

THOUGHTS ON THE MARKET

21st September 2020 - What are the implications of passing the policy peak?

SUMMARY

- The loss of momentum in global sharemarkets since August continued for a third week. The subsequent decline in share prices has come despite a very strong activity bounce so far in the September quarter in the US, China and Europe, with the lack of a policy impulse, and its growth implications, worrying investors. Over the past few weeks, investors have seen that the likelihood of a fifth fiscal package being agreed to by the US Congress before the November election is rapidly diminishing thereby exposing consumer spending to an income cliff, but the impact here is likely to be cushioned to some degree by high household savings (17% in July).

The lack of a fiscal deal is the most pressing issue for the recovery and for markets, but we still believe that if the US economy slows too much, the US Fed will provide additional market support. However, markets were clearly disappointed by the FOMC unveiling its multi-year forward guidance without additional easing and without any material details about by how much, and for how long, they will tolerate higher inflation, and Chair Powell's vagueness at his press conference provided little comfort.

There is no doubt that with official rates at 0% the Fed's, and all other central banks, policy quiver is seriously depleted. The basic problem for the Fed is that they have a policy mantra now of allowing inflation overshoots and remaining behind the curve, but this only works if they have the tools to generate a reflation impulse in the first place. If you don't, and you don't have the 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 that can help push the economy towards full employment growth and 2% inflation especially given the large output gap. This means that the recovery is likely to be subdued.

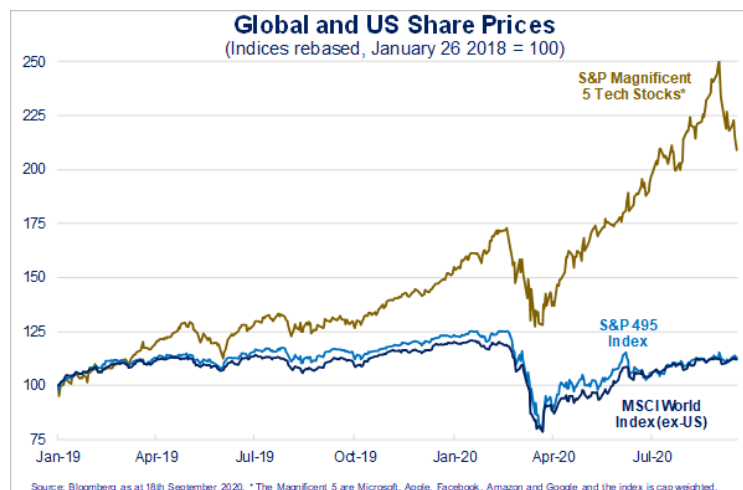
- Beneath the surface, there has been some rotation with non-US markets, value and cyclical sectors outperforming their US, momentum and growth peers, but unlike previous cycles this is not a case of larger gains, but smaller losses. Indeed, peak monetary policy is seeing stretched tech valuations come down and one cannot conclude that we are at the end of that process. So, while central bank asset purchases have lessened volatility spikes and market drawdowns, it has never prevented them. Accordingly, the lack of co-ordination between monetary and fiscal policy in the next 12 months is likely to slow the recovery down and have two potential consequences in that the US sharemarket and US dollar will moderate further, which can have consequences for other regions. This indicates that after an incredible recovery post-March, that investors may need to enhance their portfolio diversifiers in the light of continued volatility.
- In other markets, 10-year US Treasuries were unchanged at 0.69% with modest some curve steepening driven by the short-end, commodities were generally higher with gold (+0.5% m/m to USD1,951 per troy ounce) outperforming oil (+0.3% to USD 41.11 per barrel), and G10 currencies were mixed against the Greenback with the Euro (+0.4%) and Yen (+0.2% to 104.57 which is a fresh 6 month high) appreciating, the AUD steady (at USC72.89) and Sterling (-0.3%) closed lower.
- Policy clearly dominated economic data last week, but in the US, there were clear signs that the US goods sector recovery has peaked and while the services sector lift showed some improvement, the overall level of retail spending growth moderated and was a bit underwhelming. That said, there is nothing to be worried about as goods consumption has completely recovered from its H1 2020 collapse and was always going to slow after the pent-up demand from the COVID-19 lockdowns was met. Meanwhile, the recovery in China looks more V-shaped than anywhere else, but there is likely to be policy withdrawal in coming months as China does not want to repeat the same mistakes from its post-GFC recovery.

