# THOUGHTS ON THE MARKET

7th December 2020 - Is recent economic resilience the calm before the next growth storm?

## SUMMARY


- **Global risk markets rallied last week, but the pace of the advance is moderating due to some economic moderation and elevated valuations.** Although most analysts are predicting a much stronger year of growth in 2021, the global recovery will not be as straight forward as it usually is at the start of a cycle. Part of this owes to the upcoming quarter of contraction in both Europe and the US around the turn of the year, and the uncertainty about the speed and breadth of the 2021 vaccine rollout. Indeed, Pfizer re-announced a lower 2020 production estimate for its vaccine given global supply chain rigidities. Our calculations indicate that it could take up to 18 months for global herd immunity to be achieved which suggests that some parts of the Northern Hemisphere could face another winter of COVID-19 infections, but if the vaccine's actual results are close to their stage three trial estimates there is no doubt it's a game changer and still depressed service sector activity will progressively lift in the second half of 2021.

  This should see a robust private sector recovery in H2'21 which will outweigh the global fiscal cliff (-2½% GDP) but its distribution will be dependent on who gets inoculated when – i.e. it could be quite uneven. Increased service sector activity will reduce economic spare capacity through time, but **output gaps are not likely to close for three or four years which will keep a lid on inflation as the grind lower in unemployment keeps wages contained.** Headline inflation will rise in the March quarter on base effects, but core inflation will remain very low for an extended period.

  **Official activity data for October and November has been a bit mixed but on balanced it has surprised to the upside.** Although European mobility activity has been moderating since mid-September , the October releases for retail spending and industrial production detailed a still solid expansion, although the services sector PMI for November was the first material data point to plunge lower, signalling a contraction is ahead. For global growth, the constructive factor here is that unlike inter-linked manufacturing supply chains, services sector links across borders and regions are much weaker and therefore can be more isolated. Indeed the November US composite PMI slowed at the margin but only back to a brisk pace of growth, but the November non-farm payrolls shows the supply side of the US economy may be adjusting to increased mobility restrictions and we expect a marked impact in December for all US activity based gauges.

  Despite the upcoming growth hole, numerous vaccines continue to drive markets higher. In 2021 there will still be considerable policy accommodation, but this will begin to lessen through fiscal drag and central banks moderating asset purchases. Meanwhile, low core inflation will limit the rise in bond yields which will be driven by higher real rates, but this will not materially impact booming housing markets around the world. In terms of unemployment labour markets have recovered around half of their losses so far and this will continue in 2021 at a slower speed. Accordingly for financial markets, 2021 is likely to witness a potent combination of stronger growth (from a low base), low interest rates and inflation, and continued (although moderating) policy accommodation – but just mind the pothole in front of you.

- In other markets, 10-year US Treasuries sold off -13 points (4-month high) last week to 0.97% (3-week high) with curve steepening up to 0.89%, and commodities were generally higher with oil (+1.2% to USD46.09 per barrel) up for a fifth straight week whereas gold (+2.9% to USD1,839 per troy ounce) reversed some of its recent losses. Meanwhile, G10 currencies were universally higher against a weaker Greenback with advances led by the Euro (+1.3% to 121.2), Sterling (+1.0% to USD134.4), AUD (+0.5% to USC74.25 which is a 28-month high) and Yen (+0.1% to 104.2).




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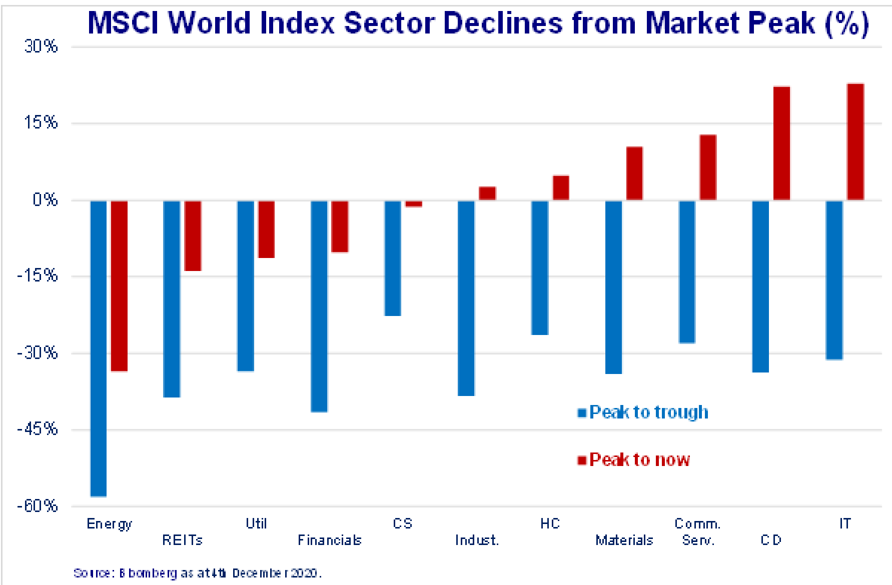
- Last week's **economic data was mixed with a robust bounce in Australia's Q3'20 national accounts following a strong recovery in the domestic services sector. More importantly, significant amounts of unused stimulus and a still extremely high household savings rate, underpins our view that there is likely to be very strong growth ahead in 2021 and 2022 at around +4% per annum**, with a complete recovery by Q3'21, as long as case numbers remain contained. Accordingly, our thoughts are that the RBA is likely to taper its QE program after April 2021, which will see more upward pressure on the AUD through time. In contrast, US data is more holistically pointing to a slowing economy with both ISM readings declining from recent highs (although both are pointing towards still solid growth in Q4) and the November non-farm payrolls (+245k to 142.6 million) confirmed a continued deceleration in hiring with the number of longer-term unemployed rising by +385k to 3.9 million which is now more than one third of total 10.7 million unemployed persons.

