Perpetual Investments

THOUGHTS ON THE MARKET

5th October 2020 - Fiscal policy has got to step up

SUMMARY

- A great win by Collingwood on Saturday night, built on a brilliant plan by Nathan Buckley to go in with tall forwards which finally clicked into gear, much faster ball movement and a great defence. West Coast have one of the most potent forward lines which put the pies defence under constant pressure, but Collingwood have a comprehensive structure in their backline which means they can withstand intense pressure better than nearly any other side. There is perhaps a message in that for investors who in a subdued growth backdrop and likely policy withdrawal, need a comprehensive portfolio defence to address periodical spikes in market volatility which are likely ahead.

- Despite a slowing growth backdrop, global risk markets rallied last week with solid gains in both equity and credit markets across most regions. The gains snapped a four-week losing streak in equities which culminated in the global market's first monthly decline since March, and high yield credit also recovered significant lost ground as spreads tightened. More importantly, the recovery has continued in the earlier stages of this week with President Trump informing the world that he will be leaving Walter Reed Hospital Monday night meaning that the market's focus will now switch to the US Congress's ability to agree on a fifth COVID-19 stimulus package.

  Markets are running on the idea that President Trump's recent illness increase the odds of another stimulus package. That to me is an aspirational goal for investors, but it is one which remains highly optimistic as the sides remain far apart on the size and scope of the desired program. However, the package is badly needed as without a breakthrough on the vaccine front, the US and global economies are only modestly recovering and in 2020 advanced economies are forecast to contract -5.0% even though the global fiscal impulse is +5.3%, and the shadow unemployment rate is much higher than official numbers indicate given furloughed workers programs etc. With interest rates at zero and the economic recovery being fragile and labour market recovery continuing to moderate, fiscal policy has got to step up, and the stage will be Josh Frydenberg's tonight in Canberra.

  In other markets, 10-year US Treasuries declined sharply with yields up +10 points to 0.78% with curve slope up to 0.69% (both four-month highs), commodities rallied with oil (+1.8% to USD39.43 per barrel) outperforming gold (+0.7% to USD1,914 per troy ounce), and G10 currencies were mostly higher against a weaker Greenback with gains led by the Euro (+0.6% to 117.85), Sterling (+0.4% to 129.85) and the AUD (+0.3% to USC71.82), whereas the Yen bucked the trend and closed lower (-0.4% to 105.7).

- There was not a lot of macro data last week and a vast bulk of releases were 'final' estimates for GDP growth and regional PMIs with no material changes from the flash estimates. However, the September US non-farm payrolls had a large miss but this was mostly explained by reduce public sector hiring and was partially offset by upgrades to July and August numbers. While US unemployment fell to 7.9% it was driven by weaker participation as the household survey employment increased by just +275k which is a worry as the employment to population ratio was flat at 56.6% with the number of permanent job losses increasing +345k to 3.8 million. There was also a continued moderation in service sector employment which provides the vast bulk of employment and is most impacted by COVID-19.

  Another worry is weak inflation, or falling deflation, in both Europe and Japan. This is me more closely resembles what is likely in the year ahead (than the recent rise in US inflation) as a smaller fiscal stimulus package in those regions has seen a weaker consumer response. This means large output gaps especially in

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service sectors which is likely to see firms lose pricing power as businesses fight for a limited market share, and for their survival.

- The number of global cases of COVID-19 is 35.34 million with another +255k cases so far (but Brazil, Colombia, Mexico and South Africa and 9 US states have not reported their numbers) which means that Sunday was the 77th consecutive day where daily increases were greater than 200k. At present, 12 countries have more than 500k cases, 25 countries have more than 200k cases and 40 countries have more than 100k cases. More importantly, the growth rate of daily confirmed cases (+1.0% since Thursday) is steady. Meanwhile, deaths stand at 1.04 million and the death rate was steady at 2.94% although the number of daily deaths remains elevated.

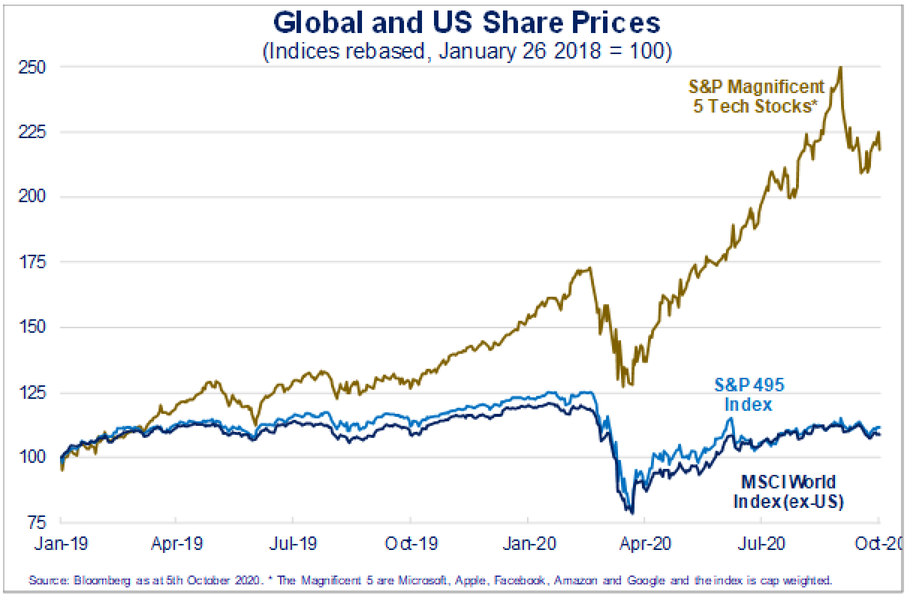
FINANCIAL MARKETS

- **EQUITIES**
  - **The MSCI World Index closed +1.5% higher last week which snapped a four-week losing streak dating back to end-August and closed out the first monthly decline in the global index since March.** Among the sectors, 10 advanced led by several defensive sectors which delivered outsized including REITs (+3.4%) and utilities (+2.9%) as investors focused on some potential M&A activity after firms raised capital. Meanwhile, **financials (+2.3%)** outperformed with solid gains among the banks despite the US Fed extending their restrictions on dividends and buybacks into 2021, but this was widely expected.

