

THOUGHTS ON THE MARKET

23rd November 2020 - Why the world needs the AstraZeneca vaccine to be highly effective

SUMMARY

- Although one could hardly say that this downturn and recovery has been standard, the usual investment strategy at the start of the cycle is to ease your exposure to defensive assets and embrace more cycle risk. This change should be governed by valuations but normally involves lowering your exposure to long duration government bonds and large-cap defensive equities and rotating your portfolio towards traditional cyclical markets and sectors and moving down the capital spectrum and buy more small caps and high yield credit. We are starting to see some of these portfolio rotations with high yield credit outperforming investment grade and equities posting another EM-led week of solid gains, with small caps and cyclicals leading the pace of gains in regional markets.

While those signs suggest that the cycle is starting to normalise after the economy experienced its worst downturn since 1946, some investors are now seemingly willing to overlook the short term risks of economic closures as they believe the vaccine should mean that the current phase of rising COVID-19 cases in the US is the last. That said, **last week the generic US 10-year government bond recorded its strongest weekly advance since mid-August and the 2-year yield declined the most since mid-September.**

- Interestingly, while the S&P 500 is +9% higher in November, the 10y US breakevens are up only 1 basis point and still well below 2% reflecting the challenge the Fed has to get inflation to its 2% target, despite the vaccine announcement. This, and asset purchase announcements by the RBA and BoE, indicates that **bond yields are likely to be anchored low for a while yet, therefore setting up a potent combination of improving growth and low yields.** However, the challenge this cycle is that valuations are very elevated so asset allocation is more challenging and this means that investors may have to dig beyond simple global market beta plays and look for regions and sectors which have been lagging, have more constructive valuations and higher correlation with economic growth.

Meanwhile, markets need to be wary about getting too optimistic about the vaccine. Less than one month ago, the US FDA said hospitals could use Remdesivir as it reduced recovery times and the need for ventilators. Yesterday, the World Health Organization hit the brakes on this and recommended that doctors avoid using the drug altogether as they said that there was no evidence that it improves survival and other outcomes in patients. The world is fortunate to have innovative dedicated public and private researchers able to deliver potential candidates for COVID-19 vaccines in record time. But the WHO's thumbs down is a timely reminder that rushed drug development and approval is highly risky.

This week we may get the AstraZeneca final stage trial results and the stakes for lower- and middle-income nations are extremely high. This vaccine costs a fraction of the price set by Pfizer, will be manufactured in multiple countries including India and Brazil, and apparently will be easy to transport across the world as it does not need ultra-cold temperatures. However, if the partners cannot match the extremely high efficacy levels of the Pfizer and Moderna vaccines, the roll out of vaccine could be more challenged and the pandemic might continue spreading and therefore can more easily evolve. So markets have rallied ahead since the US election result and the vaccine announcements but there is some risk that **the markets are factoring in a too-perfect rollout for the vaccine.**

- **In other markets, 10-year US treasuries rallied** with yields down to 0.82% with curve flattening, commodities were mixed with oil (+5.0% to USD42.15 per barrel) outperforming gold (-1.0% to USD1871 per troy ounce) for a second straight week, and G10 currencies were universally higher against a weaker Greenback with gains led by Yen (+0.7 to 103.9), Sterling (+0.7% to 132.8), AUD (+0.4% to USC73.02) and the Euro (+0.2% to 118.6).

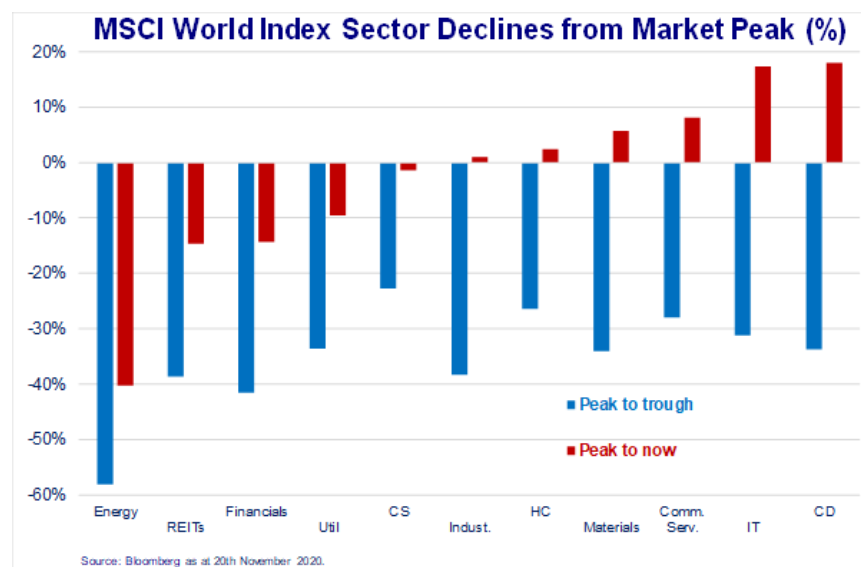
- The number of global cases of COVID-19 is 58.5 million with another +426k cases so far (but Brazil, Mexico, Pakistan, Spain and Sweden and 11 US states have not reported their numbers) which means that Sunday was the 125th consecutive day where daily increases were greater than 200k. At present, 21 countries have more than 500k cases, 37 countries have more than 200k cases and 61 countries have more than 100k cases. More importantly, the growth rate of daily confirmed cases (+1.1% since Thursday) is slightly higher. Meanwhile, deaths stand at 1.39 million and the death rate was steady at 2.37% although the number of daily deaths remains elevated and hit an all-time high on Wednesday.

