Mutual Limited

Weekly Wonderings: Monday 12 October, 2020

Quote of the day…

"Politics: Poli a Latin word meaning many and tics meaning bloodsucking creatures …" – *Robin Williams*

The short story "markets want to go higher…"

- ***Overview –*** from a likely Democratic sweep in the US election (according to the polls and odds) to the unwinding of September's correction, to a belief that a stimulus package is inevitable, a bundle of divergent explanations exist for what just spurred a meaningful boost to risk sentiment with the stock market's booking their largest weekly gain since June. Trump upped the ante on the stimulus front, "*I would like to see a bigger stimulus package, frankly, than either the Democrats or the Republicans are offering*"…there is also question marks being raised around Trump's mental capacity given the cocktail of COVID medication his doctors are dosing him with. Public holiday tonight in the US, Columbus Day.

- ***Stocks*** – "*it's been a game of name your narrative for a stretch*"…solid gains across stocks in which US markets outperformed European markets, but then the ASX 200 trumped then all. All this in a week where the Donald binned and dusted off economic aid, virus infection rates rose and more people in the US filed for first-time jobless claims than estimated. Markets generally bottomed in the recent mini-cycle some 16 days ago, since then markets have surge in the US, up ↑7% - 8%, shrugging off a presidential COVID-19 diagnosis and one of the more contentious, yet comical, electoral debates. Locally, the ASX 200 stalled on Friday, closing unchanged, but had a very solid week, outperforming all comers.

- ***Offshore Credit*** – with stocks buoyant and volatility waning, a positive week in offshore credit with a solid tightening of spreads and decent primary issuance. US markets were quiet on Friday ahead of the Columbus Day long weekend, with no deals priced. It was a reasonably active week, however. EU markets underperformed US markets, but positive nonetheless. CDS markets also tighter, ↓1.6 bps - ↓2.1 bps on the day across CDX and MAIN respectively, with both ↓4 bps tighter on the week.

"S.O.L…"

Source: www.hedgeye.com

At a glance….		*Last*	*1W*	*30D*
EQUITIES	ASX 200	67,795	5.4%	1.7%
	DOW	28,587	3.3%	3.9%
	S&P 500	3,477	3.8%	4.4%
	NASDAQ	11,726	4.2%	5.9%
	STOXX	370	2.1%	1.8%
CREDIT	AusBond FRN (bps)	48.9	-2.77	-0.26
	AusBond Fixed (bps)	94.2	-2.61	-0.33
	US Fin (OAS, bps)	103.1	-8.32	-4.94
	EU Fin (OAS, bps)	64.8	-4.91	-2.63
BONDS	ACGB (10Y, %)	0.850	0.02	-0.12
	ACGB (3Y, %)	0.138	-0.03	-0.13
	UST (10Y, %)	0.774	0.07	0.09
	UST (2Y, %)	0.153	0.02	0.01
FX & CMDTY	Oil (Brent, $/bbl)	42.73	8.8%	7.4%
	Gold ($/oz)	1,930	1.6%	-0.1%
	AUDUSD	0.724	1.1%	0.4%
	AUDEUR	0.612	0.1%	-0.1%

Source: Bloomberg, Mutual Limited

- ***Local Credit*** – going to the trader's tapes…"*an active end to the week with all sectors better bid as strong domestic real money buying picked up momentum. Corporates and Tier 2 in particular benefiting*". Spreads tighter on the day and the week…more of the same ahead, a slow grind.

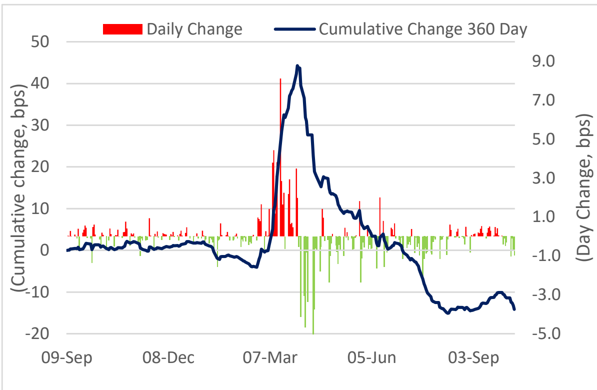
- ***Bonds*** – modest moves across the ACGB curve over the week, with a modest bear steepening as markets continue to pricing in the growing expectation of official cash rate cuts and lower three-year yield targets. ACGB ten-year bonds are hovering a few basis points below post pandemic averages (0.88%), while three-year yields are hovering a couple of basis points off all time lows, set intra-day during the week at 0.12%.

