

THOUGHTS ON THE MARKET

4th September 2020

Stocks plummet – a pause that refreshes or the start of a larger rotation out of tech?

SUMMARY

- Global stocks tumbled by the most since early June overnight as a combination of rich valuations and more data confirming a slowly improving US economy sparked a rotation away from expensive US tech stocks, with investors questioning how long their lofty valuations could last. While we have been highlighting for some time that high tech PE ratios were ultimately unsustainable, one swallow does not a summer make, and high valuations could persist for a while, just as it did in the 1990s despite Fed Chair Greenspan's famous "irrational exuberance" comment. Accordingly, it is far too early to say whether the overnight decline is simply a pause that refreshes, or it is the beginning of a larger rotation out of expensive megatech shares even though they are hugely successful companies and large surplus cashflow generators.

That said, the overnight losses confirmed what we have seen in options markets in the past few weeks has been right, in that the market had been fearful of rising equities prices which had sparked a sharp rise in the price of volatility. The recent push and pull of US equity prices could well continue in September and October, which are months renowned for volatility, considering US shares have risen +63% since the late-March trough, valuations are still very high, and all the risks out there from high unemployment and a large fiscal cliff remain. This suggests to us a -10% correction may be a healthy development.

In other markets, 10-year US rallied further with yields down -1 point to 0.64% with curve flattening, commodities fell further with oil (-0.5% to USD41.31 per barrel) doing better than gold (-0.8% to USD1,931 per troy ounce) and the G10 currencies depreciated against a stronger Greenback for a second consecutive session led by the AUD (-1.0% to USC72.73), Sterling (-0.6%) and the Euro (-0.1%), whereas the Yen (+0.0%) marked time.

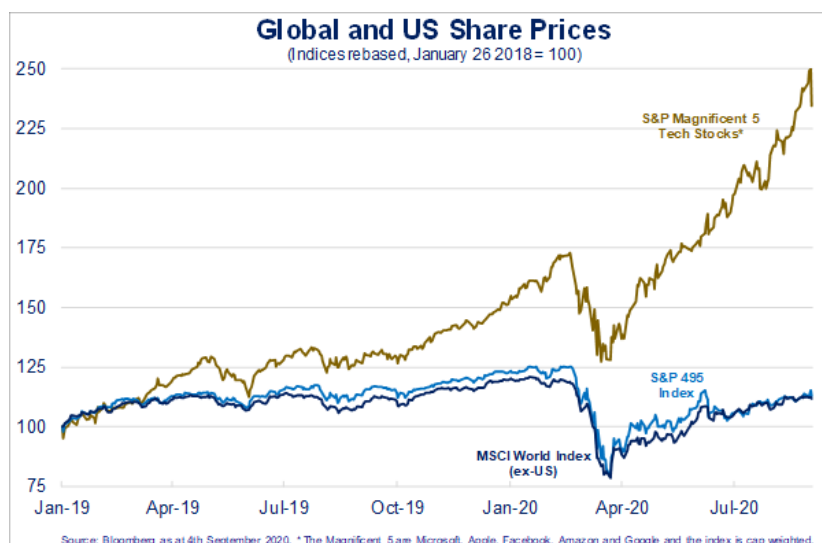
- Economic data overnight indicated that the US economy continued to rebound in August with initial claims coming in below 1 million for only the second time since March although this reflected a new seasonal adjustment regime, and the August ISM services gauge declined -1.2 to 56.9 with mixed respondent commentary. Meanwhile, in Europe retail sales were weak at -1.3% m/m (the street was at +1.4% m/m). In geopolitics, US Senate Majority Leader McConnell expressed doubt about whether a fifth coronavirus relief bill would be passed before the election.
- The number of global cases of COVID-19 is 26.2 million with another +120.1k cases so far (but Brazil, Mexico, India, Peru and Pakistan and 9 US states have not reported their numbers) which means that Thursday is set to be the 47th consecutive day where daily increases are greater than 200k. At present, 8 countries have more than 500k cases, 21 countries have more than 200k cases 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 3 days. More importantly, the growth rate of daily confirmed cases (+1.0% since Monday) is once again coming down. Meanwhile, deaths stand at 866.6k and the death rate has declined to 3.31% although the number of daily deaths remains elevated despite coming well off its peak.

