, but employment (+0.1 to 49.4) was little change which was a disappointment.

Meanwhile, the non-manufacturing index rose further in August (+1.0 to 55.4) as a decline in construction (-0.3 to 60.2) was outweighed by a strong rise in services (+1.2 to 54.3) as the economy continued to open-up with industries such as movie theatres back in business. So overall, the economic recovery remains on track if the momentum softens somewhat. This backdrop should ease the fear over the exit of monetary easing and accelerate the implementation of fiscal policy.



- **Australia's company operating profits surged 15%q/q** (which was a 3-year high – see chart) in response to three factors - the government's JobKeeper package was included as business income, the fall in labour utilisation lowered economy-wide wages, and the use of inventories in goods industries to meet existing demand. Although the profit increase was huge, it won't impact the national accounts much as private sector income strength will be offset by public sector weakness. Elsewhere, inventories contracted more than expected at -3%q/q (consensus: -1%q/q), which closes the gap to some other GDP tracking inputs which haven't been as bad as first feared such as construction work.



POLICY

- There were no major policy announcements overnight.

VIRUS UPDATE

- The number of global cases of COVID-19 is 25.35 million with another +117.0k cases so far (but Brazil, Colombia,, India, Mexico and 6 US states have not reported their numbers) which means that Monday is set to be the 44th consecutive day where daily increases are greater than 200k. At present, 8 countries have more than 500k cases, 21 countries have more than 200k cases and 29 countries have more than 100k cases.

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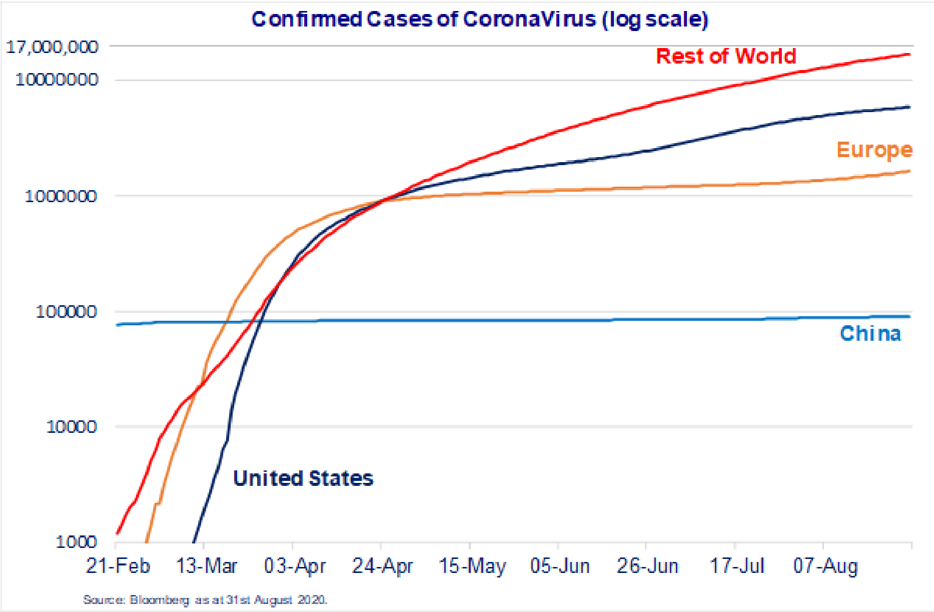
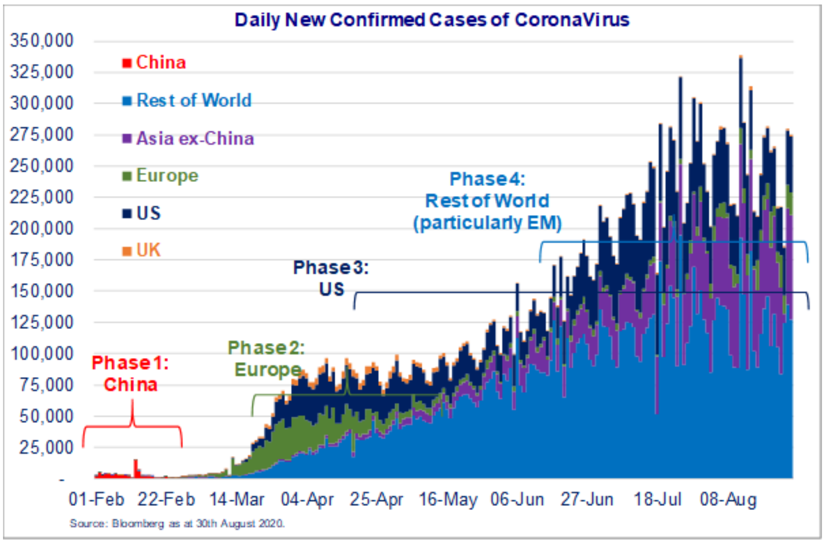
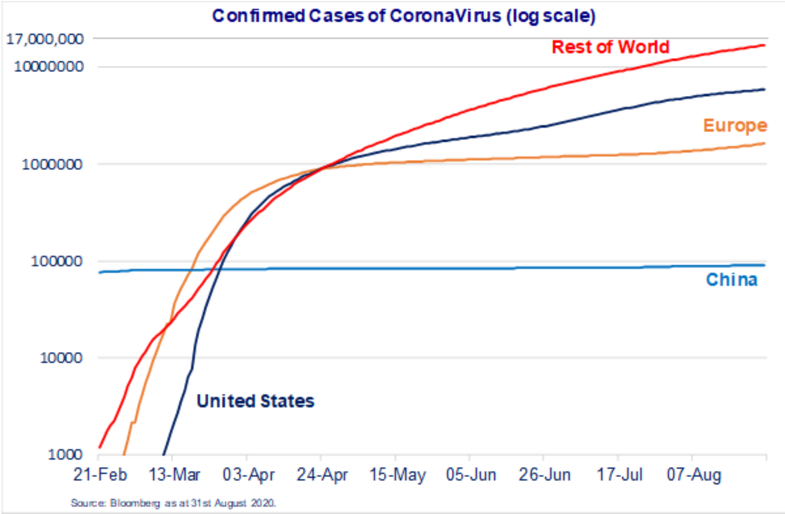


