THOUGHTS ON THE MARKET

26th October 2020 - Is Europe the Canary in the Coalmine for the US?

SUMMARY

- Global risk markets were mixed last week as investors continued to respond to rising COVID-19 case numbers and tighter mobility restrictions, particularly in Europe. Europe is doing what Europe does best and that is being at the epicentre of market and economic stresses, and we are quite worried about the world's largest trading bloc and believe that mobility restrictions will need to intensify further to get infection rates under control and this will be at the expense of economic growth, which we now suspect will fall back into contraction territory in the December quarter.

  Imortantly, this notion was supported by the flash European services sector PMI for October which fell for a third consecutive month, and outside the COVID-19-induced plunge in March to May, the index is now at a level lowest level since the 2012 European Debt Crisis, and this survey was undertaken in the earlier stages of mobility restrictions and therefore suggests downside risks for the final October estimate (out next Monday) and also in coming months. With seasonality becoming more challenging in the Northern Hemisphere as winter approaches, a key question is whether developments in Europe are a canary in the coalmine for what's ahead for the United States, where activity lifted in October, but where daily COVID-19 cases hit a record high of +83k on Friday. Rising infections and any dispute around the US election result could generate a rise in market volatility ahead, so investors need to remain cautious.

  While US and European equity markets both fell over the past week, the declines were not particularly large as investors continue to be comforted by spare health system capacity, the availability of better treatments and vaccine prospects, and also the fact that draconian lockdowns have so far been limited to economies such as the Czech Republic and Israel.

  In other markets, 10-year US Treasuries declined with yields up +10 points to 0.84% (four-month high) with curve steepening up to its highest level (0.76%) since March, commodities were mixed with gold (+0.1% to USD1,902 per troy ounce) outperforming oil (-2.5% to USD39.85 per barrel), and G10 currencies were all higher against a weaker Greenback with the appreciations led by the Euro (+1.2% to 118.6), Sterling (+1.0% to 130.4), AUD (+0.8% to USC71.39) and Yen (+0.8% to 104.7).

- Outside the regional PMIs, there was scant data out last week. The weekly US jobless report saw initial claims drop down to +787k which is a promising sign that the labour market is slowly healing, but more data is required to confirm this. Meanwhile, the average G25 headline and core inflation rates both rose +0.1% m/m although both remain well below the typical 2% target for central banks and therefore supportive policy settings will remain in place for the foreseeable future.

- The number of global cases of COVID-19 is 40.29 million with another +330k cases so far (but Brazil, Colombia, Mexico, Pakistan, Spain and Sweden and 13 US states have not reported their numbers) which means that Sunday was the 97th consecutive day where daily increases were greater than 200k. At present, 15 countries have more than 500k cases, 30 countries have more than 200k cases and 46 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 1.15 million and the death rate was steady at 2.69% although the number of daily deaths remains elevated.

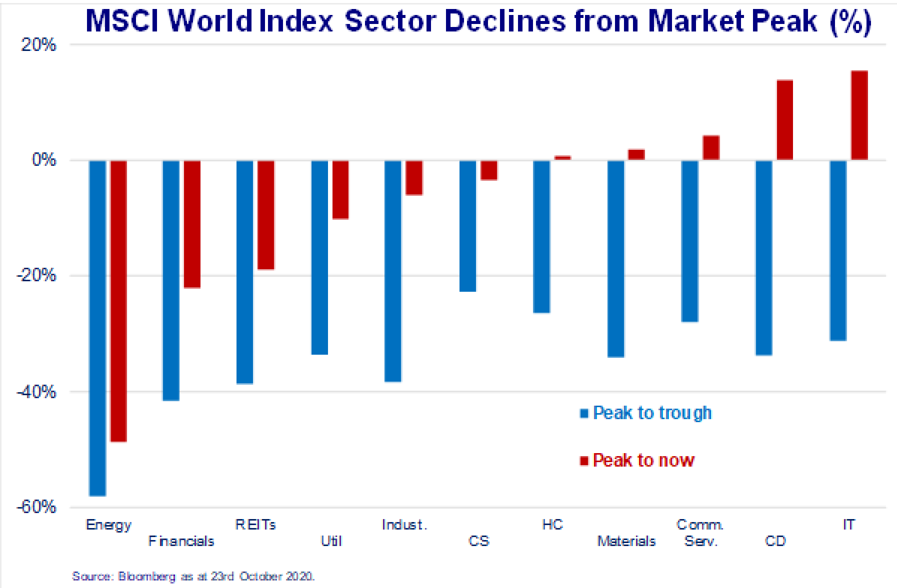
FINANCIAL MARKETS

- **EQUITIES**

  - **The MSCI World Index closed lower for a second consecutive week, but the loss of -0.4% was minor and still had the index up +2.7% so far in October, with only one week of trading left.** Eight sectors recorded declines over the past five trading sessions with tech (-2.3%) the worst performance with Intel (-11.0%) and IBM (-7.9%) notable post-earnings decliners, and Apple (-3.4%) was another drag despite more positive iPhone 12 reviews and pre-order speculation. Meanwhile, consumer staples (-1.4%) underperformed as at-home plays like big-box retailers, food and HPC lagged with Kimberly Clark (-10.7%) a notable decliner given its GM-driven EPS miss which sent the stock down to a 4-month low. REITs (-0.8%) and consumer discretionary (-0.6%) similarly lagged the market tape, with the latter weighed down by Amazon (-2.1%) which was caught up in the general pull back in growth plays, but this was partially offset by gains in re-opening plays including department stores, apparel retailers, apparel and accessories, restaurants, hotels and casinos.

    In contrast, financials (+1.2%) outperformed as yield curves steepened which underpinned a broader rotation into 'value' names. Meanwhile, communications services (+2.0%) was a standout sector for the week with advances in Facebook (+7.1%) and Google (+4.2%) contributing, as concerns about increased regulatory scrutiny were outweighed by positive signs on digital adverting. However, Netflix (-8.0%) did not share the love after recent subscriptions missed street estimates, after a strong H1 2020 in the wake of stay-at-home orders around large parts of the world.