FINANCIAL MARKETS

• EQUITIES

- **The MSCI World Index closed +0.4% higher last week which was its third consecutive weekly advance.** Although the global index rose, more sectors (6) declined than increased (5) and four of the five that advanced were traditional value sectors, whereas defensives and tech lagged performance for a second consecutive week. Energy (+4.5%) was the best performing sector as oil prices rose for a third straight week with the liquid gold resource now up +17.8% in November which is a bit less than the +22.8% rise in the share sector. Meanwhile, financials (+2.1%) also performed strongly for a third week even though the US yield curve's slope flattened -5 points, materials (+0.8%) enjoyed a third week of gains in response to higher base metals prices, and consumer discretionary (+1.7%) also beat the market tape even though October US retail sales came in below street estimates.

Elsewhere, tech-related sectors including IT (-0.1%) and communication services (-0.3%) were middle of the road, and more positive headlines of the COVID-19 vaccine front culminated in defensive sectors such as consumer staples (-1.2%), utilities (-2.1%) and healthcare (-2.3%) being at the back of the performance field. Strangely, **investors seemed unperturbed about rising COVID-19 case numbers in the US and the continued stalemate in Washington DC over the looming benefits cliff.** By the close of the week, there were more changes to our peak-to-now chart with energy (-40.3% from the February peak, with a recovery rate of +30.5%) the only sector in bear market territory, with REITs (-14.7%, 62.0%) and financials (-14.3%, 65.5%) the only sectors in correction territory but utilities (-9.6%, 71%) is not far away. Meanwhile, five other sectors have recorded a complete recovery (see chart) which was the same number as last week.



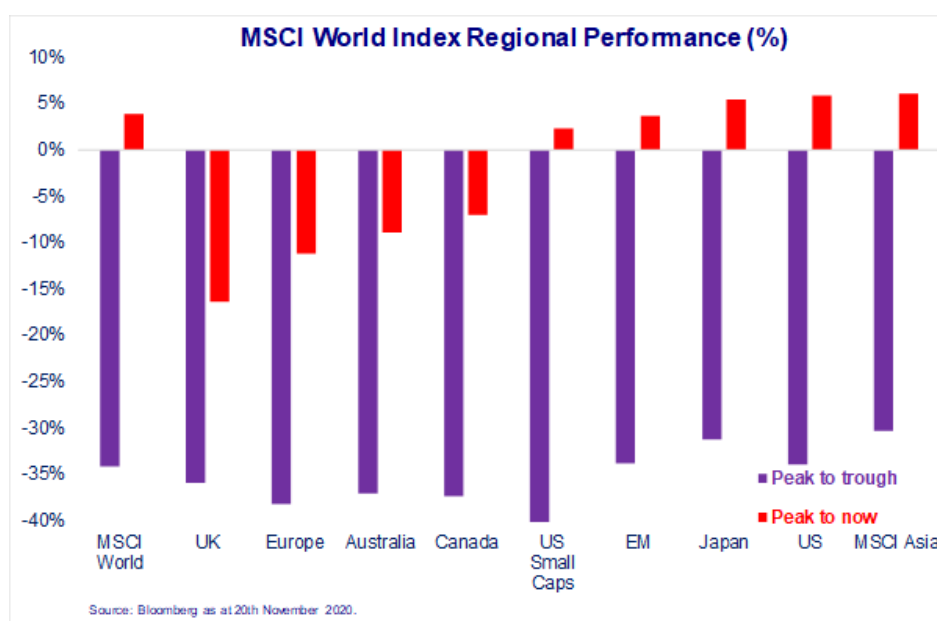
- **Among the regions, the pace of advances was led by Asia (+2.1%) which outpaced the performance of other major regions for a third time in the past five weeks.** The pro-cyclical nature of the region and its proximity to the Chinese economy which seems to be accelerating post its recovery in the September quarter, buoyed sentiment given upbeat vaccine news. On the data front there were few top tier releases around, but Australian employment data was upbeat and September quarter Japanese GDP detailed a stronger-than-expected activity bounce. There wasn't much from central banks, but the PBOC narrative solidified that it will shift policy stance toward tightening next year, as economic data continue to cement the recovery path out of the coronavirus shock. There wasn't much else and by the closing bell in Mumbai on

Friday night, all regional indices had recorded a third straight weekly increase led by Taiwan (+3.3%), South Korea (+2.4%), Australia (+2.1%), China (+1.8%), Japan (+1.4%), Hong Kong (+1.1%) and India (+1.0%).

