Perpetual Investments

THOUGHTS ON THE MARKET

2nd November 2020 - The three big changes in the past three weeks

SUMMARY

- Regional risk markets closed lower last week with the global sharemarket recording its largest weekly loss since mid-March which closed out a second consecutive monthly decline. Over recent weeks, there has been a widening gap between the macro data and trends in risks markets with the former indicating that animal spirits are alive with US and European September quarter GDP growth coming in well ahead of street estimates. In addition, the US reporting has been much better than expected given resilient revenue, strong cost control and rising margins, and this operational leverage suggests that a continuation of the economic recovery will provide a larger than normal boost to earnings in 2021.

  The strength of the global economy has been one of three key developments in recent weeks. The better-than-expected growth bounces were underpinned by a huge surge in goods sector spending supported by both labour re-hiring and falling savings rates, and surprisingly upbeat capex (in the US), whereas services remains quite depressed and inventories further declined, which sets up a likely solid rebound in industrial production in the next few quarters.

  However, markets are not focused on Q3 – they are looking ahead to Q4 and early 2021 where the growth outlook looks clouded given the move to stricter lockdowns in Europe which we anticipate will lead to another economic contraction in Q4'20. Two concerns here are that Europe's second wave is a forerunner for other large parts of the global economy with the winter months still ahead in the Northern Hemisphere (which produces around 85% of global output), and secondly the risk of spillovers with sell-side VAR analysis indicating that a -1% hit to European growth sends global GDP growth down by -0.5% over the subsequent 12 months. The key question here is how long are the lockdowns (which will be primarily aimed at the services sector) needed to get the virus under control.

  The third development is policy. Central banks are likely to do more QE to ease financial conditions, but this is unlikely to provide much offset to the economy as they don't have the tools to materially lift growth and inflation given zero rates. Conversely, we suspect that European governments will press harder on the fiscal peddle. Indeed, while European mobility restrictions are tightening, its fiscal position is easing, and they are likely to overlook ballooning deficits and could remove the entire fiscal drag in 2021 as spending/support measures stay in place.

- In other markets, the losses in 10-year US Treasuries continued for a second week with yields up +3 points to 0.87% which is a 15-month high with curve steepening, commodities were lower with oil recording its largest weekly losses in 6 months (-10.2% to USD35.79 per barrel) which saw it underperform gold (-1.2% to USD1879 per troy ounce) and G10 currencies were universally lower against a stronger Greenback with the deprecations led by the Euro (-1.8% to 116.47), AUD (-1.6% to USC70.28), Sterling (-0.7% to 129.47) and Yen (-0.1% to 104.66).\

- Economic data was upbeat last week with US and European Q3 GDP easily eclipsing street estimates, US initial claims fell nicely, suggesting that the labour market continues to improve, durable goods ex-transport doubled estimates and US personal spending was ahead of consensus underpinned by a falling savings rate. Elsewhere, European headline inflation declined to -0.3% and China service sector PMI lifted five points to 56.2.

- The US reporting season has been upbeat with 65% of the S&P 500 companies having now reported with 86% having beaten street estimates for EPS growth and 81% have beaten on revenue. (both above the 1 and 5-year averages of 73% and 61%, respectively). Amazingly, companies are reporting earnings +19% above estimates which is well above the 5-year average of +5.6%, and this means the annual US earnings decline is now just -10%

which is half the estimate at the end of September (-21.1%), but it is still the sixth quarter of the past seven where annual EPS growth has been negative.

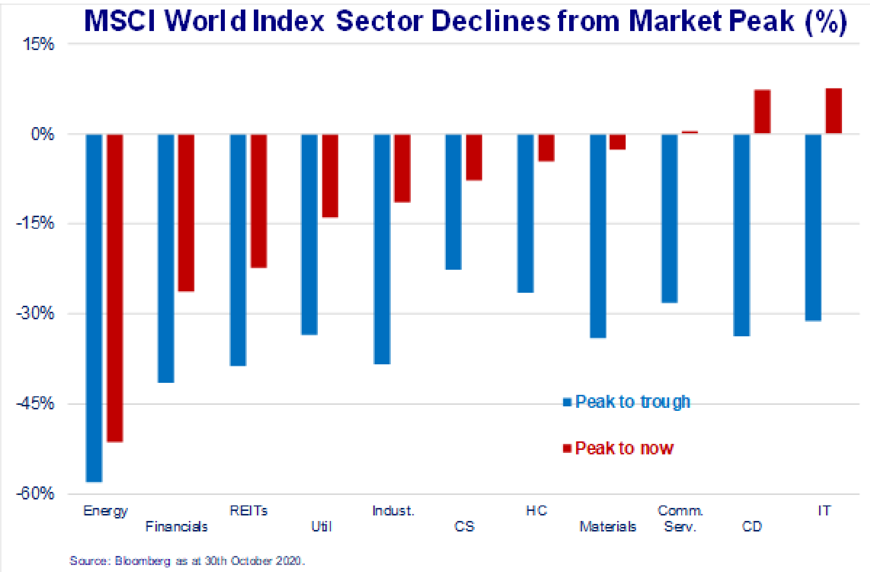
- The number of global cases of COVID-19 is 46.39 million with another +414k cases so far (but Brazil, Mexico, Spain and Sweden and 15 US states have not reported their numbers) which means that Sunday was the 104th consecutive day where daily increases were greater than 200k. At present, 16 countries have more than 500k cases, 32 countries have more than 200k cases and 50 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 1.20 million and the death rate was steady at 2.58% although the number of daily deaths remains elevated.

