Perpetual Investments

THOUGHTS ON THE MARKET

27th August 2020 - Getting the right message from the July US durable goods report

SUMMARY

- Global equity markets continued to rally overnight supported by more signs of a solid US goods sector recovery and expectations of continued stimulus. It does appear that the markets are undergoing a slow melt-up underpinned by Fed liquidity and continued backstops in the fixed income markets which prevent a steepening of the yield curve. This combination sparked strong gains in tech stocks which pushed the NASDAQ 100, S&P 500 and MSCI World Index up to record highs overnight and send the US Dollar lower.

  In other markets, 10-year US Treasuries rose +1 point to 0.69% but curve slope was steady at 0.60%, commodities were higher with gold (+1.6% to USD1,954 per troy ounce) outperforming oil (+0.1% to 43.41 per barrel which is a 6-month high) despite the production uncertainty around Hurricane Laura which is nearing Texas, and G10 currencies all rallied against a weaker Greenback with the appreciations led by the AUD (+0.7% to USC72.32), Sterling (+0.6%), Yen (+0.5% to 105.99) and the Euro (+0.1%).

- Macro headlines were constructive for markets with the July core US durable goods orders (+2.4% m/m) confirming that the US factory sector continues to dig itself out of its hole and suggests some upside risks to Q3 equipment investment. However, the overall message is that US goods production is recovering from the COVID shock, but activity is not yet indicative of a substantial underlying acceleration.

  Meanwhile, the June quarter volume of total Australian construction work was considerably less dire than street estimates at (-0.7% q/q vs -7.0% q/q) although activity is still down to its lowest point since 2016. The decline was driven by the public sector, suggesting that the multi-year public infrastructure boom is now over and will continue to drag on growth for a while yet. Nevertheless, recent data is suggesting that June quarter growth could be a percentage point of two ahead of consensus and the RBA (currently around -7% q/q), but in many ways this is not important as its H2 2020 growth that matters. On that line, the waning amount of state government projects, record low rates and high unemployment provides a strong foundation for RBA Governor Lowe's call for states to boost their capital spending. Let's hope they are listening.

- The number of global cases of COVID-19 is 24.02 million with another +195k cases so far (but Brazil, Mexico and 6 US states have not reported their numbers) which means that Wednesday is set to be the 38th day in the past 39 where daily increases are greater than 200k (the only exception was yesterday as India failed to present numbers). At present, 8 countries have more than 500k cases, 21 countries have more than 200k cases (the Philippines joined this group overnight) 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 and 4 days. More importantly, the growth rate of daily confirmed cases (+0.9% since Sunday) is once again coming down. Meanwhile, deaths stand at 822.2k and the death rate has declined to 3.43% although the number of daily deaths remains elevated.

FINANCIAL MARKETS

- **EQUITIES**
  - **The MSCI World Index rose +1.0% which pushed the index to a complete recovery from the COVID-19 bear market** and saw it close at a record high. All tech-related sectors were among the market leaders with communication services (+3.0%) leading the market higher with particular strength in Facebook (+8.2%) and Netflix (+11.6%). IT rallied hard (+2.0%) underpinned by Salesforce (+26.4%) after the software