FINANCIAL MARKETS

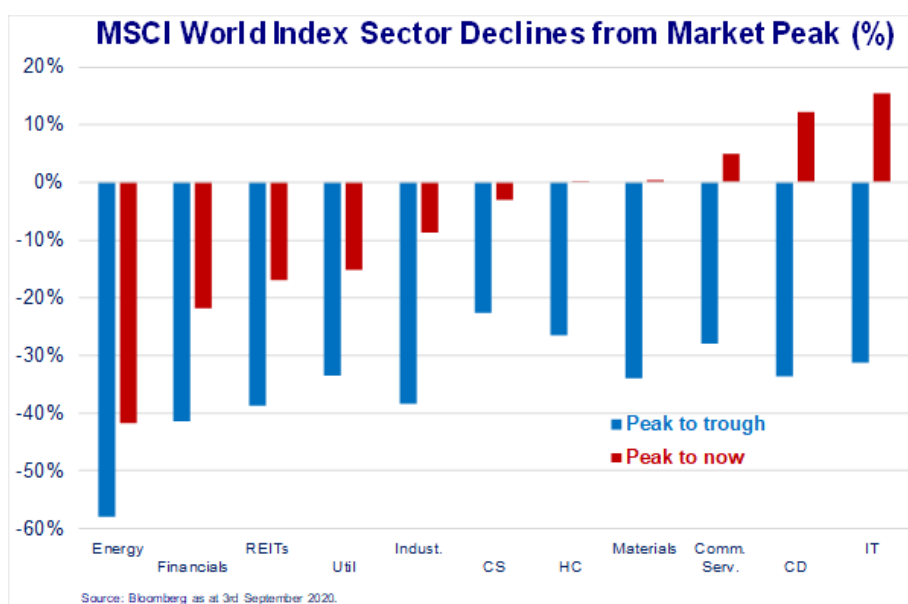
• EQUITIES

- The MSCI World Index declined -2.7% which was its largest single day loss in 12 weeks with all 11 sectors closing lower for the first time in 3 weeks. Tech (-5.5%) led the pace of losses amid major declines in Apple (-8.1%), Microsoft (-6.2%), Google (-5.1%), Amazon (-4.6%) and Facebook (-3.8%) which

pushed our Magnificent 5 tech index down -6.2% (its largest decline since mid-March (see chart) since when the index had risen 96%. Meanwhile, consumer discretionary (-2.9%) was weighed down by retailing, Amazon and autos, and communication services (-2.8%) was pulled lower by weakness in interactive media including Google. At the other end of the spectrum, financials were a relative outperformer given their lack of recovery since March and energy held up best (-0.4%) even though a lower crude price saw the sector record its 14th decline in the past 16 trading session with the total decline now at -9.3%.



By the end of trading, there was surprisingly little change in our peak-to-now chart with energy (-41.4%) still down by more between February and September than any sector was down between February and April (see chart) and financials (-21.8%) remains the only other sector in bear market territory. Meanwhile, REITs (-16.9%) and utilities (-15.1%) aren't too far away, whereas five sectors have recorded a complete recovery (see chart).



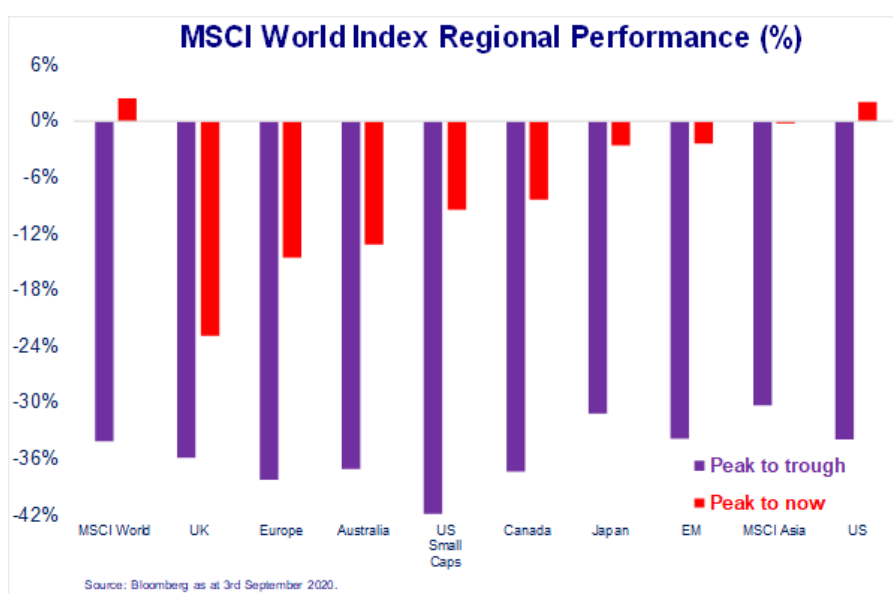
- Among the regions, the pace of losses was led by the US (-3.5%) where the S&P 500 recorded its largest loss since June and the NASDAQ100 since March, with all 11 sectors lower for only the second time in the past six weeks. The primary concern here was overbought markets and very crowded conditions in big tech which for the day outweighed the recent tailwinds of central bank liquidity, vaccine optimism, economic surprise momentum, record earnings beats and FOMO. Economic data was constructive with claims falling below 1 million for only the second time since the March quarter health crisis, and the August ISM services gauge declining but remaining firmly in expansion territory. Meanwhile, Senate Majority leader McConnell expressed some doubt about a fifth coronavirus relief bill being passed before the election and there was lots of discussion about the latest flurry of polls showing Biden holding a solid lead nationally but Trump closing gap in battleground states. By the closing bell at