FINANCIAL MARKETS

- ### EQUITIES

  - **Global equities sold off sharply last week with the MSCI World Index closing -5.7% lower which is its worst weekly performance in 7 months with all sectors recording losses for the first time in 11 weeks.** The selloff was largely blamed on worsening coronavirus trends in the US and Europe, which had investors recalibrating growth expectations and reducing overall risk given stricter European lockdowns. The backup of bond yields meant the tech sector (-6.7%) was the worst performer for the week even though its megacap names on the whole beat expectations. The cyclical sectors also performed poorly as virus concerns outweighed some very strong GDP growth beats in the US and Europe, with industrials (-5.8%) weighed down by airlines and machinery. Meanwhile consumer discretionary (-5.7%) performed in line with the market tape as reopening plays including department stores, apparel retailers, cruise lines, hotels and restaurants recorded sharp decliners. Elsewhere, financials (-5.4%) were led lower by money centre and investment banks, credit cards, life insurers and asset managers, and energy (-5.4%) was hit by demand and supply concerns which send crude prices down to its lowest level since June. Lastly, defensive sectors outperformed with REITs (-4.2%), utilities (-4.1%) and communication services (-3.7%) among the better performers but still down over -4%.

    Such large price declines sparked some major moves on our February peak-to-now chart with energy (-51.4%) now down by half (with its recovery rate down to just +11%), with financials (-26.3%, 37%) and REITs (-22.4%, 42%) also in bear market territory. Meanwhile, utilities (-13.9%, 58%) and industrials (-11.4%, 70%) went back into correction territory, with only tech sectors now having recorded complete recoveries including communication services (+0.5%, 102%), consumer discretionary (+7.3%, 122%) and IT (+7.7%, 125% - see chart).



  - **Among the regions, the pace of losses was led by Europe (-7.5%) which recorded its third consecutive weekly decline and its largest weekly price drop the past 33 weeks, which took the index back to levels last seen in May.** The price plunge was sparked by ongoing increases in COVID-19 infections across the region, which forced Germany, France and the UK to implement lockdowns for all of November and fed into worries over Q4 growth. This concern overshadowed a strong European reporting season which hit its

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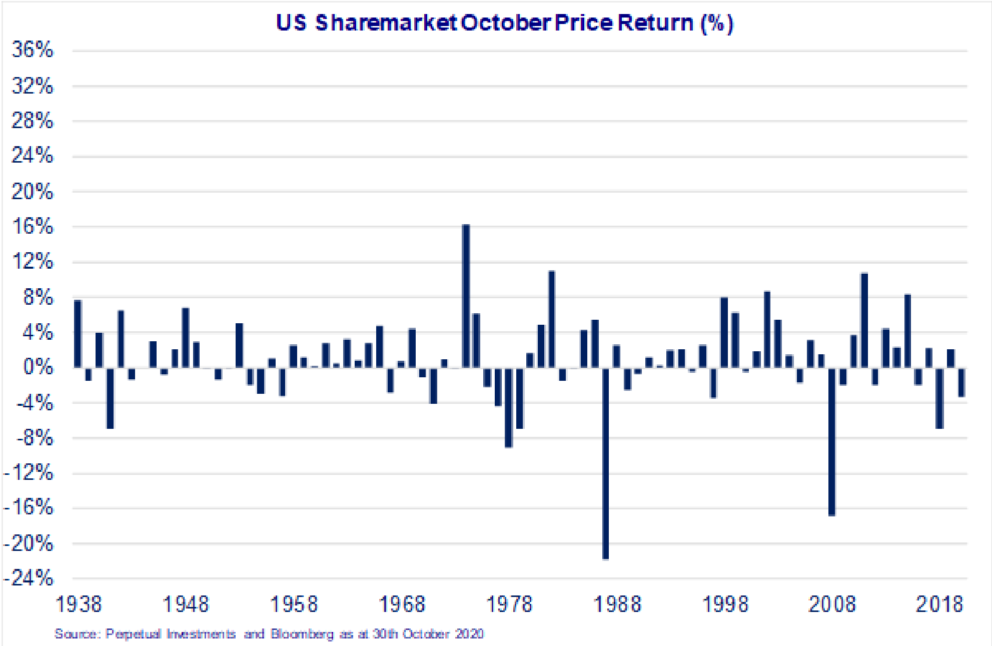
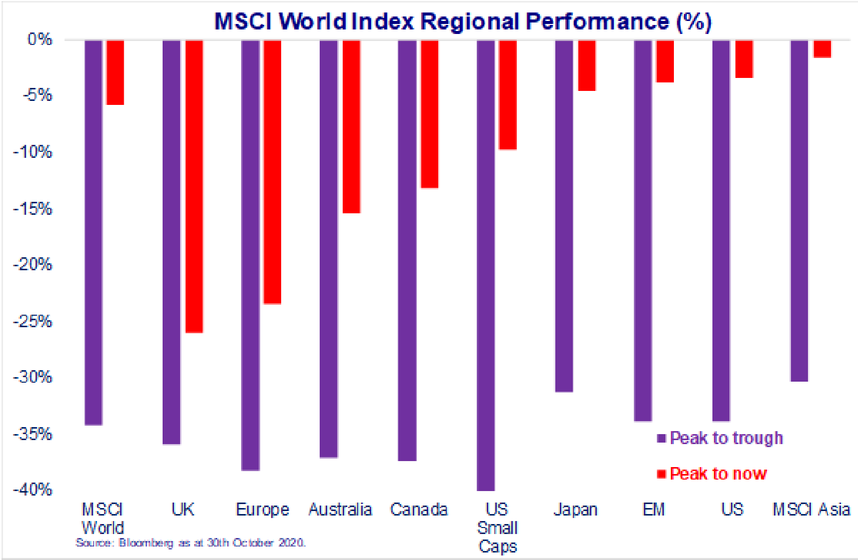
halfway market with 74% of firms having delivered results which topped street estimates and 54% are beating on revenue, but earnings are still down -17% y/y. Meanwhile, the ECB's sent a strong signal for December policy easing which saw the Euro decline and bond yields fall. Elsewhere, Brexit talks continued with some minor signs of progress. By the close of trading on Friday afternoon, all indices had taken on considerable water with losses led by Germany (-8.6%), Italy (-7.0%), France (-6.4%), Spain (-6.4%), Sweden (-5.6%), UK (-4.8%) and Switzerland (-4.4%).