Europe (+1.0%) recorded its third straight week of gains (totalling +16.5%) in response to increased vaccine optimism, which helped boost sentiment as regional cases began to level off in some major economies. There was very little in terms of the macro picture, but high frequency data showed that current lockdowns were having the most detrimental economic effect in France and Italy, but these were much less than those from earlier this year. The Brexit trade deal remains unresolved for now, but there was talk among officials and diplomats that an agreement is coming. Meanwhile, ECB's Lagarde remained dovish saying that the central bank will forcefully act to support the Eurozone economy, rejecting calls for debt cancellation and urging governments to resolve differences around fiscal stimulus. By the closing bell on Friday, all major indices posted advances led by Italy (+3.8%) which outperformed for the second time in the past three weeks, Spain (+2.5%), France (+2.2%), Sweden (+1.5%), the UK (+0.7%) and Germany (+0.6%), whereas Switzerland was flat

The US market (-0.8%) was at the back of the pack last week as good vaccine news underpinned some pockets of the pro-cyclical rotation. Accordingly, tech-related exposures were little moved even though investors sought to lessen their exposure to stay-at-home stocks which have done so well in the past seven months but nowadays trade on high multiples. There was also increased discussion centred around concerns about the economic headwinds from worsening COVID-19 trends and a flurry of new state restrictions, but these have not impacted economic data probably it detailed activity in October. These concerns were amplified by the continued fiscal stimulus stalemate in Washington and increased discussion of the benefits cliff in December although the US's high savings rate will cushion this for a while. Economic data was mixed with weaker retail sales, in line industrial production and another strong result for housing activity, but none of these had much impact on market trends. By the closing bell in New York on Friday after noon, index performance was mixed with indices with higher cyclical exposures outperforming including the Russell 2000 (+2.4%), but the NASDAQ (+0.2%) was flattish and the Dow Jones (-0.7%) and S&P 500 (-0.8%) closed in the red.

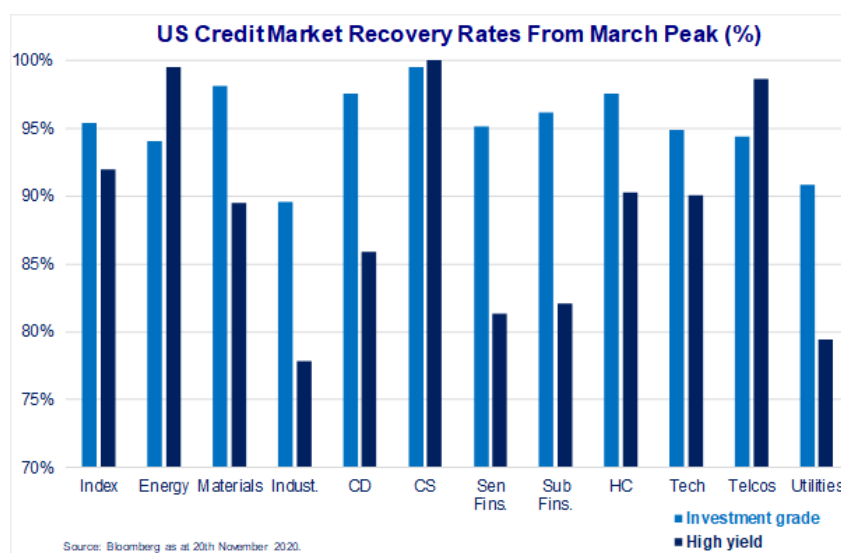
- **By the closing bell for the week, there was little change in the positioning in our February peak-to-now chart, but absolute performance lifted in most areas.** At present, the UK (-16.4%) and Europe (-11.2%) remain the only regions in correction territory, with Australia (-8.9%) and Canada (-7.2%) not far away, but US small caps (+2.3%), EM (+3.6%), Japan (+5.4%) and the US (+5.9%) have recorded complete recoveries (see chart).