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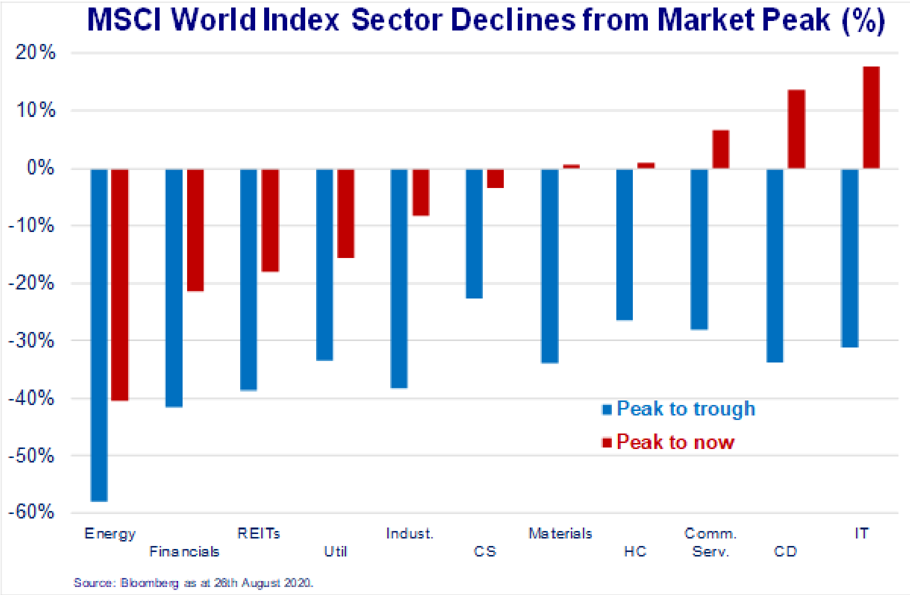
developer easily beat revenue estimates, and consumer discretionary (+1.5%) outperformed supported by Amazon (+2.9%), although dining and travel names weighed a bit on the sector. In contrast to the tech strength the traditional cyclical sectors were all at the back of the pack with materials (+0.9%) slightly behind the market tape despite solid gain in base metals prices, financials (-0.02%) were weighed down by banks, and energy (-1.5%) was the worst performer despite the crude price being at a 6-month high. By the close of trading, energy (-40.5%) and banks (-21.5%) remained in bear market territory and materials rose to an all-time high and a 100% post-COVID-19 recovery rate (see chart).

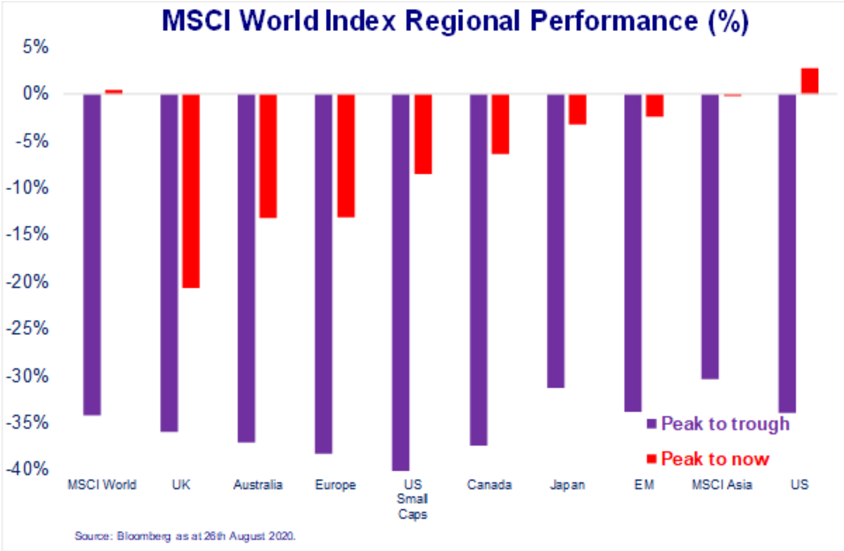


- **Among the regions, the pace of gains was led by the US (+1.0%)** with sentiment boosted by favourable COVID-19 headlines (with lower case numbers and continued vaccine talk) and positive macro data. Indeed, the headline durable goods report for July more than doubled street estimates and core capital goods shipments (which feed into the national accounts) also beat the street continuing the signs of a solid rebound in goods sector activity. Corporate news was also upbeat with several tech names trumping consensus on revenue and EPS levels, and thereby giving comfort to speculators that lofty valuations can be back up with earnings delivery. By the bell, the NASDAQ100 (+1.7%) and S&P 500 (+1.0%) both scored century gains and closed at record highs, with the Dow Jones industrial average (+0.3%, +873 points, 28,332) also higher, whereas the Russell 2000 underperformed (-0.7%) in a challenging day for small caps.

- **European shares also posted a solid advance (+0.8%)** despite opening lower and being subjected to choppy trading for most of the session with most bourses ending near their daily highs. Regional sentiment was boosted by Germany's decision to extend its furlough program to help the economy recover from the coronavirus crisis and speculation mounted that a French stimulus package which is expected to be revealed next week will provide considerable support for struggling sectors. There wasn't much of the macro calendar and Coronavirus news is still at the forefront as European case-growth accelerated thereby seeing Spain underperform its regional peers despite ruling out another national lockdown. By the closing bell all regional indices had advanced led by Germany (+1.0%), France (+0.8%), Switzerland (+0.8%), Sweden (+0.7%), Italy (+0.5%), Spain (+0.2%) and the UK (+0.1%) which was weighed down by the appreciation of Sterling.

