Perpetual Investments

THOUGHTS ON THE MARKET

20th August 2020 - The Fed provides no guidance on its future guidance

SUMMARY

- Regional risk markets were mixed overnight, and the US dollar rose for the first time in five sessions, as the minutes from the US Fed's July meeting tempered optimism about the extent of the recovery in H2 2020. There was no real surprise in the minutes with the FOMC noting that the COVID-19 health crisis would weigh heavily on activity and that the ability to control the virus would ultimately determine the shape of the recovery. In addition, the Fed seemingly backed off its earlier commitment to provide guidance on the future path of interest rates in September which send the price of equities lower, but credit markets were unchanged as the Fed is supporting them through their balance sheet rather than the price of money. The FOMC update comes on the back of the inability of Congress to resolve its stalemate about its fifth stimulus bill, which is critical as the Fed's ability to support MainStreet is very limited given rates are at 0%.

  In other markets, US 10-year Treasuries were steady at 0.68% with curve slope unchanged at 0.59%, commodity markets were lower with gold off (a further -3.9% to USD1,929 per troy ounce) more than oil (-0.2% to USD42.79 per barrel) and the US Dollar rose after a 5-day rout with declines in all G10 currencies led by the AUD (-0.7% to USC71.82), the Euro (-0.5%), Yen (-0.4%) and Sterling (-0.4%).

- In the past few days all readers of this report would know that traders had pushed the S&P 500 to a record closing price underpinned by ultra-easy monetary policy and massive fiscal stimulus. The stampede of investors pushing markets up despite a weak EPS backdrop fuelled debate about how sustainable the share price recovery was given fiscal policy is about to be pared back, and US sharemarket valuations (at 23.5x forward earnings) have risen to levels which since 1900, have delivered an average return of -3.5% per annum over the next five years. The challenge is that fiscal policy needs to continue to support incomes until labour market trends improve, but in 2021 the fiscal impulse is set to detract its largest amount from global GDP since 1946, whereas monetary policy has inflated an asset bubble at a time when activity is anaemic with near-term risks skewed to the downside. Raging markets can tempt investors to go all in and not worry about asset allocation, as diversification can be something not appreciated until you need it and don't have it. In terms of the temptation to purchase equities at high valuations, caveat emptor.

- The number of global cases of COVID-19 is 22.25 million with another +128k cases so far (but Brazil, France, India, Mexico and 5 US states have not reported their numbers) which means that Wednesday may be the first occasion in the past 32 days where daily increases are below 200k. At present, 4 countries have more than 900k cases, 20 countries have more than 200k cases and 28 countries have more than 100k cases (Bolivia has joined this group overnight). 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 and 4 days. More importantly, the growth rate of daily confirmed cases (+1.0% since Sunday) is once again coming down, and deaths stand at 783.8k and the death rate has declined to 3.52% although the number of daily deaths is on the rise.

FINANCIAL MARKETS

- **EQUITIES**
  - **The MSCI World Index closed -0.2% lower overnight** with losses in eight of the 11 sectors. REITs (-1.4%) were the worst performer, although it was hard to pinpoint what exactly had changed from yesterday. Overall cyclical sectors were mixed with energy (-0.4%) following the crude price down with the sector