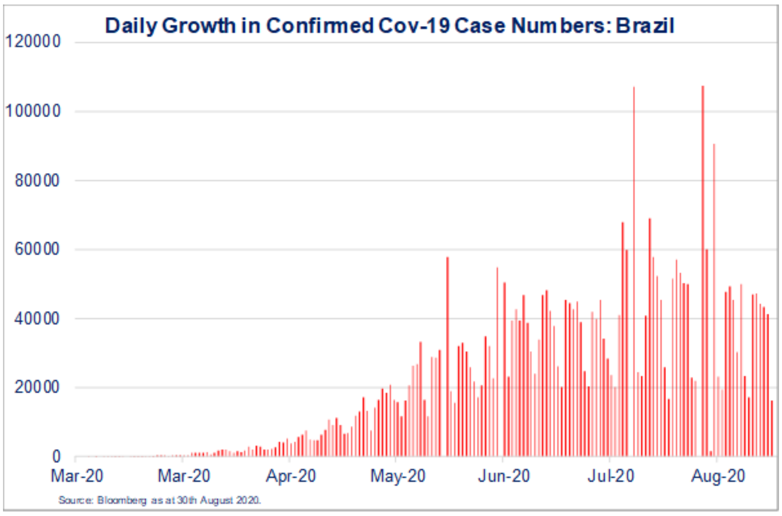
- We break the infections into four groups – the US, Europe, China and 'others' and the rest of the world outside the G3 economies now has the most total cases (+54.0k to 22.0 million) and highest daily new cases (and by a considerable margin) followed by the US (+30.5k to 6.03 million, although 6 states 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 (+31.2k (5-month high) to 1.71 million - see chart) which is the only region with an R-factor above 1.0 which indicates that the infection rate (1.20) is too high.