- The number of global cases of COVID-19 is 30.9 million with another +197.7k cases so far (but Brazil, Mexico, Colombia and 8 US states have not reported their numbers) which means that Sunday is likely to be the 64th 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 34 countries have more than 100k cases. More importantly, the growth rate of daily confirmed cases (+0.9% since Thursday) is steady. Meanwhile, deaths stand at 959.0k and the death rate was steady at 3.10% although the number of daily deaths remains elevated.

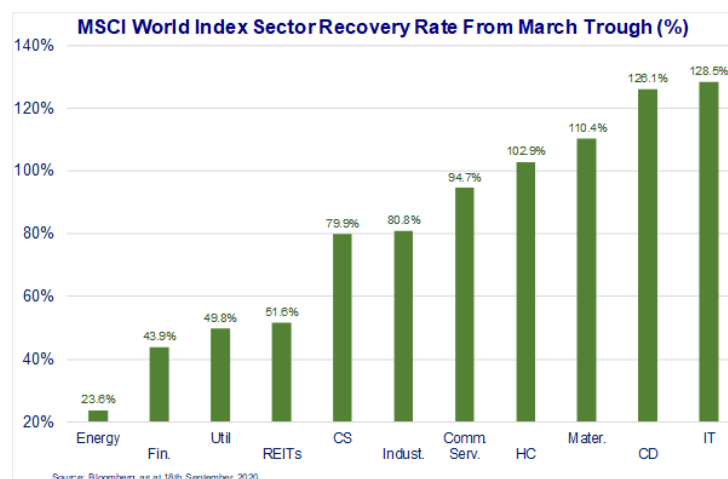
FINANCIAL MARKETS

• EQUITIES

- The MSCI World Index closed -0.7% lower on Friday night which culminated in a third week of declining prices (-0.01% albeit by a fraction). There was no specific catalyst for the decline during the session other than a continuation of the step-down from high tech-related valuations that has been evident since the end of August. At the sector level bond proxies lagged despite Treasury yields being unchanged with losses led by REITs (-1.6%) which have now declined to levels last seen at the end of July, with utilities (-1.1%) also among the worst performers. Tech continued its recent weakness with IT (-1.2%) down in the wake of losses in Apple (-3.2%), Microsoft (-1.2%) and broader semi-conductors, whereas communication services (-1.1%) lagged the market tape as Google (-2.4%) and Facebook (-0.9%) declined. Perpetual's Magnificent Five tech index declined -2.1% on Friday, -4.0% for the week, with the index now off -16.4% since the peak of early September (see chart), whereas the remainder of the US sharemarket has gone nowhere for nearly two months.



Meanwhile, traditional value/cyclical stocks declined but most beat the market tape other than energy (-1.3%), with financials (-0.5%), materials (-0.6%) and Industrials (-0.7%) doing better than their peers. Despite their recent sharp declines, tech and biotech sectors continue to outperform with IT (+128.5% since its March low), consumer discretionary (+126.1%), healthcare (+102.9%) and communication services (+94.7%) four of the top 5 performers. These stock types are followed by defensives and yield plays, with cyclicals at the tail end of the field (see chart).