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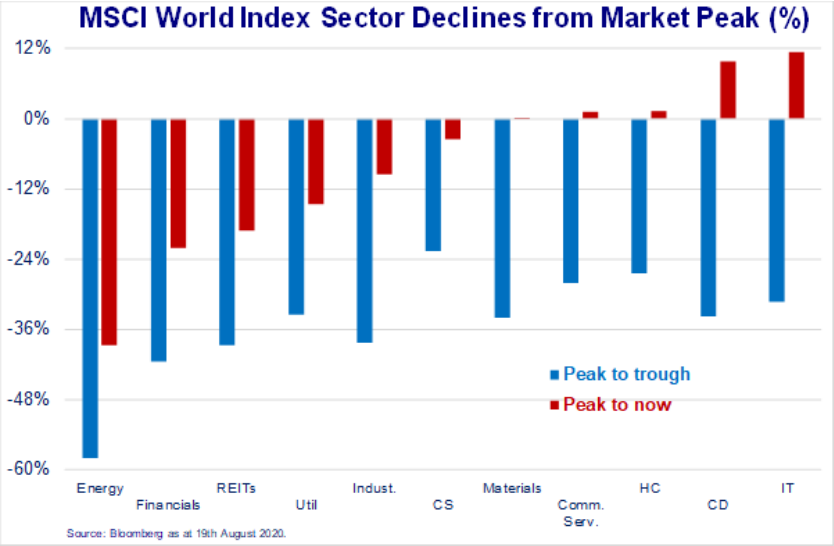
now on a 5-day lose streak which has taken the sector down -4.4%, and materials (-0.3%) also fell as declines in precious metals outweighed gains in base metals. Meanwhile, consumer discretionary stocks weakened (-0.5%) amid declines in both Amazon (-1.6%) and discount retailers, and tech (-0.2%) was also lower although the rise in Apple (+0.1%) at least helped the sector hold the market tape. In contrast, financials (+0.4%) fared best supported by credit card processors and online brokers, and industrials (+0.1%) snapped a four-day losing streak. By the ending of trading at the NYSE, the peak-to-now chart was little changed with energy (-38.8%) now approaching a double-bear market, and REITs (-19.1%) getting dangerously close to bear market territory, but five sectors have staged a complete recovery (see chart).

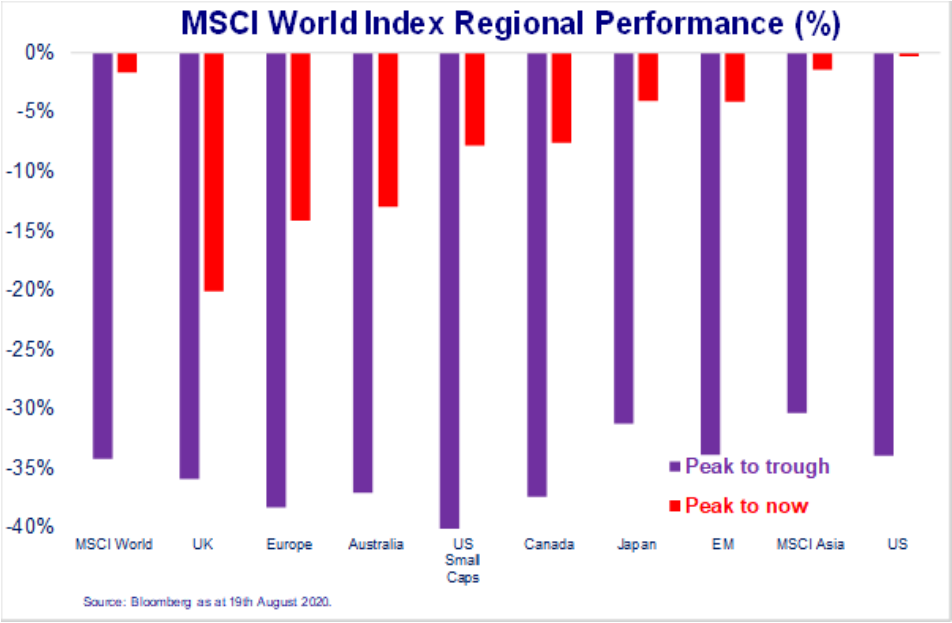


- **Among the regions, losses were largest in the US market (-0.4%)** with investors seemingly underwhelmed about the detail, or lack of it, of the Fed's policy review (still expected in September), with imminent yield curve control not gaining much traction among members at present, given the weak recovery, absence of a fiscal impulse and subdued inflation. Meanwhile, there was nothing on the macro calendar, and negotiations around the fifth COVID-19 stimulus bill remained stalled with nothing from congressional leadership to suggest a near-term path for compromise. By the closing bell at the NYSE, all indices were lower led by NASDAQ 100 (-0.6%), S&P 500 (-0.4%) and the Dow Jones (-0.3%, -85 points, 27,693).