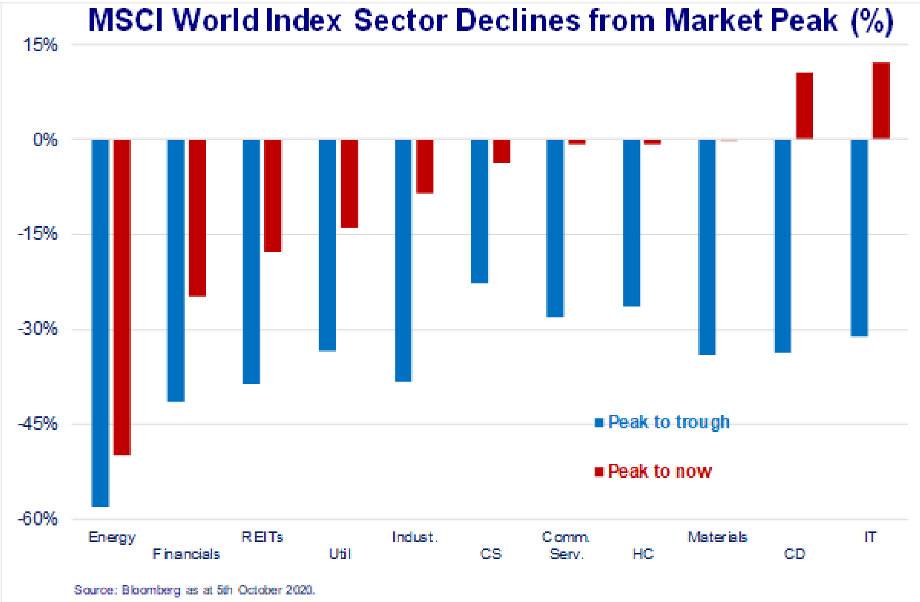
    In contrast, other cyclical sectors struggled with **industrials (+1.0%)** lagging the market tape with pockets of weakness in rail and trucking names, and materials (+0.5%) also underperformed as weakness in paper and packaging were offset by advances in precious and industrial metals names. Meanwhile, energy (-3.8%) was the worst performer for a second straight week as the price of crude continued to slide on excess supply concerns as Libya came back on stream.

    Elsewhere, tech exposed sectors were middle of the field with **consumer discretionary (+2.0%)** up strongly as homebuilders, apparel retailers, housing-related retailers and autos outperformed and offset a modest advance in Amazon (+1.0%). Elsewhere, **communications services (-1.4%)** slightly lagged on weakness in video game names and also news that large layoffs in names including Disney (-1.2%). Similarly, IT (-1.1%) underperformed the market tape as solid rises in semiconductors were offset by more modest consolidation in platforms including Google (+0.9%).

    The modest movements in tech names culminated in Perpetual's Magnificent 5 Technology Index posting a more modest gain (+0.5% - see chart) for the week whereas the S&P 495 posted a five-week high advance (+2.0%) and outperformed the MSCI World ex-US (+1.3%).



Despite advances in most sectors, only two sectors are now above their respective February 2020 peaks (see chart). Meanwhile, energy is now -50% below its February peak which meant that that its recovery rate has slipped to just +14% from its March trough, with financials (-25%) being the only other sectors in bear market territory after the rally in REITs (-18%) saw it move into correction territory along with utilities (-14%).

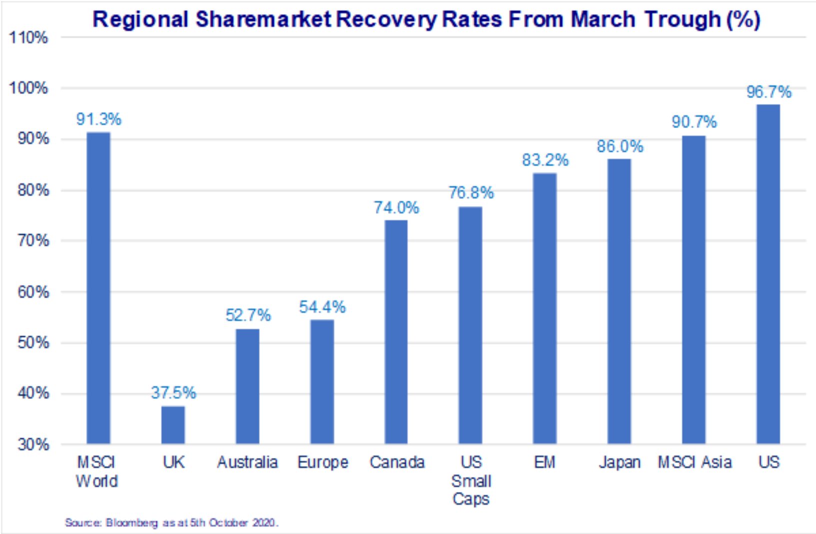


- **Among the regions, the pace of gains losses was led by Europe (+1.7%) which recovered around one third of the prior week's losses.** In terms of the market narrative very little changed with uncertainty remaining elevated given the COVID-19 second wave and stalled Brexit negotiations. That said, vaccine development continues to progress, liquidity conditions remain favourable for risk assets and European governments continue to implement targeted action to contain the virus rather than initiating a second round of national lockdowns. On the data front, information flow was minimal and conveyed no change in annual rates other than Eurozone inflation which printed at -0.3% in September for the headline rate (five-year low), and at a record low of +0.2% y/y for core, and these results reinforced expectations of more ECB stimulus. By the end of the week the pace of advances were led by France (+2.0%) and Italy (+2.0%) which made up for being the two worst performers in the prior week, with Spain ((+1.9%) not far behind followed by Germany (+1.8%), Sweden (+1.7%), the UK (+1.2%) and Switzerland (+0.7%).