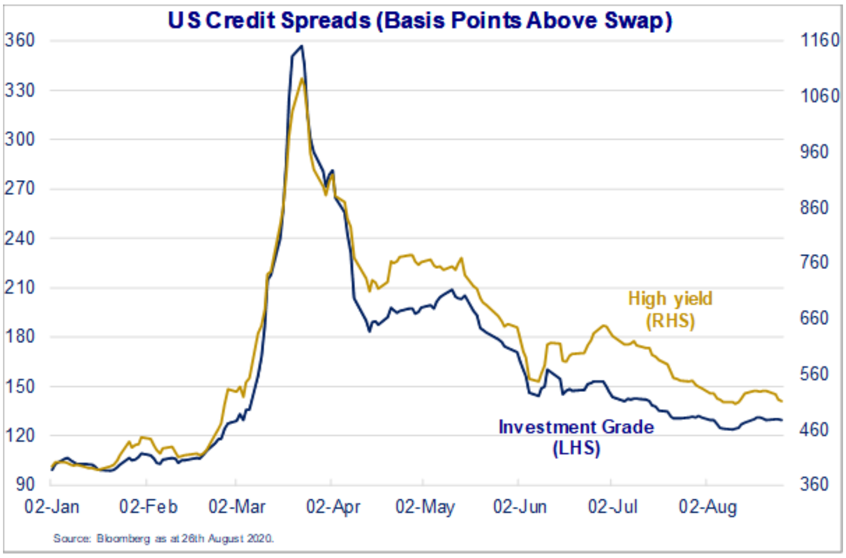
- **Asian markets also advanced yesterday (+0.4%)** is yet another quiet session amid an absence of newsflow. With an empty macro calendar, the market's focus moved to Fed chair Powell's Jackson Hole speech, where there were no firm views but lots of commentary. The latest coronavirus developments were also in focus with China's infections remaining low double digits, Japanese cases were steady (at 724), South Korea broke above 300 for first time since Sunday and Australia (151) continued to fall. By the regional closing bell, Mainland China (-1.2%), Australia (-0.7%) and Singapore (-0.7%) fell notably, followed by moderate movements in Japan (-0.03%), Hong Kong (+0.02%) and South Korea (+0.1%), whereas Taiwan (+0.6%) was the regional standout supported by a strong lead from US tech yesterday morning.

Overnight moves saw no change in our peak-to-market chart with the UK (-21.4%) lagging, but the MSCI World Index (+0.1%) has now staged a complete recovery (see chart) given its high exposure to the US sharemarket

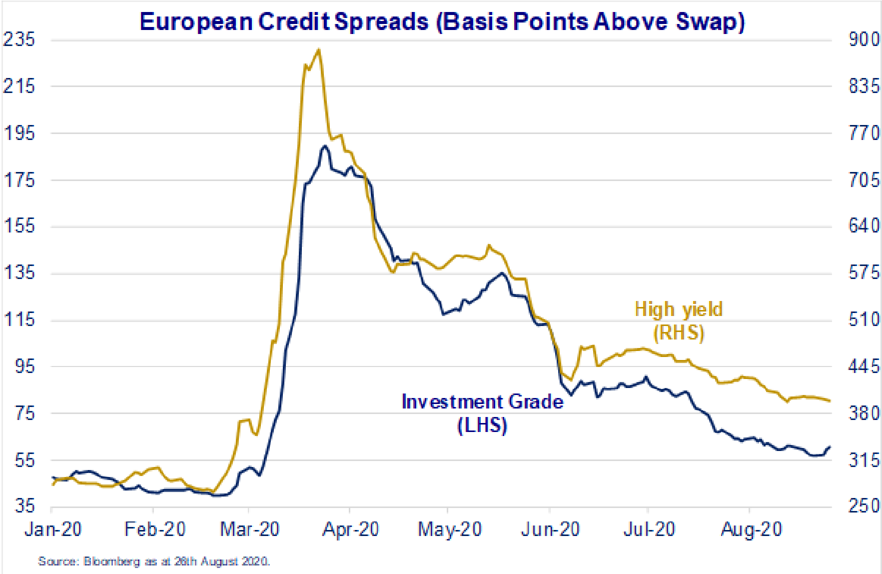


- **Futures markets suggest a modestly positive opening in Asia today** with Hong Kong (+0.1%), Australia (+0.2%) and Japan (+0.3%) all priced for advances at the opening bell.