    The weekly sector moves, produced minor changes in our peak-to-now chart, with energy (-48.6% with a recovery rate of just 16%) and financials (-22.0%, 47%) still in bear market territory with they may be joined soon by REITs (-19.0%, 51%) which continues to struggle to mount any kind of sustained bounce, and utilities (-10.2%, 69%) is the only other sector in correction territory. Meanwhile, consumer discretionary (+13.8%, 141%) and tech (+15.4%, 149%) continue to be the standout performers despite a soft recovery and high valuations.



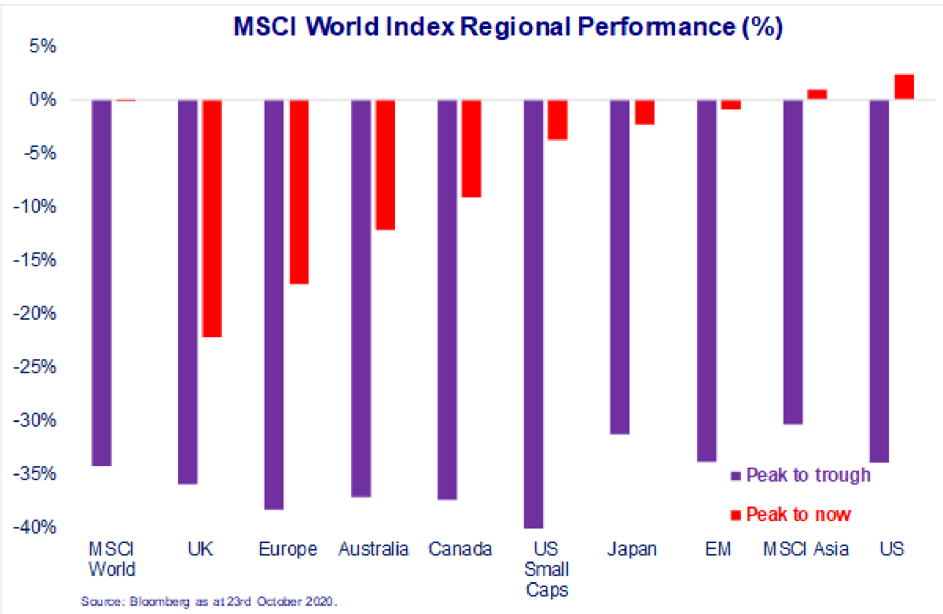
  - **Among the regions, there was mixed performance with Asia outperforming and being the only region to record positive returns with the MSCI Asia Pacific index up +0.8%.** Despite a sizable regional growth downgrade by the IMF (-2.2% for 2020) it was a quiet week with no macro data of note, and with the region's R-factor for COVID-19 infections down to a two-week low of 0.85, investors were buoyed by the rising prospect of additional US fiscal stimulus, as it meant it could get the stimulus benefit (through trade) without the cost of increased restrictions. There was the usual headlines about the US or China banning any number of things, but none of these changed the broad market narrative of a region in recovery underpinned by China which has already recovered its lost economic production – something the US and Europe hope to do in 2022. By the regional closing bell, most indices had delivered weekly advances led by Hong Kong (+2.2%), India (+1.8%), Taiwan (+1.2%), South Korea (+0.8%) and Japan (+0.5%), whereas Australia (-0.2%) was the only notable market to close lower.

Perpetual

In contrast, the US market fell -0.5% in what was a busy week from a headline perspective, although there was no material change in major market thematics. It was quiet on the macro data front but both initial and continuing claims beat the street for the first time in five weeks which was a welcome development, as was the flash October PMI which rose across both sectors. On the earnings front, the Q3 season progressed and the beat rate (84%) remained elevated and the annual EPS growth (now -16.5%) improved underpinned by better-than-feared results in materials, financial and consumer staples names. On the upcoming election, former Vice President Biden maintained a high-single-digit lead in the national polls, but President Trump is gaining notably in the swing states which determine the election outcome and with eight days to go, he is positioned exactly where he was in 2016. Meanwhile, fiscal stimulus expectations remained in focus and seemed to underpin the rotation out of growth and into value although this move could be quickly unwound if Trump prevails. Lastly, investors largely shrugged off rising COVID-19 cases, preferring to think that better treatments and falling death rates are better barometers of the economic impact. By the close of trading, the NASDAQ Composite Index (-1.1%) recorded the largest weekly decline, followed by the Dow Jones Industrial Average (-0.9%) and the S&P 500 (-0.5%), whereas the Russell 2000 Index (+0.4%) scraped out a positive week given its high domestic 'value' exposure.

Europe (-1.4%) saw the largest regional loss as the ongoing increase in coronavirus infections sapped market confidence. The impact on the Eurozone economy was evident with the consumer-facing services sector declining -1.8 to 46.2 which is enough to send the economy back into contraction territory in Q4 even though the manufacturing sector (+0.7 to 54.4) expanded. In a positive development, the UK and EU restarted Brexit talks, though there was no material cut-through yet it did boost Sterling. However, the combination of the virus, reduce mobility, Brexit uncertainty and limited policy firepower suggests that market volatility is likely to remain elevated into year-end. By the regional bell, most countries recorded weekly losses led by Germany (-2.0%), Switzerland (-1.8%), Sweden (-0.8%), Italy, France and the UK (all -0.5%), whereas Spain (+0.6%) offset some of its loss from the prior week and closed higher.

