Perpetual Investments

THOUGHTS ON THE MARKET

9th November 2020 - Will a 'contained' Biden really outweigh a surging pandemic?

SUMMARY

- **Vice President Biden appears set to be the 46th President of the United States most likely with a divided Congress.** There will be court appeals but they are highly unlikely to overturn the will of the US voters, with Biden's multiple state lead meaning that several state results would have to be overturned.

  A split Congress has two opposing effects on growth. On the positive side, it should mean that more centrist policies are likely to be pursued, which would most likely involve less disruption to the US energy industry, a lower probability of breaking up big-tech, little chance of increasing corporate taxes and even less chance of implementing far reaching environmental reforms - all of this is constructive for growth. Conversely, a Republican controlled US Senate is likely to see them dump the economic populism of President Trump and pursue a material decline of the US fiscal deficit, which is set to underpin a large US fiscal drag in 2021.

  The upcoming fiscal pullback is likely to occur at a time of moderating US growth and moves the growing pandemic (in the US and Europe) to the centre of our risk assessment. US growth looks robust in the early stages of Q4, but rising infections and fiscal drag is likely to see March '21 growth return to a sub-trend pace of +0.4% q/q, but this may already be partly priced into the US treasury market with yields declining -6 bpts points last week.

  In terms of reducing downside growth risks from a 2021 fiscal drag, increased monetary support will be required but with rates already at the zero-bound, increased asset purchases will be ineffective on this front, but it is likely to see a lower US Dollar and downward pressure on bond yields. This means that upside risks to 2021 growth is now more reliant on a COVID-19 vaccine being found as hospitalisations and death rates are on the rise.

  Lower treasury yields sparked strong tech-led gains in regional equity markets last week, and credit spreads declined to post-March lows. Consequently, risk markets have so far liked the sound of a "contained" Biden presidency, but they seem to be ignoring the growth risks and the economic disruption caused by rising COVID-19 infections and deaths, and the likely fiscal pullback. Those factors suggest to me that global growth is set to downshift and that investors need to focus on the defensive part of their portfolio and determine how they can diversify equity risk with bond yields so low.

  In other markets, 10-year US Treasuries declined to 0.73% with curve flattening, commodities were mostly higher with gold (+3.9% to USD1,951 per troy ounce – which is a 7-week high) and oil (+3.8% to USD37.14 per barrel) recording similar gains, and G10 currencies were universally higher against a weaker Greenback with the appreciations led by the AUD (+3.3% to USC72.58), the Euro (+1.9% to 118.7), Sterling (+1.6% to 131.6) and the Yen (+1.3% to 103.4).

- **Economic data last week was quite upbeat** with US non-farm payrolls rising +638k despite a loss of -268k in the government sector, which suggests strong private sector hiring with the unemployment rate down to 6.9%. Meanwhile, the US manufacturing sector continued to suggest strong production in the goods sector with the diffusion index up to a 2-year high with new orders at its highest rate in 60 years. In contrast, the service sector declined to a 6-month low with employment gauge now at stall speed.

- In terms of policy, while the Fed's November meeting was a non-event, the RBA and Bank of England set off a fresh wave of monetary support. The former lowered policy rates (both the cash rate and 3-year yield curve control) by 15 basis point to 0.1% and committed to purchase AUD100 billion in 5- to 10-year bonds on an

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aggressive six-month timetable. The RBA is clearly signalling that they will use asset purchases as a substitute for negative rates to limit currency appreciation and support growth. Meanwhile, the BoE expanded its QE program by a greater-than-expected £150 billion in an attempt to create sufficient headroom for increased weekly purchases should market functioning worsen materially again. In terms of fiscal policy, it appears that a broad range of emerging market governments are poised to tighten fiscal policy broadly next year, as large deficits and financial stability concerns prompt governments to run-off their 2020 supports.

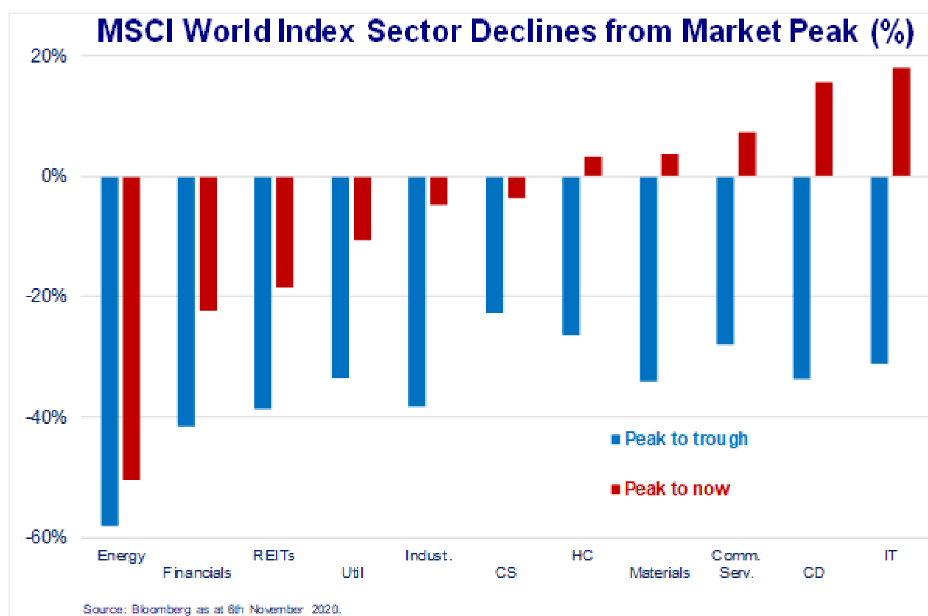
- **The number of global cases of COVID-19 is 50.26 million** with another +440k cases so far (but Brazil, Colombia, India, Mexico, Pakistan, Spain and Sweden and 17 US states have not reported their numbers) which means that Sunday was the 111th consecutive day where daily increases were greater than 200k. At present, 17 countries have more than 500k cases, 33 countries have more than 200k cases and 55 countries have more than 100k cases. More importantly, the growth rate of daily confirmed cases (+1.1% since Thursday) is slightly higher. Meanwhile, deaths stand at 1.25 million and the death rate was steady at 2.50% although the number of daily deaths remains elevated.