- **The number of global cases of COVID-19 is 66.9 million with another +409k cases so far overnight** (but Brazil, Colombia, Mexico, Pakistan, Spain and Sweden, and 18 US states have not reported their numbers) which means that Sunday was the 42nd consecutive day where daily increases were greater than 400k. At present, 24 countries have more than 500k cases, 40 countries have more than 200k cases and 68 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 1.53 million and the death rate has declined to 2.29% although the number of daily deaths remains elevated and hit an all-time high on Thursday.

## FINANCIAL MARKETS

- ### EQUITIES
  - **The global sharemarket recorded its fifth consecutive weekly advance, but the MSCI World Index was up a more sedate +0.3% w/w with 9 sectors recording capital gains.** Among styles, value slightly outperformed growth and at the sector level energy (+3.0%) outperformed its peers for a fourth straight week as the sector added to its record +27% advance in November with investors continuing to be buoyed by the rising crude price and also still attractive valuations. Tech (+2.3%) was another leading sector with strong advances in semiconductors and hardware names including Intel (+9.6%), Qualcomm (+9.6%) and Apple (+4.9%). Healthcare also beat the market tape with vaccine-driven strength in Pfizer (+8.4%) while biotech, hospitals, and most managed care names also outperformed in a broad rally. Meanwhile, Financials (+1.4%) recorded its fifth weekly advance in response to a further steepening in the US yield curve and some M&A activity among asset managers. Elsewhere, defensive names outside medical underperformed with consumer staples (-0.2%) declining as investors reduced their exposure to firmed which don't have leverage to the 2021 economic recovery including Costco (-3.9%) and Walmart (-1.8%), and utilities (-2.3%) brought up the tail of the field. By the close of the week's trading, energy (with a peak-to-trough performance of -33.5%) remained in bear market territory despite its major recovery in the past 5 weeks, with REITs (-13.9%), utilities (-11.3%) and financials (-10.2%) all in correction territory. In contrast, the three tech-related sectors have outperformed since late February including Communication services (+12.8%), consumer discretionary (+22.3%) and IT (+22.9%). but the gap with the other sectors is now diminishing.



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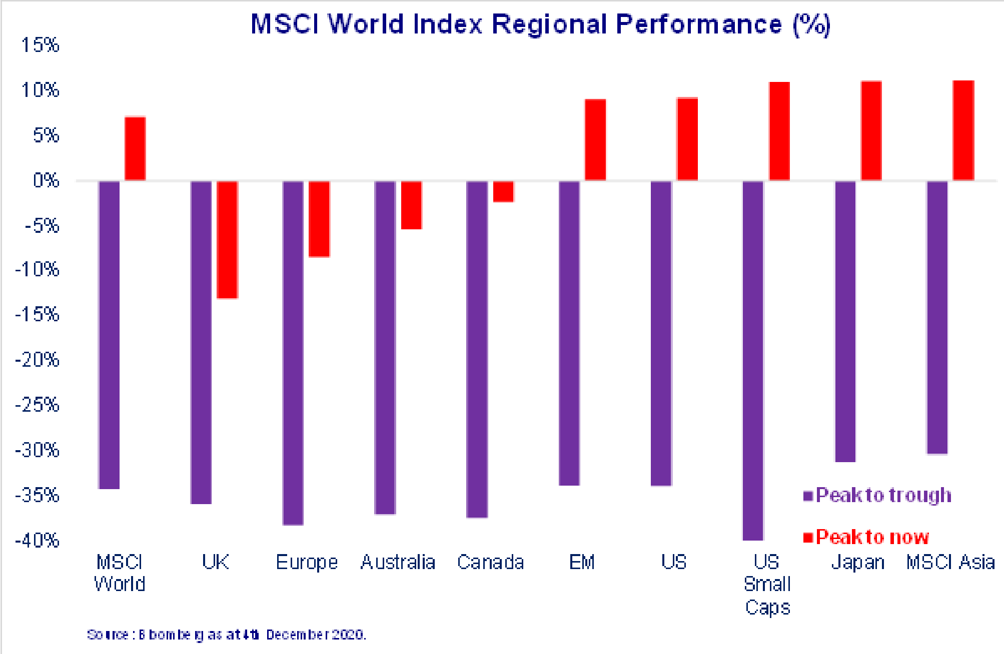
- **Among the regions, the pace of advances was led by the US (+1.7%) with the virus and the vaccine at the epicentre of sentiment trends.** The US recorded record daily cases twice last week which sparked record hospitalisation and record deaths along with new mobility restriction which have begun to weigh on spending decisions. This activity headwind was outweighed by continued vaccine optimism despite Pfizer renouncing that supply chain problems will limit the production rate of its vaccine in the near-term. Higher case numbers also sparked increased optimism of a fifth COVID-19 stimulus package being enacted by Congress with a bipartisan group of senators agreeing on a USD908 billion package which among other things would provide unemployed citizens another USD300 per month for four months, but no stimulus cheques. Meanwhile, macro data was weaker this week with both ISM gauges coming off recent highs and non-farm payrolls continuing to show slowing hiring, all of which sparked concerns that the recent rally was overdone and was due for a pullback. By the close of trading at the NYSE, all broad US indices had posted their fifth straight weekly advance with the pace of gains led by the NASDAQ Composite Index (+2.1%), the Russell 2000 Index (+2.0%), S&P 500 (+1.7%) and the Dow Jones Industrial Average (+1.0%).

  **Asian markets posted their fifth consecutive weekly advance with the MSCI Asia Pacific Index up +0.5%, with South Korea and Taiwan rising to fresh record highs given their tech exposure.** Macro data was supportive with Australia's solid Q3 GDP bounce including a services sector recovery, better than expected industrial production increases in Korea and Japan for October, and China's monthly PMI gauge both came in above the street. On policy, PBOC Governor Yi Gang warned that the central bank will not bail out companies backed by local governments and rejected the notion of debt monetisation, whereas the RBA acknowledged the potential for Australia to outperform its central scenario amid recent vaccine developments. By the close of trading for the week, regional gains were dominated by Korea (+3.7%), India (+2.1%), Taiwan (+1.9%), and China (+1.7%), but Australia (-0.1%), Hong Kong (-0.2%) and Japan (-0.7%) all retreated and weighed on the regional index.

