Perpetual Investments

THOUGHTS ON THE MARKET

30th July 2020 - Deflation hits Australia, but don't worry we are not Japan…. yet.

SUMMARY

- Stocks and government bonds rallied overnight and the US dollar retreated, after the FOMC signalled to markets that they will use all of their tools to support the world's largest economy. Quite honestly, there was nothing new from the Fed and we wonder why the market got so excited about the meeting, given rates were held at 0-0.25%, as expected, and its policy statement noted the obvious – that economic activity has picked up but remained well below pre-pandemic levels and that high frequency indicators had rolled over which is a concern. He also mentioned that the Fed's policy framework review is coming in the "near future", which suggests in September they will move to an outcome-based forward guidance, but that was no surprise.

  There is no doubt that the Fed large and presence in markets has provided risk assets with a backstop to stop a tightening in financials conditions, but they don't have any tool to engineer a recovery, which means that fiscal policy will need to remain in place to support household incomes, especially as unemployment could increase in the months ahead as the true impact of the shock on the labour market is revealed.

  In other markets, 10-year US Treasuries declined to 0.57% which is a low since early March and curve slope flattened more, commodities were upbeat with gold up +2.2% to USD1971 per troy ounce and oil rallied +0.7% to USD41.32 per barrel, and the US dollar headed south against all of its G10 peers including Sterling (+0.8%). The AUD (+0.5% to USC71.85), the Euro (+0.5%) and Yen (+0.2%).

- There was scant economic data overnight, but one key piece was Australia's June quarter CPI which declined -1.9% q/q which was the lowest result in 72 years. Several people Email me yesterday and asked has Australia has become Japan? On the inflation front the answer is no – you only get sustained deflation when aggregate supply is greater than aggregate demand, and that is not the case in Australia, but we will be Japan-like for a large portion of the next decade as interest rates will remain at 0% for a long period of time and government deficits will be very large.

FINANCIAL MARKETS

- **EQUITIES**
  - Meanwhile, tech (+1.4%) benefited from solid earnings reports from Advanced Micro Devices (+12.5%) who upgraded its guidance, as well as Shopify (+7.0%) and Juniper Networks (+3.0%). Elsewhere, the promise of continued policy support supported traditional cyclical sectors including energy (+1.2%) and financials (+1.0%), which both snapped its 5-day losing streak, and industrials (+0.8%) despite lower prices among airlines. The only sector to decline was materials (-0.4%) which was off for a second session, but in the previous two weeks it had rallied around 6%, which suggests there may be some profit taking amid a plateauing recovery. Overnight moves culminated in two sectors remaining in bear market territory, three in correction territory, three having recorded complete recoveries and three others near the breakeven line (see chart).