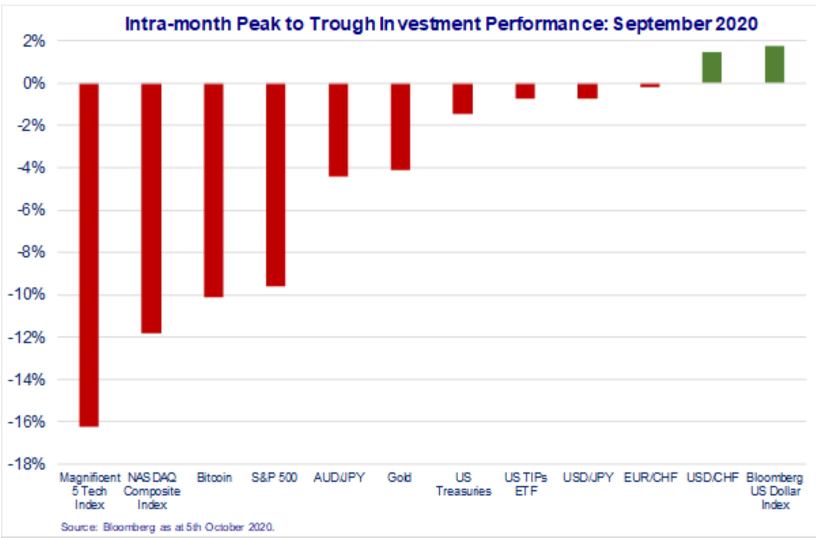
- **The US market (+1.5%) recorded a similar size rise to Europe and recovered the prior two weeks of losses with the index now only -1% below its peak of February** (which it passed in August and September). The simplest suggestion of the market rally was a bounce from the September drawdown which was driven by the removal of tech sector excesses more than a change in the macro narrative. However, the economic data is suggesting a sizable moderation from the pace of June, July and August, but this was expected. Indeed, the September nonfarm payrolls slowed more than expected in September (+661k versus the street at +858k) and while the ISM manufacturing gauge missed (55.4 , 56.3) it remained at solid levels. Meanwhile, there were renewed hopes about a fifth COVID-19 stimulus package, but a wide gap remains between both parties around the size and scope of the program so nothing of note changed there. There was also no material movement in the US opinion polls with President Trump trailing by -7% nationally and by about -3.5% in the swing states with the election only four weeks away, with a Democrat clean sweep now looking the most likely outcome. There was a bit of volatility around President Trump tested positive for COVID-19 but the case seems mild. By the closing bell at the NYSE, the weekly advance were led by the Russell 2000 (+4.4%) which recovered the prior week's decline, the Dow Jones (+1.9%) with the S&P 500 and NASDAQ Composite (both +1.5%) lagging the other gauges.

- **In contrast the solid gains in Europe and the US, Asia had a more mixed week with the MSCI Asia Pacific index up a modest +0.7%.** Macro data was mixed with China having a better than expected PMI result in both manufacturing (+0.3 to 51.5) and services (+0.7 to 55.9) which suggests that its combination of virus containment, supportive macro policy settings and its large manufacturing sector has it on a path to record a complete recovery by years' end. In contrast, Australian data was soft with retail sales (-4.0% m/m) and private sector credit (-0.0%) weighed down by the Victorian lockdowns. On policy there was more talk around another Japanese spending program but the market impact here was outweighed by appreciation of the Yen, whereas Australian investors have been drip-fed Budget leaks which have been centred around the bringing forward of tax cuts, incentives for people to buy newly constructed homes and plans to get small business hiring again. The FY21 Budget will be released 7.30pm tonight and will require a raising of the debt ceiling to over AUD1.1 trillion. There wasn't a lot else and by the closing bell in Mumbai on Friday night, regional gains were limited to Hong Kong (+1.0%) and China (+0.4%), whereas many market closed lower for the week including Japan (-1.5%), Korea (-1.6%), Australia (-2.0%) and India (-2.3%).

- **By the end of the week's trading, the UK (-22.5% and a recovery rate of just 37%) remained the only bourse in bear market territory (see chart)**, whereas Australia (-17.5%, 53%) and Europe (-17.4%, 54%) remained in correction territory, with both US small caps (-9.7%, 77%) and Canadian shares (-9.7%, 74%) just above that level. Conversely, the US market (-1.1%, 96.7%) appears close to moving above its February peak for a third time.