FINANCIAL MARKETS

- ### EQUITIES

  - **The MSCI World Index closed +7.7% higher last week, which was the largest weekly advance since the market trough in late March.** Several narratives were in play last week with the US election central but when the Democrat clean sweep did not eventuate, the investment mindset shifted to a divided government being beneficial to the market. This saw bond yields decline and the yield curve flatten which enabled growth sectors to outperform value led by Tech (+9.6%) which had its best week since mid-April, and healthcare (+8.1%) was not far behind as investors figured that the GOP-controlled US Senate would limit the most potentially disruptive healthcare policies of a Biden administration. Meanwhile, consumer discretionary (+7.6%) performed in line with the market tape supported by Amazon (+9.1%), and communication services (+6.8%) was propelled higher by megacap names including Facebook (+11.5%), Google (+8.9%) and Netflix (+8.2%). Meanwhile, among the cyclicals, the advance in financials (+5.2%) was the largest in five months but it was not really convincing having being capped by the flattening yield curve, and energy (+1.9%) was at the end of the performance list with prices gains underperforming the rise in the crude price.

    By the close of trading for the week, energy (-50.4% given a recovery rate of just +13%) and financials (-22.4%, 46%) were the only two sectors in bear market territory, with REITs (-18.5%, 52%) joining utilities (-10.6%, 68%) in correction territory. Meanwhile, healthcare (+3.2%, 112%), materials (+3.6%, 111%), communication services (+7.3%, 126%), consumer discretionary (+15.5%, 146%) and IT (+18.0%, 158%) have all recorded a complete recovery (see chart).



  - **Among the regions, the pace of gains was led by Europe (+8.3%) which recorded its strongest weekly advance in 22 weeks.** Although record COVID-19 cases saw the region go into a second lockdown which

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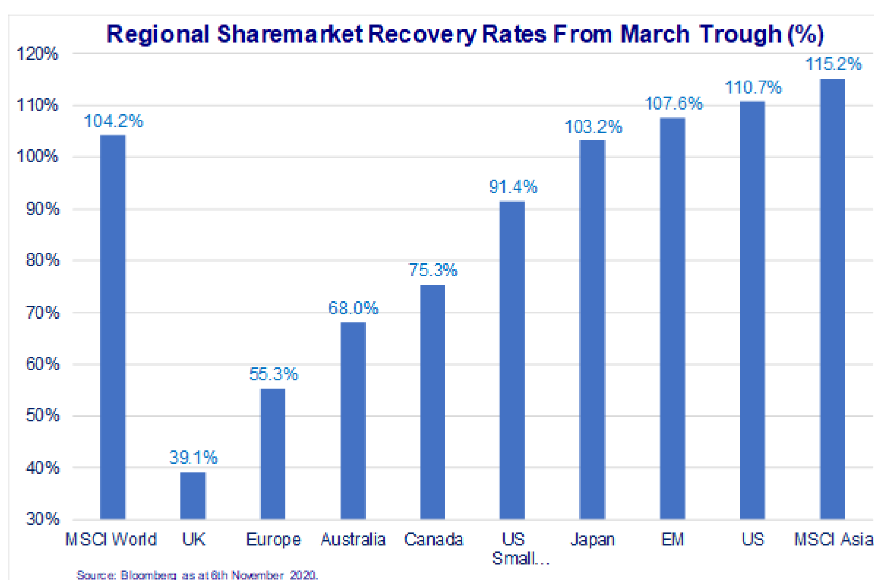
raises the risk of double-dip recession, investors were buoyed by with the US election result and the benefit of a split government. In addition, the policy environment remained supportive after the Bank of England increased its QE target to GBP150 billion which was well ahead of consensus (GBP100 billion) and came on top of the ECB pre-announcing more support in the previous week. Meanwhile, the UK Chancellor Sunak announced more support for jobs after the UK went into a month-long lockdown, which are in line with similar support measures announced in Germany, France and Italy. On the Brexit front there was no breakthrough after two-weeks of intensive talks, but in true European style more talks are scheduled to try to reach a compromise. On the earnings front, around three-quarters of European companies having reported Q3 results so far and around 70% have surprised positively with annual EPS now down -19% y/y (and -14% y/y ex-energy). By the regional closing bell, all bourses had advanced over the week led by Italy (+9.7%), Germany and France (both+8.0%), Switzerland (+7.7%), Spain (+6.5%), Sweden (+5.9%) and the UK (+5.6%).

Meanwhile, US equities (+7.3%) posted a huge election week rally which was the strongest advance since early April (and third-best of the year). The US election was centre stage on the market momentum and while the blue wave did not happen investors decided that a spilt Congress is likely to prevent several measures being legislated which would have been detrimental to corporate earnings. These included taxation increases, reducing land available for shale energy, breaking up big tech and implementing large scale changes to protect the environment. Meanwhile, the earnings season continued to detail strong corporate performance with the annual EPS decline now at -7.5% y/y, relative to expectations of -21% at the end of Q3. Elsewhere, economic data was constructive with an upbeat October Non-farm Payrolls (+638k, unemployment at 6.9% both of which were well ahead of the street) and ISM Manufacturing gauge (59.3 which is a two-year high) among the tailwinds. In contrast, US COVID-19 cases rose to record levels in the US, and there wasn't much news on the vaccine front. By the closing bell at the NYSE at Saturday morning AEST, all indices had put on weekly advances to outweigh their loss in the prior week led by the NASDAQ Composite Index (+9.0%), S&P 500 (+7.3%), Russell 2000 and Dow Jones Industrial Average (both +6.9%).

Asia (+6.3%) also put in its strongest advance since early April but lagged other major regions as it had outperformed in the prior two weeks and was due to go to the back of the peloton. It was quiet on the data front with only a couple of monthly CPI releases which did not change the recent upbeat China-led macro narrative, and there wasn't much on the policy front other than the RBA delivering on its recent statements by officials which took the official cash rate down to 0.1% and initiated a AUD100 billion bond purchase program in the 5-year to 10-year maturity over the next six months. Meanwhile, Chinese President Xi said his economy could double its total output volume by 2035 (or an average 15-year growth rate of +4.7%) which is highly ambitious considering the state of their demographics. By the closing bell on Friday night, regional gains were led by Hong Kong (+6.7%), South Korea (+6.6%), India (+5.8%), Japan (+5.0%), Australia (+4.4%), China (+4.1%) and Taiwan (+3.4%).