the NYSE, there were losses all around led by NASDAQ 100 (-5.0%), S&P 500 (-3.5%), the Russell 2000 (-3.0%) and the Dow Jones (-2.8% to 28,293).

European shares reversed early gains and closed lower (-1.0%) triggered by the sharp opening losses on Wall Street. The early focus was on economic data where the final Eurozone PMI was revised slightly higher amid German strength, but there was still a notable loss of momentum from July, which has been reflected in other leading indicators recently. This trend has also been evident in the UK services sector where the PMI reading was revised down with job losses accelerating, but the index still printed at a 5-year high. Meanwhile, Eurozone retail sales unexpectedly fell in July. On the stimulus front, France announced the details of a two-year €100 billion recovery plan including large investments in green energy, transport and industrial innovation. By the regional bell, there was red ink in most markets with losses led by Switzerland (-1.6%), Italy (-1.5%), the UK (-1.5%), Germany (-1.4%), Sweden (-1.3%) and France (-0.4%), whereas Spain (+0.1%) was the sole market to close higher.

Asian markets closed lower (-0.3%) in a quiet session in which there was modest macro dataflow and no change in the underlying market narrative. Previous gains in the US tech sector flowed through to regional tech plays, with vaccine optimism also boosting sentiment although this was somewhat watered down relative to the prior US session. In macroland, China services activity eased based according to the Caixin PMI, Japanese services activity dropped on new orders weakness and the Australian trade surplus shrank amid rising imports and lower commodity export shipments. Meanwhile, geopolitical headlines worsened as US Secretary Pompeo announced curbs on Chinese diplomats visiting US universities. By the closing bell, the MSCI Asia Pacific Index was lower (-0.3%) with advances in South Korea (+1.3%), Japan (+0.9%), Australia (+0.8%) and Taiwan (+0.5%) outweighed by declines in India (-0.3%), Hong Kong (-0.5%), Mainland China (-0.6%)

By the close of trading at the NYSE, our peak-to-now chart exhibited little change, with the UK market (-22.9%) the only country in bear market territory, Europe next at -14.5%. The US is still the only market to record a complete recovery (see chart).

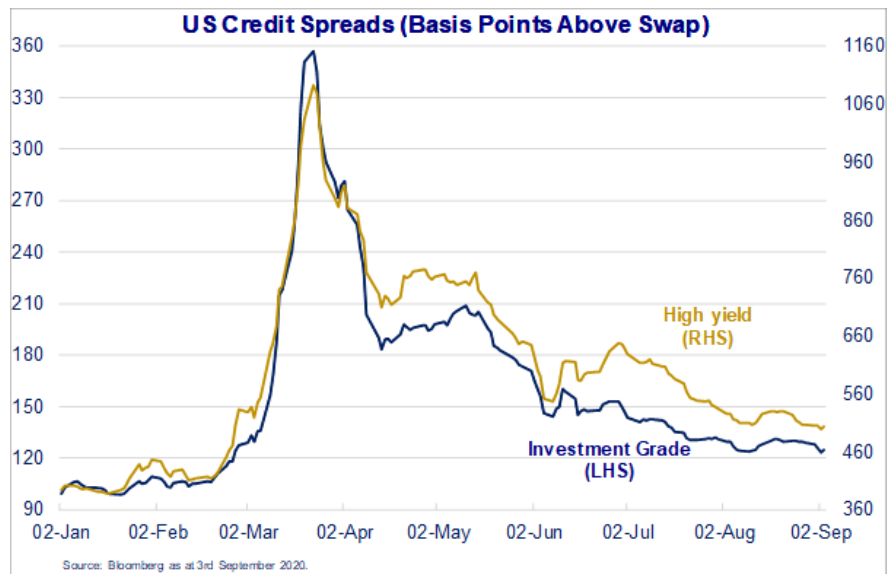


Futures markets suggest sharp opening bell losses this morning in Asia with prices pointing to declines in Australia (-2.0%), Japan (-1.7%) and Hong Kong (1.3%).