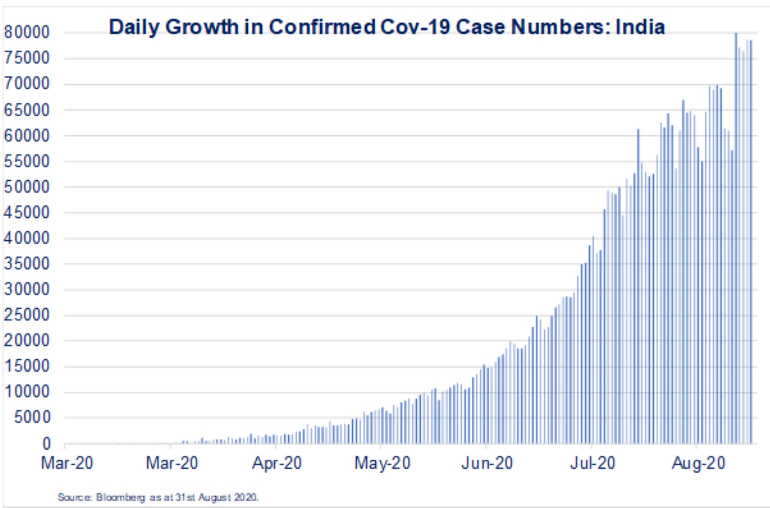


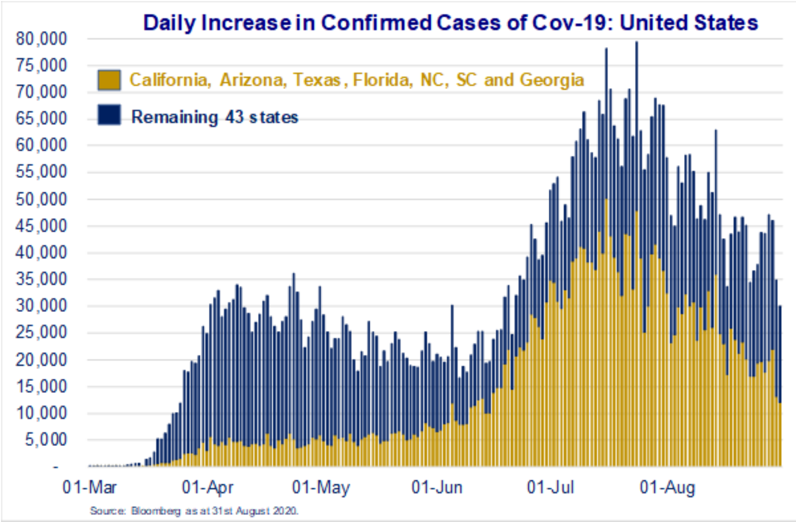


- Among countries, the most cases are in the US (+30.5k (so far) to 6.03 million, with 6 states yet to report), Brazil (not reported, 3.86 million), India (not reported, 3.62 million), Russia (+4.9k to 992.4k), South Africa (+2.0k to 627.0k), Peru (+7.7k to 647.2k), Colombia (not reported, to 607.9k), Mexico (not reported, +595.8k), Spain (+23.6k, 462.9k), Chile (+1.8k, 411.7k), Iran (+1.6k to 375.2k), United Kingdom (+1.4k to 338.1k), Saudi Arabia (+1.0k to 315.8k), Pakistan (+0.2k to +295.8k) and Bangladesh (+2.2k to 313.0k). Australia confirmed cases rose +76 to 25.7k yesterday which placed us 66th in terms of total infections.