A strong weekly performance saw some major moves on our February peak-to-now chart with Asia (+4.6% with a recovery rate of +115%), the US (+3.6%, 111%), and Japan (+1.0%, 103%) now having recorded a complete recovery, Australia (-11.9%, 68%) and Europe (-17.1%, 55%) remain in correction territory, and the UK (-21.9%, 39%) is once again the only region in bear market territory (see chart).



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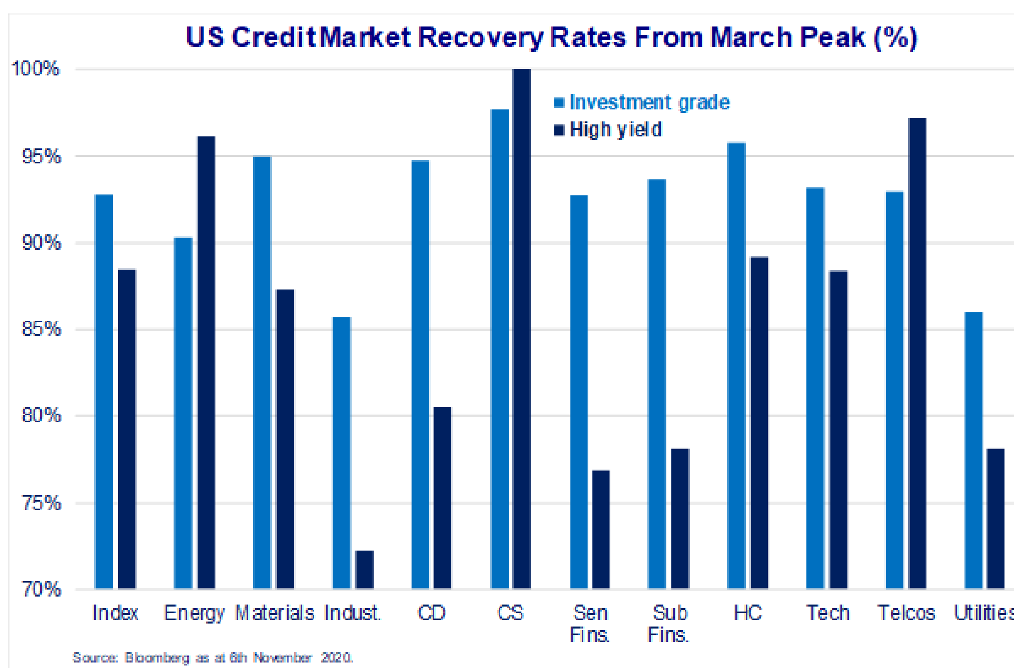
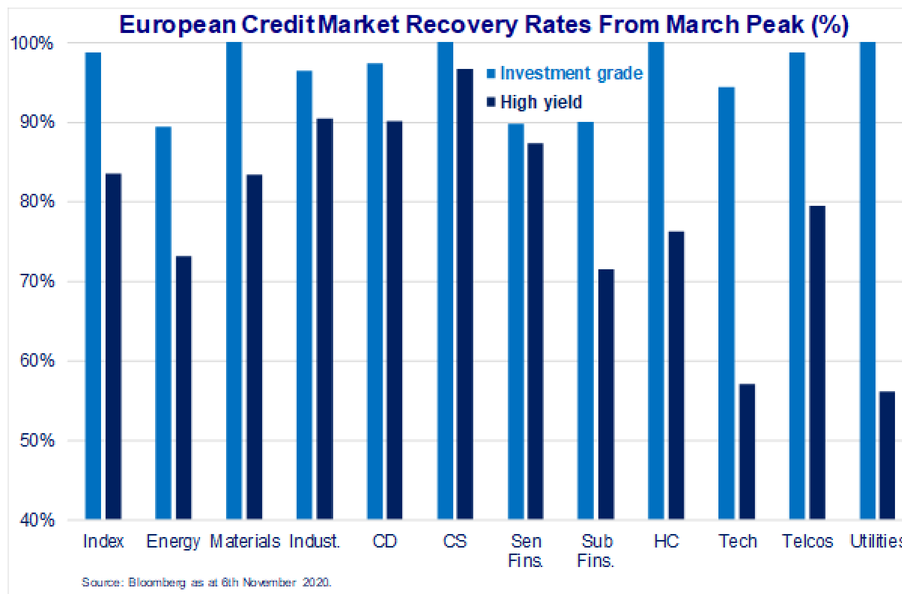
- Futures markets suggest a positive opening in Asia with Japan (+0.1%), Australia (+0.2%) and Hong Kong (+0.7%) and all set to open higher at the bell.

- **CREDIT MARKETS**
  - **Regional credit market rallied strongly last week which saw both investment grade and high yield spreads decline to post-March lows.** Spreads in the US investment grade sector declined -9 points to +118 bpts which lifted the recovery rate three notches to 93%. All 11 sub-sectors recorded capital gains but only subordinated financials (-14 points to +142 bpts, 94%), communication services (-13 to +141 bpts, 94%) and energy (-12 points, +183 bpts, 90%) recorded double-digit spread declines and all beat the market tape.

    Meanwhile, spreads in the high yield sector decreased -56 points (31-week high) to +475 bpts, which lifted the recovery rate 9 notches to 88%, as investors got a sense of renewed optimism from a strengthening labour market. Unsurprisingly, record low sector yields is likely to spark record debt sales in the period ahead. The capital gains in this universe were more widespread than in the IG universe and were led by energy (-81 points, +766 bpts, 96%), healthcare (-74 points, +407 bpts, 89%) and subordinated financials (-72 points, +486bpts, 77% - see chart). Overall, no investment grade subsector has recorded a complete recovery since the March blow-out in spreads, whereas in the high yield space, consumer staples has reached this milestone (see chart).