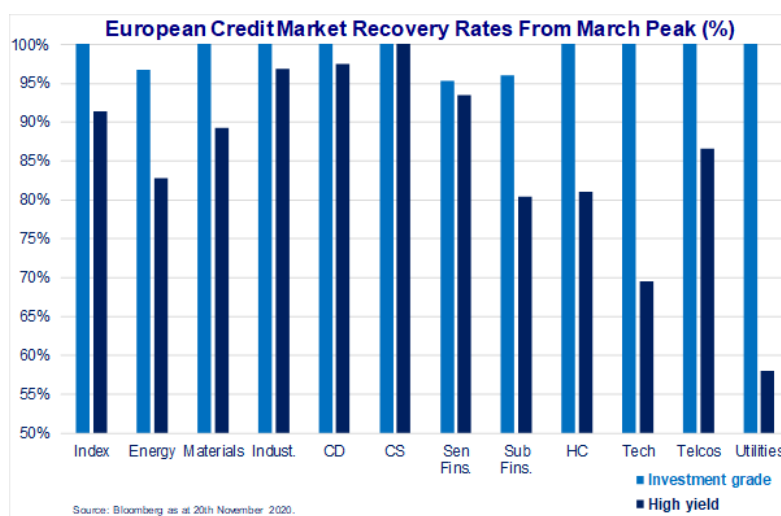
- **Futures markets suggest a positive opening in Asia** with Japan (+0.7%), Australia (+0.5%) and Hong Kong (+0.3%) and all set to open higher at the bell.

• CREDIT MARKETS

- **Regional credit market had another constructive week, although the pace of spread contraction is starting to ease as recovery rates approach 100%.** Spreads in the US investment grade sector contracted a further -5 points to +113 bpts (post-February low), which lifted the recovery rate one notch to 95% with all 11 subsectors recording lower risk premiums. The only noteworthy improvement was in energy (-10 points, +166 bpts, 94%) which responded well to the +5% rise in crude prices. Meanwhile, spreads in the high yield market contracted by -11 points to +450 bpts, which increased the recovery rate two notches to 92% (post February high) with spread contraction in all 11 subsectors. Among the sub-sectors, there was a little more price action with capital gains among cyclicals with price gains led by energy (-24 points, +712 bpts, 100%), consumer discretionary (-18 points, +418 bpts, 86%) and industrials (-16 points, +495 bpts, 78%). Overall, the movements meant that all investment grade subsectors have recovery rates above 90% other than industrials, whereas in the high yield space spreads are more diverse with four sectors having recovery rates below 85% (see chart).

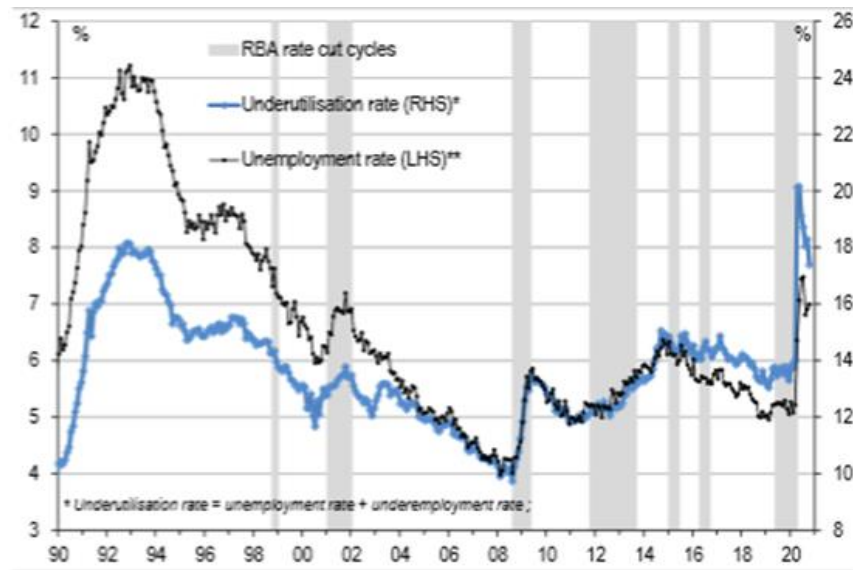


- **Meanwhile, price action in Europe was very similar to that of the US market, with spreads in the investment grade universe contracting -4 points to a post-February low of +33 points, with the market already fully recovered its COVID-19 losses.** Eight of the investment grade subsectors are yet to recover all of their price decline and these are the cyclical sectors such as energy (-3 points, +33 points, 97%), senior financials (-5 points, +47 bpts, 95%) and subordinated financials (-5 points, +114 bpts, 96%). In the high yield space, spreads contracted a further -18 points to +324 bpts, which increased the recovery rate two notches to 91%. There were double-digit gains in all subsectors other than utilities led by energy (-29 points, +443 bpts, 83%), consumer staples (-28 points, +404 bpts, 100%) and subordinated financials (-25 points, +396 bpts, 80%). Overall, the ECB's direct support for the investment grade space has already engineered a complete recovery in eight sub-sectors, whereas in the high yield space the recovery rates are less advanced than in the US, with 6 sectors having a recovery rate of over 85% (see chart).