- **CREDIT MARKETS**
  - **Regional credit indices were little moved overnight.** Spreads in the US investment grade were steady at +130 bpts, with the recovery rate still at 89%. Eight of the 11 sub-sectors recorded lower spreads, but the sixth straight session not one sector recorded a move of more than one basis point in a somewhat boring day for investors. In the high yield universe, the action did not get much more exciting with spreads declining -3 points to +511 bpts, but the recovery rate was unchanged at 85%. All 11 sub-sectors recorded capital gains, with notable advances in tech (-9 points, +416 bpts, 84%) which followed their equity peers up in price, subordinated financials (-7 points, +529 bpts, 72%) and industrials (-6 points, +638 bpts, 57%) which responded well to higher US durable goods orders.

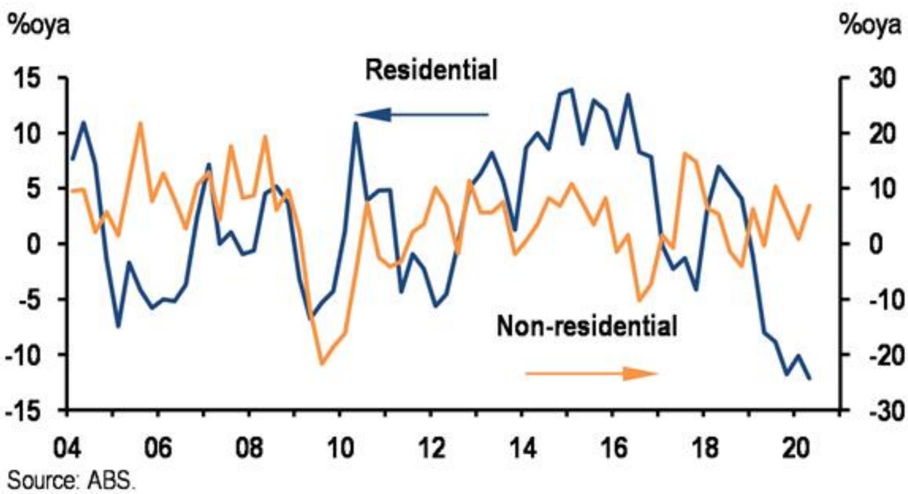


  - **European credit markets were mixed** with spreads in the investment grade universe up +1 point (third consecutive daily rise) to +61 bpts, which lowered the recovery rate one notch to 86%. All eleven sub-sectors recorded capital losses, but none were by more than a basis point. In the high yield universe, the price action was equally quiet with spreads coming in -1 point (fourth consecutive day of price gains) to +397 bpts, which lifted the recovery rate one notch to 80%. Eight of the 11 sub-sectors recorded price gains but for the tenth consecutive session no sector recorded a double digit move. In fact, overnight the largest move was in tech (-3 points, +332 bpts, 67%) which is indicative of how quiet things were.



THE GLOBAL ECONOMY

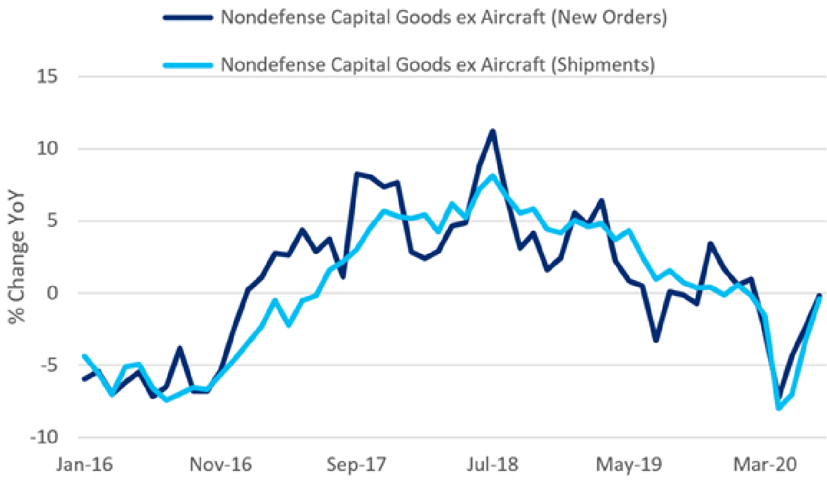
- **The volume of total construction work in Australia was considerably less dire than street estimates at -0.7% q/q (the street was at -7.0% q/q)** which pulled the annual rate down to -2.2% y/y. While that was much better than expected, activity was still down to its lowest point since 2016. By sector, construction in the private sector was fractionally higher (+0.1% q/q, -2.7% y/y) as non-residential construction lifted sharply (+4.0% GDP weighted, driven by engineering +8.6% y/y – see chart), which helped offset another decline in housing (-5.7% q/q GDP-weighted). More importantly, as the private sector stalled public construction dropped back sharply again (-3.2% q/q, and -2% GDP weighted) suggesting that the multi-year infrastructure boom (averaging ~7% y/y real growth from 2015 to 2019) in recent years is now over.