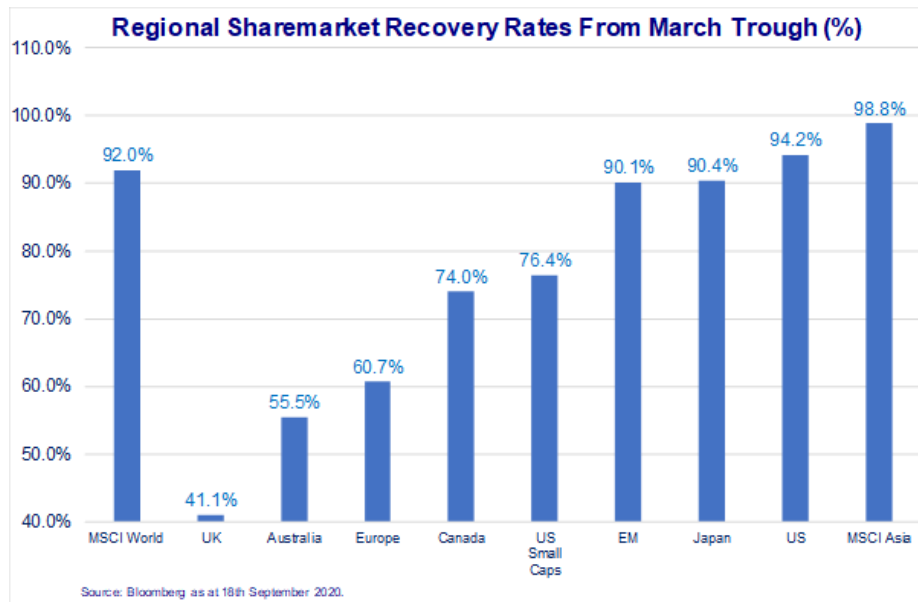


Among the regions, losses were led by the US (-1.1%) whose loss on Friday erased gains from earlier in the week and saw the S&P 500 close out its third consecutive weekly decline – a feat last seen in October 2019 – to close at a six week low. Despite the continued price decline, the session was quiet from a newsflow perspective, with the macro space only having consumer confidence which rose +5 points to a four-month high of 78.9, but it remains -22% below its February level. In central bank news, rumours circulated that the Fed will extend the bank limitation on dividends and buybacks to strengthen balance sheets after President **Kashkari (a dissenter at the September FOMC meeting) called for banks to be required to hold higher levels of equity.** There was nothing incremental out of Congress re the fifth stimulus package, and Coronavirus numbers saw a second day of 40k+ cases since Tuesday. On geopolitics, President Trump said that the US will block downloads of WeChat and TikTok domestically starting 20-September and that the app would be shut down unless a deal with Oracle is approved by November 12th. By the close of trading, all major US indices were lower led by the NASDAQ Composite (-1.1%), S&P 500 (-1.1%), Dow Jones (-0.9%, -245 points, 27,657) and the Russell 2000 (-0.4%).

Europe declined (-1.0%) for a second session which saw the region closed -1.0% lower for the week. It was a limited session in terms of newsflow with nothing of note on the macro calendar, but Brexit headlines were slightly more positive after EU officials said a deal between both sides was still possible despite recent row over UK's internal market bill. Meanwhile, reports circulated that EU regulators are moving closer to ending bank dividend ban next year, but this impact was offset by rising Cov-19 case numbers with the R-factor for the region (1.19) is now around the level for the UK (1.20) which suggests the virus spread is accelerating. The UK government is said to be considering either shutting the hospitality businesses to try to slow the second wave, or alternatively, implanting a two-week national lockdown in October, and there were large case numbers in both France and Spain. By the close of trading, most indices closed lower led by Spain (-2.2%), France (-1.2%), Italy (-1.1%), the UK and Germany (both -0.7%), whereas Sweden (+1.1%) and Switzerland (+0.2%) closed higher.

In contrast to the US and Europe, Asian markets closed +0.5% higher on Friday which closed out a very strong week (+1.7%), but China was the only market to show clear direction during the session which was attributable to positive portfolio inflow optimism as the FTSE Russell index included Chinese stocks after the regional close. This outweighed a recalibration of PBOC expectations which were realigned given recent disappointment with the US Fed and there wasn't anything incremental on the macro front with Japanese core inflation declining further into deflation territory (-0.4% y/y) which was not surprising, nor was the RBNZ's flagging that negative rates are coming. By the close of trading, China (+2.3%) was the standout performer, followed by Hong Kong (+0.5%), Korea (+0.3%), Japan (+0.2%) and Taiwan (+0.02%), whereas Australia and India (both -0.3%) closed lower.

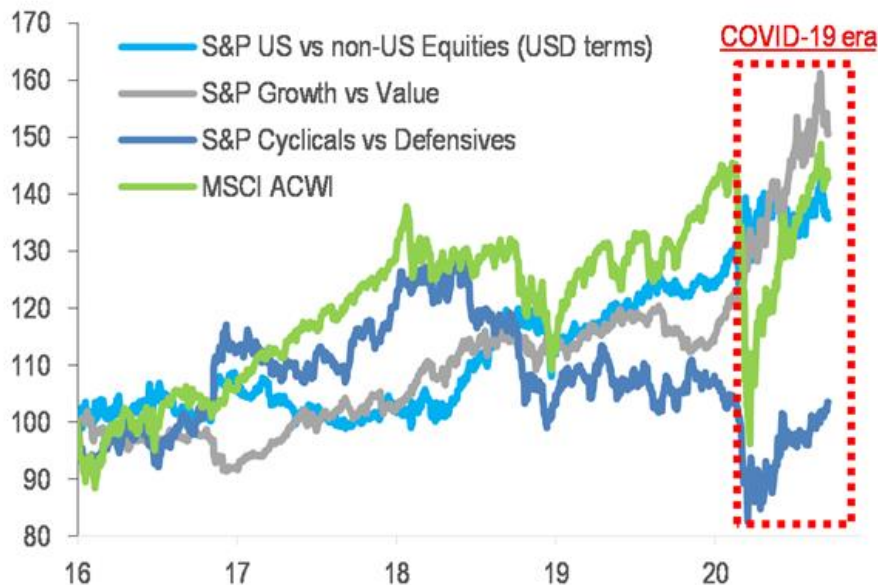
The week's trading saw little change in regional recovery rates with the UK (41.1%), Australia (+55.5%) and Europe (60.7%) all lagging given their high exposure to traditional value/cyclical stocks, whereas MSCI Asia ex-Japan (98.8%) has now recovered more than the US (94.2%) given its higher exposure to the recovering Chinese economy.