THE GLOBAL ECONOMY

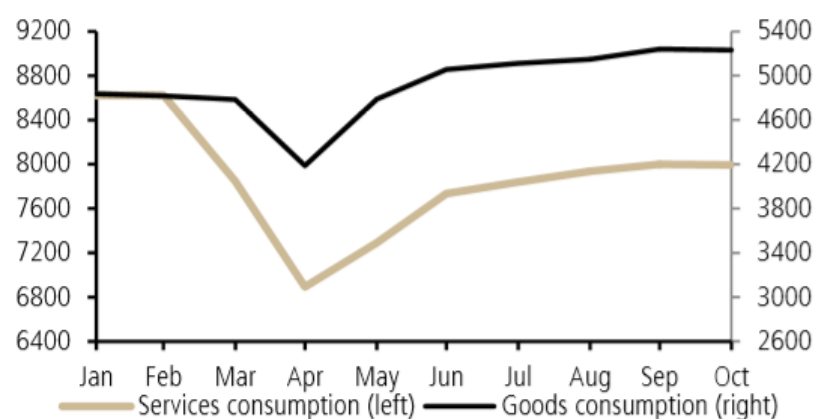
- October's Australian Labour Force Survey saw employment surprisingly boom +179k m/m which is the 2nd largest increase on record, with a -12k downward revision to the September number. The surge was driven by +82k in Victoria where participation rose more than 2% to 65.0%, despite one third of survey (4th October to 24 October) occurred during one of the strictest lockdowns in the world (27 September to 10 October). That said, the labour market is clearly recovering with cumulative job losses since February now at -226k or -1.7% which is very small compared to comparative countries (as was the -7% GDP contraction). There were increases in both full-time (+97k m/m, -2.1% y/y) and part-time (+82k, 1.3% y/y), hours worked rebounded +1.2% m/m (+0.2% m/m in September), participation rose to 65.8% (nearly a record high) and the unemployment rate ticked up to 7.0%, but the sheer amount of JobSeeker recipients is more consistent with national unemployment closer to ~10%. Looking ahead, the reinstatement of the work test and tapering of JobKeeper means unemployment is likely to rise further but the upside there now seems more limited than a few months ago as the economy is reopening, government spending has increased, confidence is higher, but the underutilisation rate (-0.9% to 17.4%) may prove harder to move lower as firms seek to maximise productivity through lower hours worked.



Source: ABS, RBA, UBS

- The pace of US retail sales growth were weak in October at +0.3% m/m and +0.1% m/m for the control group (which feeds into GDP) and there was a sharp downward revision to September (-0.4% to +0.9% m/m) which suggests activity is returning to trend levels. However, the result was buttressed by a major increase in iPhone sales and Amazon sales given their Prime days members promotion. Outside this there were declines in restaurant spending (-0.1% m/m) which suggests that rising COVID-19 cases could already be impacting services spending and this could have flow on effects to other spending areas given declines in clothing (-4.2% m/m), general merchandise (-1.1% m/m), furniture (-0.4% m/m), groceries (-0.2% m/m) and health (-0.1% m/m). As transfer payments diminish, and these are aimed at lower income group who tend to spend more on goods than services, I'd expect a shift in the wallet share away from goods.

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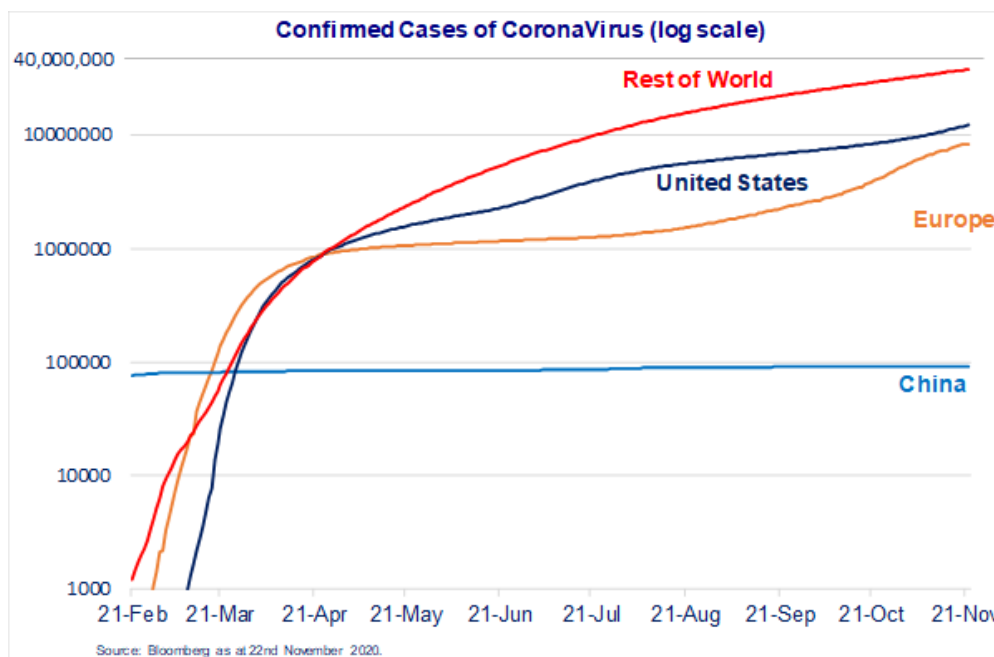
POLICY