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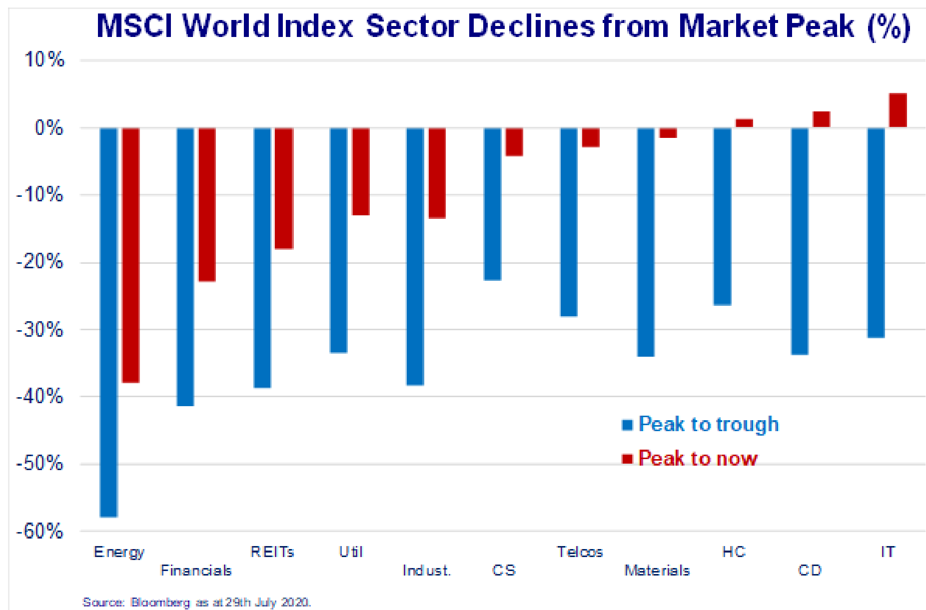
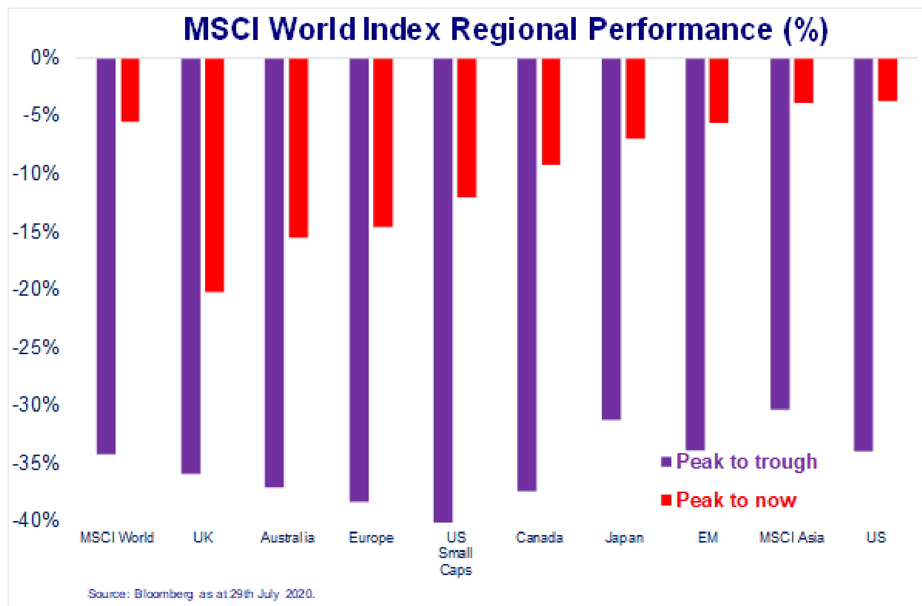


- **Among the regions, advances were led by the US (+1.2%)** which closed higher with advances in all sectors led by traditional value sectors and tech. The Fed was the main game in town overnight and the FOMC held rates at 0.0-0.25%, as expected, and its policy statement noted that economic activity has picked up but remained well below pre-pandemic levels and Chair Powell mentioned at his news conference the recent dip in high frequency indicators. He also mentioned that the Fed's policy framework review is coming in the "near future", which suggests in September they will move to an outcome-based forward guidance. Meanwhile, the Us reporting season continued with June quarter results seen as being down around -41% q/qa which is better than the -44% at the end of June, and while the average beat rate at 79% is high, it should have been expected considering the market has record negative revisions in April and May. Bu the bell, all indices were higher with gains led by the Russell 2000 (+2.1%) NASDAQ100 (+1.4%), S&P 500 (+1.2%), but the Dow Jones was less buoyant (+0.6%, +160 points to 26540) even though it closed higher.

  Asia equities also finished higher yesterday with the MSCI Asia Pacific Index rising +0.7% but it was a very narrow as mainland China Delivered the entire regional rise in a quiet session in terms of newsflow but headlines were mostly bearish with Australia returning to deflation in the June quarter, and rumours persist that Japan is about to slash its FY20 growth forecast thereby undermining its fiscal projections, Fitch downgraded its Japan outlook to 'negative' from 'stable' and investors waited for the overnight July FOMC meeting amid worries that regional COVID-19 cases continue to rise. By the regional bell, China (+2.4%), Hong Kong (+0.5%) and Korea (+0.3%) all rallied, but Australia (-0.2%), Taiwan (-0.4%) and Japan (-1.2%) all declined.