- **Futures markets suggest more losses at the bell in Asia** with Australia (-0.6%), Japan (-0.5%) and Hong Kong (-0.4%) all slated to open lower.
- **The global sharemarket is clearly struggling for momentum at present. This has come despite a very strong bounce in economic activity in the September quarter in the US, China and Europe.** The clear issue for investors is the lack of a policy impulse, and its growth implications, and over the past few weeks, the likelihood of a fifth fiscal package being agreed to before the US election has rapidly diminished, thereby exposing consumer spending to an income cliff. However, the impact of the reduction in income support is likely to be cushioned by a 17% household savings rate in July, with the next update from the personal consumer spending and income released on 1st October.

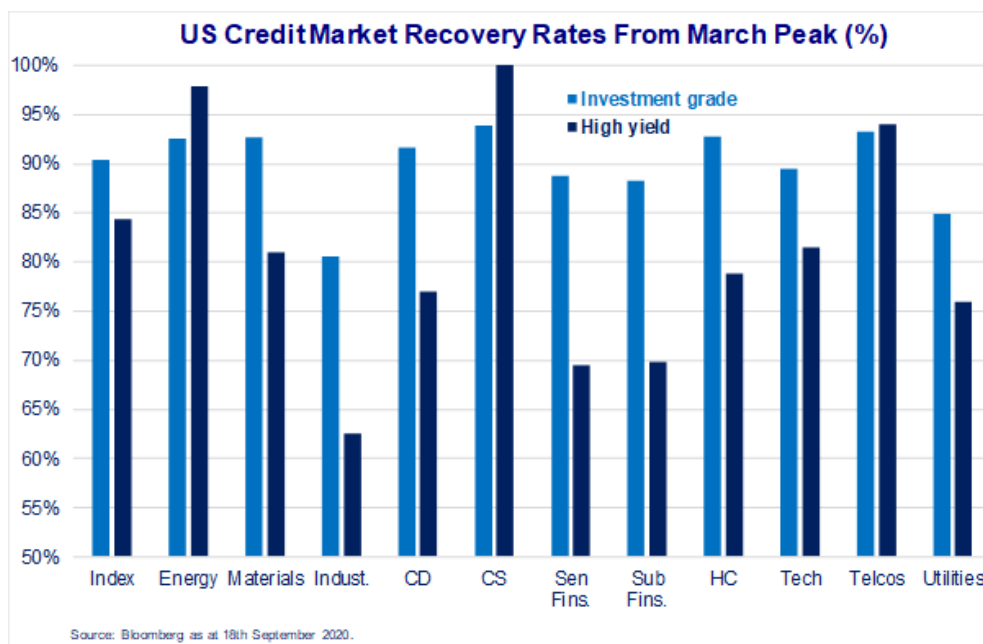
The lack of a fiscal deal is the most pressing issue for growth and for markets, but I still believe that if the US economy slows too much, the US Fed will provide additional market support. However, markets were clearly disappointed by the Fed unveiling its multi-year forward guidance without additional easing and without any material details about by how much, and for how long, they will tolerate higher inflation, and Chair Powell's vagueness at his press conference provided little comfort. There is no doubt that with rates at 0% the Fed's, and all other central banks, policy quiver is empty which means that they cannot provide large scale direct stimulus to the economy and need to be cautious not to jump at shadows in relation to the markets.