  The MSCI Asia Pacific Index (-0.2%) also closed lower yesterday in another quiet session from a macro point of view other than for Japan exports which fell at a slower pace in July, but the import decline accelerated in a bad sign for domestic demand with June core machinery orders (ex-power and ships) contracting (-7.5% m/m) against expectations for a solid rise (+2.5% m/m). Geopolitical tensions also garnered the headlines after President Trump indicated that he called off last weekend's trade talks with China which sparked concerns about the future of the Phase 1 trade deal. In addition, the US State Department has asked colleges and universities to divest its Chinese holdings in their endowment funds. Lastly there was mixed COVID-19 news with China's infections below 60 for the second straight day with zero local transmissions (for the third day) and Victoria recorded smallest infection increase in 5 weeks. By the closing bell in Mumbai, performance was mixed with Australia (+0.7%) leading the gains again followed by South Korea (+0.5%), India (+0.3%) and Japan (+0.3%), but Taiwan (-0.7%), Hong Kong (-0.7%) and Mainland China (-1.3%) came under increased selling pressure as the day progressed.

  In contrast to Asia and the US, Europe (+0.9%) traded higher, but this was probably just a technical rebound as the region had underperformed its peers in the past four sessions (-2.2% during that time). On the macro front there was only July UK inflation (+1.1% y/y) which was firmer than expected whereas the final July European inflation was in line with the flash reading at +0.4% y/y. This meant the Cov-19 case numbers dominated the headlines with Germany having large numbers as did Spain, and Ireland was the latest to reverse re-opening measures. On the Brexit front, the FT reported that Brussels rejected the UK's opening demands for continued wide-ranging access to the EU for British truckers, suggesting that the negotiations are going to be an extended and painful process. By the market close the region was a sea of green with advances led by Switzerland (+1.4%), Italy (+1.1%), Sweden (+0.9%), France (+0.8%), Germany (+0.7%) and the UK (+0.6%).

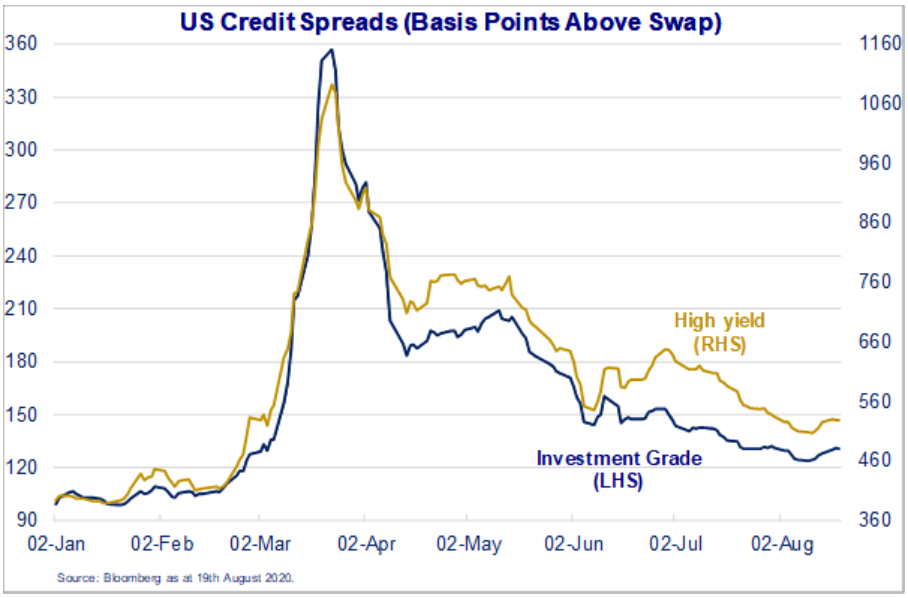
The overnight movements meant that the UK (-20.1%) just remained in bear market territory (-20.1%), and the US market's recovery rate fell back to 99.0% (see chart).