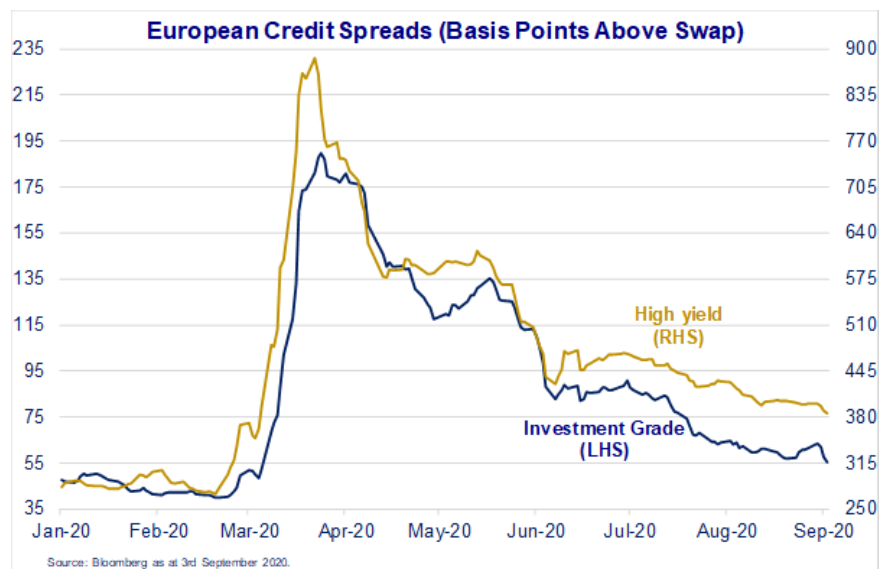
• CREDIT MARKETS

- **Regional credit indices were mixed overnight with spreads in the US investment grade universe up +2 points to +125 bpts, which lowered the recover rate one notch to 91%.** This was the first spread increase in the past eight sessions with all 11 subsectors recording capital losses although the price declines were minor and limited to a couple of basis points. Meanwhile spreads in the high yield universe increased +4 points to +503 bpts, which lowered the recovery rate one notch to 86% with higher risk premiums priced into ten of the 11 subsectors. This was the first spread increase in the past nine sessions, but the largest

rise was in industrials (+7 points, +634 bpts, 58%) and tech (+6 points, +417 bpts, 84%). Despite the decline, not one sector in this universe has moved by more than ten basis points in the last seven sessions which suggests market prices are quite stretched considering the likely default cycle ahead.



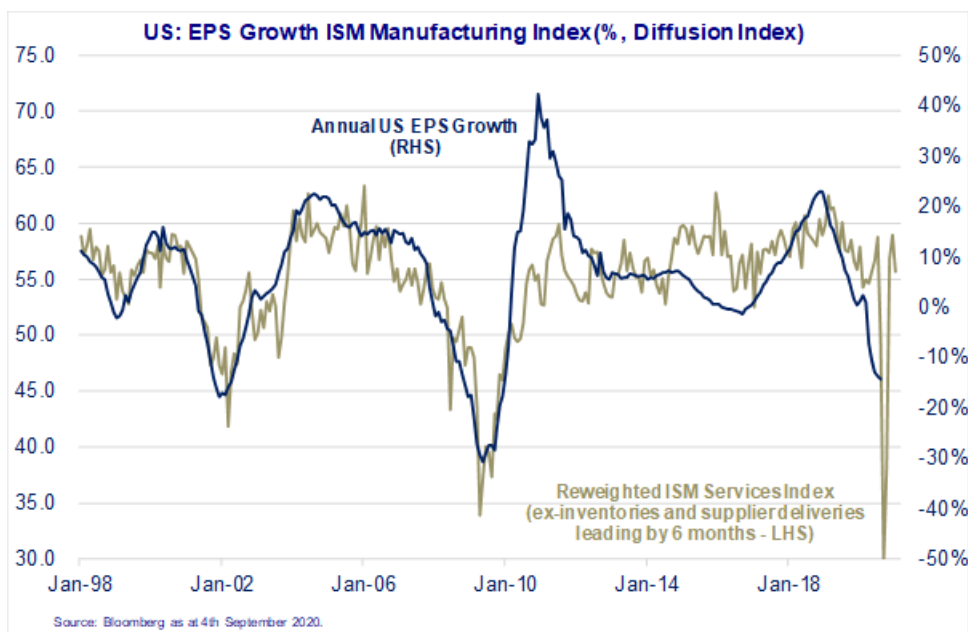
- European credit markets rallied overnight** with spreads in both universes now at post-March lows. In the investment grade universe spreads declined -2 points to +55 bpts, which increased the recovery rate to 90%. All 11 subsectors recorded lower spreads, but only subordinated financials (-7 points, +135 bpts, 87%) beat the market tape as investors embraced more risk, but this may not last long as the European recovery is showing signs of moderating. In the high yield universe, spreads declined another -3 points to +385 bpts which increased the recovery rate one notch to 82%. All 11 subsectors rallied but only consumer staples (-10 points, +505 bpts, 92%) and energy (-8 points, +481 bpts, 79%) were of note, with the former just recovery part of the Wednesday selloff.