Beneath the surface, there has been some rotation with non-US markets, value and cyclical sectors outperforming their US, momentum and growth peers, but unlike previous cycles this is not a case of larger gains, but smaller losses (see chart). So central bank asset purchases have lessened volatility spikes and market drawdowns, but it has never prevented them. Accordingly, the lack of co-ordination between monetary and fiscal policy in the next 12 months is likely to slow the recovery down, which was going to slow anyway. Two potential consequences of this is that the US sharemarket and US dollar will moderate further, which can have consequences for other regions. **This indicates that after an incredible recovery post-March, that investors may need to enhance their portfolio diversifiers in the light of continued volatility.**

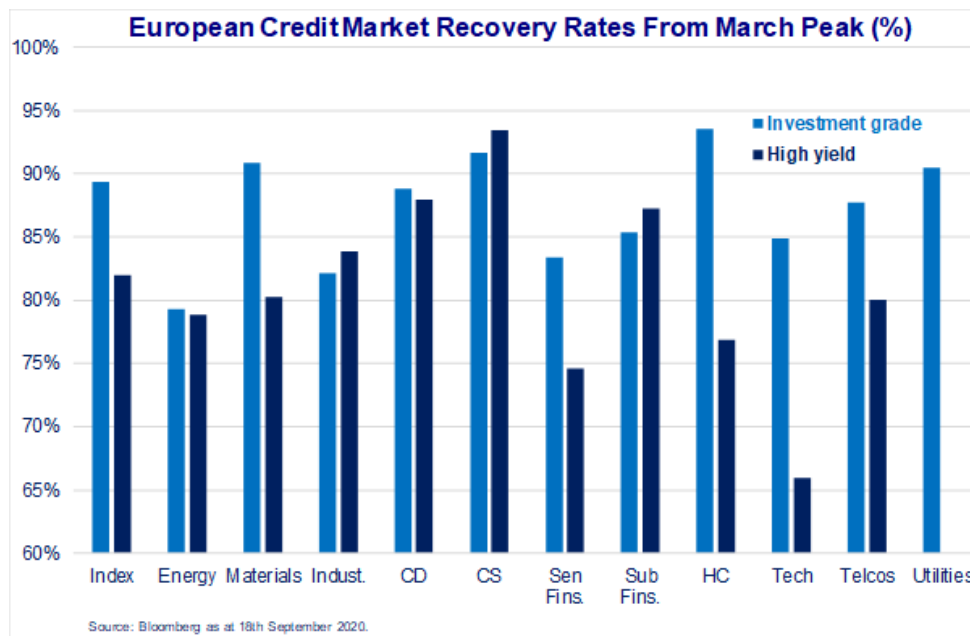


• CREDIT MARKETS

- Regional credit indices were very quiet with most sectors unchanged in the last trading session in the week. In the US investment grade universe space spreads were idle at +127 bpts, with the recovery rate also steady at 90% with no sub-sector recording a more of more than half a basis point. Similarly, spreads in the high yield space increased +1 point to +517 bpts, which lowered the recovery rate one notch to 84%. Among the subsectors capital losses were recorded in industrials (+5 points to +602 bpts, 63%) and healthcare (+4 points, +487 bpts, 79%) which were payback for gains in prior sessions, and these spread increases were partially offset by minor decreases in other sectors. Accordingly, spreads in the past week declined in both universes by only -3 points and these offset capital losses in the prior week and this is all part of an extended side trend which has been going on since the end of July since when sector recovery rates have also recorded only slightly moves (see chart).



- European credit markets were even quieter than there US peers on Friday night with spreads in both the investment grade and high yield universe unchanged at 56 bpts and 382 bpts, respectively, which left recovery rates at 89% and 82%, respectively. This meant that over the past week spreads declined fractionally in both universes, but this offset gains in the previous week with the European credit market now in a side trend which is shorter than the US one, indicating that recovery rates are idle over the past month.



THE GLOBAL ECONOMY

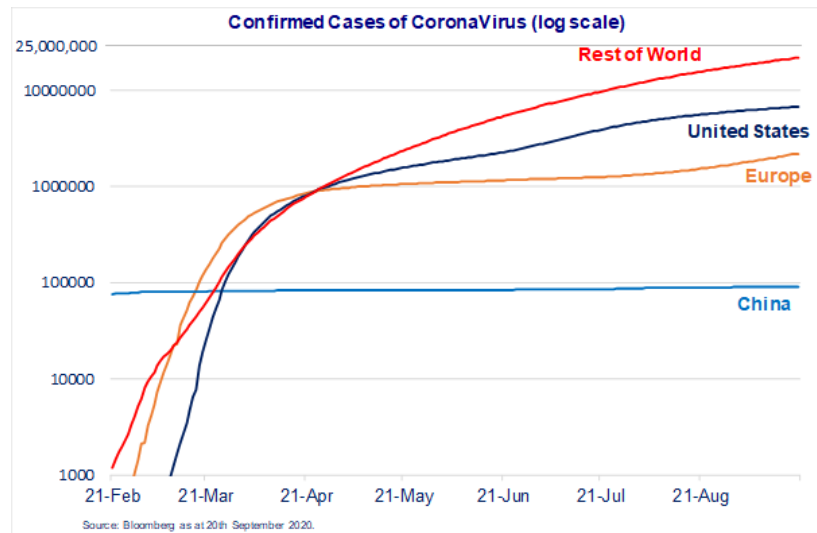
- There were no material releases on Friday night.