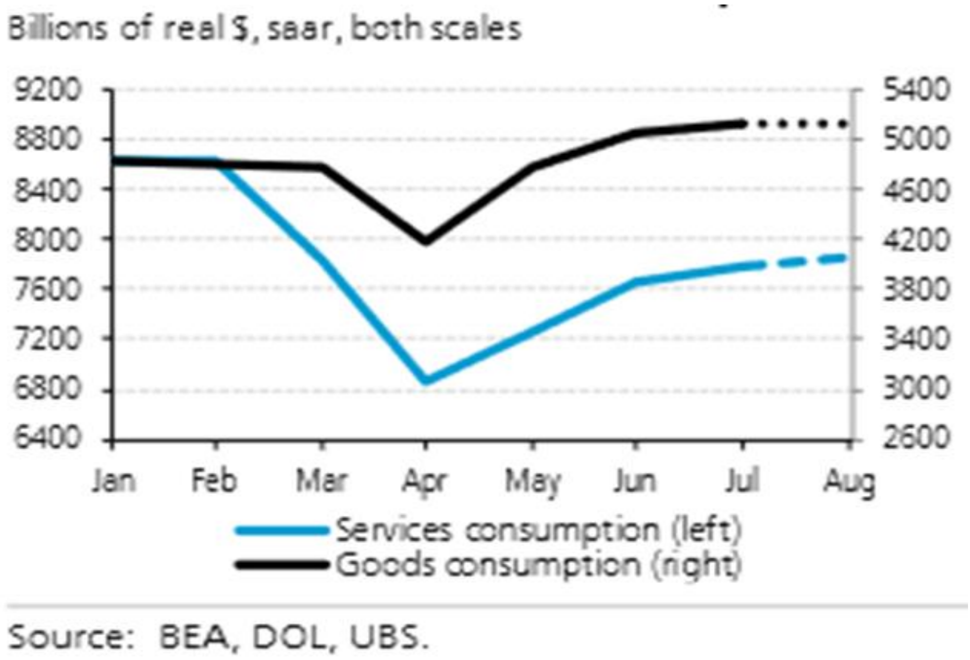


- **The US sharemarket September selloff (-3.9% m/m) was the first monthly decline since March, and the largest September decline in nine years, but intra-month the -9.6% plunge in the S&P 500 was interesting in terms of how other assets performed.** From the intra-month peak (2nd September) to the intra-month trough (23rd September) most equity markets declined sharply, but triggered little sympathy in safe havens with gold (-4.1%), US bonds (-1.7%) and US TIPs (-0.8%) all suffering capital losses over the period. Indeed, **the sharp co-movement lower in our Magnificent 5 Tech index, inflation break -evens and gold (see chart below) suggests an unwinding of overvalued positions was responsible for the market losses, rather than a fundamental reassessment of global or regional growth dynamics.** In fact, macro data has held up quite well despite fears of the US fiscal cliff, although growth is moderating in nearly every advanced economy as the September quarter ended. Accordingly, market risks ahead are likely to be based around the type of recovery priced in, rather than the global economy double-dipping in the wake of stimulus withdrawal.



We expect global growth to peak at +8% q/q in the September quarter and then step back to about +2% q/q in the December quarter (which is still well above-trend) to close out 2020 at -4.0% y/y, with the calendar year decline dominated by advanced economies (-5.25%) whereas EM (-2.0% y/y) is expected to moderate less given the sustained recovery in China (+2.3% y/y).

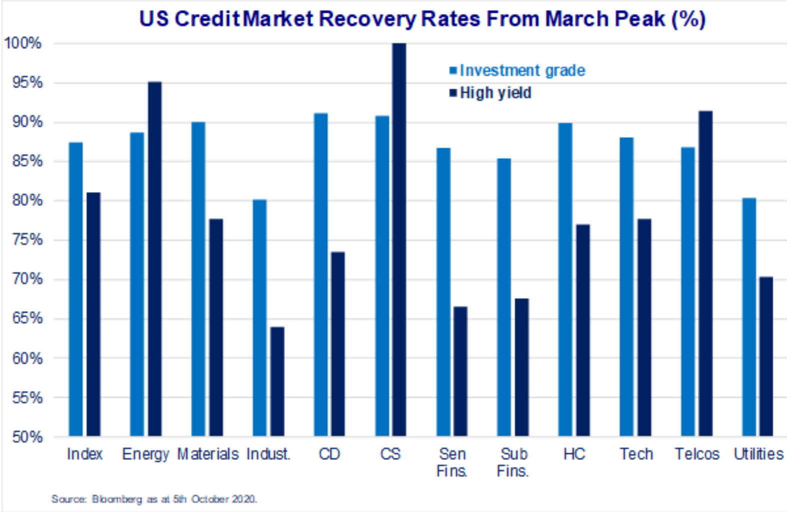
The recovery in the goods sector (spending, production and trade) is running well ahead of services. Indeed, retail sales have generally moved to about flat on an annual basis (or slightly positive) but **services demand is depressed** and still well below pre-COVID-19 levels (see chart) and the challenge here is that the latter contributes the vast bulk of employment in advanced economies, suggesting that the labour market recovery will be a slow process and that business confidence remains subdued and stimulus-dependant, with hiring slowing and not at levels equivalent with ongoing demand strength.



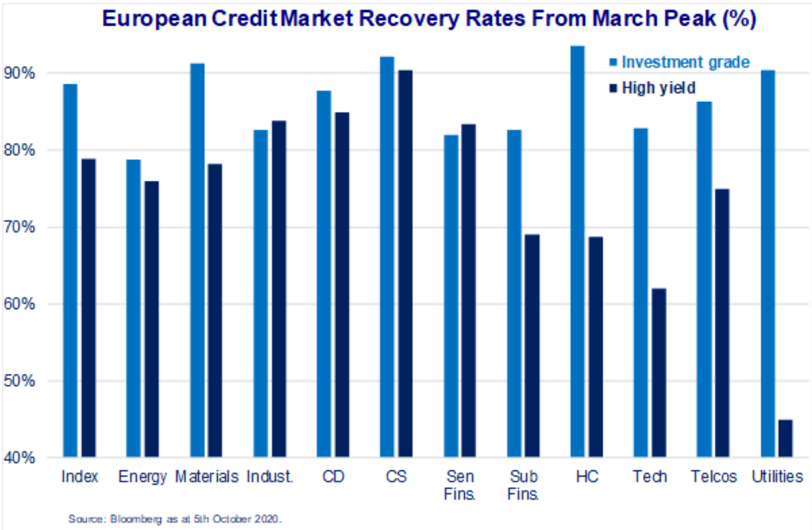
While employment flows remain upbeat relative to history, gross US job layoffs still remain higher than at any point during the Global Financial Crisis, and some of the outflow from continuing claims is starting to be influenced by expiring benefits. Tightness in state/local government budgets and lack of fiscal transfers is starting to impact hiring (witness the sharp drop in education payrolls). The key here is what happens post-election in terms of the anticipated fifth stimulus package.

- **CREDIT MARKETS**
  - **Regional credit indices rallied over the past week with spreads in the US investment grade sector contracting -2 points to +135 bpts, which increased the recovery rate one notch to 87%.** The capital gains meant this sector recovered around one fifth of the capital losses from the prior week with eight subsectors recording lower risk premiums led by industrials (-7 points, +139 bpts, 80%) even though economists were busy cutting estimates. Subordinated financials (-6 points, +169 bpts, 85%) also outperformed, but gains were offset by a second week of capital losses in energy (+2 points, +200 bpts, 89%) as investors worried about the global crude price dropping below the USD42 per barrel breakeven level.