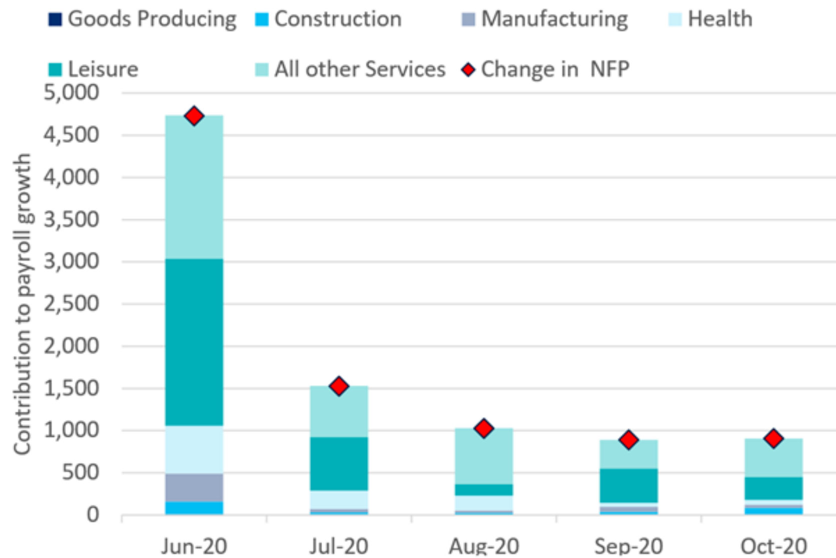


  - **Despite economic closure and a lack of monetary and fiscal firepower, European credit markets also rallied last week with spreads in the investment grade universe declining -3 points to +42 bpts which sent to recovery rate up three notches to 99%.** Interestingly, only one sector recorded a double-digit decline in spreads and that was subordinated financials (-20 points, +128 bpts, 90%) which has the second lowest recovery rate (behind energy (-4 points, +43 bpts, 89%). Meanwhile, spreads in the high yield sector were -40 points lower last week at +373 bpts, which increased the recovery rate seven notches to 84%. All 11 sub-sectors recorded double digit declines in risk premia led by healthcare (-61 bpts, +282 bpts, 76%), consumer discretionary (-54 points, +400 bpts, 90%) and materials (-50 points, +330 bpts, 83%). Overall, four sub-sectors in the European IG universe have now recorded complete recoveries, whereas no high yield subsector has reached that milestone.



THE GLOBAL ECONOMY

- **The US labour market recovery continued in October with the non-farm payrolls up +638k which was well ahead of the street (+580k) with a net +15k of upgrades for the prior two months.** The October rise was dominated by private payrolls which rose an upbeat +906k, whereas the government sector lost -268k as 147k of census workers left the payrolls, and state and local government declined -61k and -98k, respectively. Within the details, the breadth of job gains remained strong across private industries, with restaurant rehiring driving leisure and hospitality up +271k, retail accelerated +103k, construction lifted +84k and manufacturing added a solid +38k (although this a bit less than expected) – see chart. The volatile household survey detailed a much-stronger-than-expected 2.2 million increase in employment which led the unemployment rate to drop to 6.9% (consensus was 7.6%) despite a rise in labour force participation of +0.2% to 61.7%.



While the U-6 underemployment rate has nearly halved from its April peak (22.8%) to 12.1%, it is still nearly double the low of end-2019 (6.7%), indicating that there is still a lot of labour market displacement which needs to be addressed. This is most evident in the low-wage industries where more than -10% of jobs have gone, whereas the high-wage jobs are much less at -3.5% (see chart). Elsewhere, average hourly earnings rose just +0.1% m/m as rehiring skewed towards lower wage jobs, and the average workweek was unchanged at 34.8 hours and this meant that aggregate earnings were up +0.9% m/m and are now down just -0.9% y/y. Looking ahead, the next few months of payrolls reports may be volatile as Cov-19 case numbers culminate in

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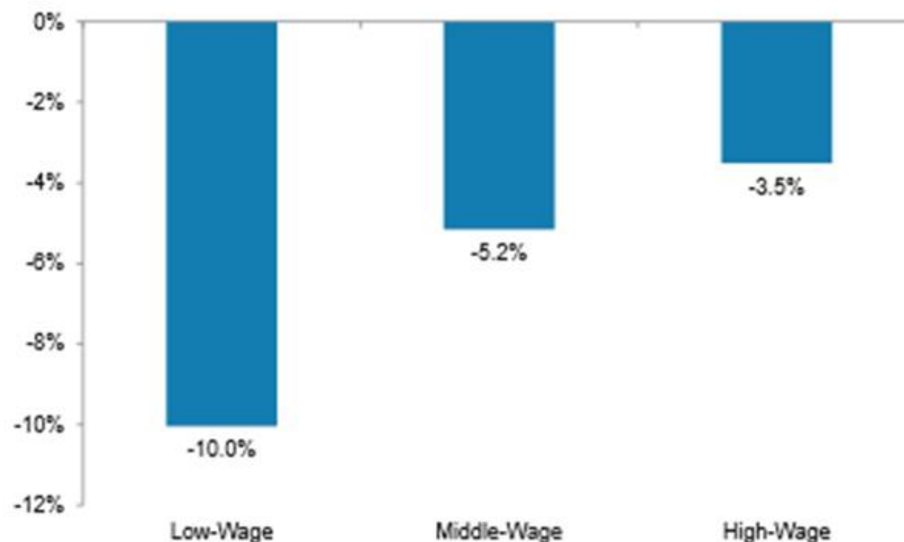
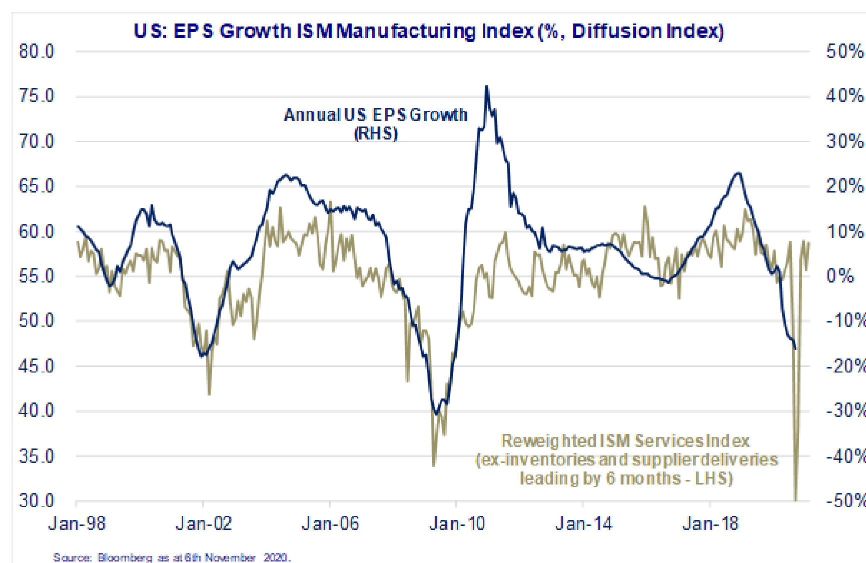
the usual holiday hiring being weaker than normal. The continued solid rise in aggregate private incomes in this report should help spending remain solid in October.