- In a communication to US Fed Chair Jerome Powell, US Treasury Secretary Mnuchin declined to extend the Fed's credit, municipal lending and Main Street Lending programs as he claimed that they had "achieved their objective. Moreover, the Treasury Secretary requested that the Fed return the unused USD445 billion of funds to enable Congress to re-appropriate them. Interestingly, the Fed responded that its preference would be to keep the full suite of programs intact as they are providing an important backstop role. However, the Fed would still have around USD750 billion to re-establish the programs should market disruption occur. But the length of time between now and the vaccine being widely available and implemented is likely to see the Fed announce a lengthening of the duration of its existing programs, and this could occur as early as December.

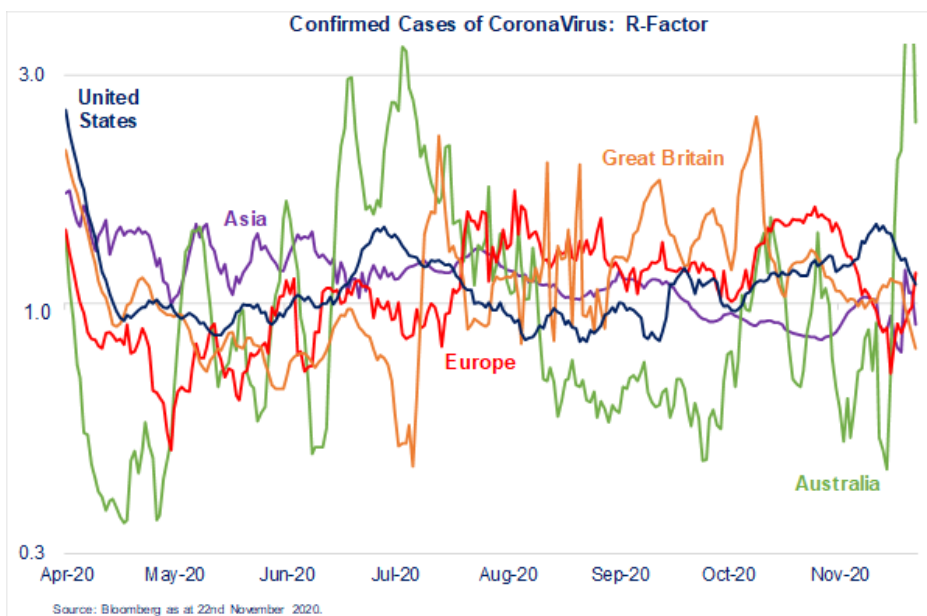
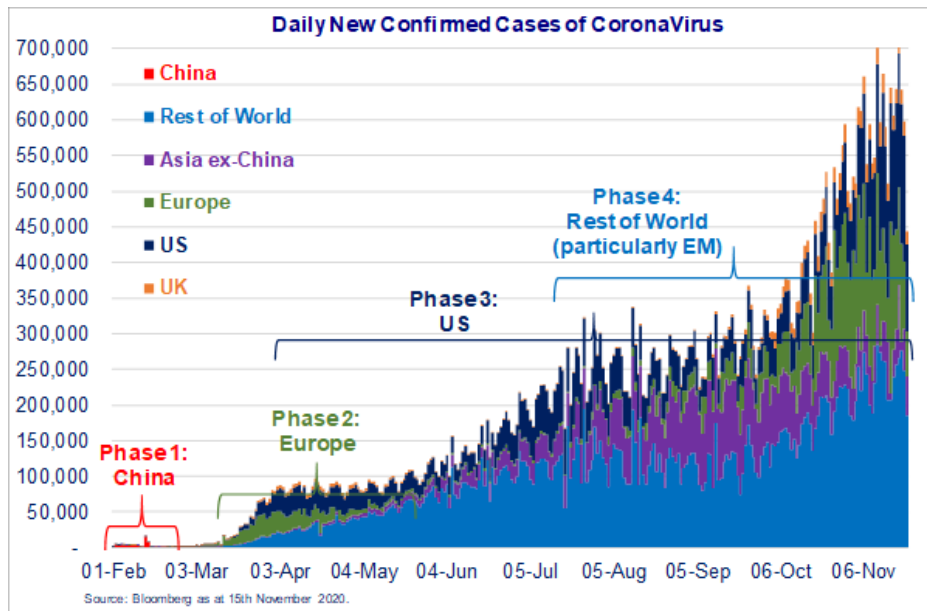
VIRUS UPDATE