Meanwhile, US shares (-5.6%) were subjected to second week of price declines as worsening COVID-19 trends dominated the headlines and this saw the region close out a second consecutive month decline (-3.3% in October which is the fourth worst October result in the past 41 years – see chart). The US recorded its four highest daily case counts last week in which an average 72k people had tested positive which is the highest on record with pressure on the health system intensifying which sparked fears of more lockdowns like have been implemented across much of Europe, but there seems to be resistance to more draconian measures. On the macro front, data was upbeat with September quarter GDP, the week's initial and continuing jobless claims, September personal income and spending, and durable goods, all coming in ahead of the street. There was also considerable discussion about the election on Tuesday where polls suggest the battleground states have tightened and there now seems no hope of stimulus being passed until the election result in known which could takes weeks. By the close of trading for the week, all indices closed in the red led by the Dow Jones (-6.5%), Russell 2000 (-6.2%), S&P 500 (-5.6%) and the NASDAQ Composite Index (-5.5%).



Asia (-2.5%) outperformed its peers for a third straight week with the mainland Chinese market repeating its ability to shrug off early weakness to close higher. Conversely, other bourses seemed more susceptible to the growing sense of unease about COVID-19 infection rates and its impact on the global recovery, as well as fading hopes of near-term US fiscal stimulus and the US election itself. On macro front, data was limited but Japan and South Korea logged stronger growth in industrial production, Japan unemployment was unchanged (at 3.0%) in defiance of expectations for a clear upshift and Australian private sector credit returned to growth. On the policy front, the BoJ was unchanged as widely expected but downgraded FY20 economic forecasts at the margin. By the closing bell in Mumbai on Friday night, all bourses closed with weekly declines including China (-0.5%), Australia (-1.9%), India (-2.6%), Taiwan (-2.7%), Japan (-2.8%), Hong Kong (-3.3%) and South Korea (-4.0%).

The weekly price movements saw the UK (-26.0%) return to its lowest level since May as did Europe (-23.5%) which is now firmly entrenched in bear market territory. Meanwhile, Australia (-15.5%) and Canada (-13.2%) are both in correction territory with US small caps (-9.8%) seemingly one day away from joining that group. All other regions are now below their February peak with Asia (-1.6%) now the best performing market (see chart) with Japan (-4.6%) seemingly defying both the higher Yen and the massive decline in its earnings (which is down -29% since February).



- **This week was the peak week of Q3 US earnings season in which 65% of the S&P 500 companies have now reported with 86% having beaten street estimates for EPS growth, which is more than both the one- and five-year average (both 73%), with 81% of firms beating on revenue (both 61%), which is a record high.** Amazingly, companies are reporting earnings +19% above estimates which is well above the 5-year average of +5.6%, and this means the annual US earnings decline is now just -10% which is half the estimate at the end of September (-21.1%), but it is still the sixth quarter of the past seven where annual EPS growth has been negative. There was no real surprise from a thematic perspective with companies leveraged to at-home trends (work, learn, watch, eat) reporting some of the best results, with cloud, auto and housing exposures providing a tailwind while Q3, whereas travel, cross-border and urban exposure remained the big headwinds.

  Mega-tech companies were punished last week even by investors last week despite a very strong set of results. For example, Apple (-5.4%) beat on revenue and EPS but as iPhone revenue missed and there was no formal revenue guidance the stock was sold down heavily. Similarly, Amazon's (-5.3%) revenue beat and operating income almost doubled last year's result given the structural shift to e-commerce, but the light guidance about Q4 saw the company recorded losses similar to Apple. Meanwhile, Facebook (-7.6%) reported a big beat underpinned by a recovery in digital advertising in the US and Canada, but the company guided for higher investment and highlighted risks surrounding economic normalisation and the regulatory environment which sent the stock down sharply. All of this may reflect the market pricing in a Biden and Democrat clean sweep which could see a steeper yield curve, more regulation and a tightening of tax rules.

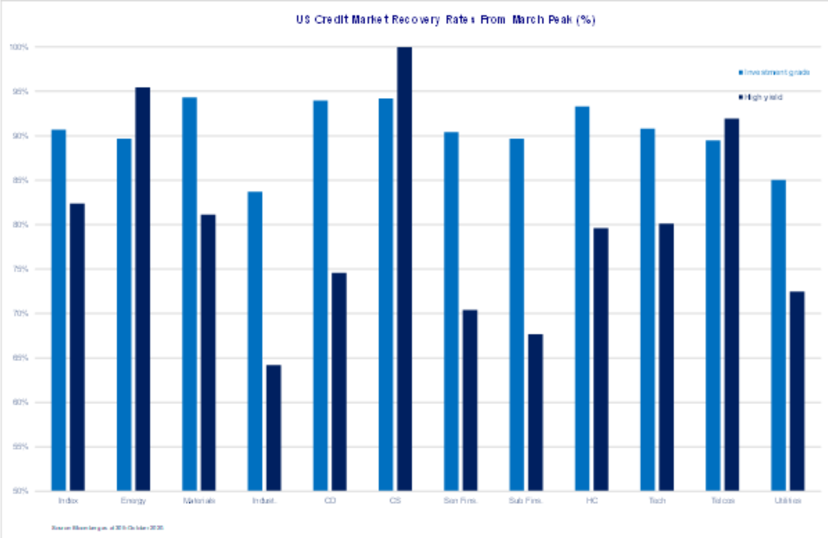
  Notwithstanding this trend, the market continued to punish underperforming firms two days either side of the announcement with losses of -5.6%, whereas outperformers saw a smaller -1.7% decline. Looking ahead analysts expect another quarter of negative revenue and EPS growth in December 2020 (-0.5% y/y and -11.2%, respectively) before returning to position growth for both in each of the subsequent two quarters and CY2021 (+7.9% y/y, +23.0% y/y – see chart).