Overall, the only modest decline in Q2 construction creates material upside risk to GDP forecasts (consensus, the RBA and Treasury are all around -7% q/q) which could be as large as two percentage points. The picture will become clearer over the next 6 days when all the lead-up partials are released, but I would not over-emphasise their importance as the September quarter is looking like a recovery perhaps of just +0.75% q/q and there is the fiscal cliff in Q4.

- **The US factory sector continues to dig itself out of its hole, as evidence by the headline July US durable goods orders which were up a very strong +11.2% m/m** which were more than double street estimates (+4.5% m/m), with the headline number now -1.3% below pre-COVID-19 levels. The headline print was helped by a big monthly gains in volatile items such as motor vehicles and parts and transportation equipment, but when these are excluded durables ex transport were still up a strong +2.4% m/m which was also ahead of consensus (+2.0% m/m) although it was down considerably from the June result (+4.0% m/m). This suggests some small positive upgrades to September quarter growth, with this gauge now only -1.3% below the February level.

The overall message here is that goods production is recovering from the COVID shock, but activity is not yet indicative of a substantial underlying acceleration. As such, while equipment investment may be a bit stronger than first thought, I am not upgrading September quarter growth.



POLICY

- There were no major policy announcements overnight.

VIRUS UPDATE

- The number of global cases of COVID-19 is 24.02 million with another +195k cases so far (but Brazil, Mexico and 6 US states have not reported their numbers) which means that Wednesday is set to be the 38th day in the past 39 where daily increases are greater than 200k (the only exception was yesterday as India failed to present numbers). At present, 8 countries have more than 500k cases, 21 countries have more than 200k cases (the Philippines joined this group overnight) and 29 countries have more than 100k cases.