    In the high yield universe, spreads declined a collective -26 points over the past week to +539 bpts, which increased the recovery rate four notches to 81%. The spread decrease was recorded in all sub-sectors and enabled investors to recover around one half of the prior week's spread increase with large double-digit declines in cyclical sectors led by industrials (-54 points, +593 bpts, 64%) which has been the laggard since the March spread peak, healthcare (-50 points, +498 bpts, 77%) and energy (-37 points, +850 bpts, 95%).



- **European credit markets rallied over the past week with spreads in the investment grade space declining -2 points to +57 bpts,** which increased the recovery rate one notch to 89%. The capital gains meant was the seventh consecutive week of oscillating performance between gains and losses during which prices have been unchanged and while all 11 sub-sectors recorded lower spreads the overall movements were minor. In the high yield space, there was more price action with spreads decreasing -28 points to +401 bpts, which increased the recovery rate five notches to 79%. The price increase meant investors recovered 60% of the sector losses from the prior week which itself was the largest spread blowout since March, with 8 subsectors recording lower spreads led by industrials (-46 points, +458 bpts, 84%) given a 12-month high in the regional manufacturing PMI, consumer staples (-42 points, +516 bpts, 90%) and consumer discretionary (-31 points, +445 bpts, 85%).

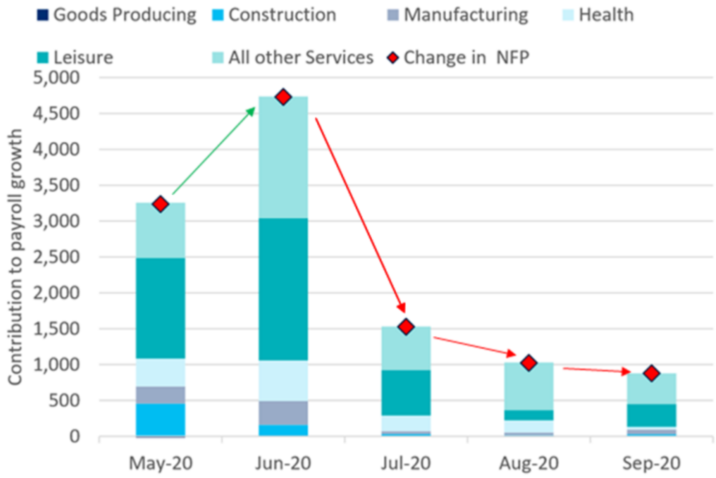


THE GLOBAL ECONOMY

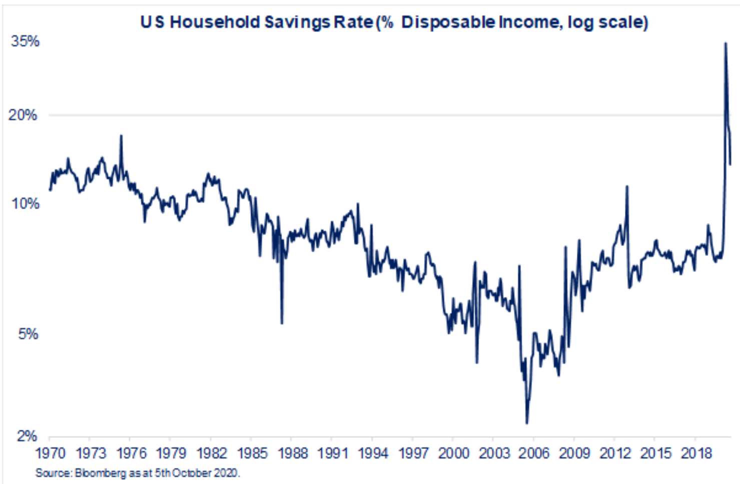
- **The September US non-farm payrolls detailed +661k of jobs growth which was well below the street at 859k.** The forecast miss was primarily driven by a net -216k in the government sector job losses as -40k census workers lost work and Budget tightness at state and local government levels which led to a lessening in essential services. This was partially offset by a net +145k of upgrades in numbers for July and August, but the September result means there is a net -10.7 million of US workers without employment relative to the February peak. Among the sectors, private payrolls at +877k were much closer to consensus at 913k as was hiring in the goods sector (+93k), but services were fairly soft at +784k with retail (+142k), professional business services (+89k) and education (-69k) all somewhat underwhelming. It will be important to see if this softness extends. Among other key sectors, manufacturing hiring was solid at 66k, and leisure and hospitality (which includes restaurants and hotels) more than doubled to +318k (see chart) as the US economy continued its reopening process, but these tailwinds were partially offset by seasonal patterns such as private sector education (-69k) and administrative services (+31k).

Meanwhile, US unemployment fell -0.5% to 7.9%, but a lot of this reflected a -0.3% decline in the participation rate to 61.4% as household survey employment increased by just +275k which is a worry as the employment to population ratio was flat at 56.6% and the number of permanent job losses increasing +345k to 3.8 million. Elsewhere, wages rose +0.1% m/m and +4.7% y/y and while this sounds impressive it mostly reflects compositional changes with low wage workers initially displaced and are now slowly re-joining payrolls.

So overall, the September miss on payrolls growth is not by itself a concern - as it fits into the broadly accepted view that the US recovery will moderate in Q4 and in 2021, but the slowdown in the services sector and the participation rate decline would both be worries if the they persist, but the latter is quite a volatile time series and therefore makes me cautious against reaching any firm conclusion after one month of weak data. That said, the correlated decline in both temporary layoffs and participation could be a sign that some workers who thought they would be swiftly rehired have now dropped out of the labour force and that might explain why the permanent job losses as a share of the unemployed rose +5% to 36%.