- ***Ahead*** – RBA Guvna Lowe speaks at the Citi Investor Conference on Thursday. We're looking for some guidance on the direction of monetary policy and whether November will be a live meeting (market pricing suggests it is). Also on Thursday, we have local labour force data, which is expected (consensus) to see 35K jobs added (vs 111K last month), but with unemployment rate to rise to 7.1% from 6.8%.

The long story…

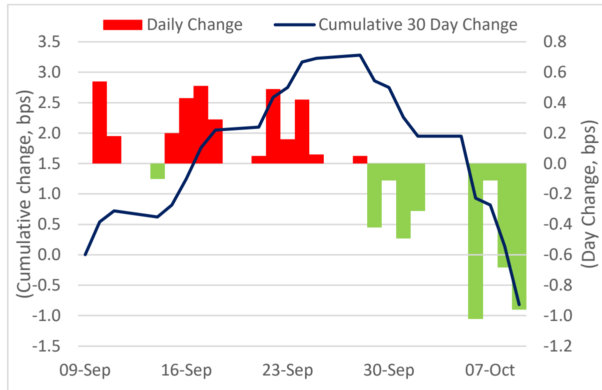
Credit – "falling volatility and US political 'certainty' driving buoyant risk appetite…?"

AusBond Credit FRN, 360D cumulative change…



Source: Bloomberg, Mutual Limited

AusBond Credit FRN, 30D cumulative change…



Source: Bloomberg, Mutual Limited

- A subdued end to the week in offshore primary issuance. Credit spreads continued to grind tighter in secondary, buoyed by declining volatility in equity markets and the perceived clearer political path. Trump also realising the perilous state of his presidential campaign has thrown his support behind a larger stimulus package and encouraged his troops to do a deal with the Democrats.
- A couple of solid sessions in local credit, as reflected in the green bars on the above two charts. A mix of positive vibes from offshore markets combined with the slow dawning realisation among investors that supply of A$ paper is going to remain subdued, especially from the local banks. And that's one thing about the local credit market, under 'normal' operating conditions, there is generally always demand for new paper…compulsory superannuation helps the cause. It is noted however, that Australian super assets are heavily weighted to stocks and underweighted to fixed income (second lowest amongst the top 50 OECD countries at around 10% - average is 3x – 4x)….but that's a discussion for another day.
- Major bank senior paper edged tighter toward the back half of the week, with the Jan-25's closing at +43 bps, around ↓3 – 5 bps tighter over the week. In the tier 2 space we saw demand sweep back into the market, something we've been positioning for over the past month. The ANZ 31-26 closed at +179 bps on Friday, ↓3 bps tighter, while the NAB 31-26 was a step behind in the tightening stakes, ↓2 bps to+190 bps. The shorter dated CBA 30-25 was on the same page as the ANZ deal, tightening ↓3 bps to close the week at +174 bps, now ↓6 bps inside reoffer levels. The Macquarie 30-25 is trending well and could find itself sub +200 bps before long, ↓2 bps to +209 bps. Lastly, the well populated 29-24 strip edged a basis point tighter to +170 bps. Too much vigour on the tightening front and another tier 2 deal for the calendar year might just squeak out. If so, it'll likely be WBC and if it comes, I'd say November, post results (scheduled for November 2).
- ***Prevailing theme – tactically equity volatility has eased off on the apparent stabilising US political outlook, which is generally supportive of spreads. Prevailing fiscal and monetary policy stances are supportive of the recovery prospects, which exerts a tightening bias on spreads. Spread practicalities are however that local spreads are generally tight, so scope for meaningful tightening is limited – especially in major bank senior paper. Tier 2 is offering more scope however. Risk appetite will likely firm up further once we get through the US election and the result pans out as markets currently expect. Spreads will also benefit from more accommodative monetary policies from the RBA. Longer term, over the next 6 months or so, we're focused on when the Victorian economy is to re-open and what happens with mortgage deferrals (i.e. bank asset quality impact) as key fundamental events.***