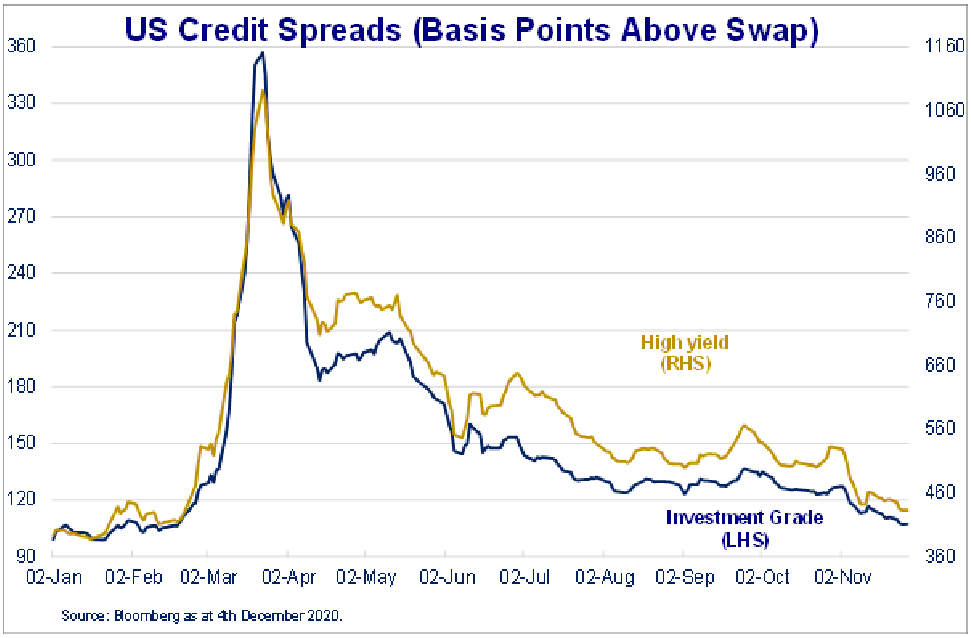
  **Europe also recorded its fifth weekly advance with the Stoxx 600 Index up +0.3%, but there was a broader range of price action under the hood.** The underlying tone remained constructive with vaccine and liquidity supports, and the UK was the first country to approve the Pfizer-BioNTech vaccine which will be rolled out this week which supported risk market prices, but concerns remain about how much research and analysis has been done and the storage, transportation and distribution issues are unresolved. European vaccine trials are now lagging notably behind its western peers thereby making it more vulnerable the pandemic. Meanwhile, Brexit headlines were predictably volatile with France threatening to veto a bad deal with only three weeks until the transition period ends, and debate continues around EU budgets with Hungary and Poland refusing to drop their veto over the rule-of-law mechanism. Elsewhere, economic data was a non-event with regional unemployment (8.4%) and core inflation (+0.2%) both in line with consensus, but the final regional composite PMI was a touch above the preliminary estimate (45.3 vs 45.1). By the week's end, there was a wider spread of performance relative to recent weeks, with the UK (+3.0%), Spain (+1.6%) and France (+0.2%) all recording their fifth straight weekly increase, whereas Germany (-0.3%), Italy (-0.8%), Sweden (-1.0%) and Switzerland (-1.3%) recorded their first decline since October.

  **By the close of weekly trading, only the UK (-13.1% from its February peak) remained in correction territory,** whereas the EM (+9.1%), US (+9.2%), Japan (+11.1%) and MSCI Asia (+11.2%) have all recorded complete recoveries (see chart).

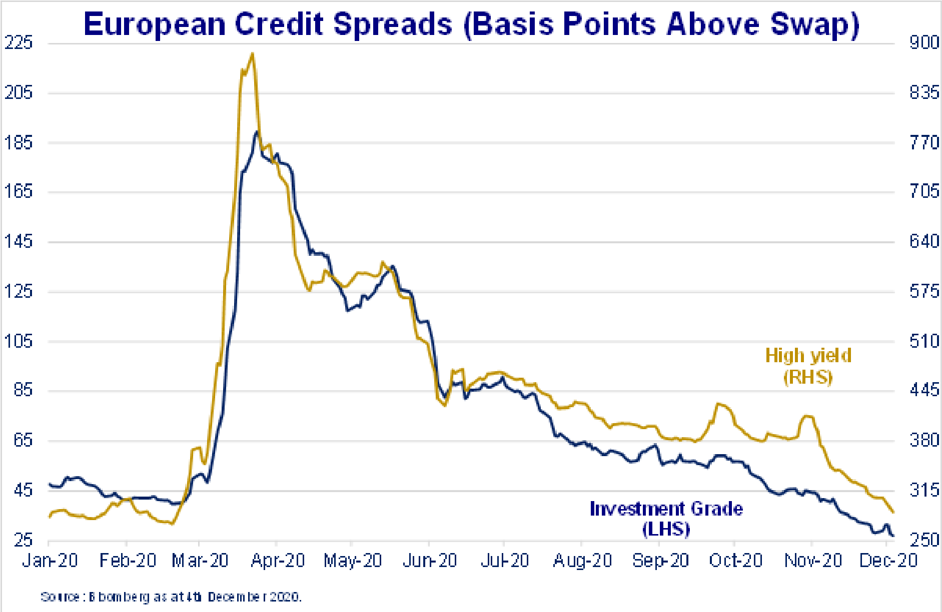



**Futures markets are pointing to a mixed opening in Asia** to start the week with opening gains priced in for Australia (+0.6%) and Japan (+0.2%), whereas Hong Kong (-0.2%) is priced for a modest decline.

- **CREDIT MARKETS**
  - **Regional credit indices recorded another week of solid gains with spreads in the US investment grade universe contracting another -6 points to +101 bpts, which lifted the recovery rate two notches to 99%.** Spreads in all sectors declined but only industrials (-11 points to +101 points, 96%) and energy (-11 points +148 bpts, 98%) recorded double digit declines. There were larger declines in the US high yield universe, whereas spreads came in a further -32 points to +401 bpts, which lifted to recovery rate five more notches to 99%. All sub-sectors recorded double digit declines led by utilities (-75 points, +308 bpts, 97%) despite their highly leveraged balance sheets, energy (-68 points, +610 bpts, 106%) which responded well to another rally in crude prices and subordinated financials (-41 points, +402 bpts, 90%) all of whom beat the market tape.