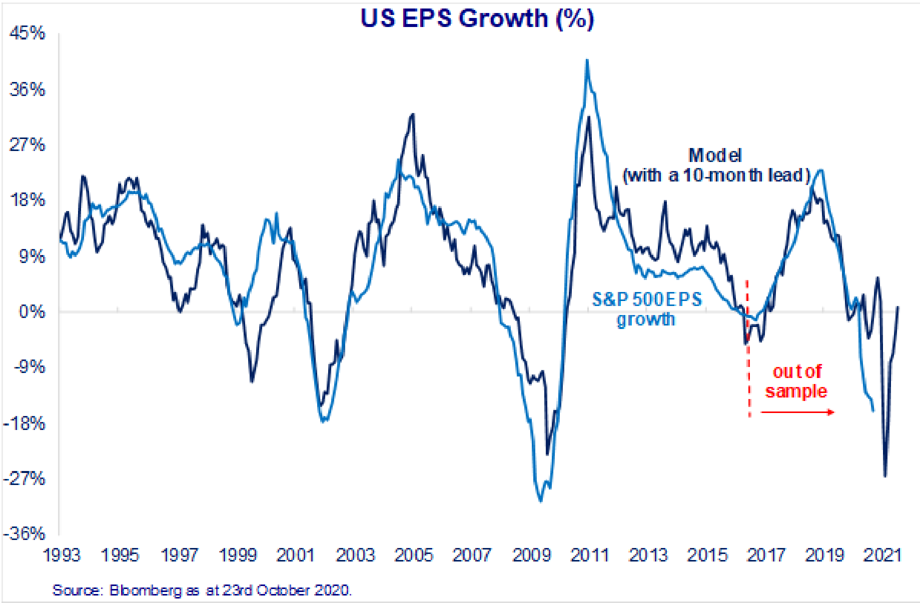
By the end of the week's trading, the UK (-22.3% with a recovery rate of 38%) is the only region in bear market territory, but Europe (-17.2%, 55%) is not far away, but then it's a large path to Australia (-12.2%, 67%) which has so far hung onto its Budget-induced gains in October. Meanwhile, the US (+2.3%, 107%) remains one of only two markets which have recorded a complete recovery from its February peak (see chart).



- **In terms of the US reporting season, 27% of the companies in the S&P 500 have reported results so far for Q3'20 and a record 84% have reported earnings above the street, which is well above the 5-year average of 73%.** The elevated beat rate has seen the blended earnings decline for the third quarter decline to -16.5% y/y and this suggests that the rate of earnings deterioration is now troughing. The market beats have been strongest in financials where annual EPS growth in now at -5.5% relative to the end-September estimate of -22.8%, with materials (-11.3% y/y, -17.9% y/y) and consumer staples (+0.9% y/y, -4.8% y/y) also significantly beating estimates (see chart). In terms of revenues, 81% of S&P 500 companies have reported revenue above consensus, which is greater than the 5-year average of 61% and this has pulled the annual decline in revenues up to -2.9% y/y.

	Health Care	Consumer Staples	Utilities	Info. Technology	Financials	Real Estate	Materials	S&P 500	Comm. Services	Consumer Disc.	Industrials	Energy
Today	3.8%	0.9%	-1.8%	-1.9%	-5.5%	-6.5%	-11.3%	-16.5%	-19.6%	-34.2%	-58.9%	-123.6%
30-Sep	-0.6%	-4.8%	-2.1%	-2.7%	-22.8%	-8.3%	-17.9%	-21.0%	-20.5%	-36.7%	-61.5%	-111.4%

- **Our US earnings model suggests that at this stage, US annual earnings growth is forecast to be back into positive territory in July 2020 (see chart below) but this would still be -1% below its all-time high from February 2020.** A complete earnings recovery would likely to occur late in 2020, but there is a lot of water to go under the bridge over the next year, including the upcoming US winter which is likely to see higher COVID-19 case numbers which has the potential to negatively impact some of the model's key explanatory variables (such as consumer confidence). In the end, the model is not designed to work in a pandemic, but there is no reason to believe it won't have its usual strong lead in predicting an earnings recovery.



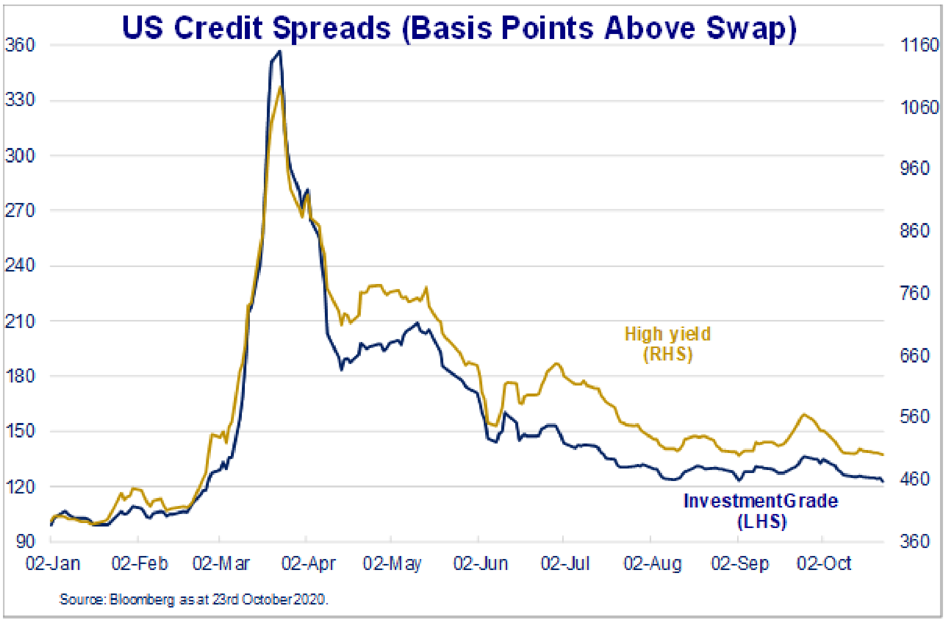
- **Futures markets suggest a subdued opening in Asia this morning** with Australia (+0.3%), Japan (+0.3%) and Hong Kong (+0.1%) all set to open slightly higher at the bell.