- The number of global cases of COVID-19 is 58.5 million with another +426k cases so far (but Brazil, Mexico, Pakistan, Spain and Sweden and 11 US states have not reported their numbers) which means that Sunday was the 125th consecutive day where daily increases were greater than 200k. At present, 21 countries have more than 500k cases, 37 countries have more than 200k cases and 61 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, 3 days, 4 days, 3 days, 4 days, 4 days, 3 days, 4 days, 4 days, 2 days, 2 days, 3 days, 2 days, 2 days, 2 days, 3 days, 2 days, 2 days, 2 days, 2 days, 2 days, 1 day, 2 days, 2 days, 2 days, 2 days, 2 days and 1 day. More importantly, the growth rate of daily confirmed cases (+1.1% since Thursday) is slightly higher. Meanwhile, deaths stand at 1.39 million and the death rate was steady at 2.37% although the number of daily deaths remains elevated and hit an all-time high on Wednesday.

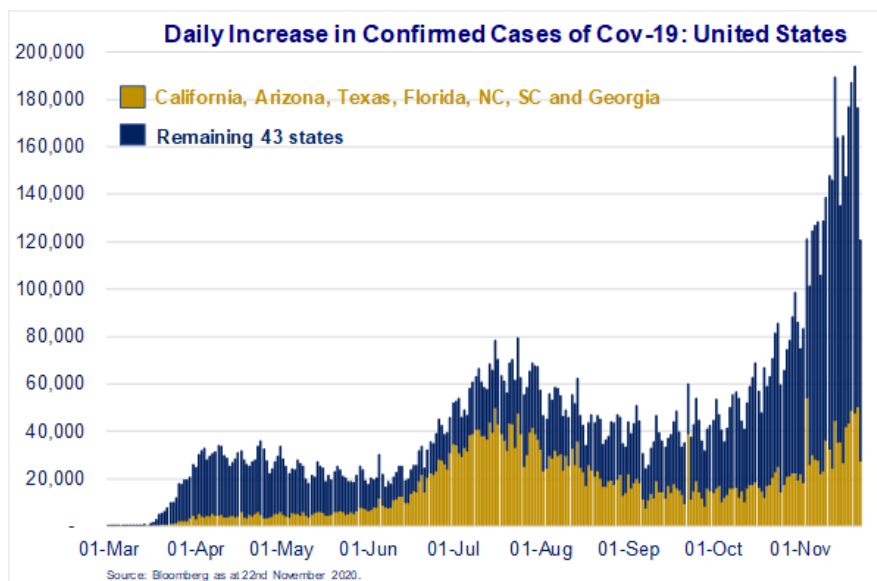
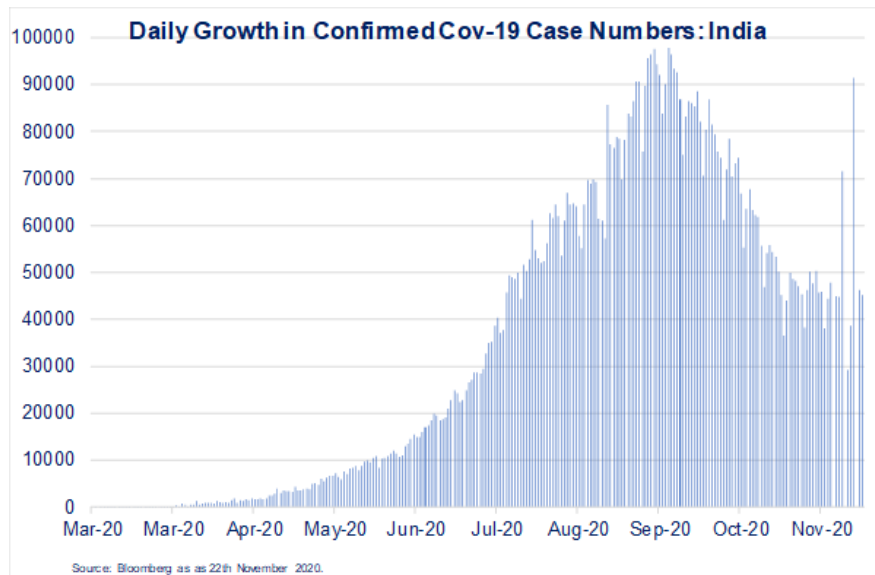


- We break the infections into four groups – the US, Europe, China and ‘others’ and the rest of the world outside the G3 economies now has the most total cases (+240k to 48.5 million) and highest daily new cases (and by a considerable margin) followed by the US (+121.8k to 12.2 million, although 11 states 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 (+64.1k to 8.4 million - see chart) although their curve is flattening with an R-factor at 1.16 which indicates that the infection rate is now declining but remains above the UK (0.81), the US (1.10) and Asia (0.90).