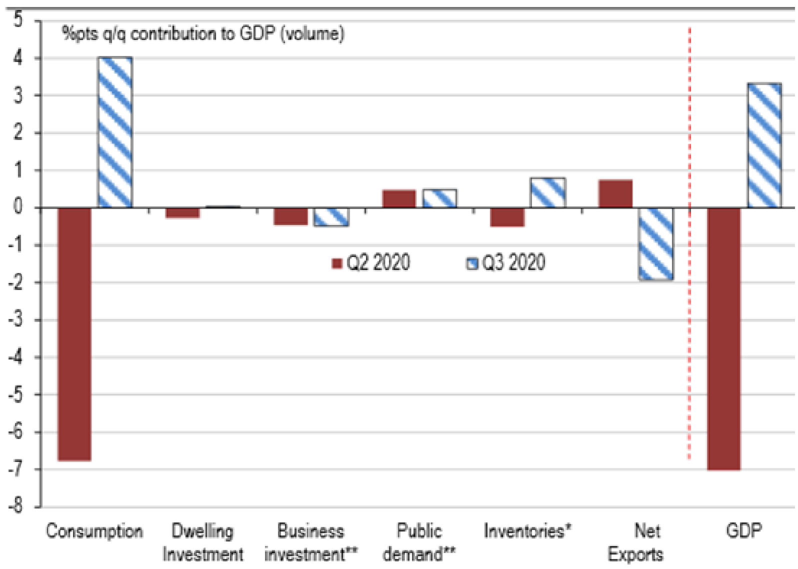



  - **European credit markets were a bit more subdued over the week that their US peer, with spreads in the investment grade universe declining -1 point to +27bpts, which held the recovery rate from the February spread trough at 109%.** Interestingly, only three of the 11 sub-sectors recorded lower spreads but the declines and increases in nearly all sectors were minor. In the high yield universe, the price action was more amplified with spreads contracting -19 points to +287 bpts, which increased the recovery rate three notches to 97% with double digit spread contraction in 9 of the 11 sub-sectors. Lagging cyclical sectors were at the top of the performance tables with risk premiums moving lower in subordinated financials (-30 points, +342 bpts, 88%), consumer discretionary (-29 points, +283 bpts, 104%) and energy (-19 points, +401 bpts, 87%).




## THE GLOBAL ECONOMY

- **Australian September quarter GDP bounced +3.3% q/q which was the strongest result in 44 years, and this took the annual rate back up to -3.8% y/y indicating that the economy has already recovered nearly half of its contraction from March and June.** Among the expenditure components, domestic demand leapt +4.5% q/q (-3.5% y/y) despite Victoria (-1.0% q/q, -9.8% y/y) being in stage 4 lockdown for a vast bulk of the quarter. Public demand was strong (+1.8% q/q, +6.2% y/y), but private demand was much stronger (+5.5% q/q, -6.7% y/y) led by a rebound in consumption (+7.9% q/q, -6.5% y/y) but new business investment (-4.3% q/q, -9.5% y/y) declined again to its lowest share of GDP since 1992 underpinned by mining (-5.2% q/q, +4.5% y/y) more than non-mining (-2.1% q/q, -13.9% y/y). **Importantly, within consumption the rebound was led by services** (+9.8% q/q) and goods (+5.2% q/q) also performing solidly. Elsewhere, inventory levels made a very large contribution (+0.8%pts) and net exports made a record subtraction (-1.9%pts) as exports dropped again (-3.2%q/q, -14.8% y/y) and imports rebounded sharply (+6.5% q/q, -13.9% y/y). Lastly, after two years of adjustment, the housing downturn finally ended (+0.6% q/q, -7.6% y/y) as massive amount of stimulus underpinned a boom in alterations and additions (+5.1% q/q +2.3% y/y).