POLICY

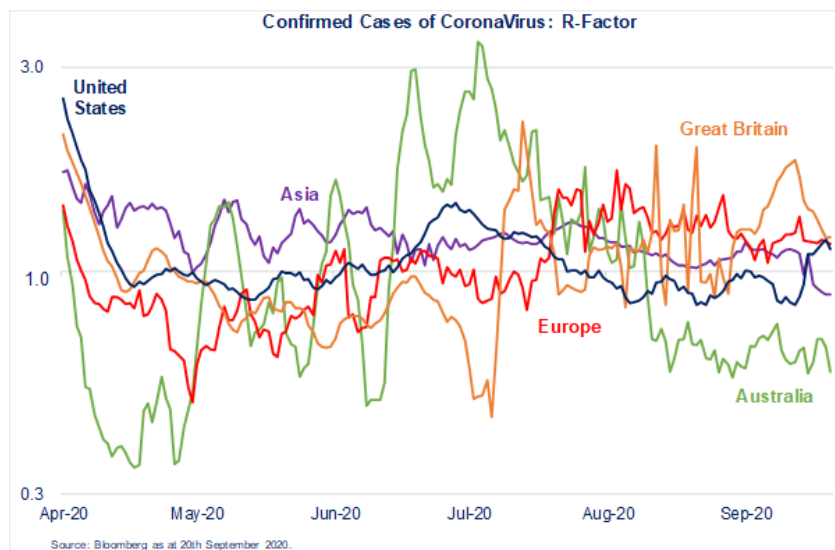
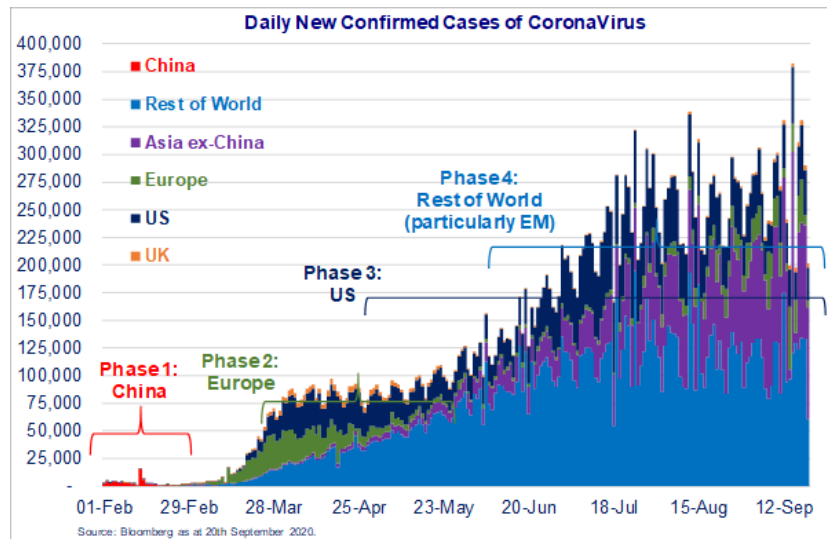
- There were no policy announcements on Friday night. However, the Fed said that it will announce whether banks need to extend current restrictions on dividends and share buybacks into Q4 by the end of September. The board released its two hypothetical scenarios for the next round of stress tests which centred around severe global downturns with substantial dislocation in financial markets. Under the first scenario, the peak in unemployment is higher with a faster recovery, where the second has a lower peak but a slower recovery. The board said it will release firm-specific results from banks' performance under both scenarios by the end of 2020, but the board was somewhat vague as to whether the second set of test results will replace earlier tests which raised each firm's capital minimum.

VIRUS UPDATE

- The number of global cases of COVID-19 is 30.9 million with another +197.7k cases so far (but Brazil, Mexico, Colombia and 8 US states have not reported their numbers) which means that Sunday is likely to be the 64th 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 34 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 (+0.9% since Thursday) is steady. Meanwhile, deaths stand at 959.0k and the death rate was steady at 3.10% although the number of daily deaths remains elevated.