	Energy	Industrials	Consumer Disc.	Materials	S&P 500	Financials	Comm. Services	Info. Technology	Health Care	Consumer Staples	Utilities	Real Estate
Today		78.4%	67.4%	29.7%	23.0%	21.0%	16.6%	14.1%	11.5%	6.5%	5.7%	5.6%
30-Sep		87.5%	75.8%	25.8%	29.9%	29.1%	20.0%	13.6%	13.6%	6.8%	5.9%	7.0%

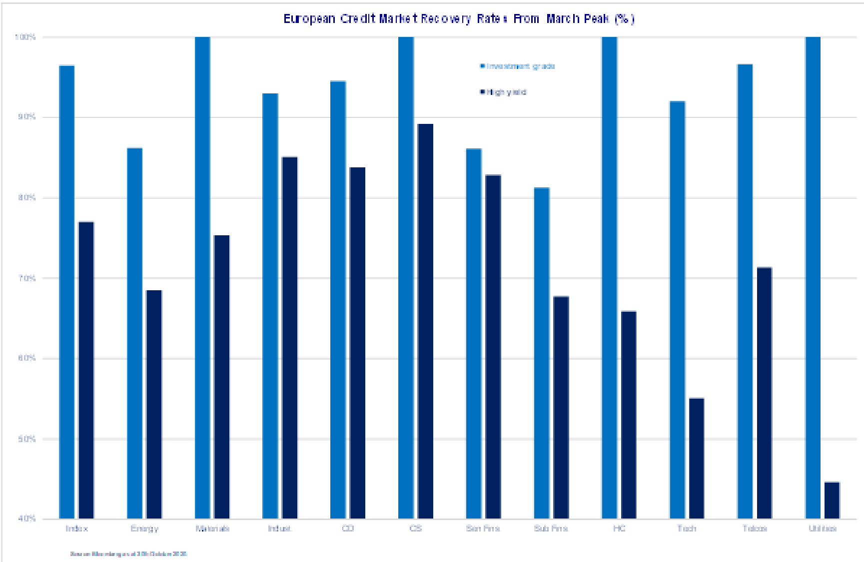
- **Futures markets suggest a strong opening in Asia** with Japan (+1.3%) and Australia (+0.9%) priced for a strong advance, but Hong Kong is signalling a modest decline (-0.1%) at the bell.

• CREDIT MARKETS

- **Regional credit indices were lower over the past week, but the central bank backstop in the investment grade markets is achieving its purpose with spreads in the US investment grade sector rising only +4 points to +127 basis points, which lowered the recovery rate one notch to 91%.** All 11 sub-sectors recorded capital losses but only energy (+8 points, +196 bpts, 90%) and industrials (+5 points, +131 bpts, 84%) lagged the market tape. In contrast, spreads in the high yield sector increased +31 points (5-week high) to +531 bpts, which lowered the recovery rate five notches to 82% with capital losses in all 11 sub-sectors. Traditional cyclical sectors experienced the largest spread increase led by energy (+45 points, +846 bpts, 95%) which responded as expected to the largest weekly decline in oil prices in 29 weeks, subordinated financials (+40 points, +558 bpts, 68%) despite the steepening of the US yield curve, and industrials (+33 points, +591 bpts, 64% - see chart).

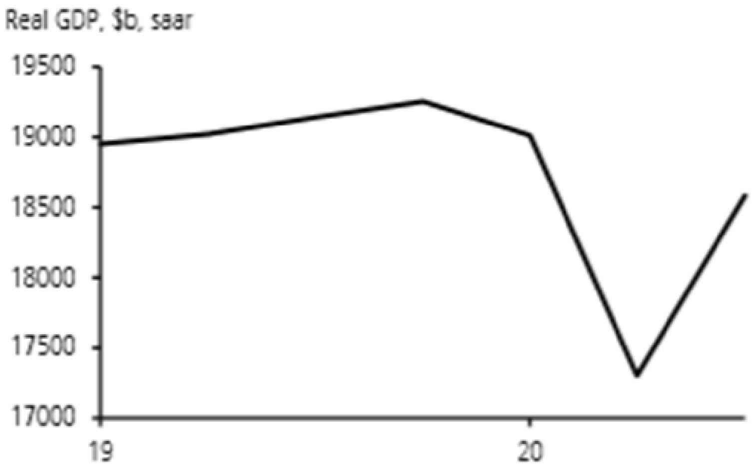


- **European credit markets were mixed with spreads in the investment grade space unchanged from last week at +45 basis points** with the recovery rate at 96%. Among the sub-sectors 6 recorded capital losses led by subordinated financials (+12 +148bpts, 81%) but after this, no market area recorded a move of more than a handful of points. In contrast, the lack of a central bank backstop saw spreads in the high yield universe increase +31 points to +413 bpts, which lowered the recovery rate five notches to 77%. All 11 sub-sectors recorded double digit spread increases led by energy (+54 points, +582 bpts, 69%) where spreads rose to a 16-week high given the lower crude price, tech (+47 points, +390 bpts, 55%) and subordinated financials (-38 points, +483 bpts, 68% - see chart).

