Perpetual Investments

THOUGHTS ON THE MARKET

11th June 2020 - Powell speaks and markets sell off

SUMMARY

- Global credit and equity markets sold off for a second consecutive session with large losses in cyclical/value sectors such as energy, financials and industrials offset by another surge in tech prices which saw the latter completely recover its March quarter losses. It was a real whipsawing session as the market assessed the May FOMC meeting where the institution provided detailed analysis on the US economy and its policy path forward.

  In other markets 10-year Treasuries recorded their strongest rally in 8 weeks with yields declining -10 bpts to 0.73% with curve flattening, gold strengthened +1.7% to USD1,735 per troy ounce, oil rebounded +2.3% to USD39.06 per barrel and G10 currencies all rallied against the US dollar led by Australia and Japan (both +0.9% to USC 69.96 and 107.13, respectively) with Sterling and the Euro (both +0.8%) not far behind.

- The primary overnight news with the Fed meeting where policy settings (both rates (0%-0.25%) and asset purchases (USD120 billion per month)) were left unchanged with the FOMC not seeing any rate increase through 2022. More importantly, <u>Chair Powell suggested the pandemic could inflict longer-lasting damage on the economy, which sparked profit taking in value sectors as the Fed failed to announce new policy measures, but the fragile state of the recovery also highlights that any danger signs about the V-shape recovery that markets have priced in, could see stock prices tumble very quickly. This suggests the current market situation is not a one-way bet and that investors need a comprehensive suite of portfolio diversifiers especially with bond yields so low.</u>

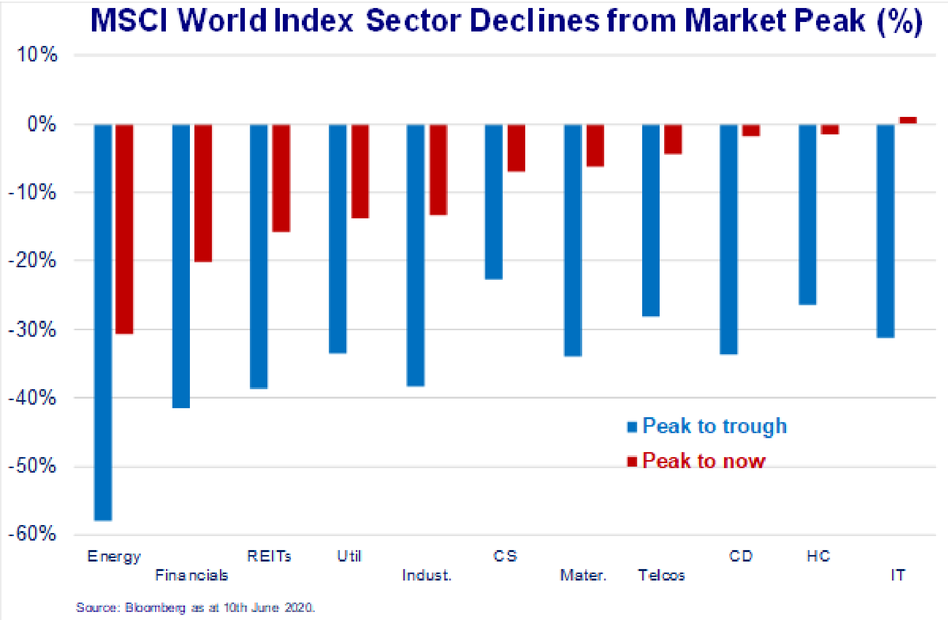
- In economic news, inflation continues to be the one statistic which has universally underperformed street estimates in May. Overnight US core inflation fell to 1.2% and China's was +1.1% (both are near 10-year lows) and this will worry central banks especially with a large fiscal drag likely in 2021. However, with rates at or near 0% advanced economy central banks will want to continue to ease financial conditions through asset purchases, and policy easing in EM as the recovery will remain incomplete by end-2021.

- Although final numbers are not in for another 5.5 hours, the number of global cases of COVID-19 stands at 7.35 million with another +114.1k cases so far overnight (before Mexico and some US states report their numbers) which means that Wednesday was the 72nd occasion in the past 73 days where daily increases have topped 70k) and the 17th occasion in the past 22 days where cases have topped +100k. This means 3 countries have more than 400k cases, 8 countries have more than 200k cases (Peru joined this group overnight with a rise to 208k), 16 countries have more than 100k cases, and 59 over 10k. It took 73 days to record 1 million cases, 13 days for the next million, 11 days for the third million, 12 days for the fourth million, ten for the fifth million, 11 for the six million and 8 days for the seventh million, and in the past 3 days hours another +347k cases have been confirmed. More importantly, the growth rate of daily confirmed cases (+1.6% since Sunday) has ceased declining having been close to 1.7% for the past 20 days. Meanwhile, deaths stand at 415.2k, and the death rate dropped for a thirty fifth straight day to 5.63%.