Source: Bureau of Labor Statistics, Morgan Stanley Research

- **The October ISM reports for manufacturing (+3.9 to 59.3) and non-manufacturing (-1.2 to 56.6) were released last week and gave mixed indications on future trends of the US economy.** The services sector has slowed to a six month low with similar declines in business activity (-1.8 to 61.2) and employment (-1.7 to 50.1) with the latter now at stall speed, and new orders were down by more (-2.7 to 58.8) but remain at elevated levels. A reweighed services gauge which uses these three indices suggests that US earnings will improve in the months ahead (see chart).

  Meanwhile, the manufacturing diffusion index rose to a two-year high with activity in "boom" territory with new orders (+7.7 points to 67.9) up to the highest level ever (i.e. a 60-year high), employment (+3.6 to 53.2) returned to expansion territory for the first time in 15 months and production (+2.0 to 63.0) remains are three-year highs. Although the headline index is indicative of continued growth, the bounce from reopening should be ending soon as factory shipments have stalled in recent months, as has employment and inventories have begun to be refilled.



Source: Bloomberg as at 6th November 2020.

- **Jobless claims this week were mixed with new claims failing to extend their recent streak of declines,** and outflows from unemployment implied by continuing claims continued to grind lower. That said, initial claims stayed below 800k for the third straight week dropping to +751k, which was worse than the street (+735k). The median state had a meagre -0.4% W/W drop in non-seasonally adjusted terms which confirms a lack of broad-based improvement, with lower claims in places with lower COVID-19 case growth. Indeed,

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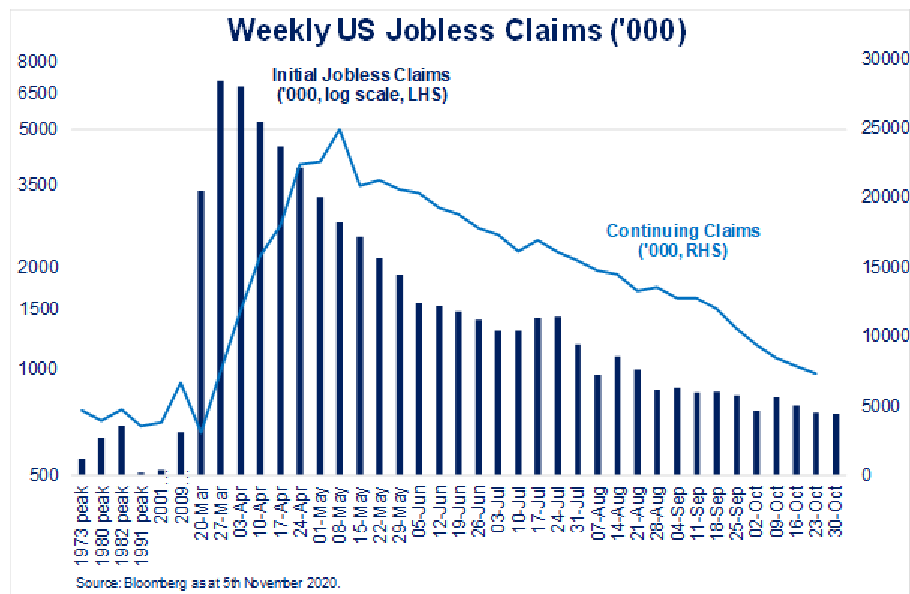
there has been a 32% correlation in these statistics over the past month. Continuing claims for the week ending Oct. 24 fell by -538k to 7.3 million which is a 7-month low, but there were some upward revisions to last week's numbers. The claims data combined with other internet labour market surveys still show the labour market recovery is continuing but slowing with some of this clearly attributed to rising Cov-19 infections.



POLICY

- The November FOMC meeting was a non-event with no changes made to the policy rate and no edits were made to the new forward guidance from September. The accompanying statement made a few language changes relating to the economic picture, but the over-arching view was unchanged with economic activity "continued to recover", financial conditions "remain accommodative" and so on. There were no new details on the Fed's asset-purchase plans, though at the post-meeting press conference Chair Powell said the program was discussed and that it is currently delivering the right amount of accommodation.

- The RBA's November meeting provided a triple cut to interest rates, by reducing the cash rate by -0.15% to +0.1%, the target for the 3-year bond yield (i.e. Yield Curve Control) was lowered to the same rate, as was the TFF. Governor Lowe also lowered the deposit rate floor (in Exchange Settlement Accounts) from 10bps to 0bps, and noted that the RBA had done all it could on interest rates. While the Bank decided against extending the YCC to 5-year yields, it launched a AUD100 billion government bond purchase program focused on the 5 to 10 years over the next 6 months. The bank may buy outside 5 to 10s if market conditions warrant, but would not purchase inflation linked bonds, and will split purchases 80/20 across Australian Government and State & Territory bonds.

  Meanwhile, in its Quarterly Statement on Monetary Policy, the Bank upgraded its growth forecast for CY-2020 (+0.2% to -3.7% y/y) and 2021 (+0.1% to +3.1%), but they revised down 2022 (-0.3% to +3.6%). Meanwhile, the Bank continued to indicate that they would underperform their underlying inflation target until at least the end of 2022 with forecasts of +1.2% y/y in 2021 and +1.5% in 2022. In addition, they downgraded their unemployment forecasts to a peak below 8% (rather than 10%) falling to 6% by the end of 2022).