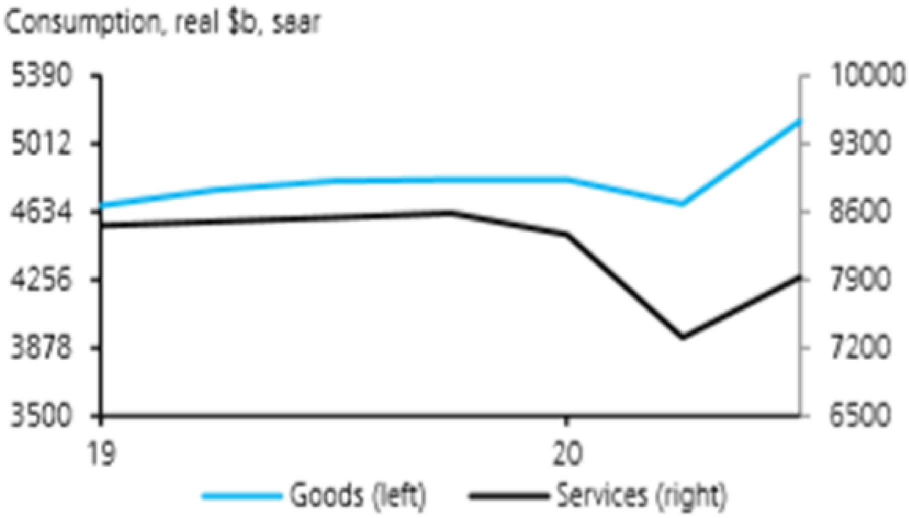


THE GLOBAL ECONOMY

- **The first estimate of September quarter US GDP was a strong report which detailed growth of +33.1% q/qa (and +7.4% q/q) which was above expectations and the largest quarterly gain on record,** but even that record increase still meant the recovery was far from complete with economy-wide output down -3.5% y/y (see chart).



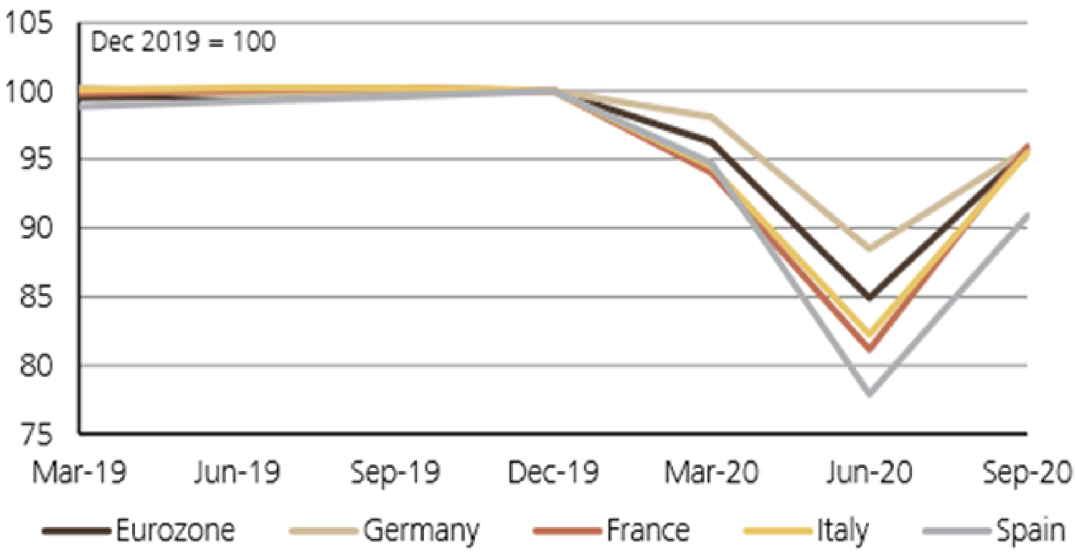
Among the components, personal consumption rose +40.7% q/qa (-2.9% y/y) underpinned by spending on goods (+45.4% q/qa, +6.9% y/y) which overshot pre-COVID-19 levels by around USD0.5 trillion (see chart), with solid increases also recorded in residential investment (+59.3% q/qa, +6.6% y/y, supported by low rates and higher savings) and business equipment investment (+70.1% q/qa).



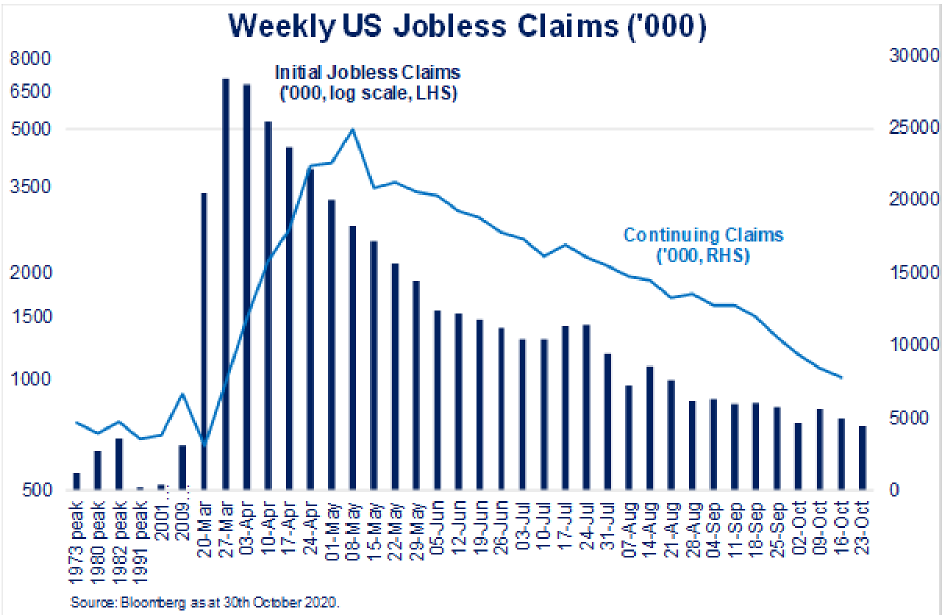
In contrast, consumer services spending did rise but remains depressed (-6% below pre-COVID 19 levels – see chart), business structures declined further (-14.6% q/qa, which was the fourth consecutive quarter of declines) and government spending, (-4.5% q/qa) also dragged with falls in both Federal and State and local government. Meanwhile, net exports detracted (-3.1% pp).

