WILSONS

The Global Equity Correction: What's Weighing on Markets?

Our weekly macroeconomic view.

28 September 2020

Investigating the Drivers Moving Markets

After a 7% surge in August, the US equity market now sits 10% below its early September highs. Australia is down a more modest 4% from its highs, but as we discussed last week, the local market has been locked in a relatively tight trading range for over 3 months.

Read last week's report on Plotting the Course of the Australian Equities Market.

US tech has led the global equity correction, but recent price action shows a broader pattern of weakness. The sell-off has clearly moved beyond just a technical correction in an overbought tech sector.

There are multiple drivers at play that could further weigh on stocks in the coming weeks; however, it is unlikely these concerns will drive a significant and sustained downshift in equities. We examine the drivers of recent equity weakness along with the positive drivers we expect to re-emerge over coming months.

US Tech: The Correction We Had to Have

The US tech sector was looking quite overheated, with accelerating performance in August occurring alongside narrowing market breadth. This was a warning sign that a correction was likely.

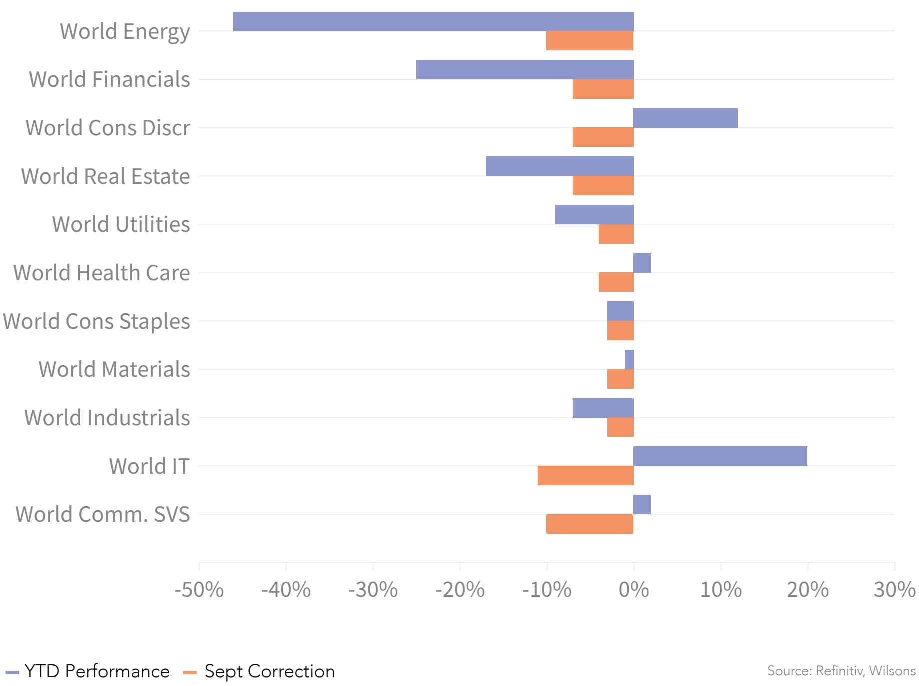
Read more on Dissecting the US Tech Sell-Off.

We think the pullback in US tech is likely to be a correction within an uptrend rather than a bubble popping. Valuations for the US mega caps generally do not look outrageous versus proven track records and solid future growth expectations. However, we could see a market leadership shift from tech to recovery trade stocks over the coming year.

Exhibit 1: US equity market down 10% from early September highs

Source: Refinitiv, Wilsons

Exhibit 2: Tech has led the correction though energy and financials also weak



Source: Refinitiv, Wilsons

US Stimulus Gridlock

The ongoing gridlock in the US over a new stimulus bill is now raising concerns about the sustainability of the US recovery. The equity market is beginning to worry that we will not get a bill passed until after the US election. While possible, we still see President Trump and the Republicans as being motivated to sign off on a deal ahead of the election.

Rising US Election Uncertainty

The US election in itself is the source of increasing market uncertainty as we approach the business end of the election campaign. While Biden is still considered to be the front runner, the polls have tightened, and the risk of a contested election ending up in the Supreme Court is increasingly being contemplated. A Biden victory with enough margin to avoid a legal challenge is still the most likely scenario in our view, but a bitterly contested election aftermath cannot be ruled out.

