PGIM MARKETS

Insights on Events Moving the Financial Markets

NAVIGATING CROSS CURRENTS, MARKETS GRIND HIGHER

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On the October PGIM Global Partners CIO call hosted by QMA, the chief investment officers and senior investment professionals from PGIM's international businesses, PGIM Fixed Income and QMA, discussed the ongoing recovery in the global economy, the rally in the stock markets and the outlook for financial markets as they navigate several cross currents.

Global equity markets corrected in September after strong gains in July and August amidst concerns about rising infections, signs of growth moderation after the solid Q3 rebound, rising US-China tensions, and increased uncertainty ahead of the US elections. Despite the September correction, stocks posted solid gains in Q3 in the US (+8.9%), the Eurozone (+4.3%), Japan (7.1%) and Emerging Markets (EM) (+9.7%). From the March lows, the US S&P 500 is up 54.3%, while the Nasdaq surged 66.4%. International markets have trailed the US with 45% gains in the Eurozone, 37% in Japan and 49% in EM. Year-to-date (through October 7th), the US is up 7.4%, Japan is flat at 0.6%, EM has gained a modest 1.5%, while the Eurozone is still in the red, down -6.8%.

Developed market sovereign bond yields eased modestly in September. Volatile equity markets, uncertainty over US elections, and mixed signals on the COVID-19 vaccines front contributed to downward pressure on bond yields. However, better-than-expected US data pushed Treasury yields higher. Yields rose further in early October as rising odds of Joseph Biden winning the US presidential election and Democrats capturing the US Senate increased the prospects for aggressive fiscal stimulus.

Economic Recovery Continues but Pace Slows

The global economy appears to have emerged from the deepest recession on record with a double-digit growth rebound in Q3 in the US (30%), Eurozone (35%), UK (30%) and Japan (15%). The Q2 GDP contraction was brutal with a -32% decline in the US, a -48% fall in Eurozone, an -80% plunge in the UK, a -28% decline in Japan and a -24% contraction in India. However, the rebound has been stronger and faster than expected, and the recovery continues, with international agencies, central banks and market consensus upgrading their economic outlooks to a smaller growth decline in 2020. However, the pace of the recovery is moderating from what was seen in the early days of the economic rebound, with fiscal stimulus fading and increases in infection cases raising the specter of fresh restrictions that could slow or even short-circuit the recovery.

In its September update, the Organisation for Economic Cooperation and Development (OECD) made an upward revision to its global growth forecast for 2020 from its June 2020 economic outlook projections. The OECD made sizeable upward revisions in China and the United States, and smaller upgrades in the

European economies. China is the only G-20 country with positive GDP growth in 2020 (1.8%) helped by the earlier timing of the virus outbreak, rapid control of the virus, and policy support that fueled a quick rebound in activity. However, the OECD expects deeper GDP contractions in Argentina, India, Mexico and South Africa, reflecting the prolonged spread of the virus, high levels of poverty, large informal sectors, and stricter confinement measures for an extended period. In other countries like Korea, Taiwan and Japan, where the virus continues to be contained effectively without economy-wide shutdowns, the growth outlook was relatively unchanged, with fiscal support helping sustain activity. For 2021, the OECD made little change to its global growth prospects from the June Outlook, with the assumed intermittent virus outbreaks and the rising costs from a prolonged period of sub-par output constraining the momentum of the recovery. The OECD forecasts illustrate considerable uncertainty about the speed and shape of the recovery. The US Federal Reserve (the Fed) revised up its forecast for US growth and expects a smaller GDP decline in 2020, projecting the US should fully regain lost output by late 2021.

Similarly, the International Monetary Fund (IMF) raised its global growth forecasts in its October update of the World Economic Outlook. The IMF expects a smaller -4.4% GDP contraction in 2020 (from a -5.2% decline in its June forecast) reflecting the smaller decline in Q2 GDP growth in the developed economies "where activity began to improve sooner than expected after lockdowns were scaled back in May and June." The IMF expects a stronger recovery in the third quarter. For 2021, it projects global growth of 5.2%, about -0.2% lower than in the June Update, reflecting the smaller downturn in 2020 and "consistent with expectations of persistent social distancing."