- Futures markets are pointing to a weak opening in Asia this morning, with opening bell losses priced in for Australia (-0.3%), Japan (-0.2%) and Hong Kong (-0.1%).

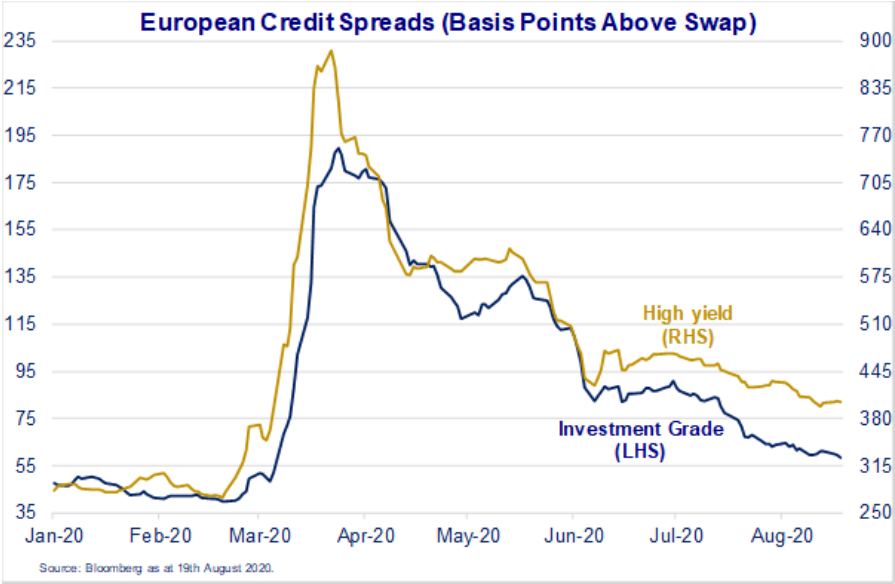
• CREDIT MARKETS

- **Regional credit indices were flat overnight** with the asset unaffected by Fed minutes as the institution continues to provide support through its balance sheet. Spreads in the US investment grade market were unchanged at +131 bpts with the recovery rate at 89%, with seven sectors recording lower spreads, but nothing was of note as most sub-sectors hugged the breakeven line. Spreads in the high yield universe were equally quiet moving down only -1 point to +528 bpts, which kept the recovery rate at 83%. Seven of the 11 sub-sectors recorded lower risk premiums but the largest was healthcare (-3 points, +509 bpts, 75%) and energy (+3 points, +776 bpts, 100%) suggesting that investors don't want to push spreads in much more as the recovery remains weak and balance sheets remain highly leveraged.



- **European credit markets** were also quiet with investment grade spreads decreasing -1 point to +58 bpts, which was enough to lift the recovery rate one notch to 88%. However, the only noteworthy move was subordinated financials (-4 points, +139 points, 85%) with all other sectors having movements of only 1

point either side of the breakeven line. In the high yield space, spreads also came in -1 point to +397 bpts, which kept the recovery rate at 79%. Although ten of the 11 sub-sectors recorded lower spreads, the largest was consumer staples (-3 points, +480 bpts, 97%) which continues to perform well but this was offset by a rise in healthcare (+7 points, +301 bpts, 73%).



THE GLOBAL ECONOMY

- There were no major macro data releases overnight.

POLICY

- There were no major policy announcements overnight, but the Fed released the minutes from its July FOMC meeting which contained few surprises and showed support for forward guidance on rate hikes. However, the lack of detail on this matter suggests formally adopting the new guidance could potentially be pushed beyond September, although we still expect it will be given by this date. I think that there is little doubt that the FOMC will commit to keeping policy rates at the zero-lower bound until inflation is sustainably at or above 2%. There was no new guidance on the pace of asset purchases, but the committee discussed the need to evolve Treasury and MBS purchases to support the economic recovery.