CREDIT MARKETS

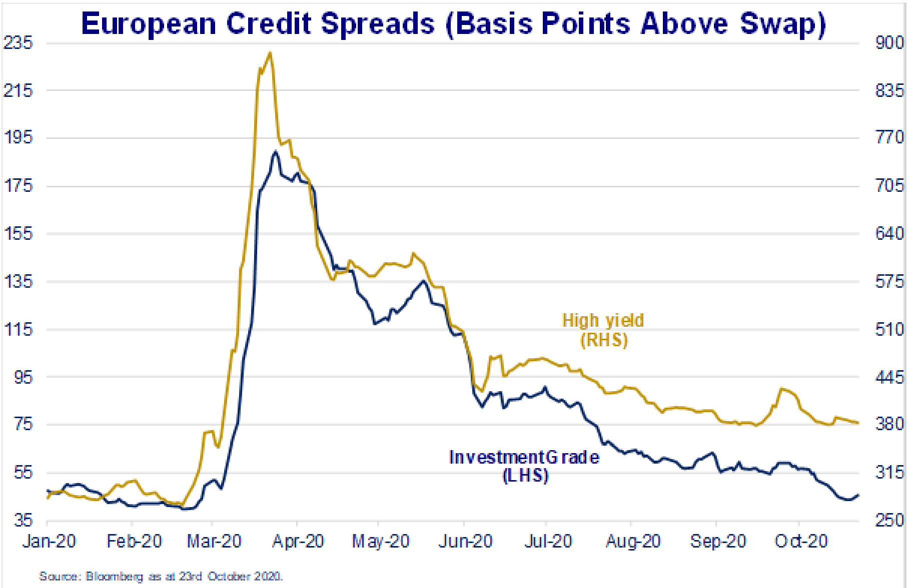
- **Regional credit indices were slightly higher over the past week, but the rate of advance has really flattened out. Indeed, spreads in the US investment grade sector declined -3 points to +123 bpts (8-month low), which increased the recovery rate one notch to 92%,** with all 11 sub-sectors recording capital gains. The decline in risk premiums were led by the cyclical sectors including subordinated financials

(-5 points, +152 bpts, 91%), industrials (-4 points, +126 bpts, 86%) and consumer discretionary (-4 points, +130 bps, 95%), with defensive and growth sectors barely registering any movement.

In the high yield universe, spreads compressed -7 points which offset the prior week's minor expansion and sent spreads down to +500 bpts and raised the recovery rate one notch to 87%. All 11 subsectors recorded capital gains with the cyclical sectors outperforming led by subordinated financials (-12 points, +347 bpts, 72%), consumer discretionary (-10 points, +470 bpts, 79%) and materials (-10 points, +420 bpts, 85%).



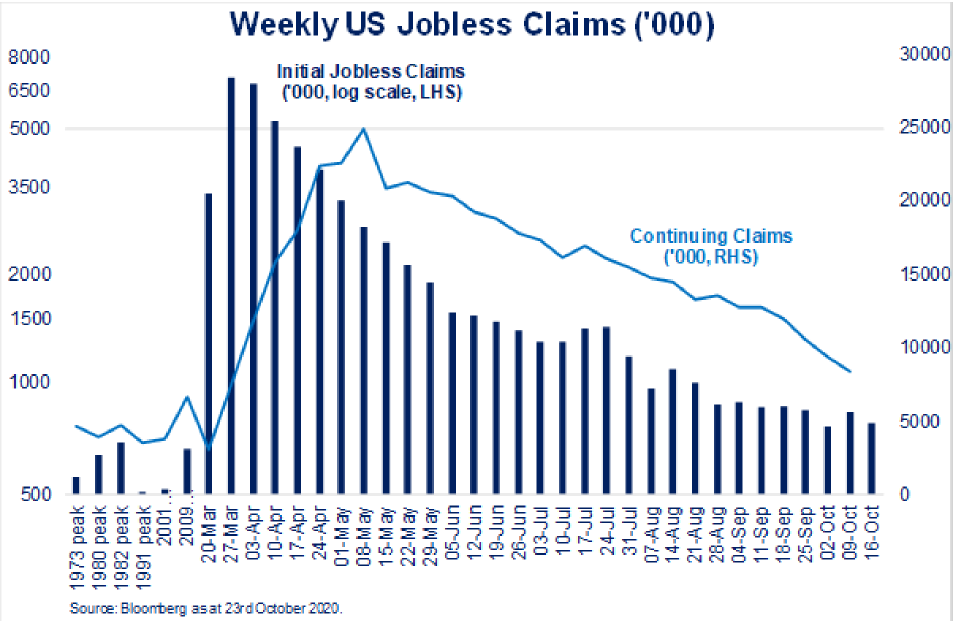
- **European credit markets were mixed with spreads in the investment grade space increasingly +1 point to +45 bpts, which was enough to send the recovery rate down one notch to 96%.** Interestingly, four sectors recorded capital losses and 7 capital gains, with the increases in the larger cap spaces including healthcare (+2 points, +18 bpts, 100%) and IT (+1 point, +17 bpts, 92%) and utilities (+1 point, +25 bpts, 100%). Meanwhile, spreads in the high yield sector declined by -6 points to +382 bpts, which took the recovery rate up one notch to 82%. Nine of the 11 subsectors recorded capital gains over the week led by consumer staples (-19 points, +490 bpts, 95%), senior financials (-15 points, +445 bpts, 73%) and consumer discretionary (-9 points, +421 bpts, 88%), but these mostly offset similar sized spread increases in the previous week (see chart).