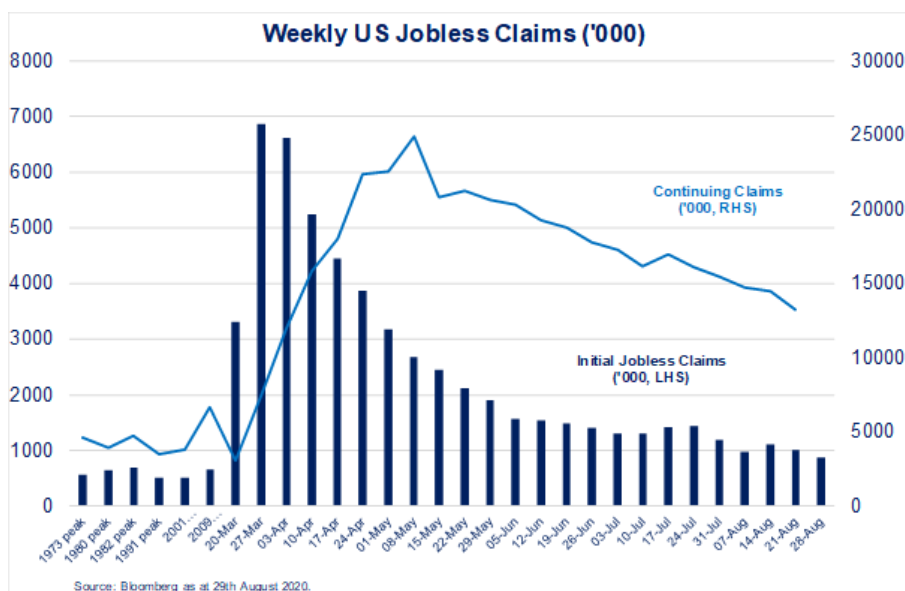
THE GLOBAL ECONOMY

- The ISM services gauge for August declined by -1.2 points to 56.9** which was close to street estimates. However, things were quite mixed below the surface with new orders (56.8 vs July's reading of 67.7) much weaker, with activity (62.4, 67.2) also lower, but employment improved significantly (47.9, 42.1) even though it remained in contraction territory. The headline number was also supported by longer supplier delivery times which rose from 55.2 to 60.5, its highest level since May, but when this and inventories are excluded and the index is reweighted, it suggests that annual US earnings growth should be back in positive territory

in the first quarter of 2021 – this is a similar conclusion to the manufacturing gauge from earlier this week. The employment subcomponent also provides some hint about some upside risk to tonight's August payroll report, but I would caution investors about over-analysing a diffusion index which only asks firms whether activity is rising from low levels. That said, the rising employment subcomponent, suggests the reopening rebound extended into August.



- **Initial jobless claims came in at +881k for the week to 28th August which is below 1 million for only the second week since March.** However, the declines reflected new methods of seasonal adjustment rather than underlying improvement, so comparisons the prior numbers are spurious. Indeed, non-seasonally adjusted claims (NSAC) increased +8k over the week. Along those lines, NSAC have been declining at an average rate of -6% per week since June, albeit with some weekly variation, and last week there was a 20% increase in NSAC in California, which has witnessed ravage from bushfires in recent weeks, but excluding this state, claims declined -4.3% w/w, which is not far away from its recent levels. Meanwhile, continuing claims came in at 13.25 million (-0.8 million to 13.1 million on a NSA basis) in its most recent week which brings the total jobs recovery to 9.7 million from the peak and this suggests that the labour market recovery is continuing.