  Importantly, the minutes repeated calls for ongoing fiscal support with the nature of COVID-19 shock making fiscal policy even more important in supporting MainStreet (recall this meeting occurred before the Washington impasse). The minutes also reaffirmed the FOMC's view going forward that inflation is likely to be soft, as the shortfall in aggregate demand is likely to outweigh supply constraints. While projections are for a core inflation pickup starting in 2021 the current forecast it for it to reach only at +1.7% by end-2022.

VIRUS UPDATE

- The number of global cases of COVID-19 is 22.25 million with another +128k cases so far (but Brazil, France, India, Mexico and 5 US states have not reported their numbers) which means that Wednesday may be the first occasion in the past 32 days where daily increases are below 200k. At present, 4 countries have more than 900k cases, 20 countries have more than 200k cases and 28 countries have more than 100k cases (Bolivia has joined this group overnight).

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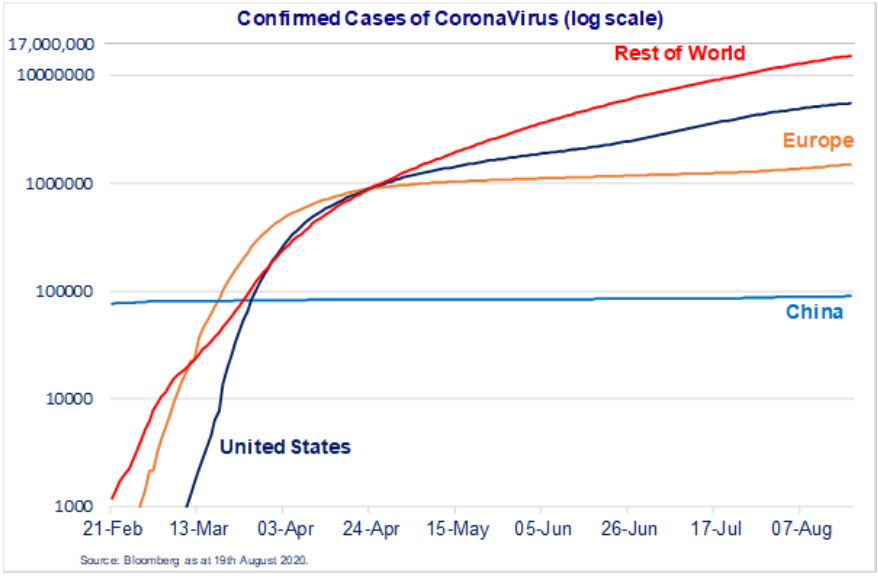
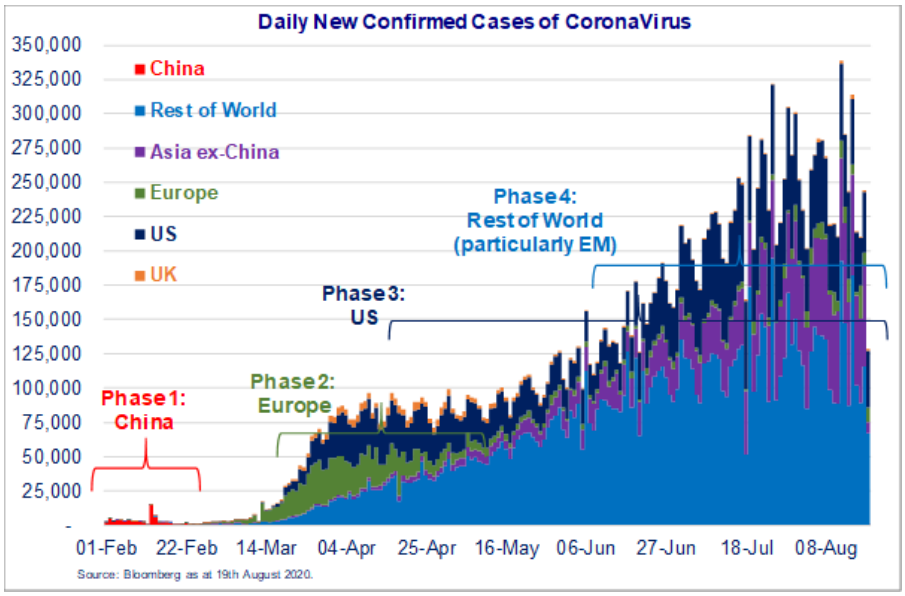
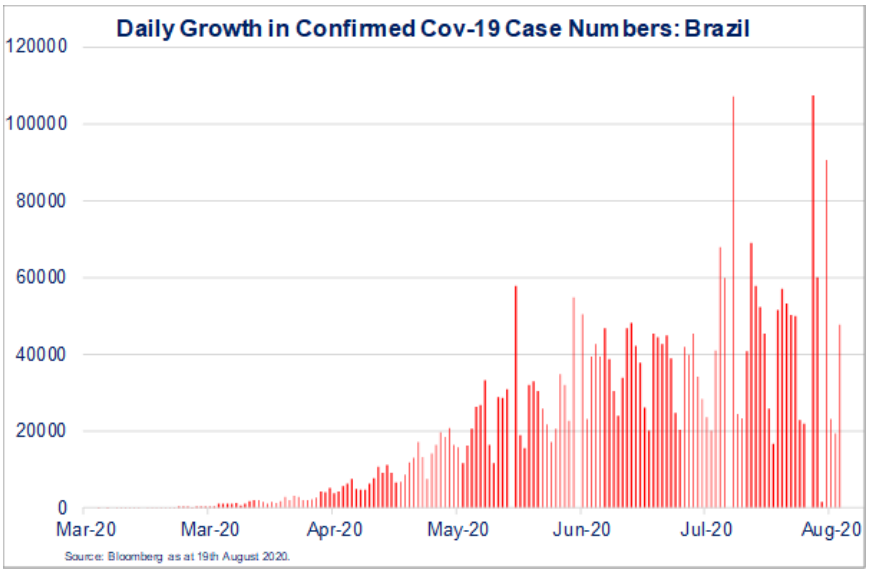