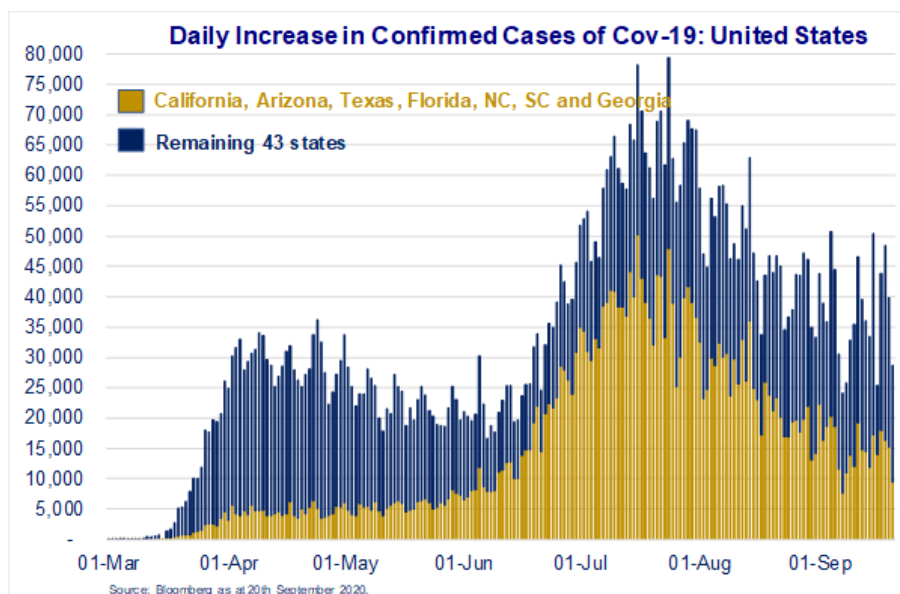
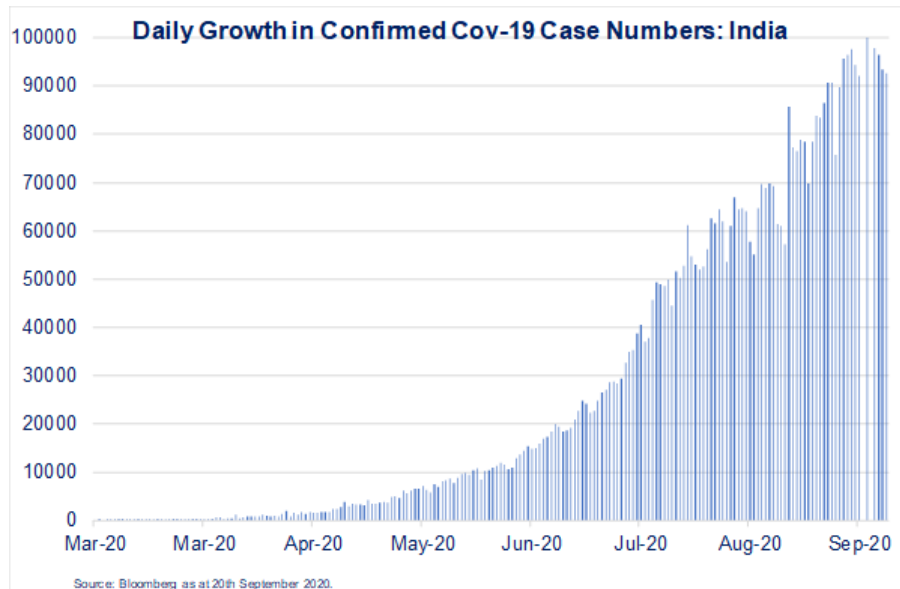


- We break the infections into four groups – the US, Europe, China and ‘others’ and the rest of the world outside the G3 economies now has the most total cases (+161.6k to 28.2 million) and highest daily new cases (and by a considerable margin) followed by the US (+29.6k to 6.80 million, although 8 states 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 (+6.5k to 2.18 million - see chart) which is the only region other than the US, with an R-factor above 1.0 which indicates that the infection rate (1.13 is too high, especially in Britain (1.44)).