- **European retail sales declined -1.3% m/m in July relative to consensus which expected a +1.4% m/m rebound** which confirms a notable moderation in consumer spending from the June rate of +5.7% m/m. The July reading meant the annual rate also slipped (to +0.4% y/y – the street was at +3.5% y/y) and this was a surprising result considering the lifting of COVID-19 related restrictions on economies, with Eurostat saying

that clothes and shoes led the decline with food, drinks and cigarettes flat for the month (+1.5% up y/y, but sales of non-food products fell -2.9% m/m (+0.5% higher on the year).

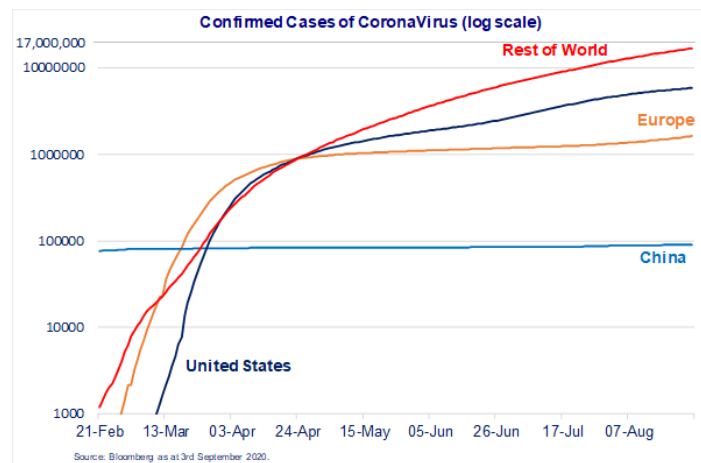
POLICY

- There were no major policy announcements overnight.

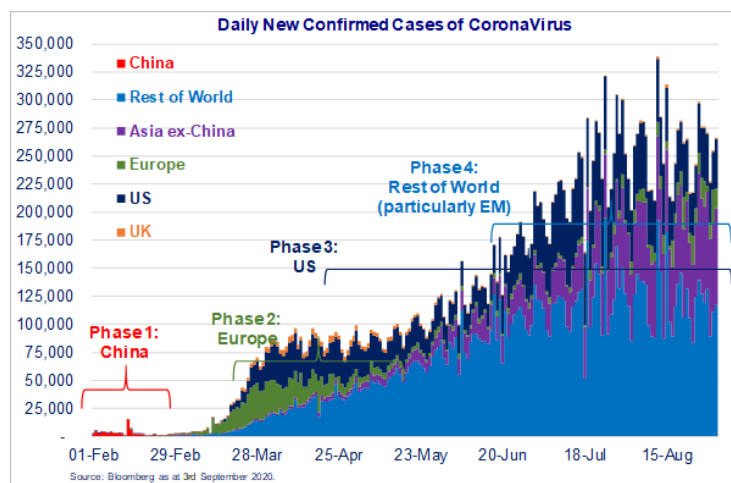
VIRUS UPDATE

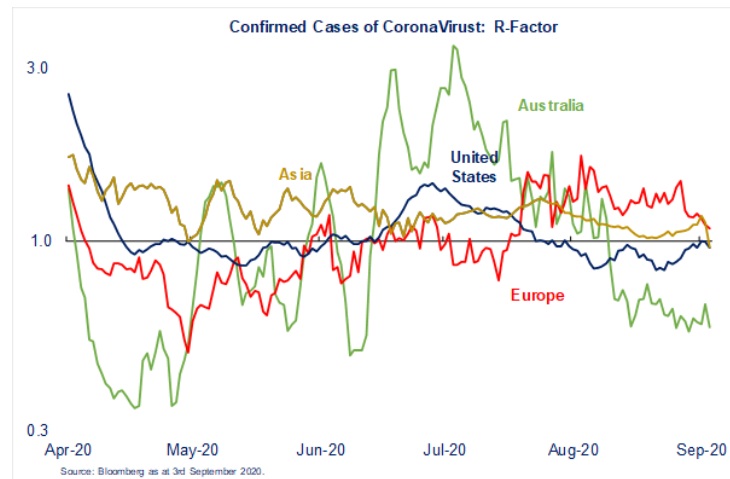
- The number of global cases of COVID-19 is 26.2 million with another +120.1k cases so far (but Brazil, Mexico, India, Peru and Pakistan and 9 US states have not reported their numbers) which means that Thursday is set to be the 47th consecutive day where daily increases are greater than 200k. At present, 8 countries have more than 500k cases, 21 countries have more than 200k cases and 29 countries have more than 100k cases.