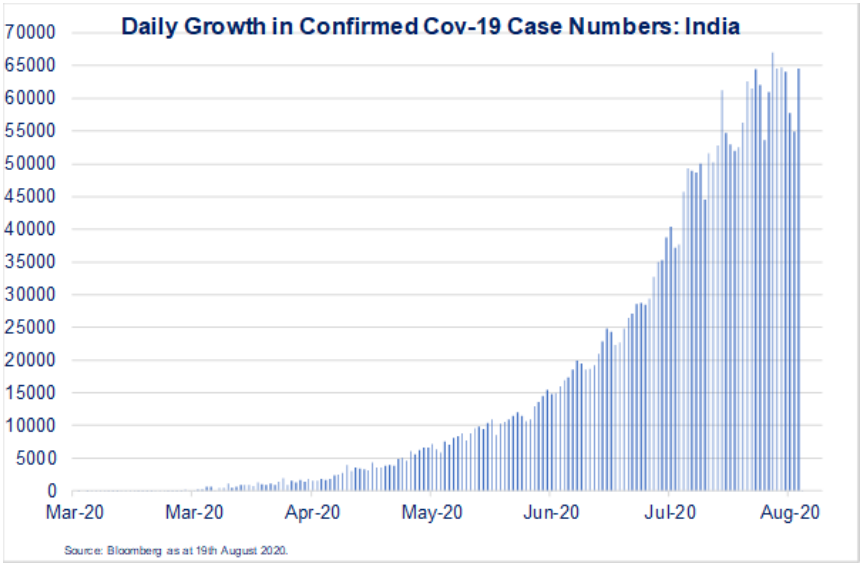
- We break the infections into four groups – the US, Europe, China and 'others' and the rest of the world outside the G3 economies now has the most total cases (+83.4k to 18.7 million) and highest daily new cases (and by a considerable margin) followed by the US (+41.5kk to 5.5 million, although 5 states are yet to report and two reported record case numbers (Nebraska and Wisconsin). 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 (+10.9k to 1.50 million - see chart).