- **US personal consumer spending rose +1.0% m/m, as goods spending declined -0.2% m/m with downward revisions to prior months** (totalling -0.8%). This was no surprise as goods spending was already back above pre-COVID-19 levels, but there was a clear shift in spending towards services (+1.4% m/m). Meanwhile, nominal personal income declined -2.7% m/m largely due to the end of the $600 per week supplemental unemployment insurance benefits, which was partially offset by better labour market dynamics with strong payrolls growth in August and higher wages (+1.3% m/m in this report). Importantly, there appears to be some residual supplemental unemployment benefits carried over to August (about one-third of the program's July payments), which imply some downside risk to income growth for September. Together, lower income and higher spending mathematically lowered the US household savings rate by -3.6% to 14.1% which suggest this trend has at most two months to go (see chart) after which spending will more closely resemble trends in income growth.



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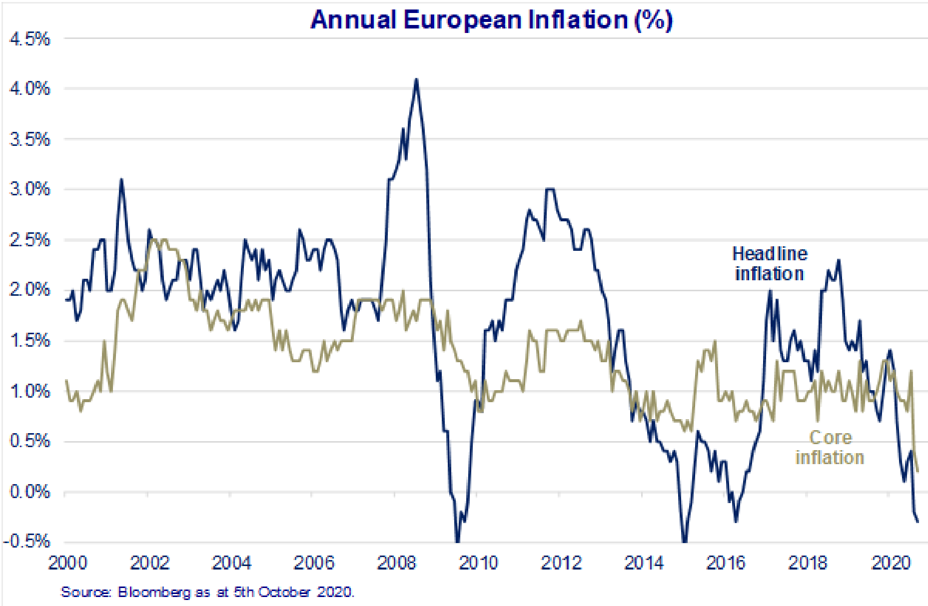
- **European inflation declined in September with the headline CPI declining marginally to -0.3% y/y which is a post-February 2015 low.** Among countries, deflation is widespread and strongest in Italy (-0.4% to -0.9% y/y) and Spain (steady at -0.6% y/y), whereas Germany (-0.3% to -0.4% y/y) and France (-0.3% to -0.4% y/y) had better annual results but worse monthly numbers. The aggregate of these countries is consistent with Eurozone headline deflation at around -0.4% y/y, which suggests a positive contribution from smaller countries who publish their numbers in three weeks' time. Among the components, food inflation rose +0.1% to +1.8% y/y and energy dropped -0.5% to -8.2% y/y, and when these two components are excluded, the remaining core inflation halved to a record low of +0.2% y/y despite a large September quarter lift in growth.



The downward pressure on services inflation (-0.2% to +0.5% y/y) is particularly concerning as it is normally very stable and could be a precursor to more entrenched disinflationary pressure. The ECB are forecasting very low inflation for 2020, so won't have an urge to do something immediately, but, like the Fed, they are very limited in what effective policy options they have as rates are already negative and the yield curve is low and flat. The go-to-answer here has been more fiscal support combined with QE, but these sorts of policies on the whole have been massively ineffective over the past 8 years as inflation has declined. Nevertheless, there is increased market conjecture that the ECB will be forced to act again, although President Lagarde and Vice President de Guindos pre-emptively argued before the data that it has already anticipated inflation rates close to zero for the remainder of the year with a gradual pick-up next year as the economy recovers.

POLICY

- **It was a busy week of Fedspeak, but the narrative was mostly unchanged** with Kaplan (voter) reiterating the risks of holding rates near zero too long and expressed scepticism about the benefits of enhanced forward guidance given already-low rates. Meanwhile, Williams (voter) said the economy is on a pretty good trajectory, but fiscal policy will tilt that outlook either way. Elsewhere, the Fed extended its restriction on dividends and share buybacks for the biggest US banks through to the end of 2020 in an attempt to reduce the risk of any bank having insufficient capital to cope with elevated non-performing loans, but interestingly Governor Brainard dissented on that decision.

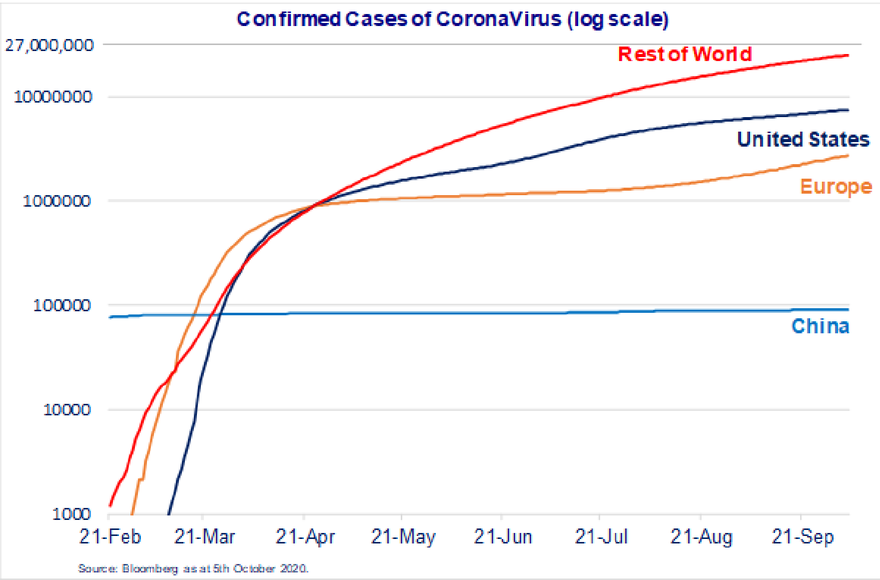
- **ECB President Lagarde laid the foundations for a Fed-style policy framework review. In a keynote speech she said that the ECB will consider a review to let inflation overshoot its target after a period of sluggish price growth.** The thinking here is that such a strategy can (theoretically) help stabilise an economy when faced with the lower bound because it raises inflation expectations and lowers real interest rates. Sadly, the theory falls down as the central bank does not have the tools to generate an inflation impulse in the first place, hence the desire to remain behind the curve would be an aspirational target and nothing more. That said, persistent weak growth and below-target core inflation will spark a policy response, but the timing here is uncertain as the ECB already expects this in 2020 and therefore should have already eased policy.