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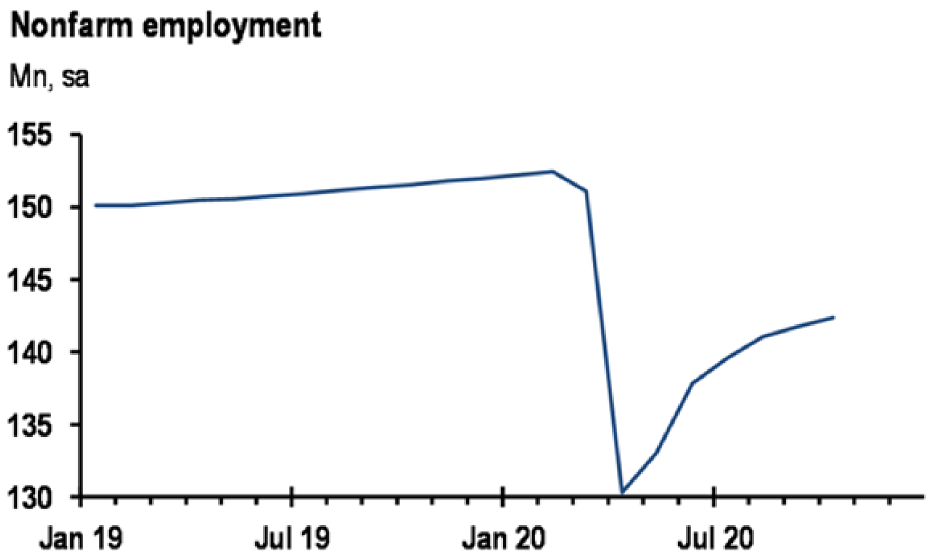
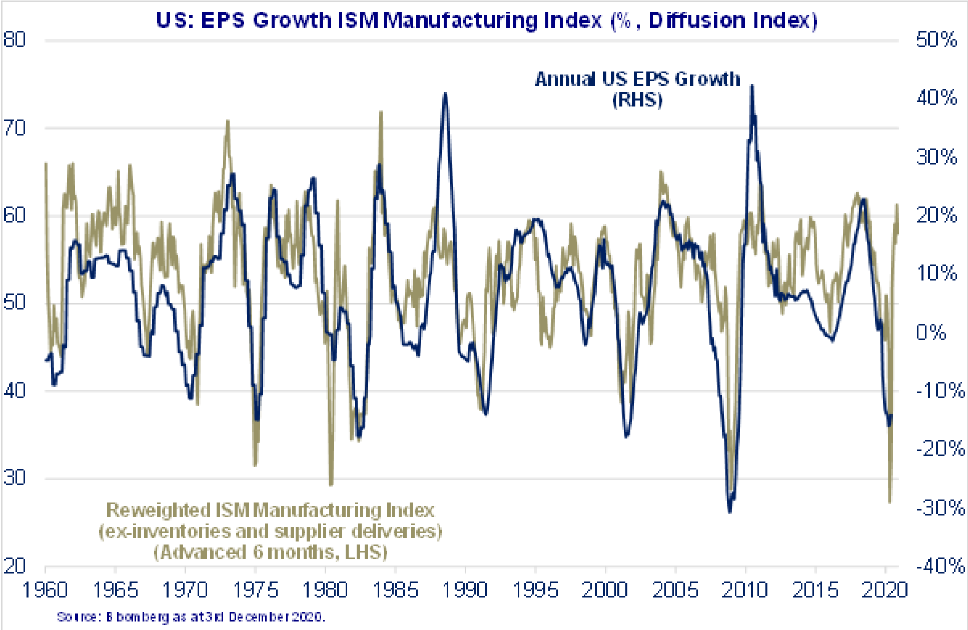
In terms of some of the income components, company profits picked up again (+2.5% q/q, +11.3% y/y) and nominal household income rose (+3.4% q/q, +8.1% y/y) at its fastest pace since 2011 supported by large scale fiscal stimulus which saw employee compensation bounce solidly (+2.3% q/q, +2.0% y/y) which partially funded the consumption recovery and this was augmented by a slight decline in the household savings ratio (-3.2% to a still extremely high +18.9% of disposable income. Stronger economic growth underpinned by services and Victoria reopening, combined with a still high savings rate, suggests that economic activity appears set to accelerate at a brisk speed in the next two years. That will require sustained low Cov-19 cases and an appropriate vaccine rollout and if that is the case, Australia should have above-trend growth in 2021 and 2022 (around +4% pa) which will culminate in a complete recovery next year.

- **The US labour market recovery slowed sharply in November with non-farm payrolls up just +245k which was the weakest month of gains since the labour market troughed in April.** While one month of data cannot be conclusive, the softness raises questions as to whether the expected March quarter 2021 contraction is coming earlier and that will only be known with more data. The modest payrolls gains were underpinned by another month of cuts in government workers (-99k) and a slowdown in private payroll growth (-533k to +344k in November) underpinned by a sharp decline in service sector jobs growth from +770k in October to just +289k last month with a slowdown in professional business services (-171k to +60k) and leisure (-239k to +31k), and an outright decline in retail (-130k to -35k). The November reading means that **55.6% of jobs lost in March and April have been recovered, but 9.8 million workers remain displaced which puts the shadow unemployment rate at circa 9.5% and the G-6 gauge declined fractionally to 12.0%.**

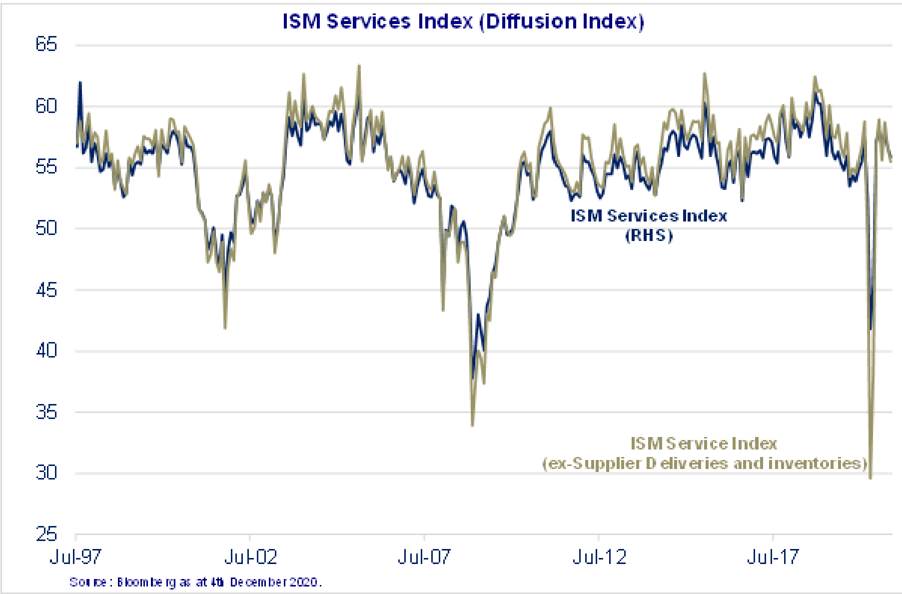
  While the US unemployment rate declined two-tenths to 6.7% it was driven by a worrying two-tenths drop in the participation rate to 61.5% and the employment-population rate ticked down (by -0.1% to 57.3%) for the first time since April. Meanwhile, the average workweek was steady at an elevated 34.8 hours and average hourly earnings increased +0.3%m/m to +4.5%y/y, although the increase reflected compositional effects, as lower-paying industries lagged in job growth. At the November pace of job growth it would take over three years to get back to the level of employment seen in February and it is reasonable to expect an even larger decrease in payrolls in the December report as mobility restrictions have tightened in numerous state and the reference week for this report is this week.




