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## Slippage in September

- **US equities continue to slip from their highs.**
- **Economists cut GDP forecasts as fiscal stimulus wanes – but governments may be forced back into action.**
- **Insider selling by US corporate management**
- **US financial sector looks still, by and large, strong enough to cope with the economic challenges**

**The global economy and markets continue their correction from the strength seen earlier in the summer.** For the moment, it's tough to see anything on the immediate horizon to arrest the weakness. **But keep in mind that if the global economy is weak enough, the policymakers will have to respond, and they have the tools to make a difference as they did in March.**

Unfortunately for the moment, policymakers are dragging their feet, most noticeably in the United States where there is little sign of agreement on a follow up to the CARES act. Several economists have downgraded their GDP forecasts for the developed economies this past week. JPMorgan points out in the absence of government action in 2021, the global economy faces an environment where government spending will act as a net 2.4% drag on global GDP drag after a +3.7% stimulus in 2020.

**September has been a tricky one for markets.** We have seen a reversal of earlier gains as some of the risk-on upside that drove markets after April has given way to the market's more sober assessment of the immediate outlook. At the very macro level, data coming in from various sources indicates broad economic performance that is solid but faltering in some instances.

Various factors are contributing to the global loss of economic momentum. First, the pandemic is not retreating fast enough for all regional economies to get back anywhere close to where they started the year. In particular, the service sector is struggling. The UK is emblematic of the problem where further local lockdowns have been necessary: the initial government response was to use expansive fiscal policy to re-start the economy. In a measure of how bad that looked with the electorate, Prime Minister Boris Johnson couldn't even bring himself to be in the house of Commons for his Chancellor's statement.

**The governments will have to deliver more fiscal help if the lockdowns linger.** This is a scenario seen across Europe, the USA and even in parts of Asia where the government's virus response has been of a higher standard than the West. Without further stimulus, there is a growing risk of relapse to the catastrophically bad but thankfully short-lived economic performance seen in the second quarter.

Ahead of the US presidential election, the fractious nature of the campaign has opened the risk that additional fiscal stimulus will not be forthcoming either fast enough or in large enough volume to limit the damage to the economy. The market sees the risk of a failure of fiscal policy to come to the rescue as a fiscal cliff. That may be an exaggeration. More likely it is a fiscal slope (a downhill one). The scale of government stimulus seen in April and May will not be necessary, but the market is rightly concerned at the slow pace and limited scale of assistance.

**Senior management of leading US companies are seemingly concerned.** Insider selling by S&P500 executives has been at the highest level since 2012. Such selling has contributed to what may end up being one of the worst

September's for the S&P500 since the global financial crisis. The S&P500 is barely changed for the year, and down 9.6% for the month.

**As the markets sit on critical support levels, you must ask yourself what further could go wrong to send the markets into a tailspin.** To-date the markets have market financials much lower, but there is little chatter about a pending financial crisis. Flat yield curves have not helped bank profitability. And with most central bankers looking to stay fully engaged in supporting their respective economies with QE we assume that yield curves will be unlikely to 'normalise' any time soon. In the absence of a marked recovery, companies will need the Fed to keep funding rates - out to ten years low. A sudden spike in funding costs would not be supportive of the broader effort to shore up the economy. Despite the challenges in the global economy, corporate debt market issuance has been robust so far in 2020, supporting refinancing that has helped to stave off a potential default wave that threatened to engulf the market. We expect central banks to maintain downward pressure on the whole yield curve to maintain a supportive funding cycle.

**At least for the moment, analysts do not sense that bank's balance sheets are at risk from having to make significant provisions for bad debts.** In the US, the Federal Reserve's tests, including modelling for various potential outcomes for COVID19. The tests have shown that US balance sheets that can cope. However, it hasn't stopped the market worrying. As an example, Bank of America announced credit losses 400% above the previous year, which were set at a level to incorporate all future expected losses from COVID19. But the world doesn't look as secure as it did when markets were rallying through the summer. COVID19 cases are rising. Fiscal policy is at best dysfunctional and political situation must be draining confidence. Also, we note that some areas of credit see continuing rises in delinquencies. In the category of single-family loans, 3.2% of all such loans are in serious delinquency (90+ days) the highest since 2012 and likely to rise still further.

Another recent challenge to the banks has been the release of extensive files full of reporting related to suspicious client activity: money laundering and tax evasion. It is too early to know if there will be repercussions beyond reputational damage.

However, recent experience in specific instances in Europe led to underperformance for banks where anti-money laundering failures were significant. Analysts expect the banks affected to be fined no more than say 0.5% of their book values. Such an impact is already more than baked in given the 5% fall in bank share prices on the breaking news.

**For the moment, we expect limited downside risk for bank shares.** And hence it should not be the catalyst of any meltdown in the markets. The index of global banks trades on a relatively cheap price-to-book of 1.0x and a forward P/E of 9.7x. Most banks also have dividend yields at a significant premium to the local 10-year yield. However, if COVID is still causing considerable economic damage by the end of the first quarter 2021 and economies have not provided a significant stimulus the banks could be nursing losses they probably don't want to contemplate.

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