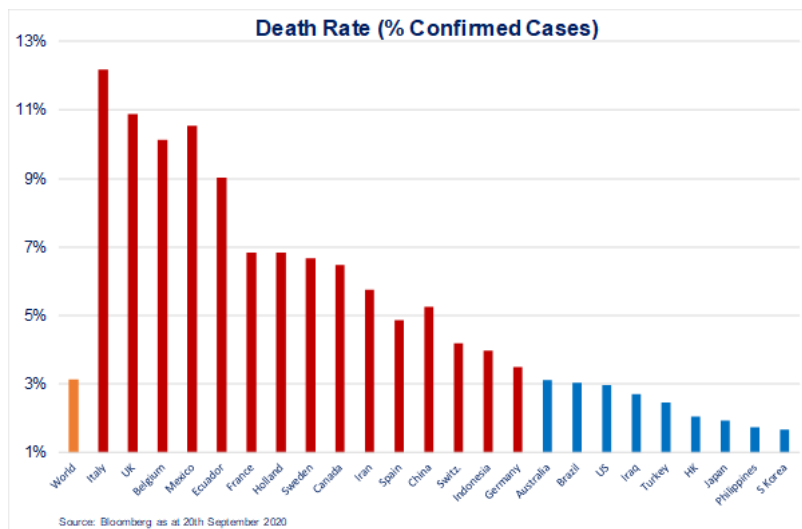
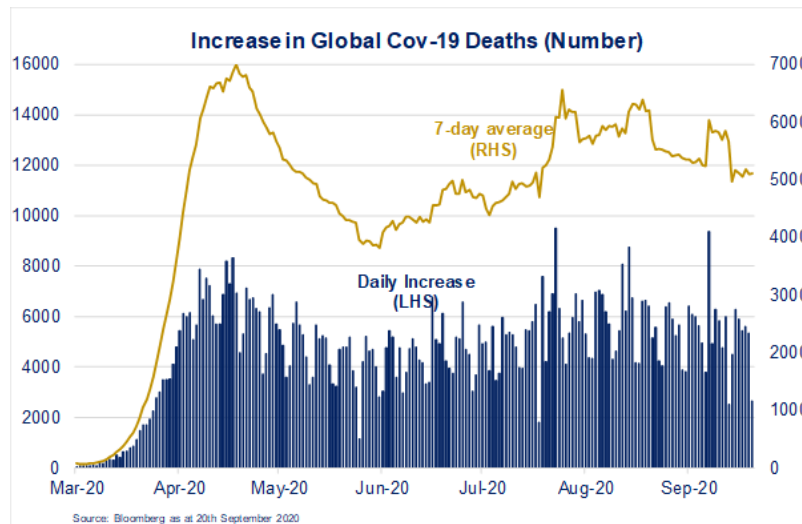


- Among countries, the most cases are in the US (+29.6k (so far) to 6.80 million, with 8 states yet to report), India (+92.6 to 5.40 million), Brazil (not reported, 4.54 million), Russia (+6.0k to 1.1 million), Peru (+6.5k to 762.9k), Colombia (not reported, 758.4k), Mexico (not reported, +694.1k), South Africa (+1.6k to 661.2k), Spain (not reported, 640.0k) and Argentina (+12.2k to 631.4k). Australia confirmed cases rose +11 (7-week low) to 26.9k yesterday which placed us 71st in terms of total infections.

Elsewhere, Singapore recorded +18 new cases to 57.6k most of which are linked to foreign workers who are forced to live in crowded dormitories, but Indonesia (+4.0k to 244.7k) is now on the rise and has the second most cases in the region behind only the Philippines (+3.3k to 286.7k).



- Although final numbers are not in until 1pm AEST, the global death rate was steady at 3.10% with the global total to 959.0k after another +2.7k deaths overnight, so far, which indicates the daily average deaths is stabilising again (see chart). The US (+0.2k so far) has the most deaths at +199.5k, with Brazil (not reported, 136.9k), India (+1.2k to 86.8k), Mexico (not reported, 73.3k), the UK (+18 to 41.9k), Italy (+15 to 35.7k) and France (0 to 31.3k) all over +30k. The death rate is highest in European countries where the health systems had collapsed led by Italy (-0.1% to 12.2%), the UK (steady at 10.9%), Belgium (-0.1% to 10.1%), France (-0.1% to 6.9%), the Netherlands (-0.1% to 6.8%), Sweden (steady at 6.7%) and Spain (-0.1% to 4.9%). However, several emerging markets are now on the leader board including Mexico (+0.1% to 10.6%), Ecuador (-0.2% to 9.0%), Indonesia (steady at 4.0%) and Brazil (steady at 3.0%).



Yours sincerely,



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