- **Eurozone flash GDP data for Q3 showed the regional economy expanded +12.7% q/q which was much stronger than expected** (+9.4% q/q). The better outturn came after strong readings from Germany at +8.2% q/q (-4.2% below its end-2019 level), France +18.2% q/q (-4.1%), Italy +16.1% q/q (-4.5%) and Spain +16.7% q/q (-9.1%). No expenditure breakdown is available yet (that comes in 12 days at the second estimate) and although the growth rebound was impressive, overall output remains well below pre-COVID levels (see chart) and attention has already turned to the disconcerting rise in COVID-19 infections which has already sparked significant tightening in social mobility in the G4 regional economies (including partial lockdowns in Germany and France). Rising case numbers have already prompted Eurozone confidence to ease in October and Italian consumer confidence has deteriorated. France said its month-long lockdown would cut output by

-15% but Germany was more upbeat. We suspect that one month of lockdowns will not be enough to stem the virus spread and that a longer lockdown will be required, which will be at the expense of economic growth.



- **In other results:**
  - **US jobless claims** - Claims data were positive as the string of recent improvements continued and new claims fell by -40k to 751k which is the lowest since the crisis began in February. Meanwhile, continuing claims -709k for the week ending Oct. 17 to 7.8 million which was in line with the street, but I continue to think that like recent weeks, much of the drop reflects expiring benefits not rehiring (with the PEUC program which is the extended benefits beyond CARES rose by +387k). The claims data combined with other internet labor market surveys still show the labor market recovery is continuing but with slightly slower employment growth in October relative to recent months.



  - **US personal spending and income** - Personal spending increased +1.4% m/m in September, with goods spending up +2.0% m/m (+8.2% y/y), as was evident in already-released retail sales data. In contrast, services spending increased +0.8% m/m (-7.0% y/y). Meanwhile, personal income increased +0.9% m/m with labour income up solidly on increasing payrolls (+0.8%), and transfer payments (-0.1%) were weaker than expected as unemployment fell and the executive order unemployment benefits did not fill in as much as expected. Interestingly, compensation of private sector employees is now up +0.5% y/y which provides some hope that spending can be self-sustaining, but spending is still being funded through a lower savings rate which fell for a fifth consecutive month but remains elevated at 14.3%, but this is a finite pool and needs the private sector to get back on its feet quickly, but rising Cov-19 cases may limit its ability to do so.

POLICY

- **As widely expected, the BoJ left short, and long-term rates, and its guidance, unchanged as its October meeting in an 8-1 vote.** However, there was a minor downward revision to FY20 GDP growth given the sluggish recovery in service sector demand and core inflation was tweaked lower given the government's 'Go To Travel' campaign which lowered the cost of domestic tourism, but the revisions were minor and were only just noteworthy. However, the balance of risks are still skewed strongly to the downside given COVID-19 impacts on major economies.

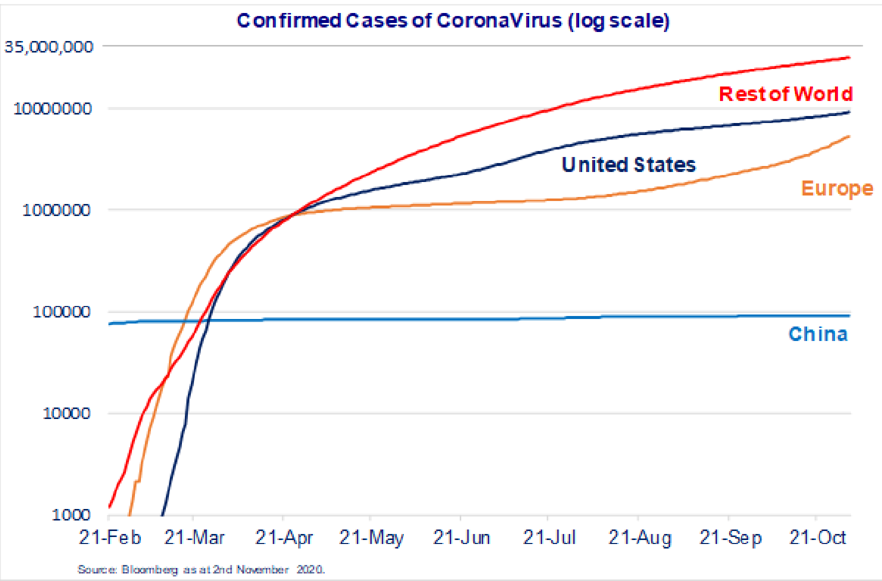
- **The ECB's October meeting left its key policy settings unchanged but sent a strong signal that easing will be provided at its December meeting** to ensure financial conditions remain easy. President Lagarde noted that there should be little doubt that the ECB will act in December and she said that the policy committees has begun to determine the optimal policy mix. The (now) four-week lag until its next meeting will enable the ECB to evaluate incoming data, monitor vaccine developments and analyse the effectiveness of COVID-19 mitigation measures and to have clarity on the US presidential election and Brexit. However, no matter what they do, they can provide little additional direct support to the economy as rates are already negative but an extra €500 billion of asset purchases and another extension of the TLTROs should help ease financial conditions at the margin.

- **The UK and EU continued their intensive talks to nut out a Brexit deal** before the end of the transition period at end-2020, but the latest time to enable a ratification of the deal is about 15th November. While there appears to be a touch more optimism (form a very low base) about a deal being reached in early November, there still appears to be huge differences around fishing quota with French President Macron signalling a hard-line position, but apparently he told fishing industry chiefs that access to UK waters would not be the same post-Brexit. UK PM Johnson and EU President von der Leyen will try to have another meeting this week. Stay tuned.

VIRUS UPDATE

- The number of global cases of COVID-19 is 46.39 million with another +414k cases so far (but Brazil, Mexico, Spain and Sweden and 15 US states have not reported their numbers) which means that Sunday was the 104th consecutive day where daily increases were greater than 200k. At present, 16 countries have more than 500k cases, 32 countries have more than 200k cases and 50 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, 3 days, 4 days, 4 days, 2 days, 2 days, 3 days, 2 days, , 2 days, 2 days and 3 days. More importantly, the growth rate of daily confirmed cases (+1.1% since Thursday) is slightly higher. Meanwhile, deaths stand at 1.20 million and the death rate was steady at 2.58% although the number of daily deaths remains elevated.