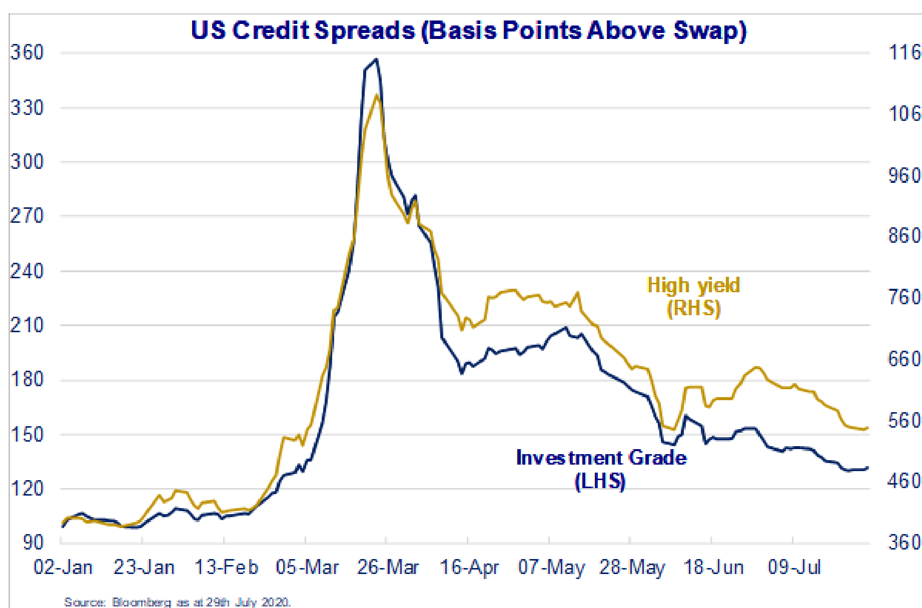
  In contrast to the US and Asia, **European markets closed lower** (-0.1%) as investors focused on earnings and COVID-19 developments as macro updated very in short supply. UK PM Johnson commented that Europe was beginning to suffer a second wave of infections and UK ministers prepared to take action where necessary over summer, whereas in corporate news healthcare stocks Sanofi (+0.6%) reported better-than-expected earnings and raising guidance, whereas GlaxoSmithKline (-3.1%) missed and investors voted with their cash. Both companies have reached an agreement, subject to a final contract, with the UK government for the supply of up to 60M doses of a COVID-19 vaccine. By the bell, the regional index was slightly lower with gains in France (+0.6%), Sweden (+0.4%) and the UK (+0.04%) outweighed by losses in Switzerland (-0.04%), Germany (-0.1%), Italy (-0.1%), and Spain (-0.06%).

  The overnight moves, saw the US market once again become the best performing since its trough in late March, but Japan is slipping as the market struggles with a higher Yen, whereas the UK remains the only bourse in bear market territory (see chart).



- Futures markets are pointing to strong gains at the opening in Asia with Hong Kong (+0.3%) Japan (+0.8%) and Australia (+0.9%) slated for positive starts.

- **CREDIT MARKETS**
  - Regional credit indices were little changed overnight despite the positive lead from equity markets. Spreads in the US investment grade universe snapped a three-day losing streak but were little changed at +131 bpts, which left the recovery rate at 89%, with 9 of 11 sub-sector recording lower risk premiums, although no sector saw a movement of more than one basis point. In the high yield space, spreads contracted -8 points to +540 bpts, which increased the recovery rate one notch to 81%. Ten of the 11 subsectors recorded spread contraction with three in the double-digit territory, namely, consumer discretionary (-11 points, +544 bpts, 69%), healthcare (-11 points, +485 bpts, 79%) and consumer staples (-10 points, +385 bpts, 100%).



  - **European credit markets** were also little moved overnight, with the spreads in the investment grade space little changed at +64 bpts with the recovery rate steady at 84% with 9 subsectors recording higher risk premiums, but none were more than +1 point. The high yield space was also little changed from yesterday's close at +426 bpts, which had the recovery rate steady at 75%. There wasn't much movement at the sector level where 4 market area saw wider spreads with increases in energy (+12 points, +559 bpts,