VIRUS UPDATE

- The number of global cases of COVID-19 is 50.26 million with another +440k cases so far (but Brazil, Colombia, India, Mexico, Pakistan, Spain and Sweden and 17 US states have not reported their numbers) which means that Sunday was the 111th consecutive day where daily increases were greater than 200k. At present, 17 countries have more than 500k cases, 33 countries have more than 200k cases and 55 countries have more than 100k cases.

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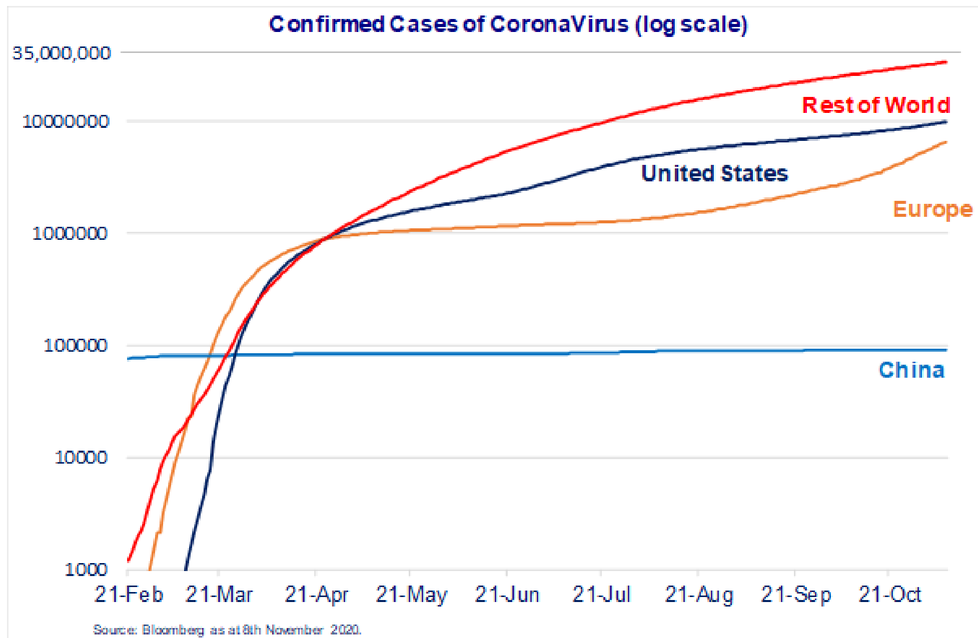
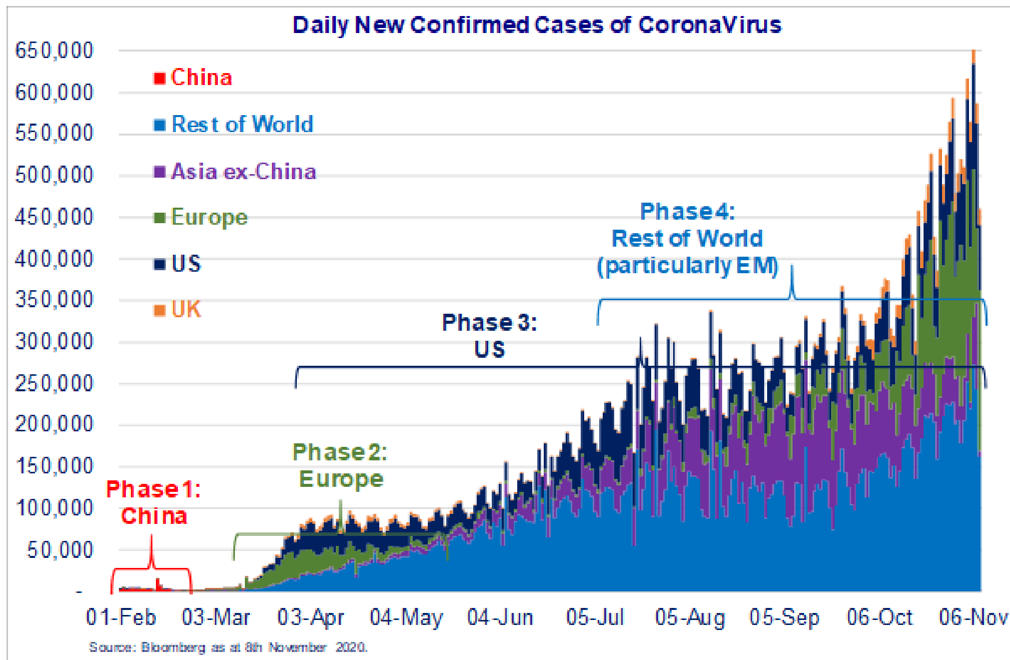
It took 73 days to record 1 million cases, and after this each subsequent million has taken 13 days, 11 days, 12 days, 10 days, 11 days, 8 days, 8 days, 7 days, 6 days, 5 days, 5 days, 5 days, 4 days, 5 days, 3 days, 4 days, 4 days, 4 days, 4 days. 4 days, 4 days, 4 days, 4 days, 4 days, 4 days, 4 days, 4 days, 4 days, 3 days, 4 days, 3 days, 4 days, 4 days, 3 days, 4 days, 4 days, 2 days, 2 days, 3 days, 2 days, , 2 days, 2 days, 3 days, 2 days, 2 days, 2 days and 2 days. More importantly, the growth rate of daily confirmed cases (+1.1% since Thursday) is slightly higher. Meanwhile, deaths stand at 1.25 million and the death rate was steady at 2.50% 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 (+163k to 43.6 million) and highest daily new cases (and by a considerable margin) followed by the US (+77.9k to 9.94 million, although 17 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 (+193.0k to 6.53 million - see chart) with an R-factor at 1.05 which indicates that the infection rate is still rising, and this is higher than the UK (0.98), the US (1.28) and Asia (0.90).