- **Last week's final round of Brexit talks failed to yield a breakthrough**, with EU lead negotiator Barnier and UK negotiator Frost confirming there were still big differences on fisheries and divergence on level playing fields and state aid. This sparked news that UK PM Johnson will hold talks with European Commission President von der Leyen to try to break the impasse.

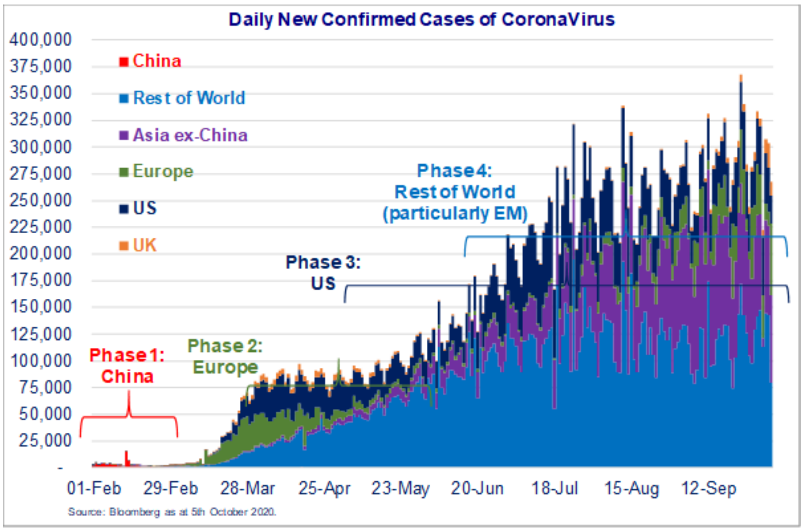
VIRUS UPDATE

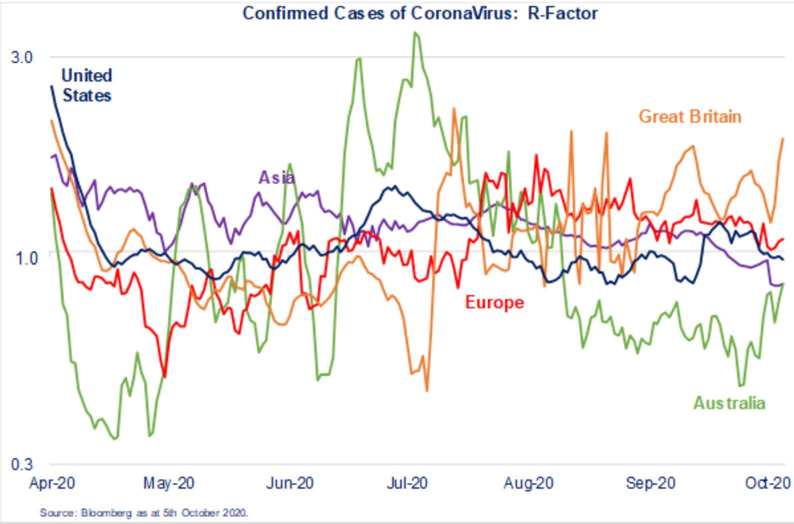
- The number of global cases of COVID-19 is 35.34 million with another +255k cases so far (but Brazil, Colombia, Mexico and South Africa and 9 US states have not reported their numbers) which means that Sunday was the 77th consecutive day where daily increases were greater than 200k. At present, 12 countries have more than 500k cases, 25 countries have more than 200k cases and 40 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 and 4 days. More importantly, the growth rate of daily confirmed cases (+1.0% since Thursday) is steady. Meanwhile, deaths stand at 1.04 million and the death rate was steady at 2.94% although the number of daily deaths remains elevated.



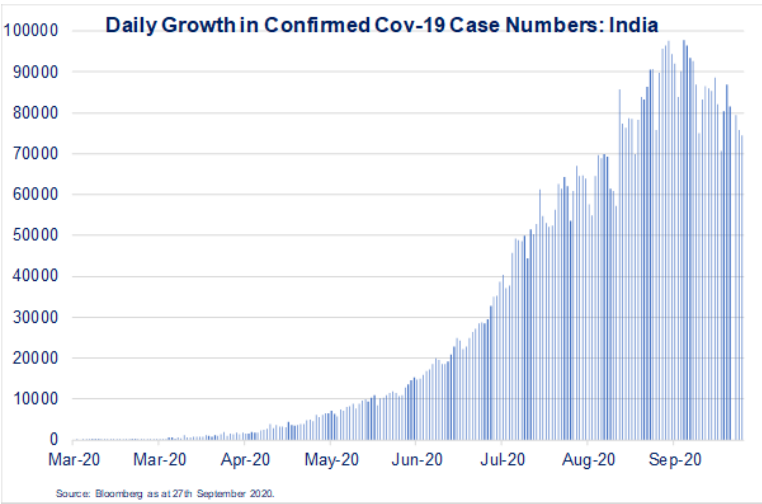
- We break the infections into four groups – the US, Europe, China and 'others' and the rest of the world outside the G3 economies now has the most total cases (+161.1k to 32.83 million) and highest daily new cases (and by a considerable margin) followed by the US (+26.4k to 7.44 million, although 9 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 (+67.3k (second highest day) to 2.74 million - see chart) which is the only region with an R-factor above 1.0 which indicates that the infection rate (1.07 is too high, especially in Britain (1.89).