- **The November ISM manufacturing gauge declined -1.8 points to 57.5 which whilst lower, is still the second highest reading in the past two years.** Among the components, new orders declined -2.8 to a still very strong 65.1, production dropped -2.2 to 60.8 but employment index fell a more solid -4.8 back into contraction territory at 48.4, where it has been for 15 of the past 16 months. Given the limitations of goods consumption, the bounce in manufacturing activity from reopening should be ending soon, but the overall diffusion score has been higher, on average, in the December quarter to date, than it was in Q3. That said, the moderation in employment is a clear sign that things are slowing, as is the slowdown in goods imports, but **core capital goods remain upbeat and there is also a likely inventory build ahead which is likely to support activity**. Meanwhile our reweighted ISM manufacturing index (the gold line in the chart below) suggests that US earnings growth has now bottomed and should soon begin moving higher.




- **The ISM services sector PMI also had a modest pullback in November, but the overall index and its key components remain elevated, in contrast to Europe, for example,** which suggests continued US growth despite some localised activity restrictions. That said the index did decline (-0.7 points) to a six-month low (of 55.9) which adds to the picture that resurgent case numbers are slowing the recovery. and among the components, employment (+1.0 to 51.5) recovered its decline from October and remained above 50 for a third straight month, where business activity (-3.2 to 58.0) and new orders (-1.6 to 57.2) declined again.




- **Initial jobless claims reversed some of its recent weakness, but the overall tone only changed from 'improvements reversing' to now 'pausing'.** Indeed, initial claims fell by -75k this week to +712k which was below the street but well above the peak of previous recessions (see chart). The median state had a -13% w/w drop in the seasonally adjusted data, but the four-week average of unadjusted claims is only -2% lower than a month ago suggesting the pace of improvements has stalled, and high-frequency data last week suggested initial claims will remain elevated in the week ahead. Meanwhile, continuing claims fell for the tenth consecutive week by -569k to 5.52 million for the week ending November 21and this meant that the pace of implied outflows from unemployment improved +0.3k to 1.4 million amid still solid rehiring. Indeed, in the median state, continuing claims as a share of employment fell by -0.2% w/w which is a touch more than the -0.15% decline from the prior month.



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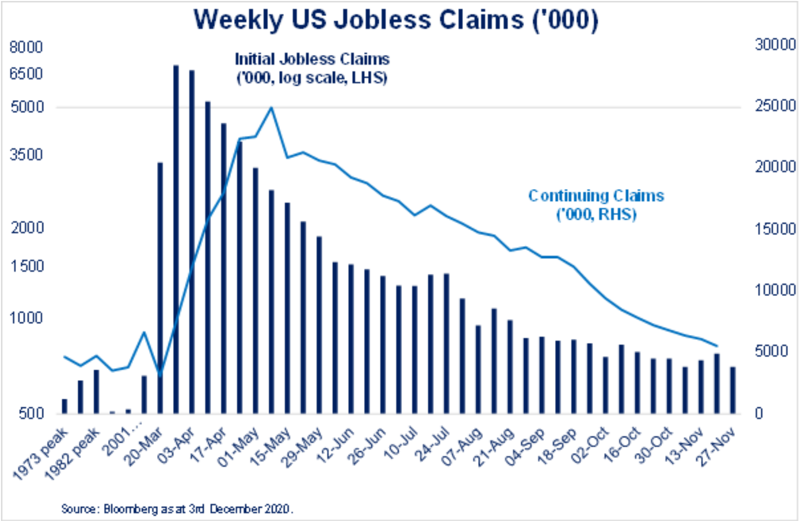
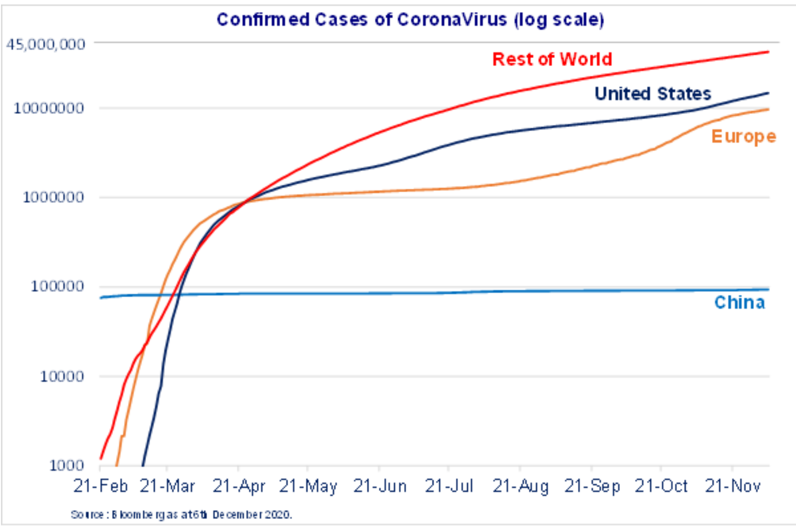