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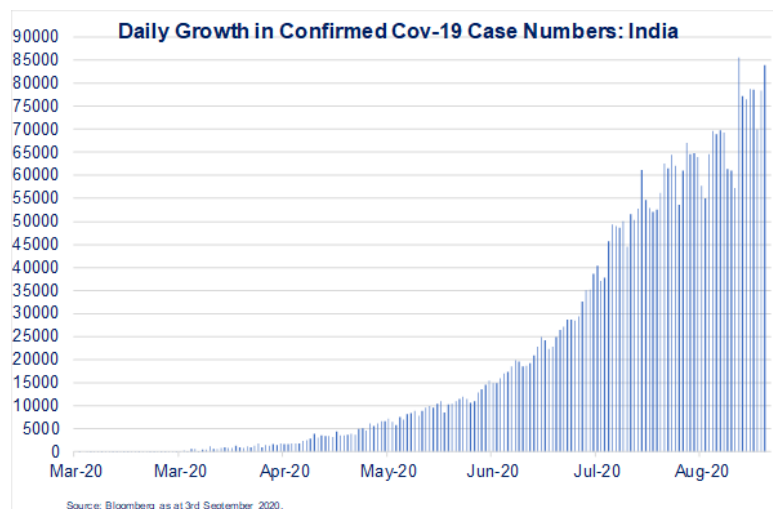
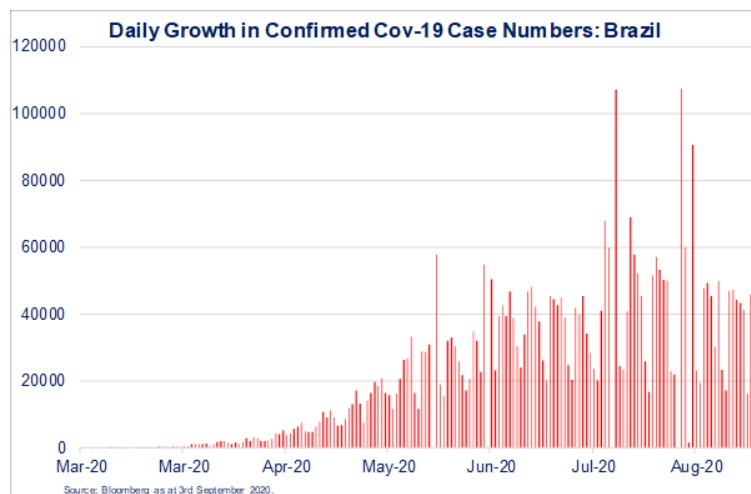
- We break the infections into four groups – the US, Europe, China and ‘others’ and the rest of the world outside the G3 economies now has the most total cases (+64.5k to 22.9 million) and highest daily new cases (and by a considerable margin) followed by the US (+32.9k to 6.15 million, although 9 states 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 (+21.6k to 1.77 million - see chart) which is the only region with an R-factor above 1.0 which indicates that the infection rate (1.10) is too high.