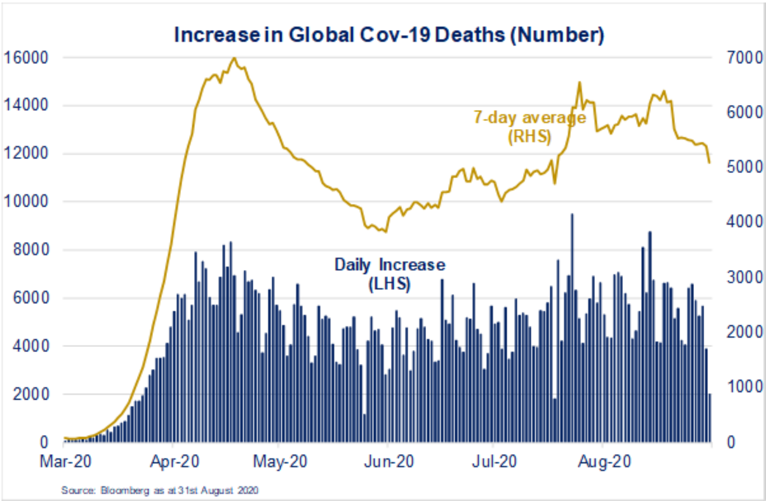
  Elsewhere, Singapore recorded +41 new cases to 56.8k most of which are linked to foreign workers who are forced to live in crowded dormitories, but Indonesia (+2.7k to 174.8k) is now on the rise and has the second most cases in the region behind only the Philippines (+4.3k to 220.8k).

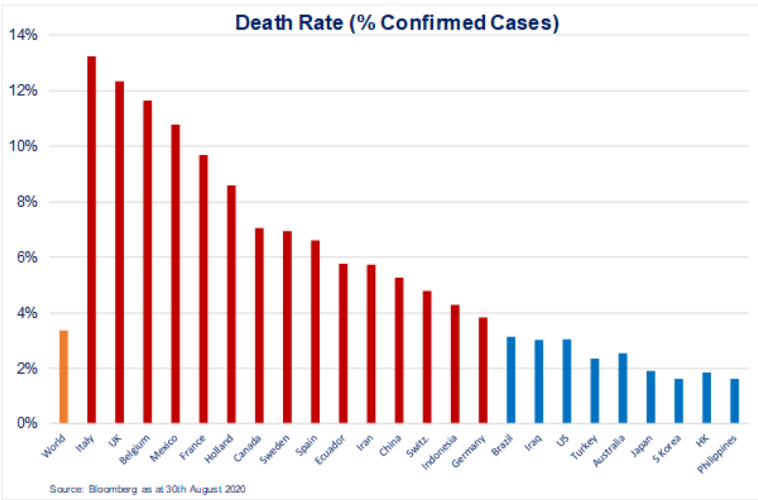






- Although final numbers are not in until 1pm AEST, the global death rate declined to 3.33% with the global total to 848.4k after another +2.0k deaths overnight, so far, which indicates the daily average deaths is stabilising again (see chart). The US (+0.4k so far) has the most deaths at +183.5k, with Brazil (not reported, 120.8k), India (+0.9k to 64.5k), Mexico (not reported, +64.1k), the UK (+2 to 41.6k), Italy (+6 to 35.5k) and France (+10 to 30.6k) all over +30k. The death rate is highest in European countries where the health systems had collapsed led by Italy (-0.1% to 13.2%), the UK (steady at 12.4%), Belgium (-0.1% to 11.7%), France (-0.2% to 9.7%), the Netherlands (-0.1% to 8.6%), Sweden (steady at 6.9%) and Spain (-0.1% to 6.6%). However, several emerging markets are now on the leader board including Mexico (-0.1% to 10.8%), Ecuador (-0.1% to 5.8%), Indonesia (steady at 4.3%) and Brazil (steady at 3.1%).





Yours sincerely,

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