THE GLOBAL ECONOMY

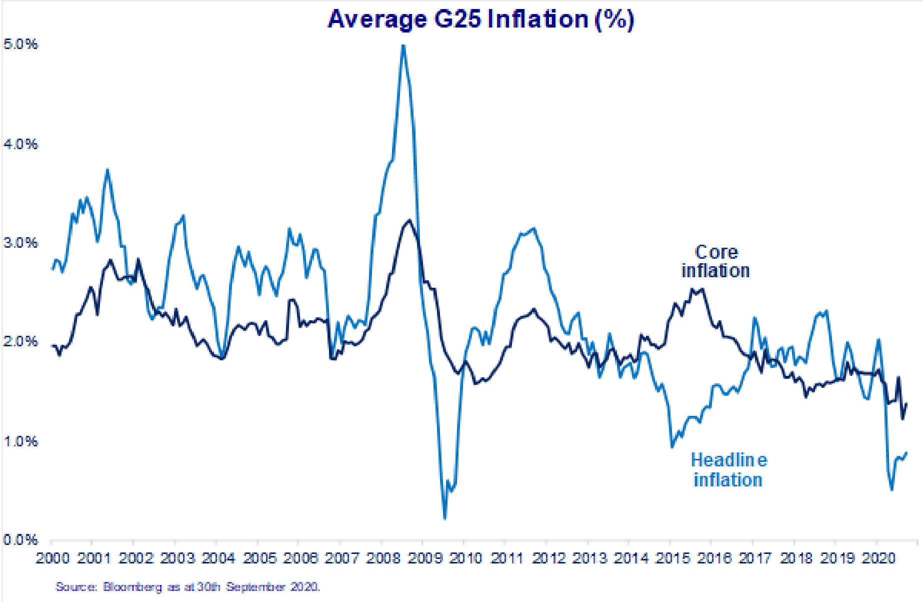
- **Last week's jobless claims were well ahead of street estimates with initial claims declining by -55k to 787k (versus consensus at 870k) for the week ending October 16th with the prior week revised down to 842K (from 898k) underpinned by a reset in California.** Irrespective of the reason, the weekly decline was the third in the past four weeks and it was also the lowest level since March. Initial claims followed on from seven weeks of claims oscillating within the 800k-900k range, but overall claims are still above peak levels from the past six recessions dating back to 1973 and the ratio of initial claims as a share of total employment still remains elevated at 0.4%, so many more good weeks are needed for the labour market recovery to accelerate.

  Meanwhile, continuing claims declined by one million to 8.37 million, however, much of the reduction here reflects expiring benefits, not economic rehiring, with CARES extended benefits increasing +510k in the week to October 3rd, but this is a noisy series, so its wise not to come to any quick conclusion based on a handful of data points. That said, it is still clear that the pace of rehiring has slowed in line with rising COVID-19 case numbers, and a key question here is whether this moderation is seasonal, or something more extended and only time will reveal that answer.

- **Other than Australia, all inflation reports for all G25 economies for September have now been released and the average headline inflation rate has increase +0.07% to +0.88% y/y, and the average core rate bounced by a similar margin off its all-time low to 1.4% (see chart).** The bounces for headline inflation was driven a bit more from the advanced economies (+0.10% to 0.5% y/y) than their emerging peers (-0.03% to 1% to 1.83%), whereas for core inflation for increases were quite similar (+0.09% to 1.14% in the advanced economies, and +0.06% to 1.71% for the emerging markets).

  All these rates are below the typical 2% target by respective central banks and suggests that policy can remain highly accommodative for several years to help economies absorb spare capacity from highly dislocated labour markets. Although all countries have their separate issues, I still fear that Europe could be on the precipice of the deflation abyss, which suggests that respective governments, and to a lesser extent the ECB, needs to get their skates on and ease policy further, but the latter forecasts Europe harmonised core inflation falls into deflation territory in the December quarter 2020 but it lasts only one quarter. While I agree with the concept of falling core consumer prices in the region, I'm not convinced of a short duration.

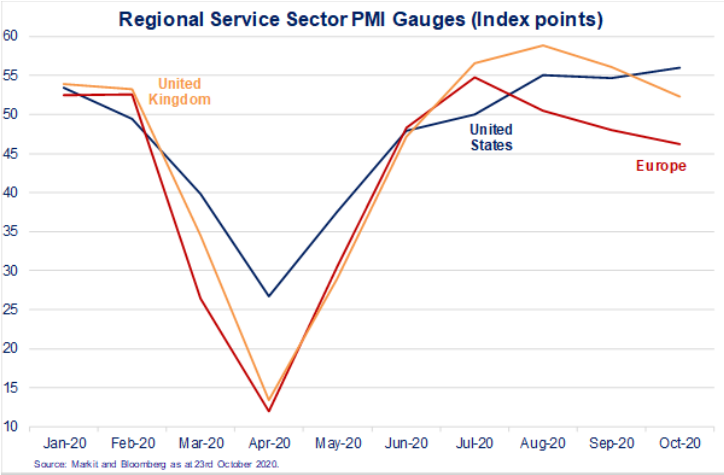


Indeed, with regional COVID-19 cases surging and restrictions increasing across the region I suspect that the recovery is likely to move into contraction territory in the December quarter which will place more downward pressure on consumer prices. We are unlikely to receive any data confirmation for at least another month to ascertain the impact of tightening mobility restrictions and while these have so far, on balance, been designed to limit the growth disruption, last week extensive lockdowns were announced for the Czech Republic, Belgium, Ireland and Wales and risks are rising that more will follow. Fortunately, preliminary Budgets for 2021 has little fiscal austerity in the pipeline for the region given a lack of attention of the regional austerity rules, and also the recovery fund transfer which are on offer in 2021 for governments to use.

- **Regional G4 PMIs for October were released and the Markit flash US manufacturing PMI gained 0.1 points to 53.3 which was in line with consensus and constituted a fresh 21 month high for activity** underpinned by a sizable pickup in domestic new orders which outweighed a moderation in new export orders, production and employment. Importantly, the services PMI rose +1.4 points to 56.0 despite moderations in new business, employment and sales prices, and this took the composite gauge up +1.2 points to 55.5.

  In contrast, weakening confidence from rising COVID-19 infections and tightening mobility restrictions saw the Eurozone composite flash PMI fall -1 point back into contraction territory at 49.4. With the manufacturing PMI increasing +0.7 to a 2-year high of 54.4, the entire decline was underpinned by the people-facing services sector where the gauge dropped -1.8 to 46.2. This was the third consecutive monthly decline and interestingly, outside the depths of the 2020 COVID-19 disruption, the services PMI gauge is now at its lowest level since the European Debt Crisis in 2012. Interestingly, the results for German manufacturing (+1.6 to 58.0) showed considerable resilience, whereas the rest of the region fell firmly into contraction territory.