Central Banks Continue to Do the Heavy Lifting

The recovery remains underpinned by policy support, especially from central banks. The Fed continues to provide stimulus by keeping rates at zero and providing guidance that it will likely keep rates at zero for the next several years. At its September meeting, the Fed confirmed and clarified the change in its operational framework to flexible average inflation targeting. The Fed clarified that under the new regime, it will allow inflation to overshoot its 2% target to offset inflation running persistently below that target in the past. In the view of Ellen Gaske, a senior economist at PGIM Fixed Income, the key change in the Fed's stance is in the context of unemployment and how low the Fed is willing to let it go before tightening policy. The new framework implies an asymmetry around the unemployment rate. If it is high, the Fed will loosen policy, but a low unemployment rate will not, by itself, trigger tightening, unlike in previous cycles, when the Fed typically began tightening policy preemptively when employment fell to low-enough levels.

The European Central Bank (ECB) left policy unchanged at its mid-September meeting. The minutes of the September meeting show the ECB starting to become more concerned about the euro appreciation, a loss of momentum in services and weak levels of inflation and inflation expectations. However, the ECB wants to gather more information, including on the pandemic, Brexit and European Union fiscal plans, before considering further policy action. The ECB has aggressively expanded its balance sheet in response to the pandemic, in particular through the Pandemic Emergency Purchase Program (PEPP). The timing and size of an expansion of the €1.35 trillion PEPP is likely to be discussed ahead of the next meeting, with a potential increase of another €200 billion likely in December and a €500-billion expansion in 2021.

Fiscal Support Wavers

Fed Chairman Jerome Powell has called for another fiscal package, however, more fiscal stimulus in the US has been held up due to the stalemate between Democrats and Republicans. Both Gaske and Ed Keon, a portfolio manager at QMA, think the odds of additional fiscal stimulus coming before the November 3rd US elections are low due to the little time left before the vote and the politics behind the stimulus negotiations. However, a stimulus package is likely after the election, no matter who wins. A Democratic win is likely to result in a large stimulus package covering infrastructure, healthcare, education, and transfer payments funded, to some extent, by tax hikes on businesses and wealthier individuals. A Republican win might lead to a smaller package, given that the recovery is already underway and could include some tax cuts and benefits for the unemployed.

Patrizia Bussoli of Pramerica Italy SGR notes that fiscal stimulus is also tapering in Europe. Further, the European Recovery Fund is scheduled to start only after the spring of 2021, leaving a period of four to six months when growth could stall. Seiji Maruyama, the chief investment officer of PGIM Japan, points out that while there will be policy continuity under Prime Minister Suga's administration, another large fiscal stimulus package in Japan is unlikely except for emergency COVID-19 related fiscal spending. In India, the PGIM India team expects the government to pass a fiscal stimulus package in the form of infrastructure spending and an urban jobs scheme.

Virus vs. Vaccine – The Tug of War Continues

The recent rise in COVID-19 cases, especially in Europe and some parts of North America has raised concerns about renewed lockdowns and the risk that it will dampen growth, if not short circuit the recovery. In the Northern Hemisphere as temperatures begin to decline heading into autumn and winter, new cases are rising in Europe (France, Spain, the UK, and Nordic countries) and are beginning to edge up in the US. By contrast, after rising strongly over the summer, new cases in emerging markets are cresting, with India trending downward since mid-September and Latin American cases steadily easing from the highs in July and August.