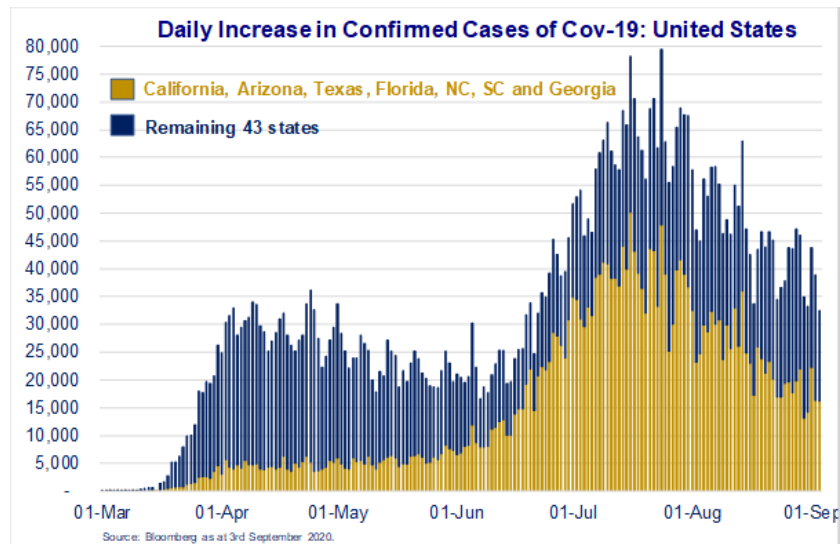




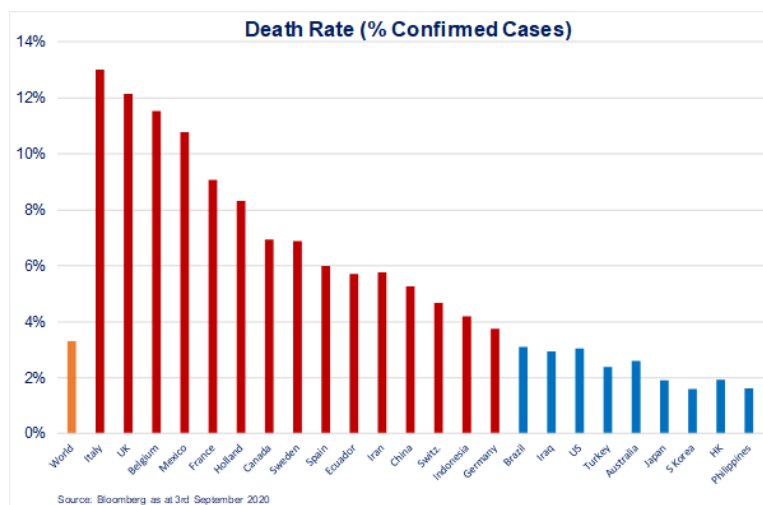
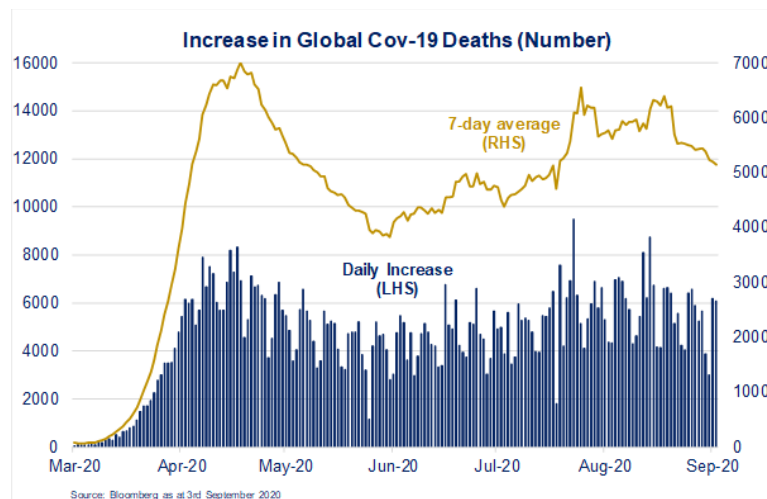
- Among countries, the most cases are in the US (+32.9k (so far) to 6.15 million, with 9 states yet to report), Brazil (not reported, 4.04 million), India (not reported, 3.85 million), Russia (+5.0k (3 week high) to 1.01 million), Peru (not reported, 657.1k), Colombia (+9.2k to 633.3k), South Africa (+2.4k to 633.0k), Mexico (not reported, +610.9k), Spain (+8.9k, 488.5k), Chile (+1.8k, 416.5k), Iran (+2.0k to 380.8k), United Kingdom (+1.8k to 342.7k), Saudi Arabia (+0.8k to 318.3k) and Bangladesh (+2.2k to 319.7k). Australia confirmed cases rose +126 to 26.1k yesterday which placed us 66th in terms of total infections.

Elsewhere, Singapore recorded +48 new cases to 56.9k most of which are linked to foreign workers who are forced to live in crowded dormitories, but Indonesia (+3.6k (second highest on record) to 184.3k) is now on the rise and has the second most cases in the region behind only the Philippines (+2.0k to 228.4k).





- Although final numbers are not in until 1pm AEST, the global death rate declined to 3.31% with the global total to 866.6k after another +3.8k deaths overnight, so far, which indicates the daily average deaths is stabilising again (see chart). The US (+1.0k so far) has the most deaths at +186.7k, with Brazil (not reported, 124.6k), India (+1.1k to 67.4k), Mexico (not reported, +65.8k), the UK (+13 to 41.6k), Italy (+10 to 35.5k) and France (+20 to 30.7k) all over +30k. The death rate is highest in European countries where the health systems had collapsed led by Italy (-0.1% to 13.0%), the UK (steady at 12.1%), Belgium (-0.1% to 11.5%), France (-0.2% to 9.1%), the Netherlands (-0.1% to 8.3%), Sweden (steady at 6.9%) and Spain (-0.1% to 6.0%). However, several emerging markets are now on the leader board including Mexico (+0.1% to 10.8%), Ecuador (-0.1% to 5.7%), Indonesia (steady at 4.2%) and Brazil (steady at 3.1%).



Yours sincerely,



MATT SHERWOOD
Head of Investment
Strategy, Multi Asset



MICHAEL O'DEA
Head of Multi Asset

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Perpetual Investments 1800 062 725

Email investments@perpetual.com.au

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