  However, the PMI survey was taken over the two weeks to 22nd October and thereby captures the early mobility restrictions and this implies that the final October PMI (released next Monday) are likely to be lower. Stress in the services sector underpins my expectation that Eurozone GDP is likely to contract in the December quarter (albeit 'only' -0.2% q/q), and it raises the risk that the region may not record a complete recovery from its -8% contraction this year until 2023.



POLICY

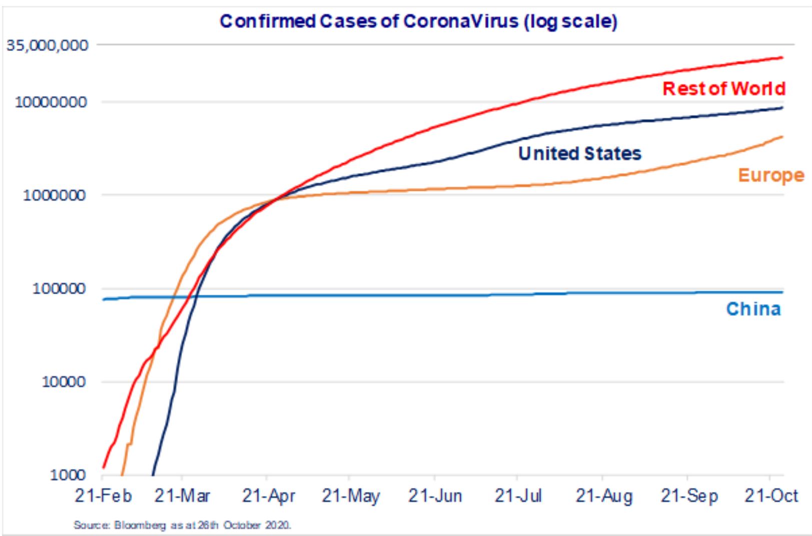
- There were no major policy announcements over the past week, but there was plenty of commentary from officials. The Fed's Governor Brainard said economic disparities could become a drag on the economic recovery, whereas Mester warned that low policy rates could lead to more financial system vulnerabilities. Interestingly, the Fed's balance sheet grew USD25.8 billion to a record USD7.2 trillion.

- The RBA's Assistant Governor Kent also spoke, and his comments played into the idea that the central bank will complement a rate cut in November with an announcement about a sizable QE program with several analysts suggesting AUD100 billion or more.

VIRUS UPDATE