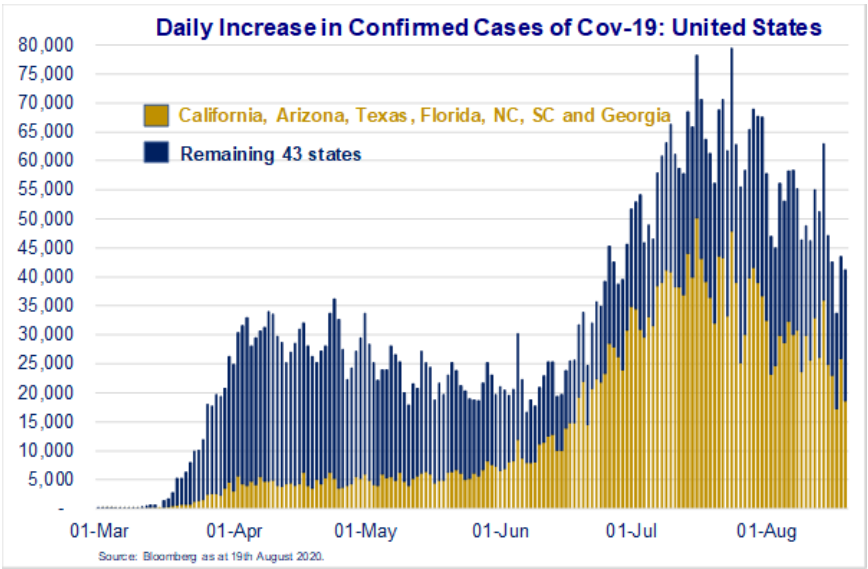


- Among countries, the most cases are in the US (+41.5k (so far) to 5.50 million, with 5 states yet to report), Brazil (not reported, 3.40 million), India (not reported, 2.77k), Russia (+4.8k to 935.1k), South Africa (+3.9k to 596.1k), Peru (+7.8k to 549.3k), Mexico (not reported, +531.2k), Chile (+1.2k, 390.0k), Iran (+2.4k to 350.3k),Spain (+6.7k to 370.9k), United Kingdom (+0.8k to 323.0k), Saudi Arabia (+1.4k to 302.7k), Pakistan (+0.6k to +290.4k), Bangladesh (+2.3k to 285.1k), Italy (+0.6k to 255.3k), France (not reported, 256.5k), Turkey (+1.3k to 253.1k), and Germany (+1.6k to 229.7k). Australia confirmed cases rose +220 to 24.0k yesterday which placed us 69th in terms of total infections.

  Elsewhere, Singapore recorded +0.1k new cases to 56.0k most of which are linked to foreign workers who are forced to live in crowded dormitories, but Indonesia (+1.9k to 145.0k) is now on the rise and has the second most cases in the region behind only the Philippines (+4.6k to 173.8k).