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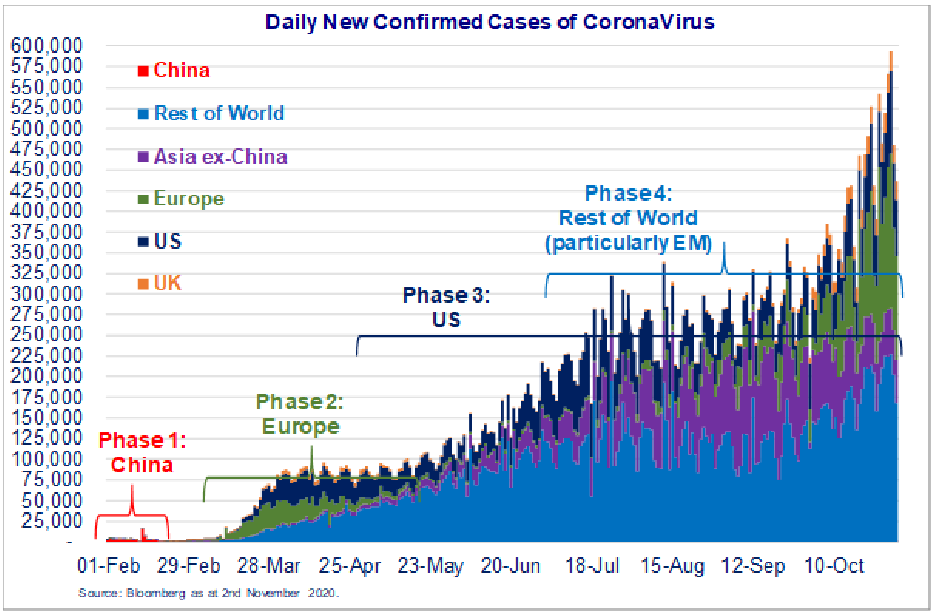
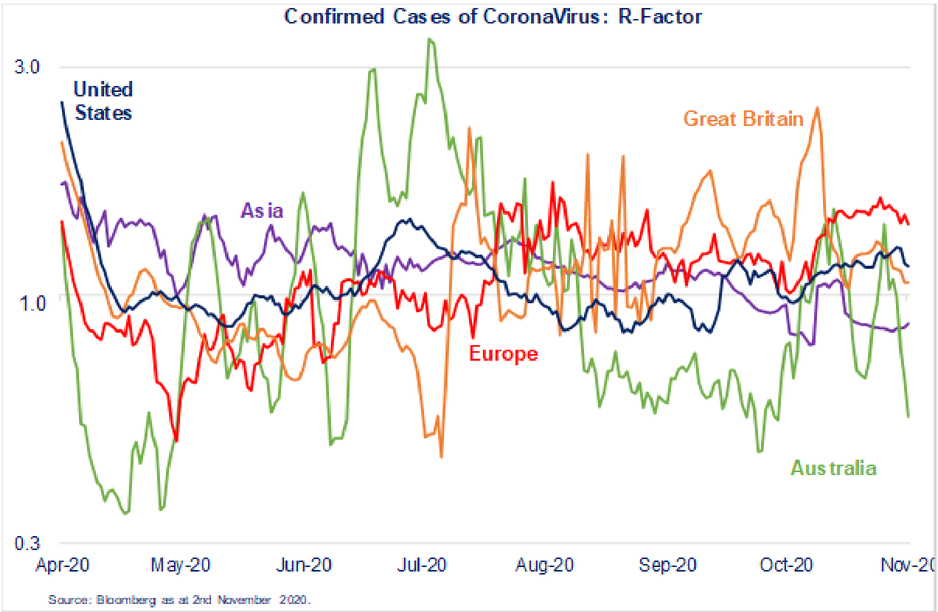
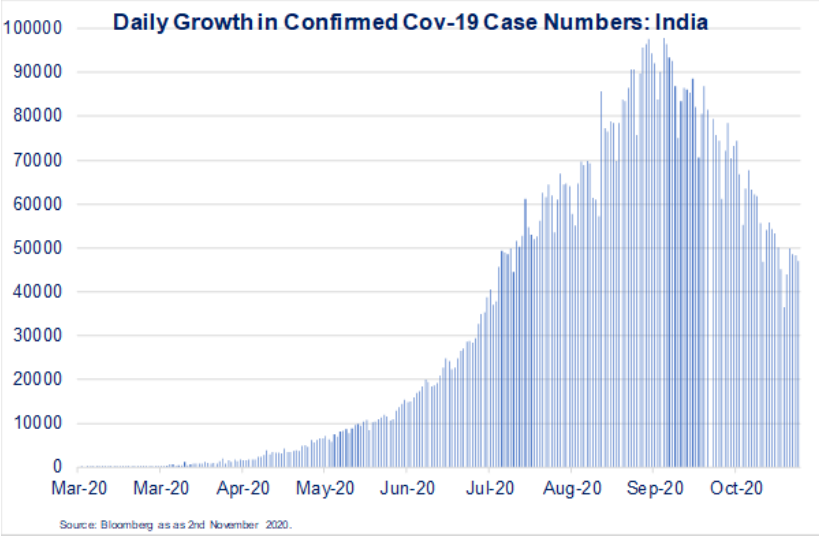
- We break the infections into four groups – the US, Europe, China and 'others' and the rest of the world outside the G3 economies now has the most total cases (+220.9k to 41.29 million) and highest daily new cases (and by a considerable margin) followed by the US (+67.6k to 9.19 million, although 16 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 (+125.4k to 5.35 million - see chart) with an R-factor at 1.41 which indicates that the infection rate is rising rapidly, and this is higher than the UK (1.06), the US (1.15) and Asia 0.87.