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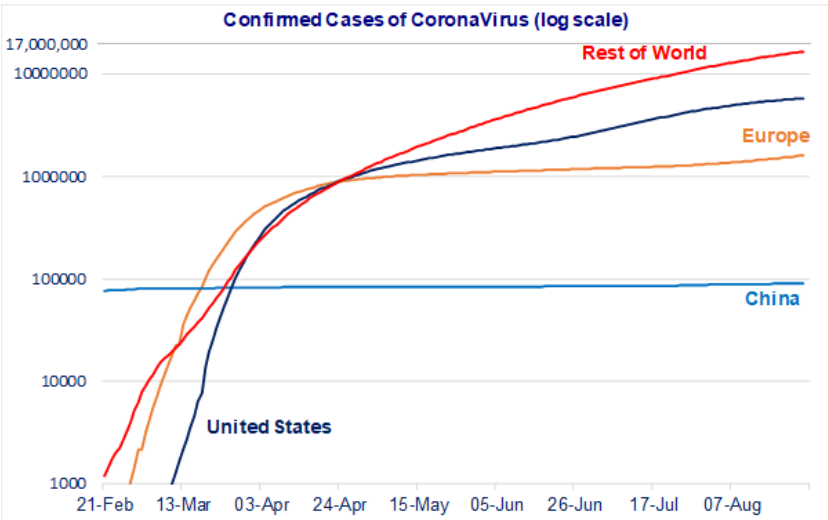
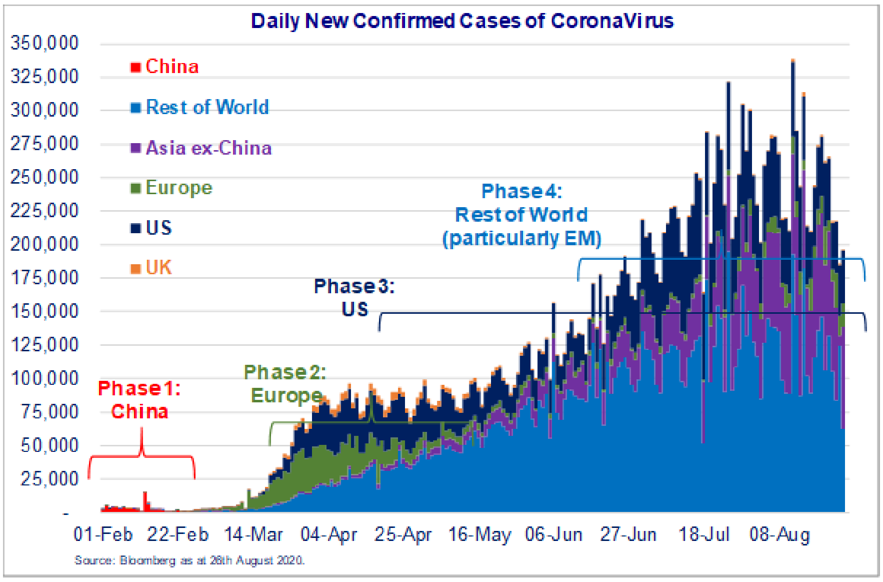
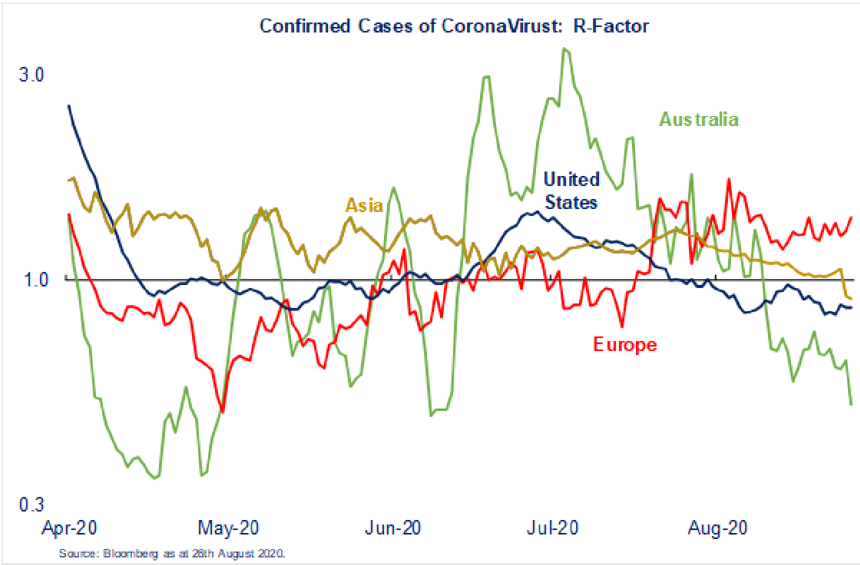


Source: Bloomberg as at 26th August 2020.

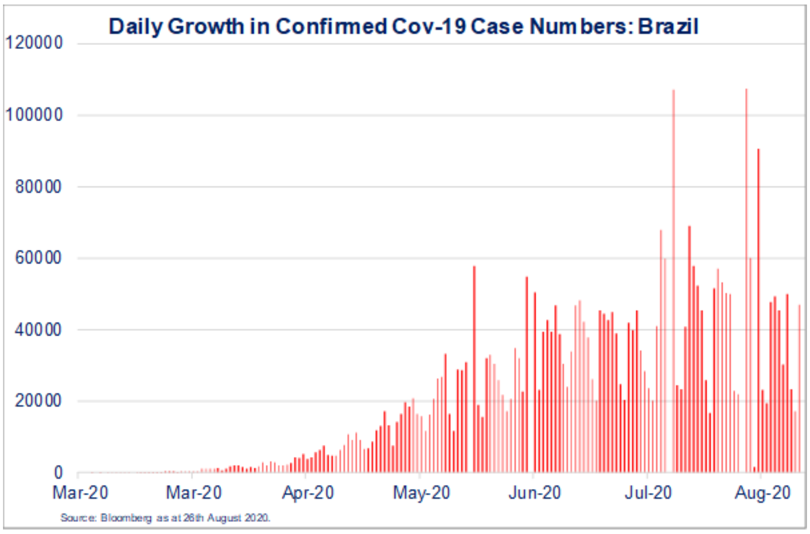
- We break the infections into four groups – the US, Europe, China and 'others' and the rest of the world outside the G3 economies now has the most total cases (+80.0k to 20.3 million) and highest daily new cases (and by a considerable margin) followed by the US (+39.3k to 5.82 million, although 6 states 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 (+17.8k to 1.62 million - see chart) which is the only region with an R-factor above 1.0.