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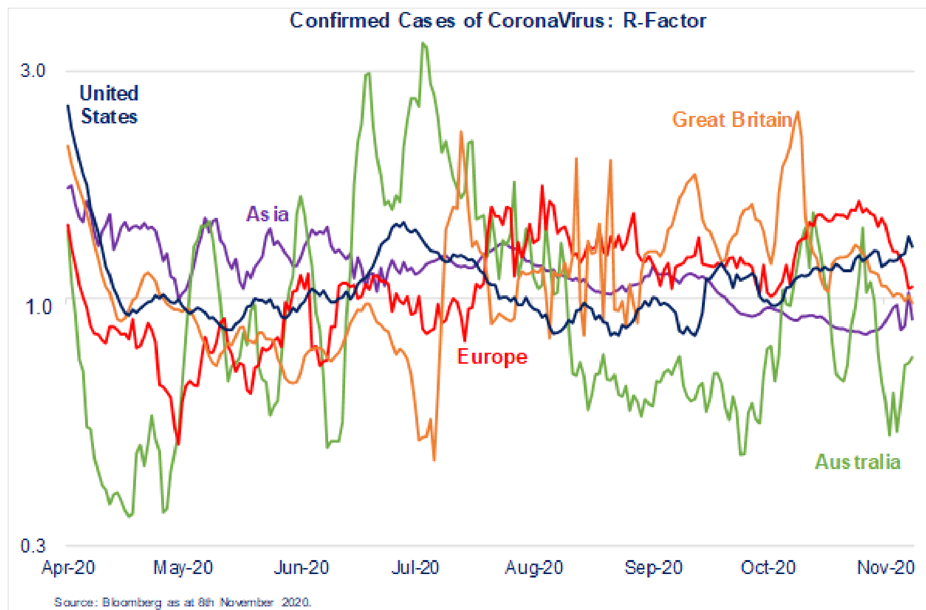
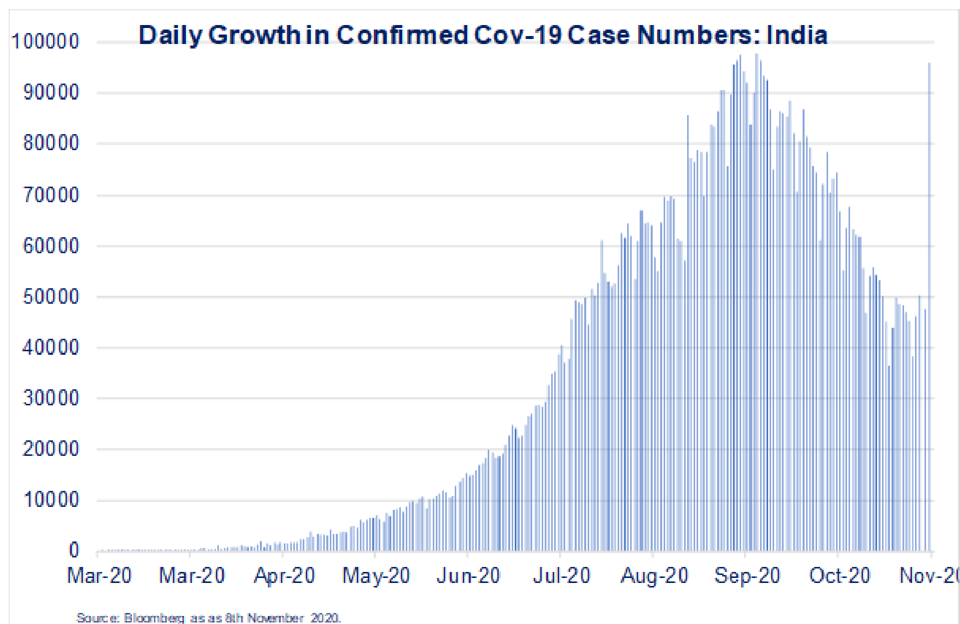


- Among countries, the most cases are in the US (+77.9k (so far) to 9.94 million, with 17 states yet to report), India (not reported, 8.51 million), Brazil (not reported, 5.65 million), France (+125.4k to 1.84 million), Russia (+20.2k to 1.76 million), Spain (not reported, 1.33 million), Argentina (+9.9k to 1.24 million), UK (+20.6k to 1.20 million), Colombia (not reported, 1.14 million) and Mexico (not reported, +962.0k). Australia confirmed cases were +3 yesterday at 27.5k yesterday which placed us 87th in terms of total infections.

  Elsewhere, Singapore recorded +2 new cases to 58.1k most of which are linked to foreign workers who are forced to live in crowded dormitories, but Indonesia (+3.9k to 437.7k) is now on the rise and has now surpassed the Philippines (+2.4k to 396.4k) to be the most infected country in South East Asia.