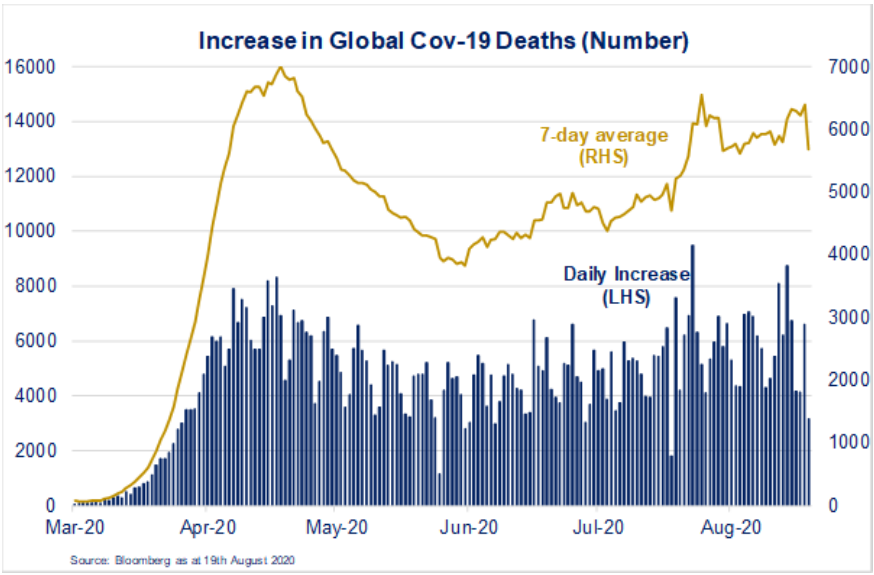


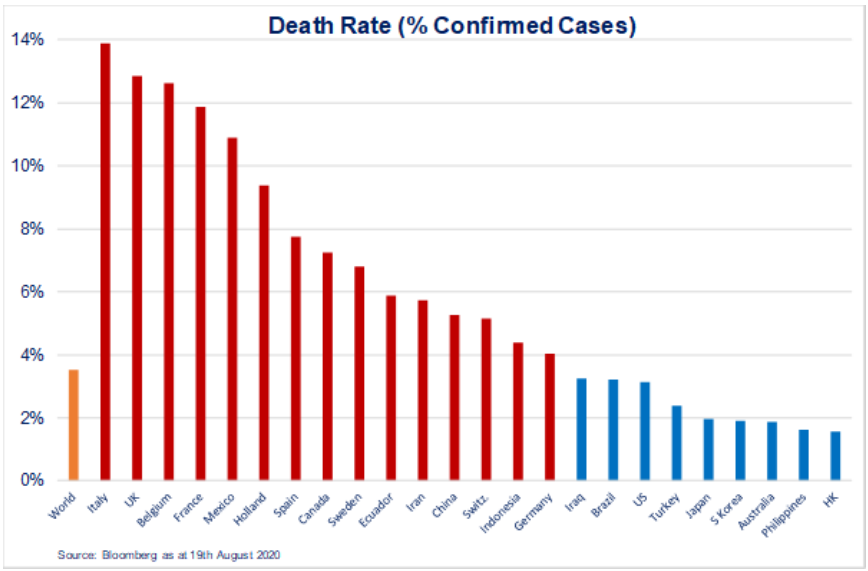




- Although final numbers are not in until 1pm AEST, the global death rate declined to 3.52% with the global total to 783.8k after another +3.2k deaths overnight, so far, which indicates the daily average deaths is increasing again (see chart). The US (+1.1k so far) has the most deaths at +172.9k, with Brazil (not reported, 110.0k), Mexico (not reported, +57.8k), India (+0.9k to 52.0k), the UK (+0.02k to 41.5k), Italy (+7 to 35.4k) and France (not reported,

30.4k) all over +30k. The death rate is highest in European countries where the health systems had collapsed led by Italy (steady at 13.9%), the UK (steady at 12.8%), Belgium (steady at 12.6%), France (steady at 11.9%), the Netherlands (-0.1% to 9.4%), Spain (-0.1% to 7.8%) and Sweden (steady at 6.8%). However, several emerging markets are now on the leader board including Mexico (+0.1% to 10.9%), Ecuador (-0.1% to 5.9%), Indonesia (steady at 4.4%) and Brazil (steady at 3.2%).





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Yours sincerely,

MATT SHERWOOD
Head of Investment
Strategy, Multi Asset

MICHAEL O'DEA
Head of Multi Asset

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Perpetual Investments 1800 062 725
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