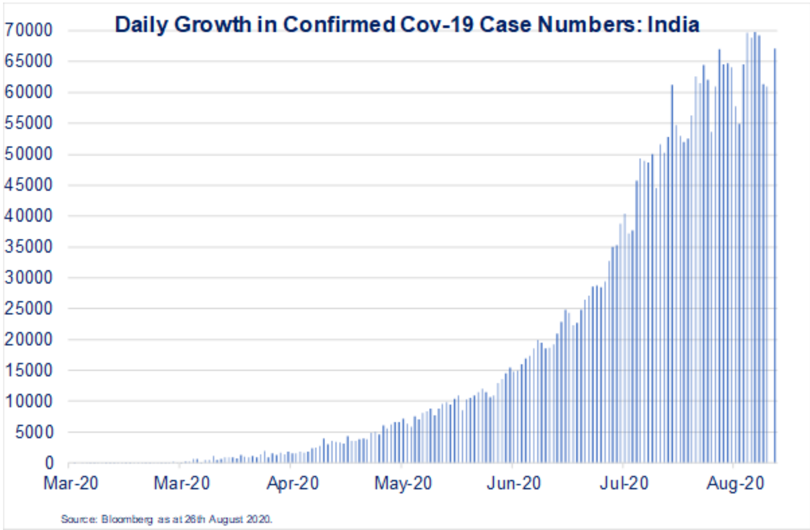


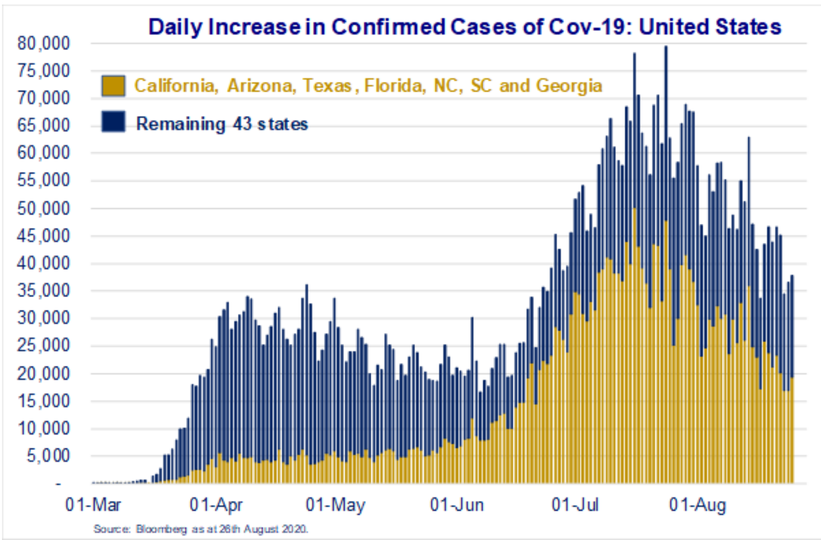


- Among countries, the most cases are in the US (+38.3k (so far) to 5.82 million, with 6 states yet to report), Brazil (not reported, 3.67 million), India (+67.2k to 3.23 million), Russia (+4.6k to 968.3k), South Africa (+2.7k to 615.7k), Peru (+6.9k to 607.4k), Mexico (not reported, +568.6k), Colombia (+10.4k to 562.1k), Spain (+7.3k to 419.8k), Chile (+1.4k, 402.4k), Iran (+2.2k to 365.6k), United Kingdom (+1.1k to 330.9k), Saudi Arabia (+1.1k to 310.8k), Pakistan (+0.5k to +294.3k) and Bangladesh (+2.5k to 302.1k). Australia confirmed cases rose +151 to 25.2k yesterday which placed us 66th in terms of total infections.