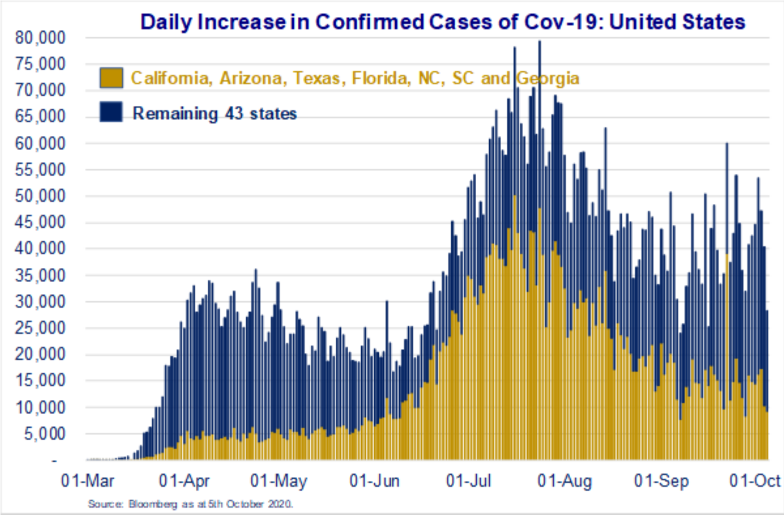




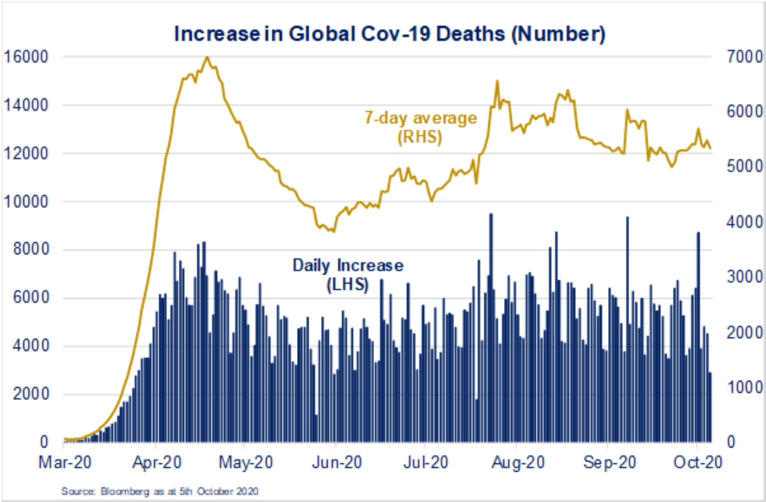
- Among countries, the most cases are in the US (+26.4k (so far) to 7.44 million, with 9 states yet to report), India (+77.4k to 6.62 million), Brazil (not reported, 4.92 million), Russia (+10.8k to 1.22 million), Colombia (not reported, 855.1k), Peru (+6.6k to 828.2k), Spain (+23.5k to 813.4k), Argentina (+12.9k to 798.5k) and Mexico (not reported, +761.7k). Australia confirmed cases rose +9 yesterday to 27.15k yesterday which placed us 78th in terms of total infections.

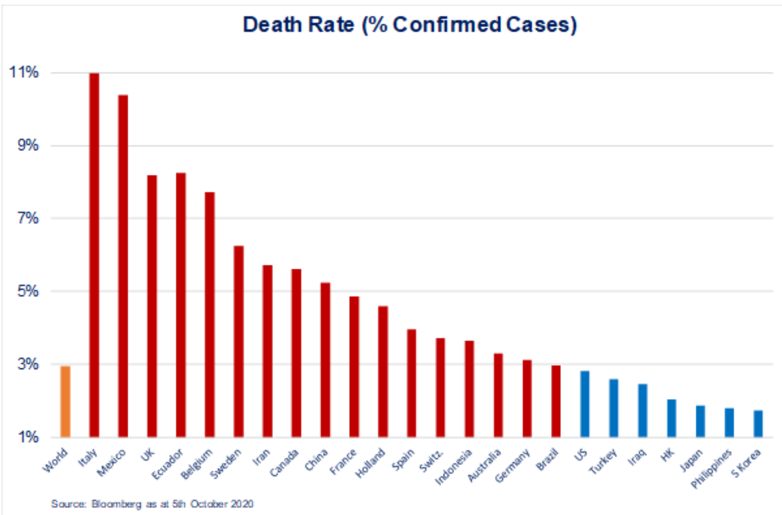
  Elsewhere, Singapore recorded +7 new cases to 57.8k most of which are linked to foreign workers who are forced to live in crowded dormitories, but Indonesia (+3.6k to 307.1k) is now on the rise and has the second most cases in the region behind only the Philippines (+2.3k to 324.8k).





- Although final numbers are not in until 1pm AEST, the global death rate declined to 2.94% with the global total to 1.04 million after another +2.9k deaths overnight, so far, which indicates the daily average deaths is stabilising again (see chart). The US (+0.23k so far) has the most deaths at +210.1k, with Brazil (not reported, 146.4k), India (+1.2k to 102.7k), Mexico (not reported, 79.1k), the UK (19 to 42.5k), Italy (+16 to 36.0k) and France (+145 to 32.3k) all over +30k. The death rate is highest in European countries where the health systems had collapsed led by Italy (-0.1% to 11.0%), the UK (-0.2% to 8.2%), Belgium (-0.1% to 7.7%), Sweden (steady at 6.3%), France (-0.1% to 4.9%), the Netherlands (-0.1% to 4.6%) and Spain (-0.1% to 4.0%). However, several emerging markets are now on the leader board including Mexico (-0.1% to 10.4%), Ecuador (-0.1% to 8.3%), Indonesia (steady at 3.7%) and Brazil (steady at 3.0%).





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Yours sincerely,

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