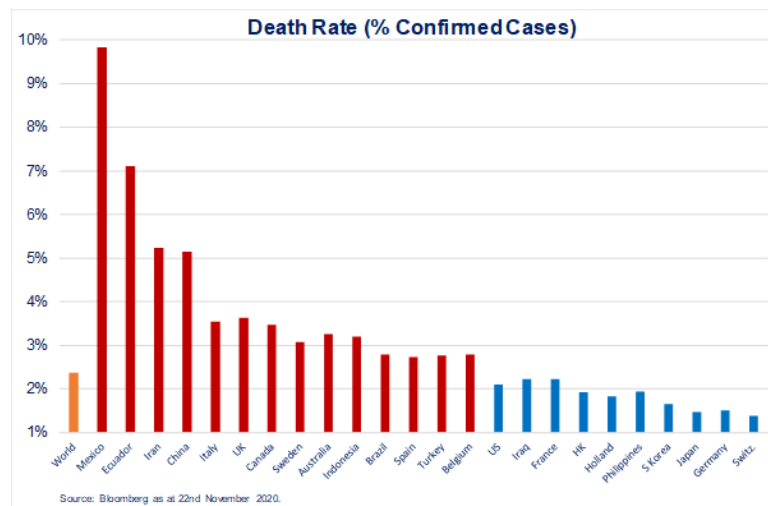
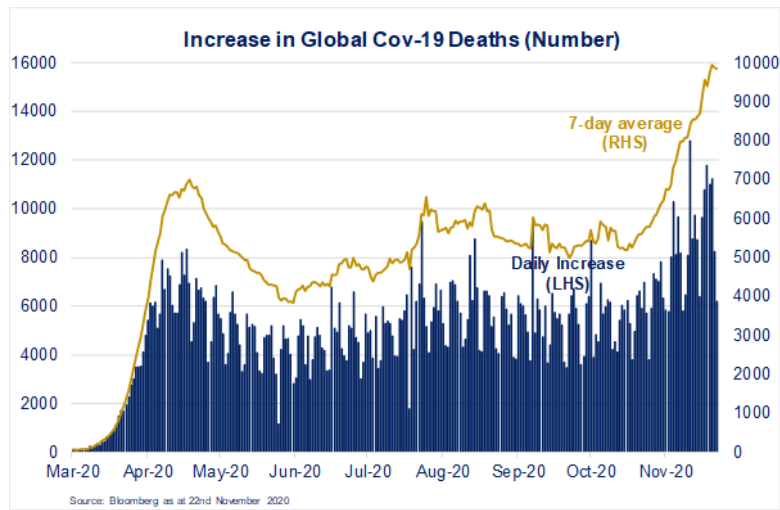


- Among countries, the most cases are in the US (+121.8k (so far) to 12.2 million, with 11 states yet to report), India (+45.2k to 9.1 million), Brazil (not reported, 6.1 million), France (+13.2k to 2.19 million), Russia (+24.3k to 2.1 million), Spain (not reported, 1.56 million), UK (+18.7k to 1.52 million), Argentina (+9.2k to 1.37 million), Colombia (+7.9k to 1.25 million) and Italy (+28.4k to +1.41 million). Australia confirmed cases were +15 yesterday at 27.8k yesterday which placed us 96th in terms of total infections.

Elsewhere, Singapore recorded +12 new cases to 58.2k most of which are linked to foreign workers who are forced to live in crowded dormitories, but Indonesia (+4.4k to 497.7k) is now on the rise and has now surpassed the Philippines (+2.0k to 418.8k) to be the most infected country in South East Asia.



- Although final numbers are not in until 1pm AEST, the global death rate declined to 2.37% with the global total to 1.39 million after another +6.2k deaths overnight, so far, however, the 7-day average is at 9.8k which is very close to a six month high. The US (+0.84k so far) has the most deaths at +256.7k, with Brazil (not reported, 169.0k), India (+0.5k to 133.2k), Mexico (not reported, 100.8k), the UK (+0.4k to 55.1k), Italy (+0.5k to 49.8k) and France (+0.2k to 48.8k) all over +40k. The death rate in advanced economies is highest in European countries where the health systems had collapsed led by Italy (-0.1% to 3.5%), the UK (-0.1% to 3.6%), Canada (-0.1% to 3.5%), Sweden (-0.1% to 3.1%), Australia (-0.1% to 3.3%), Spain (-0.1% to 2.7%), Belgium (+0.1% to 2.8%) and the US (-0.1% to 2.1%). However, several emerging markets are now on the leader board including Mexico (steady at 9.8%), Ecuador (-0.1% to 7.1%), Iran (-0.1% to 5.2%), China (steady at 5.2%), Indonesia (-0.1% to 3.2%) and Brazil (steady at 2.8%).



Yours sincerely,



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