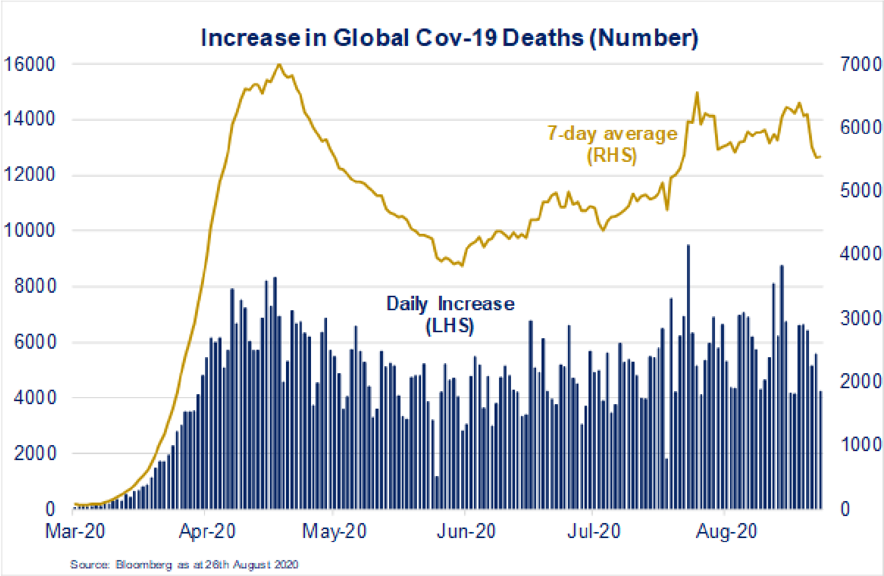
  Elsewhere, Singapore recorded +60 new cases to 56.5k most of which are linked to foreign workers who are forced to live in crowded dormitories, but Indonesia (+2.3k (third highest) to 160.2k) is now on the rise and has the second most cases in the region behind only the Philippines (+5.2k (fourth highest) to 202.4k).

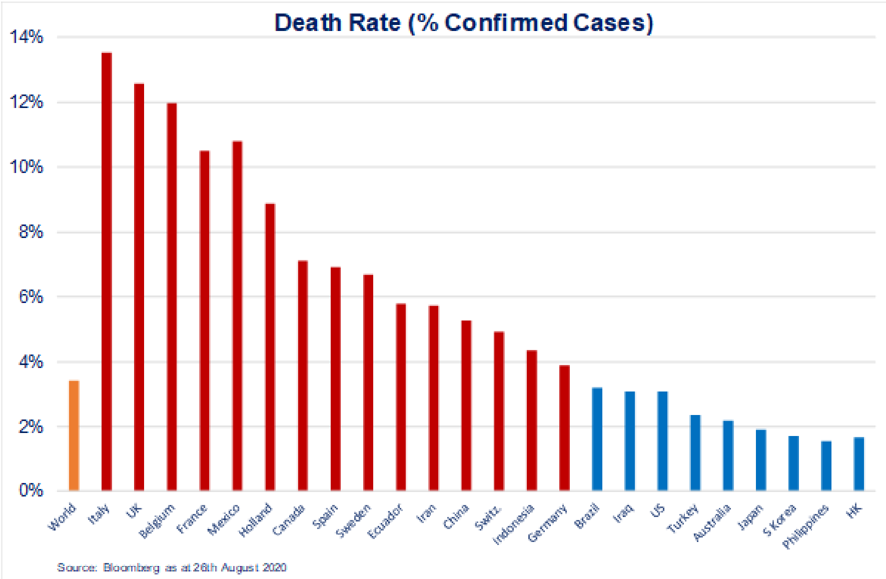






- Although final numbers are not in until 1pm AEST, the global death rate declined to 3.42% with the global total to 822.2k after another +4.0k deaths overnight, so far, which indicates the daily average deaths is stabilising again (see chart). The US (+1.1k so far) has the most deaths at +179.6k, with Brazil (not reported, 116.6k), Mexico (not reported, +61.5k), India (+1.0k to 59.4k), the UK (+16 to 41.5k), Italy (+13 to 35.4k) and France (+0 to 30.5k) all over +30k. The death rate is highest in European countries where the health systems had collapsed led by Italy (-0.1% to 13.5%), the UK (steady at 12.6%), Belgium (-0.2% to 12.0%), France (-0.3% to 10.5%), the Netherlands (-0.1% to 8.9%), Spain (-0.2% to 6.9%) and Sweden (steady at 6.7%). 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 3.2%).





Yours sincerely,

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MORE INFORMATION

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