## POLICY

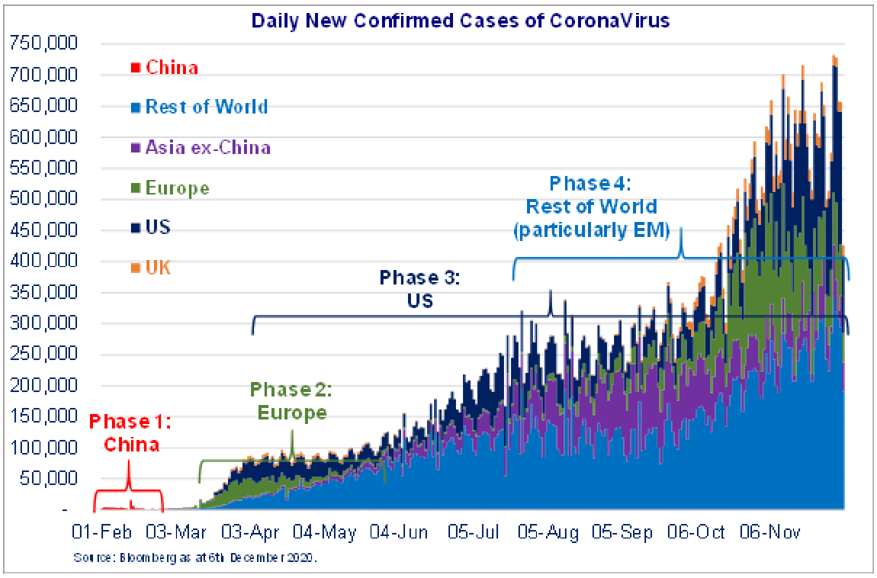
- It was a week of talks and adjustments for central banks. The Fed was busy in the week ahead of the blackout before the December FOMC meeting (15-16 Dec) with the Bank extending several lending facilities through the end of March, but **Chair Powell's testimony on Capitol Hill didn't offer anything new and the Beige Book noted that four districts experienced little or no growth**. Meanwhile, the leaks suggested that the ECB is open to a 12-month QE extension and Chief Lagarde reiterated that the ECB is ready to recalibrate policy as required. It was quiet in the UK, with BoE Saunders welcoming vaccine developments and said if more support is needed, rate cuts and QE may be the best approach. More interestingly, the **PBOC Governor Yi Gang warned the central bank will not bail out companies backed by local governments and rejected the notion of debt monetisation**. Lastly, the RBA acknowledged recent better-than-expected economic outcomes and potential for Australian growth to outperform its central scenario amid recent vaccine developments. However, commentators remained largely of the view the central bank will enhance and extend its asset purchase program in 2021, reflecting an overarching emphasis on driving down the unemployment rate.

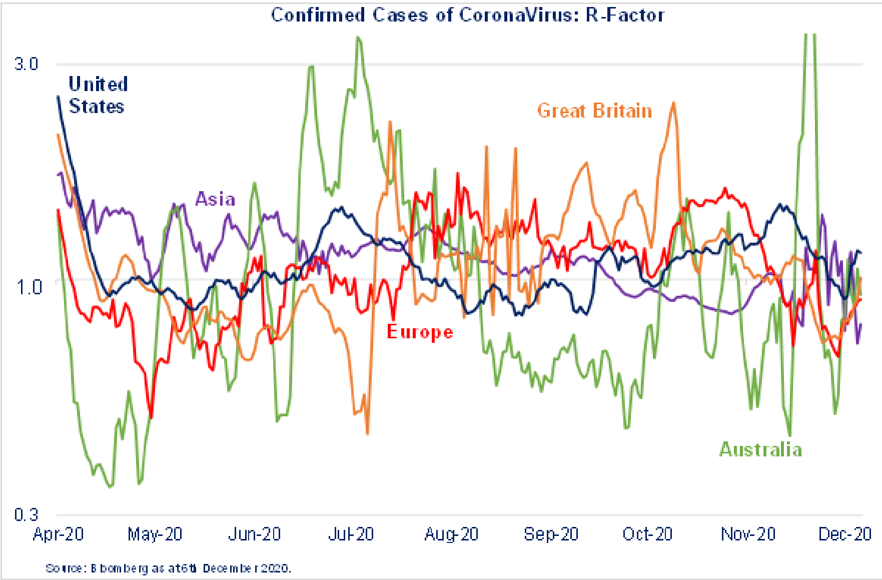
## VIRUS UPDATE

- **The number of global cases of COVID-19 is 62.7 million with another +409k cases so far overnight** (but Brazil, Colombia, Mexico, Pakistan, Spain and Sweden, and 18 US states have not reported their numbers) which means that Sunday was the 42nd consecutive day where daily increases were greater than 400k. At present, 24 countries have more than 500k cases, 40 countries have more than 200k cases and 68 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 1.53 million and the death rate has declined to 2.29% although the number of daily deaths remains elevated and hit an all-time high on Thursday.