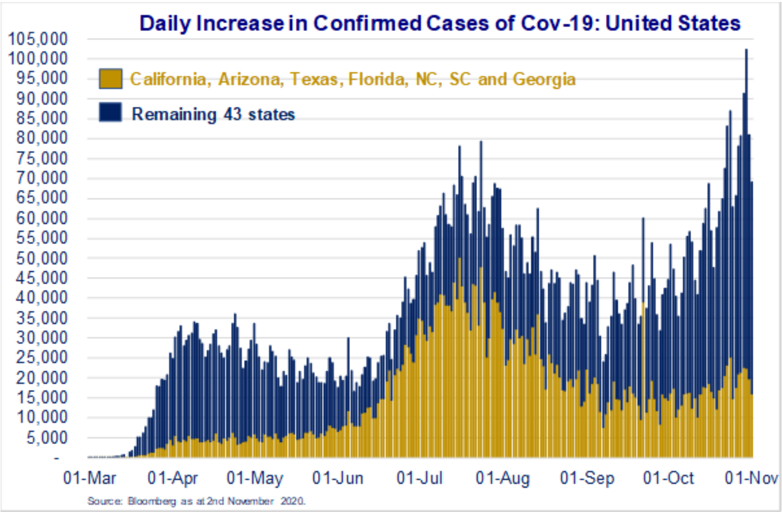




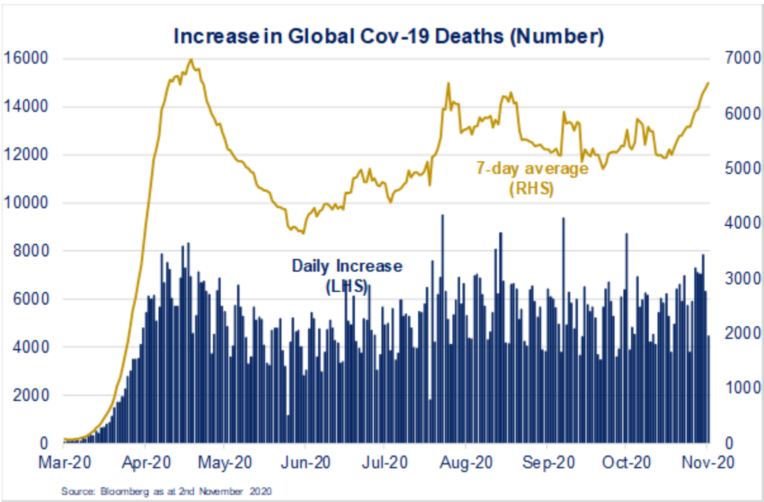
- Among countries, the most cases are in the US (+67.6k (so far) to 9.19 million, with 16 states yet to report), India (+47.0k to 8.18 million), Brazil (not reported, 5.54 million), Russia (+18.4k to 1.62 million), France (+46.3k to 1.46 million), Spain (not reported, 1.19 million), Argentina (+9.9k to 1.17 million), Colombia (+20.7k to 1.07 million), UK (+23.3k to 1.04 million) and Mexico (not reported, +925.0k). Australia confirmed cases were zero yesterday at 27.5k yesterday which placed us 89th in terms of total infections.

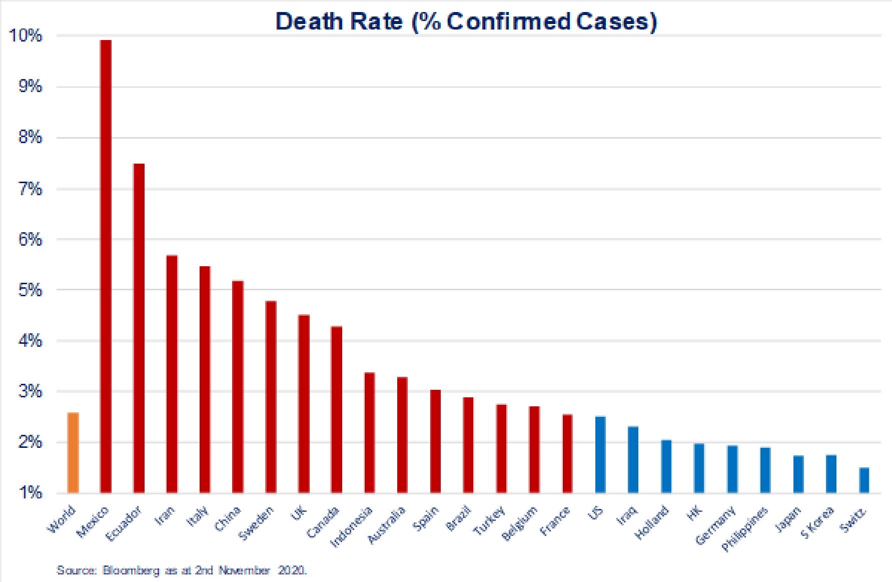
  Elsewhere, Singapore recorded +4 new cases to 58.0k most of which are linked to foreign workers who are forced to live in crowded dormitories, but Indonesia (+2.7k to 412.8k) is now on the rise and has now surpassed the Philippines (+2.4k to 383.1k) to be the most infected country in South East Asia.





- Although final numbers are not in until 1pm AEST, the global death rate declined to 2.58 with the global total to 1.20 million after another +4.5k deaths overnight, so far, however, the 7-day average is at 6,565 which is a six months high. The US (+0.37k so far) has the most deaths at +230.9k, with Brazil (not reported, 159.9k), India (+0.5k to 122.1k), Mexico (not reported, 91.8k), the UK (+161 to 46.8k), Italy (+208 to 38.8k) and Spain (not reported, 35.9k) 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 5.5%), Sweden (-0.2% to 4.8%), the UK (-0.1% to 4.5%), Canada (-0.1% to 4.3%), Spain (-0.1% to 3.0%), Australia (-0.1% to 3.3%), Belgium (-0.2% to 2.7%) and France (-0.1% to 2.5%). However, several emerging markets are now on the leader board including Mexico (-0.1% to 10.0%), Ecuador (-0.1% to 7.5%), Iran (-0.1% to 5.7%), China (steady at 5.2%), Indonesia (steady at 3.4%) and Brazil (steady at 2.9%).





Source: Bloomberg as at 2nd November 2020.

Yours sincerely,

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