- The number of global cases of COVID-19 is 40.29 million with another +330k cases so far (but Brazil, Colombia, Mexico, Pakistan, Spain and Sweden and 13 US states have not reported their numbers) which means that Sunday was the 97th consecutive day where daily increases were greater than 200k. At present, 15 countries have more than 500k cases, 30 countries have more than 200k cases and 46 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, 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 and 3 days. More importantly, the growth rate of daily confirmed cases (+1.1% since Thursday) is slightly higher. Meanwhile, deaths stand at 1.15 million and the death rate was steady at 2.69% although the number of daily deaths remains elevated.



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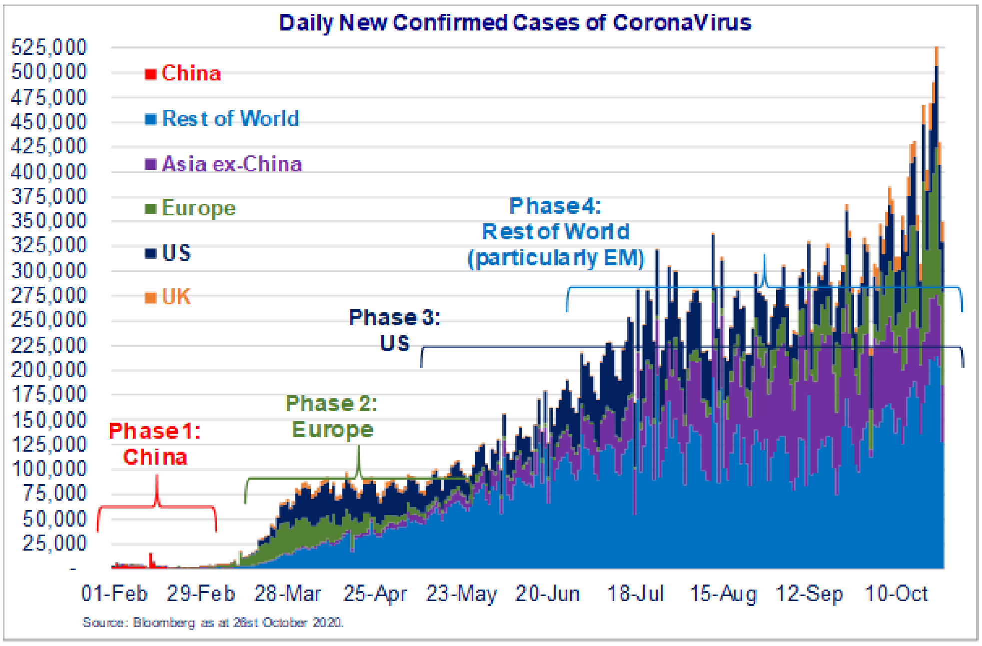
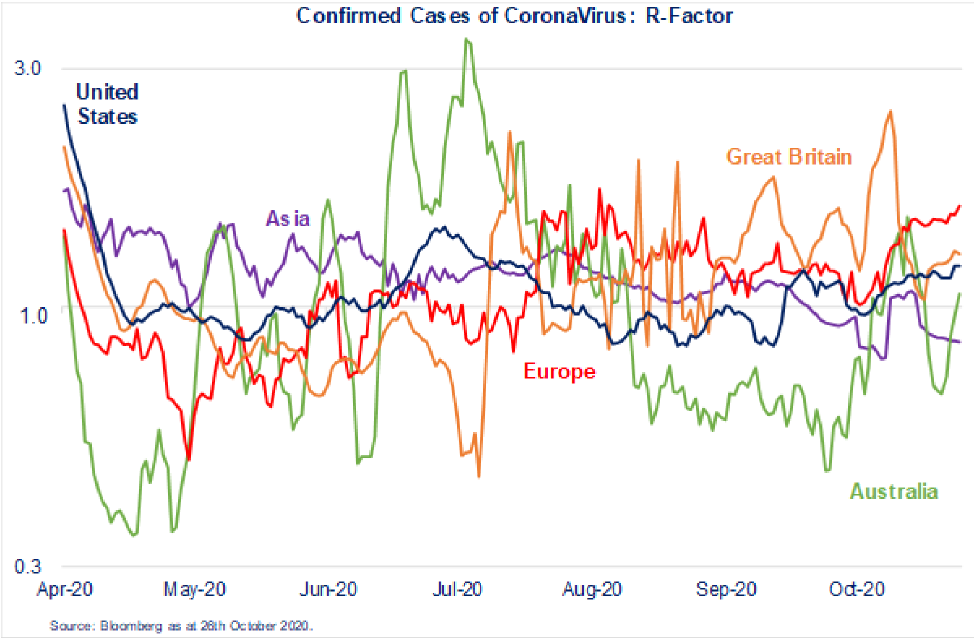
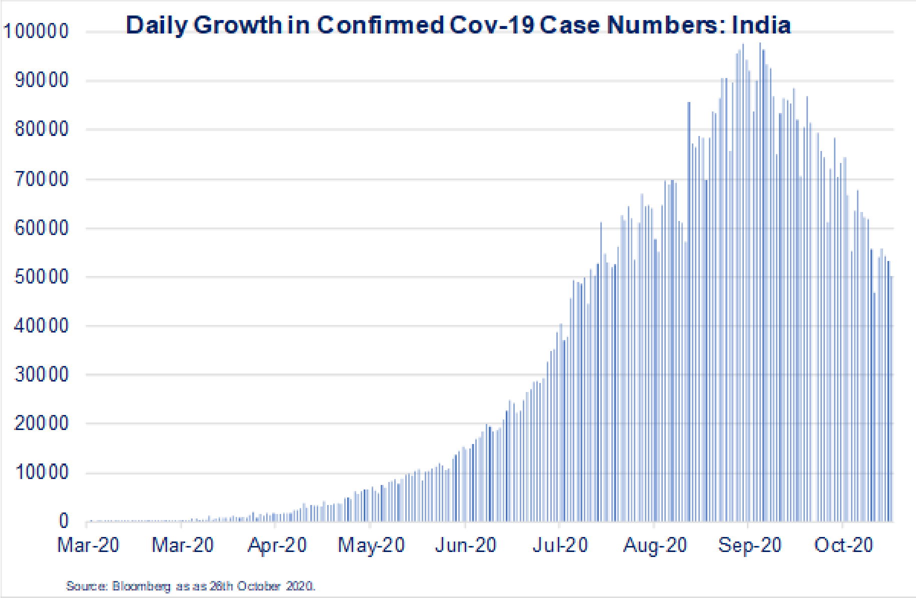
- We break the infections into four groups – the US, Europe, China and 'others' and the rest of the world outside the G3 economies now has the most total cases (+184.6k to 39.07 million) and highest daily new cases (and by a considerable margin) followed by the US (+51.43k to 8.63 million, although 13 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 (+93.6k to 4.26 million - see chart) with an R-factor at 1.60 which indicates that the infection rate is rising rapidly, and this is higher than the UK (1.28), the US (1.21) and Asia 0.85.