On the vaccine front, there continues to be progress, with more potential vaccine candidates and regulators preparing to consider emergency approval measures. The World Health Organization has published a draft landscape document, which provided the latest information on COVID-19 vaccine candidates. Among the 42 candidate vaccines currently under clinical evaluation, ten are in Phase III trials. According to the National Institute of Allergy and Infectious Diseases, a COVID-19 vaccine could be available as soon as in November and widely distributed for vaccinations before the end of 2020. The US Food and Drug Administration has released new guidelines for vaccine developers. Among the recommendations (nonbinding), vaccine makers should include a follow-up with Phase III trial participants for around two months after the final dose has been administered to assess the efficacy of the vaccine. This is likely to extend the timeline for any vaccine to be approved for early use and makes it highly unlikely that a vaccine would be given emergency authorization ahead of the US election.

Earnings Continue to Decline but Outlook Improving

The US Q3 earnings season is set to begin in mid-October. Earnings are expected to contract -21.5% year over year in Q3, an improvement from the -30.6% decline in Q2. The earnings contraction is expected to moderate to around -13.5% in Q4, taking the full-year 2020 earnings contraction to -19.7%. Earnings are expected to rise to their pre-COVID level by Q3 2021 and grow around 28% in 2021. The rebound in economic growth has pushed earning revisions sharply back into positive territory. *Thus, the earnings hole for 2020 is unlikely to be as deep as originally feared, and US earnings are expected to reach new highs by year-end 2021.*

The Bottom Line

Global stock markets resumed their uptrend in October after the September correction. Stocks remain supported by the economic recovery that remains on track, albeit moderating, continued central bank support and fiscal stimulus, which may be delayed but not denied, and progress on a vaccine. However, volatility is likely to remain elevated in the countdown to the US elections with potential for delay in knowing the result and even a contested outcome. Finally, another risk is that the onset of colder weather in the Northern Hemisphere and start of the flu season could lead to a surge in infections and trigger new restrictions on activity, slowing the recovery. Until there is a clear outcome for the US elections and success on vaccine development and mass deployment, markets are likely to remain volatile, hence caution is warranted.

IN OTHER NEWS…

PGIM Fixed Income contributed the following analysis.

- We continue to examine the evolving inflation backdrop and the likelihood that core CPI may continue to rise well past 2.0% by the Spring of 2021. September's month-over-month core CPI of 0.19% likely translates into an estimated core PCE reading of 0.15% for September. If core PCE maintains that pace, we believe it could reach the 2.50% area by April and May of 2021.
- We believe it is highly likely that the Fed will "look through" the temporary increase to core PCE—driven by the low base effects from the spring of 2020— given its prior projection that the Fed funds rate would remain in place through 2023 in addition to some historical precedent. In the first half of 2008, oil and commodity prices surged and the European Central Bank (ECB) under President Trichet raised the benchmark policy as a result, only to quickly unwind the hike amid the onset of the financial crisis. Conversely, the US Federal Reserve under Chair Bernanke was adamant not to respond to the temporary increase in commodity prices, and the Fed funds rate was held steady leading up to the crisis.
- In our global scenarios for real GDP growth, our base case of a "U" recovery has global growth hitting an annual average of 5.4% in 2021, and the economy would return to Q4 2019 levels by the second quarter of the year. In the US, our base case also calls for a "U" shaped recovery with average annual global growth of 4.6% in 2021 and the economy returning to Q4 2019 levels by the third quarter of next year.
- China's recovery remains quite strong as we anticipate Q3 2020 growth of 10.4%, which would already surpass its economic activity level from Q4 2019. Our full-year growth estimate for China is +2.5% and +9.0% in 2020 and 2021, respectively.
- After some recent strengthening, the US dollar may resume its downward trend, possibly pressured by the effects of the Fed's new inflation targeting regime and a growing trade deficit that recently topped 4% of GDP.
- Although the Fed's activity in the US corporate market has been very modest, the ECB's significantly larger purchases in Europe may filter through to adjacent markets. For example, quantitative easing in Europe has brought Spain and Italian government debt to 70 basis points (bps) and 122 bps over Bunds respectively, while European IG spreads sit at 111 bps over Bunds. Given investors' ongoing search for yield, we believe they could eventually gravitate toward US investment grade and high yield debt (spreads of +126 bps and +492 bps, respectively) as well as emerging market hard and local currency bonds.

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