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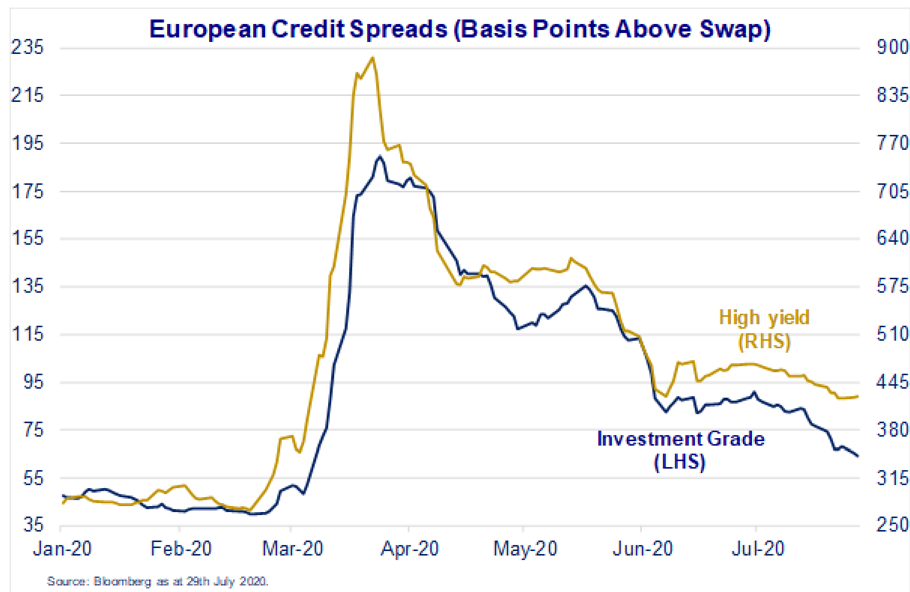
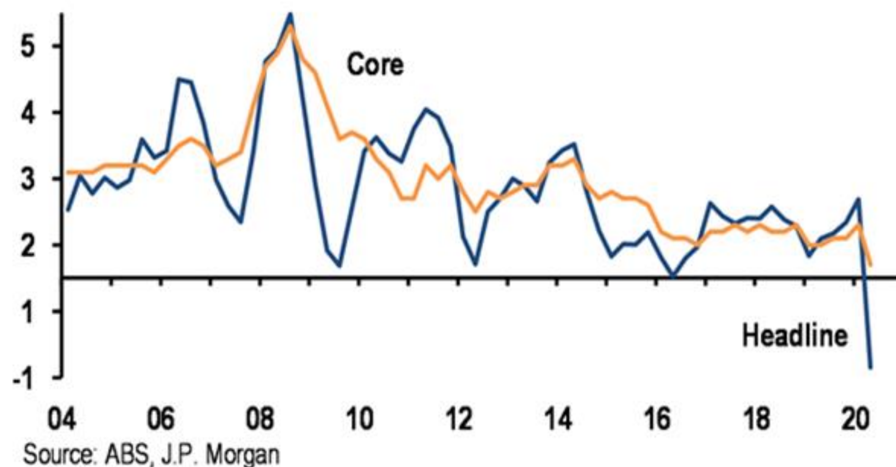
71%) offset by a decline in senior financials (-13 points, +314 bpts, 84%) and everything else was rats and mice levels.



THE GLOBAL ECONOMY

- **Australian headline inflation** was -1.9%q/q in the June quarter which is a 72-year low and this send the annual rate falling into deflation territory at -0.3% y/y for the first time since 1997. Among the contributors, the deflation outcome was driven by sharp declines in prices for fuel (-20% q/q, dragging -0.6% off the headline print), childcare services (-95% q/q, -1.1%), and lower rents (-1.3% q/q, -0.1%), and these were partially offset by increases in food (+1.0% q/q) and which were knows well in advance, hence nothing to see there. However, underlying price trends also softened markedly with the trim mean recording its first ever quarterly decline (-0.1% q/q, +1.2% y/y) and the weighted median up just 0.1% q/q.



Looking forward, the government's childcare subsidy has closed which suggests the June quarter drag will be short-lived and is likely to reverse in Q3 and a similar rebound in fuel prices would also be expected. This suggests that e forecast annual headline inflation to rebound to 0.8%oya in the September quarter and gradually drift higher in 2021, while staying below the RBA's target band.

POLICY

- There was little new from the Fed overnight who left their policy settings and characterisation of the recovery unchanged at its July policy meeting. Indeed, the target Fed Funds rate was unchanged at 0-0.25%, as widely

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expected, and there was no change made to its forward guidance, stating its expectation that "to maintain this target range until it is confident that the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals." In the accompanying statement, the FOMC's assessment of the current economic situation was mostly unchanged from the June meeting, but they noted that employment had "picked up somewhat in recent months" but that it remained "well below" levels at the beginning of the year, and that "the path of the economy will depend significantly on the course of the virus." Nothing to see there, but when asked about the possibility of a "double dip," at the press conference, he acknowledged a clear risk coming from the resurgence of COVID-19 case numbers.

Yours sincerely,

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