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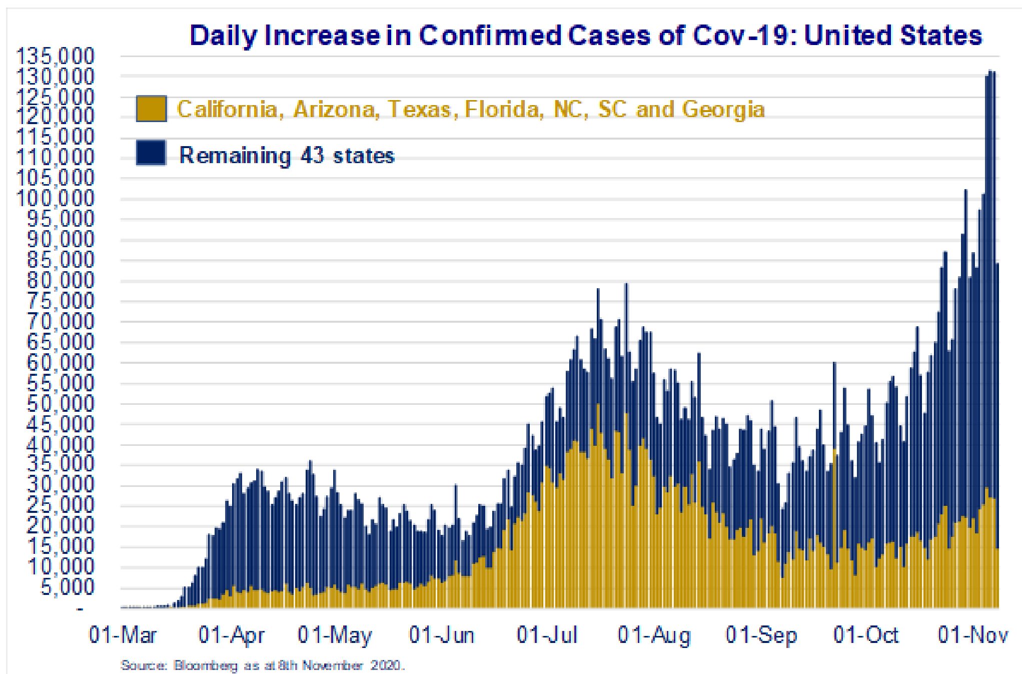
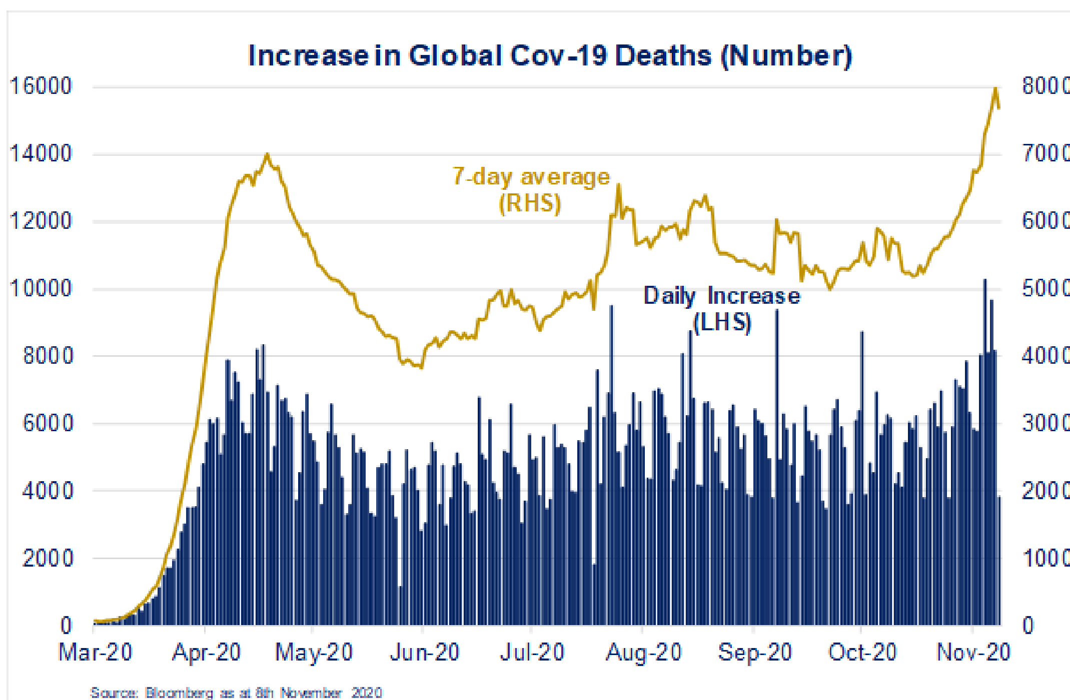


- Although final numbers are not in until 1pm AEST, the global death rate declined to 2.50% with the global total to 1.25 million after another +3.8k deaths overnight, so far, however, the 7-day average is at 7.7k which is close to a six month high. The US (+0.38k so far) has the most deaths at +237.5k, with Brazil (not reported, 162.3k), India (not reported, 126.1k), Mexico (not reported, 94.8k), the UK (+156 to 49.1k), Italy (+331 to 41.4k) and Spain (not reported, 38.8) all over +30k. The death rate in advanced economies is highest in European countries where the health systems had collapsed led by Italy (-0.2% to 4.4%), Sweden (-0.2% to 4.1%), the UK (-0.1% to 4.1%), Canada (-0.1% to 4.0%), Australia (-0.1% to 3.3%), Spain (-0.1% to 2.9%), Belgium (-0.1% to 2.6%) and the US (-0.1% to 2.4%). However, several emerging markets are now on the leader board including Mexico (steady at 10.0%), Ecuador (-0.1% to 7.3%), Iran (-0.1% to 5.6%), China (steady at 5.2%), Indonesia (+0.4% to 3.8%) and Brazil (steady at 2.9%).



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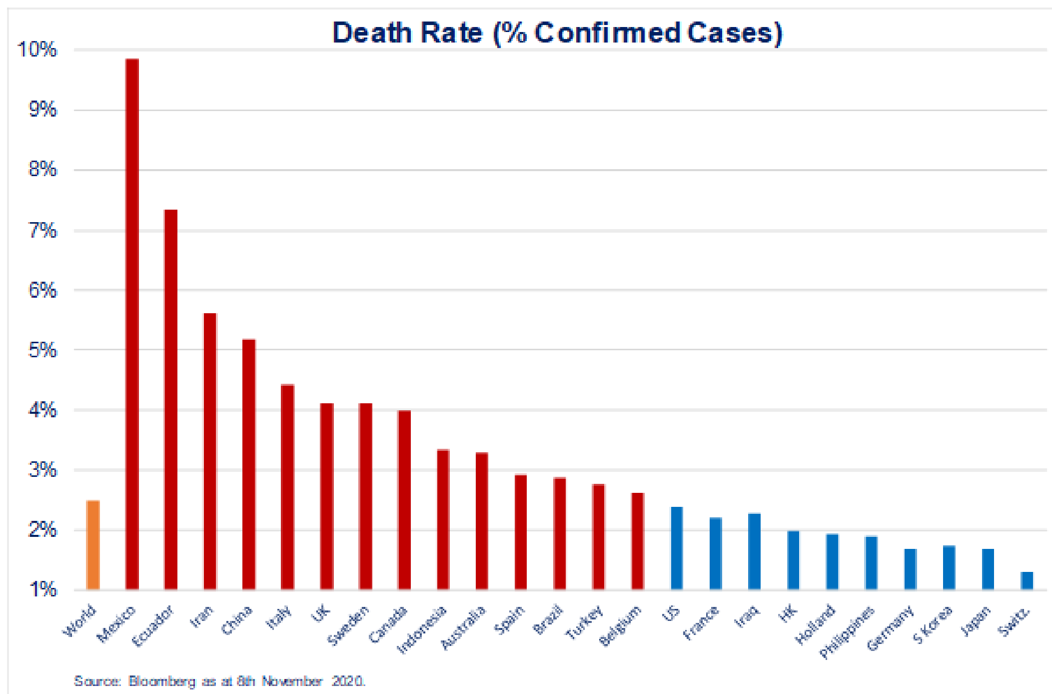

Yours sincerely,

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