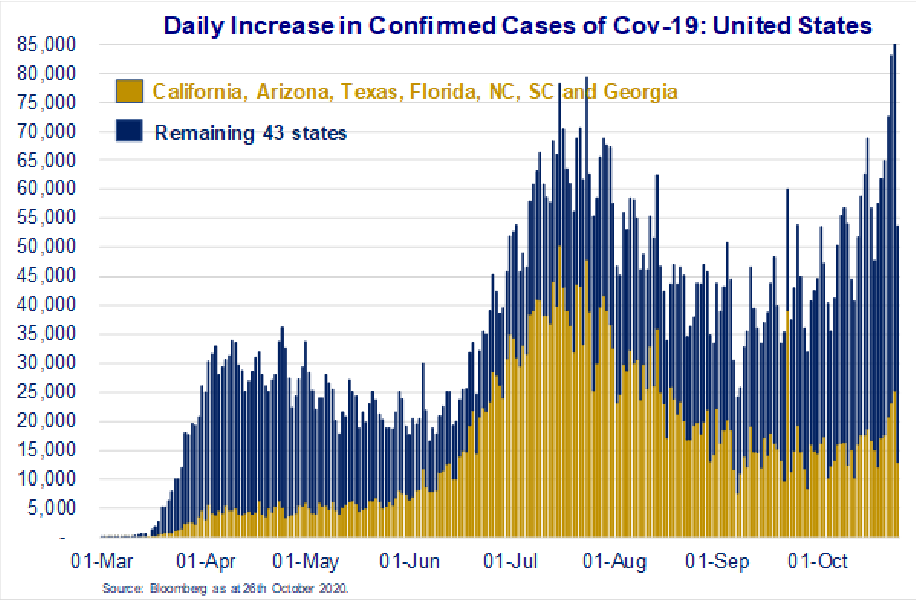




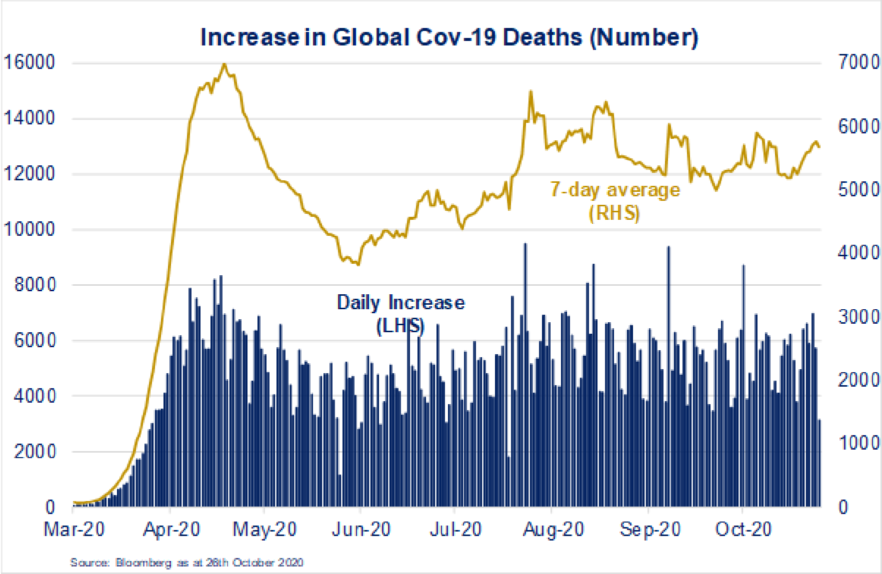
- Among countries, the most cases are in the US (+51.5k (so far) to 8.63 million, with 13 states yet to report), India (+50.1k to 7.86 million), Brazil (not reported, 5.38 million), Russia (+16.4k to 1.50 million), France (+45.4k to 1.13 million), Argentina (+12.6k to 1.08 million), Spain (not reported, 1.05 million), Colombia (not reported, 1.00 million), Mexico (not reported, +886.8k) and Peru (+3.1k to 886.2k). Australia confirmed cases rose +18 yesterday to 27.5k yesterday which placed us 82nd in terms of total infections.

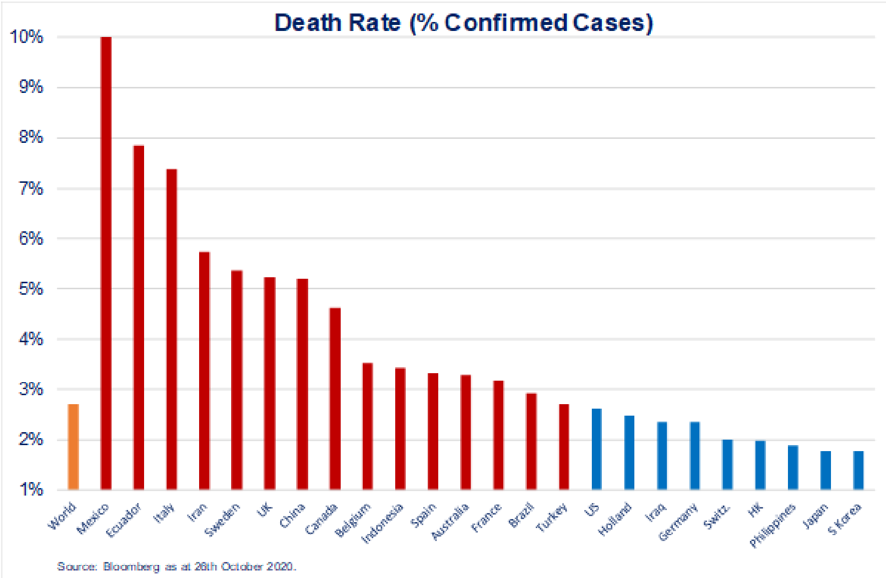
  Elsewhere, Singapore recorded +5 new cases to 58.0k most of which are linked to foreign workers who are forced to live in crowded dormitories, but Indonesia (+3.7k to 389.7k) is now on the rise and has now surpassed the Philippines (+2.2k to 370.0k) to be the most infected country in South East Asia.

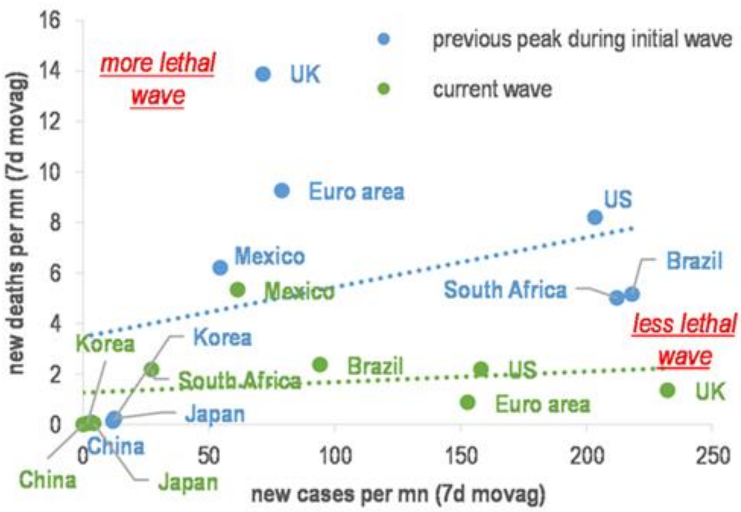




- Although final numbers are not in until 1pm AEST, the global death rate declined to 2.69% with the global total to 1.15 million after another +3.1k deaths overnight, so far, which indicates the daily average deaths is stabilising again (see chart). The US (+0.31k so far) has the most deaths at +225.2k, with Brazil (not reported, 156.9k), India (+1.7k to 118.5k), Mexico (not reported, 88.7k), the UK (+151 to 45.0k), Italy (+128 to 37.3k) and Spain (not reported, 34.8k) all over +30k. The death rate in advanced economies is highest in European countries where the health systems had collapsed led by Italy (-0.2% to 7.4%), Sweden (-0.2% to 5.4%), the UK (-0.2% to 5.2%), Canada (-0.1% to 4.6%), Belgium (-0.1% to 3.5%), Spain (-0.1% to 3.3%), Australia (-0.1% to 3.3% and France (-0.1% to 3.2%). However, several emerging markets are now on the leader board including Mexico (-0.1% to 10.0%), Ecuador (-0.1% to 7.9%), Indonesia (steady at 3.4%) and Brazil (steady at 2.9%). Having said that, the second Cov-19 wave has been far less deadly than the initial wave (see last chart) especially in the advanced economies such as the UK, Europe and the US.







Source: J.P. Morgan

Yours sincerely,

MATT SHERWOOD
Head of Investment
Strategy, Multi Asset

MICHAEL O'DEA
Head of Multi Asset

MORE INFORMATION

Perpetual Investments 1800 062 725
Email investments@perpetual.com.au
www.perpetual.com.au/investments