Second Wave Drags Recovery in Europe

The number of COVID-19 cases in Europe continues to rise quickly, spurred on by Northern Hemisphere August holidays alongside a general easing in mobility restrictions.

This week's release of the September Flash PMIs in the Euro area highlighted the impact of Europe's COVID-19 second wave on economic activity. The Composite measure declined from 51.9 to 50.1, dragged down by a sharp fall in services from 50.5 to 47.6. Interestingly, the manufacturing series (less impacted by mobility restrictions) rose from 51.7 to 53.7, beating expectations of 51.9.

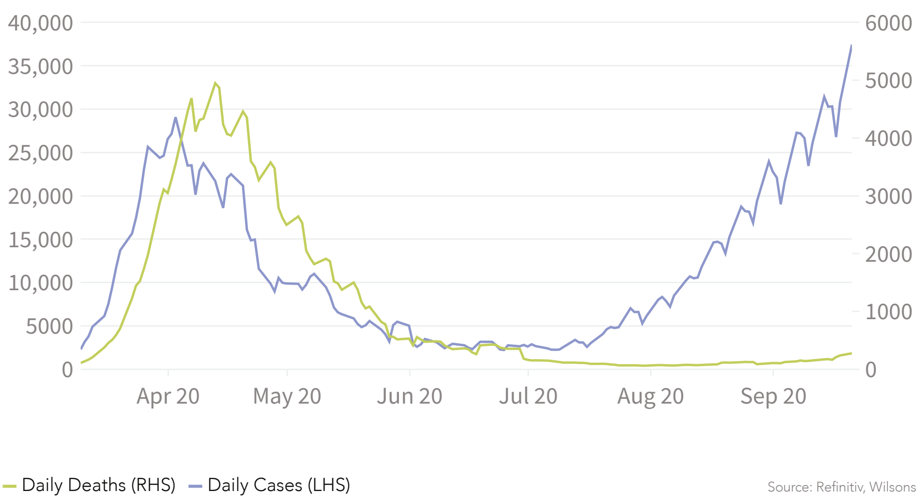
Further evidence of a weakening data trend is likely in the near term, though the distinguishing feature of Europe's second wave is a much lower death rate. Crucially, this makes the chance of an aggressive lockdown relatively low. We expect more news of increased mobility restrictions such as those announced in the UK this week, but we expect only a very partial reversal of the re-opening trend. Nevertheless, the second wave will drag on the recovery in the coming months.

Wall of Worries a Tough Near Term Hurdle

While these are the primary factors weighing on markets at present, we could also point to additional concerns such as disappointment that the Fed did not give stronger guidance on enhanced quantitative easing (QE) measures last week and the (likely associated) rebound in the US dollar which is tightening global financial conditions somewhat.

While the list is growing, none of these concerns are likely to cause terminal damage to the primary uptrend in equities, but in combination, they are a significant hurdle for the market right now. We could therefore see more short-term weakness, particularly with the US election just 5 weeks away.

Exhibit 3: Europe's second wave far less deadly



Source: Refinitiv, Wilsons

Positive Drivers Coming Back Into Play

We emphasise that we can still see several positive drivers coming back into play over the next few months:

1. While timing is uncertain a new US Stimulus Bill will ultimately be passed and it will be substantial
2. The US election should be resolved by its November 3 poll date
3. Good news on vaccine progress is reasonably likely by the end of the year or early next year
4. The global recovery is still preceding reasonably well (see exhibit 4), and evidence should ultimately build in the coming months
5. Ultra-low interest rates should continue to drive investment flows into equities once volatility subsides

Exhibit 4: Global manufacturing PMI shows activity has rebounded quite solidly

Source: Refinitiv, Wilsons

The Local Recovery

The Australian recovery has been slowed by our own second wave, but news on the virus locally is starting to look encouraging. There is scope for a quicker than flagged end to the Victorian lockdowns and an opening of state borders before year-end. We also expect more stimulus at the October 6 Budget and also from the RBA. The recent ebbing of the A$ is also a positive.

Despite a number of near term concerns we continue to see the 6 to 12-month equity trend as positive for both global and local equities.

Exhibit 5: Easing in the A$ should help the economy

Source: Refinitiv, Wilsons

Disclaimer and disclosures

Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

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