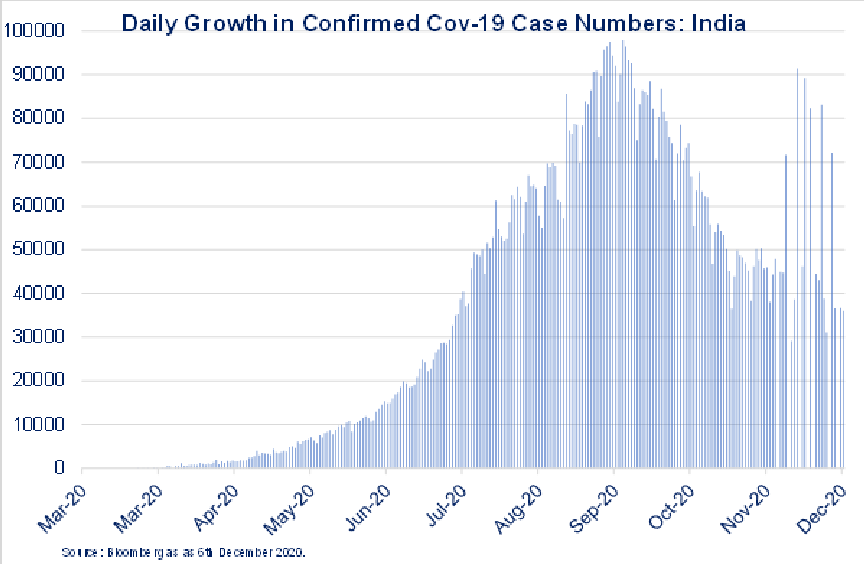


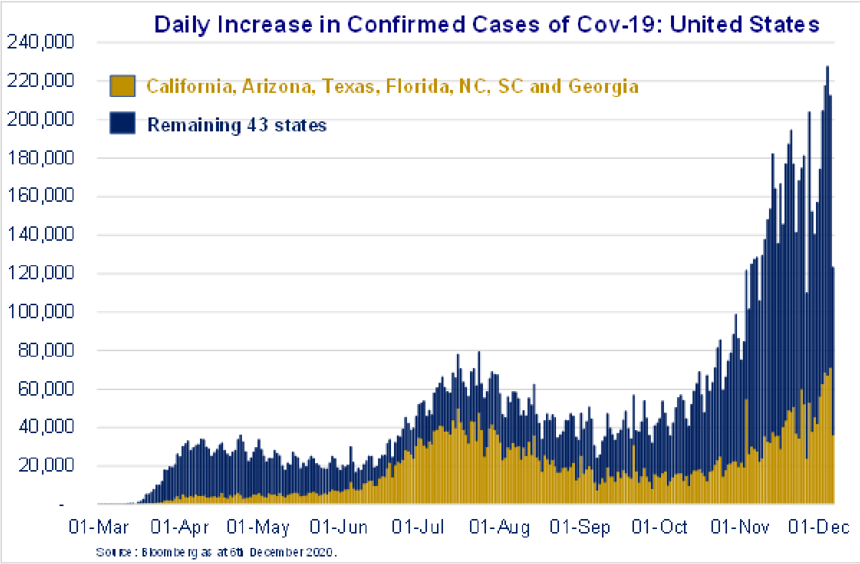
- We break the infections into four groups – the US, Europe, China and 'others' and the rest of the world outside the G3 economies now has the most total cases (+238k to 53.9 million) and highest daily new cases (and by a considerable margin) followed by the US (+124.5k to 14.7 million, although 18 states 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 (+46.0k to 9.6 million - see chart) although their curve is flattening with an R-factor at 0.90 which indicates that the infection rate is now declining which is less than the UK (1.01) and the US (1.15), but more than Asia (0.80).



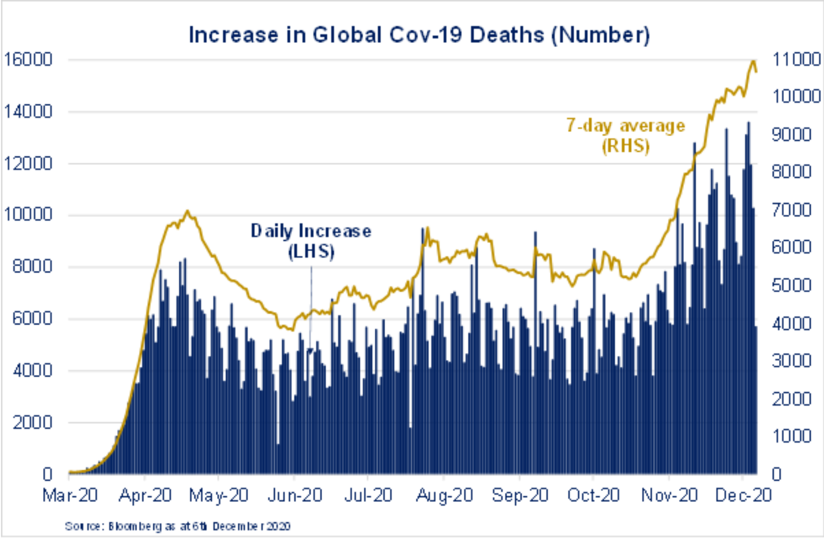



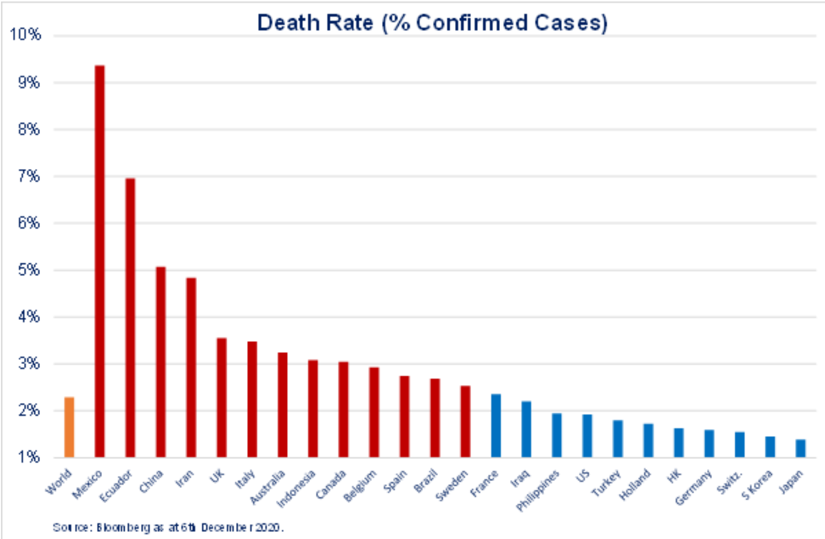

- Among countries, the most cases are in the US (+125.0k (so far) to 14.7 million, with 18 states yet to report), India (+36.0k to 9.64 million), Brazil (not reported, 6.58 million), Russia (+28.7k to 2.44 million), France (+11.0k to 2.35 million), Italy (+18.9k to +1.73 million), UK (+17.4k to 1.73 million), Spain (not reported, 1.68 million), Argentina (+9.8k to 1.46 million) and Colombia (not reported, 1.36 million). In Australia confirmed cases were +9 yesterday at 28.0k yesterday which placed us 100th in terms of total infections.




- Although final numbers are not in until 1pm AEST, the global death rate declined to 2.29% with the global total to 1.53 million after another +5.7k deaths overnight, so far, however, the 7-day average is at 10.7k which is very close to an all-time high. The US (+0.84k so far) has the most deaths at +282.06k, with Brazil (not reported, 176.6k), India (+0.5k to 140.2k), Mexico (not reported, 109.5k), the UK (+0.2k to 61.3k), Italy (+0.6k to 60.1k) and France (+0.2k to 55.2k) all over +50k. The death rate in advanced economies is highest in European countries where the health systems had collapsed led by the UK (steady at 3.6%), Italy (-0.1% to 3.5%), Australia (-0.1% to 3.3%), Canada (-0.2% to 3.0%), Belgium (+0.1% to 2.9%), Spain (+0.1% to 2.8%) Sweden (-0.3% to 2.5%), and the US (-0.1% to 1.9%). However, several emerging markets are now on the leader board including Mexico (-0.2% to 9.4%), Ecuador (-0.1% to 7.0%), China (steady at 5.1%), Iran (-0.3% to 4.8%), Indonesia (-0.1% to 3.1%) and Brazil (steady at 2.7%).




Yours sincerely,

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