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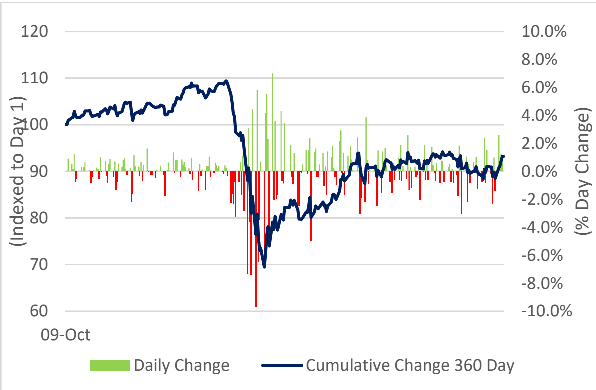
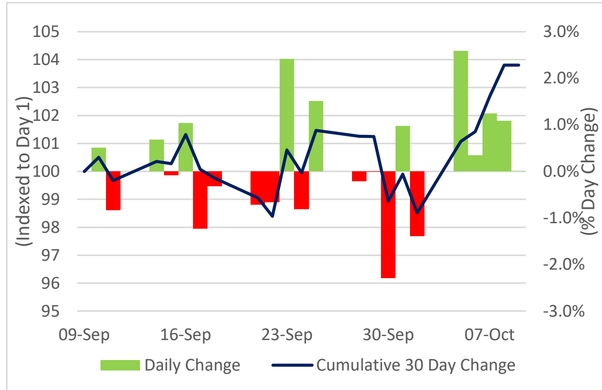
Stocks – "in Biden markets trust…apparently"

ASX 200, 360D cumulative change…



Source: Bloomberg, Mutual Limited

ASX 200, 30D cumulative change…



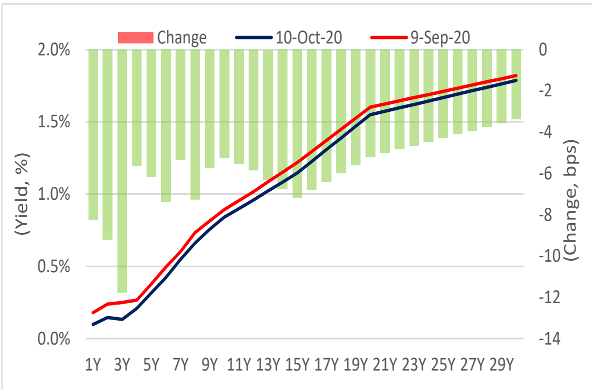
Source: Bloomberg, Mutual Limited

- US fiscal stimulus seems to be back in play after a brief rest on the sidelines with the oranges and the fat wheezy kids. In what smells of an insecure kid in the schoolyard trying to talk himself up, Trump said on Friday "*I would like to see a bigger stimulus package, frankly, than either the Democrats or the Republicans are offering*." No details provided though and suggesting a complete 180-degree spin to his prior stance. His comments also contradict own negotiators. On Friday, Treasury Secretary Steven Mnuchin reportedly presented Nancy Pelosi with a new $1.8 trillion offer – up from the $1.6 trillion offer that was previously on the table, and closer to the $2.2 trillion package the Dems were hustling. To dampen the immediate optimism, Mitch McConnell said any deal is unlikely before the election (November 3).
- I spend a lot of time talking about the US market because it is the biggest market in the world and the ASX 200 is highly correlated to the S&P 500 (~90% - 95%). The two most dominant themes in the US markets right now are expectations of fiscal stimulus, touched on above, and the likely outcome of the US Presidential Election. Polls have Biden leading at 51.9%, with Trump at 42.1% and 6.0% undecided – oddly enough at the same stage of the last election, Trump was also at 42.1% in the poll's vs Clinton a 47.6%, and a much larger 'undecided' vote at 10.2%. In the odds market, Biden has tightened into $1.33, which Trump is out to $3.20 vs $2.80 last week.
- Optimism that the election will produce a 'clean' result, with an absolute and outright winner (i.e. margin beyond doubt and no likely shenanigans from Trump if he doesn't win) is seeping through to the local markets. While odds of a comprehensive fiscal package being done before the election (three weeks away) are long, markets sill nonetheless are content that one is coming, at least that's what's being priced.
- Valuations are still frothy vs fundamentals and the broader, uncertain, macro outlook. But, at the moment fundamentals are being dominated by technicals, specifically flow. With bond yields in the toilet (very low), and credit spreads tightening, combined with massive amounts of stimulus and liquidity being pumped into the system, investors want more returns and are willing to take more risk for that little bit more. At the end of the day, the central banks of the world have said, "*whatever it takes*". So, the music keeps playing, and we keep dancing. But at some stage fiscal there'll be a day of reckoning.
- What does froth valuations look like? The ASX 200 is sporting a forward PE ratio of 21.0x, two turns above pre-pandemic levels of 19.0x, which itself was elevated vs long averages (~15.0x). Post pandemic peaks were 22.5x. Forward EPS are down 23% since the start of the pandemic, reflecting the recessionary impact of lockdowns and elevated unemployment. Uncertainty on the path of recovery remains high despite the volume of stimulus in the system.
- ***Prevailing theme: the ASX 200 is clinging to its 5800 – 6150 three-month trading range, albeit near the top of the range (closed Friday at 6102). Domestic fiscal stimulus and accommodative monetary policy will continue to provide supporting pillars, however to drive markets higher, and beyond the prevailing range, sentiment needs a***

boost. Likely sources of fuel include a clean and un-contested US election, and a new US fiscal aid package. Momentum aside, which tactically looks positive, by most traditional measures, stocks are still expensive compared to fundamentals and the uncertain macro outlook. It's all politics for now…

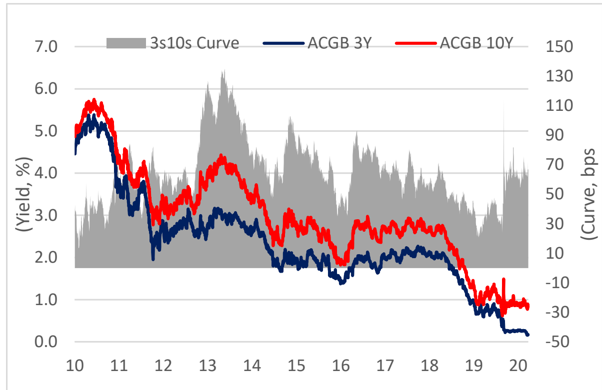
Bonds & Data – "RBA is in play…"

ACGB Curve & 30D change…



Source: Bloomberg, Mutual Limited

ACGB 3-Year vs 10-Year and curve….



Source: Bloomberg, Mutual Limited

- Markets have priced in more accommodative monetary policy from the RBA, including the likelihood of a lower three-year yield target, from 0.25% to say 0.10%. Deputy Guvna signalled as such at a recent speech and the talking heads ran with it. Three-year yields closed at 0.14%, but has been as low as 0.12%. Potentially providing clarity, and now with some clean air with the budget behind us, RBA Guvna Philip Lowe is scheduled to speak Thursday morning at the Citi Australia & New Zealand Investor Conference. Market watchers will be looking for hints that the November meeting is in play for some policy action. There is a growing view the central bank will cut the cash rate, 3-year yield and term funding facility (TFF) rate to 0.10%. Also, perhaps undertake QE targeting bonds further out the curve, possibly five-to-ten years.
- *Prevailing theme: still lower for longer, but risk to trending higher (yields) exists if the fiscal stimulus and monetary accommodation is deemed to be highly stimulatory, then rates will rise on recovery prospects. It will then be subject to RBA meddling (buying) to maintain as much accommodation as deemed necessary – which will be quite a lot.*