FINANCIAL MARKETS

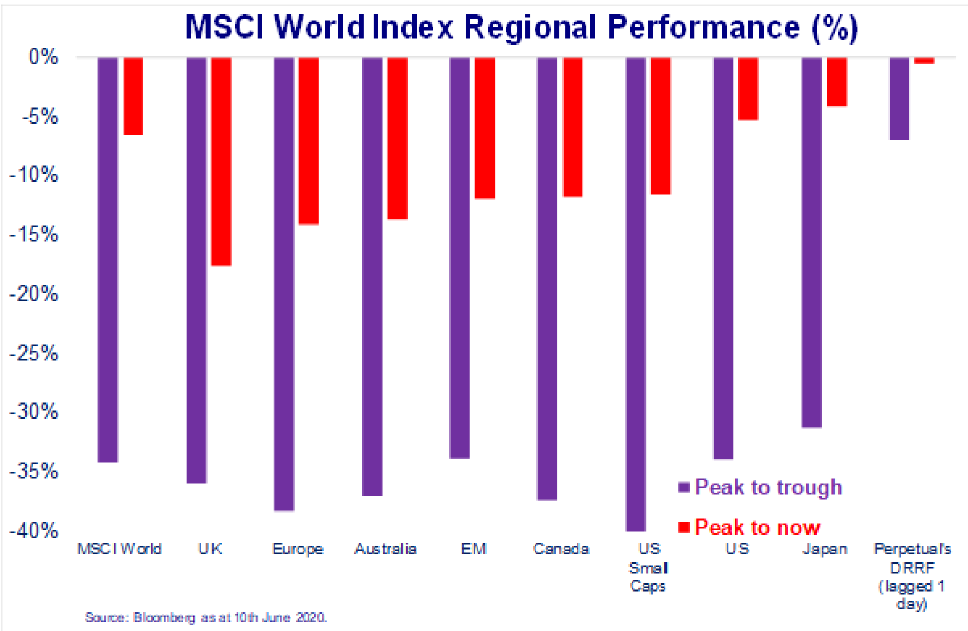
- **EQUITIES**
  - The MSCI World Index declined -0.4% overnight. The recent market surge, elevated valuations and the overnight FOMC meeting combined to have investors take profits with value/cyclical plays as the brunt of the selloff. In particular, losses were led by energy (-3.7%) despite a solid rally in the oil prices, financials (-2.4%) as yield curves flattened, REITs (-1.8%) as investors fretted about increased vacancy rates and industrials (-1.5%) which is a play on overall economic growth. In contrast, tech (+1.5%) rallied strongly, led by the FANG stocks, and this enabled the sector to finalise a complete recovery from the March quarter

losses (see chart). The overnight movement saw financials re-enter bear market territory, with energy now down -30% from its Q1 peak.



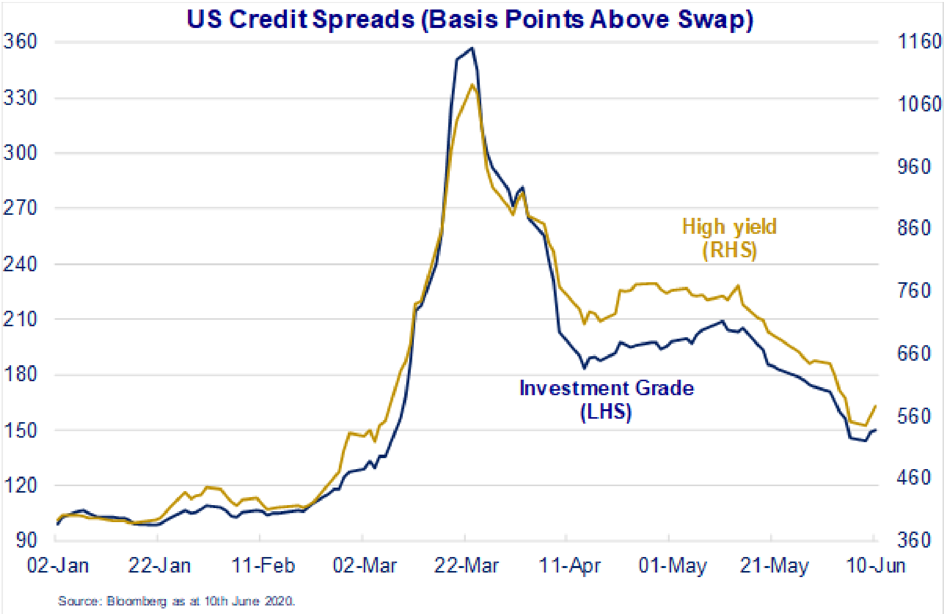
- Among the regions, overnight losses were led by the value/cyclical markets which had performed strongly in recent weeks. Europe dropped -0.8% with larger losses evident in the periphery markets such as Greece (-2.4%), Spain (-1.1%) and Italy (-0.9%), whereas the northern markets performed slightly better with France (-0.8%), Germany (-0.7%), Switzerland (-0.4%) and the UK (-0.1%) outperforming their peers.

  The negative vibe from Europe spread to the other side of the Atlantic with US markets having a whipsawing session as investors digested some complex information from the US Fed. The lack of new policy initiatives ultimately weighed on sentiment and the losses were largest on the Dow Jones Index (-282 points, -1.0% to 26,990) given its lower tech exposure, with the S&P 500 (-0.5%) also down, but the NASDAQ 100 rallied +0.7% and closed above 10,000 for the first time. Earlier, the MSCI Asia Pacific index (+0.5%) closed higher with gains in India (+0.9%), Korea (+0.3%), Japan (+0.2%) and Australia (+0.1%) offset by declines in Hong Kong (-0.03%) and China (-0.4%). These movements had markets moving closer the bear market territory (see chart), but it would probably take several more session to get there.

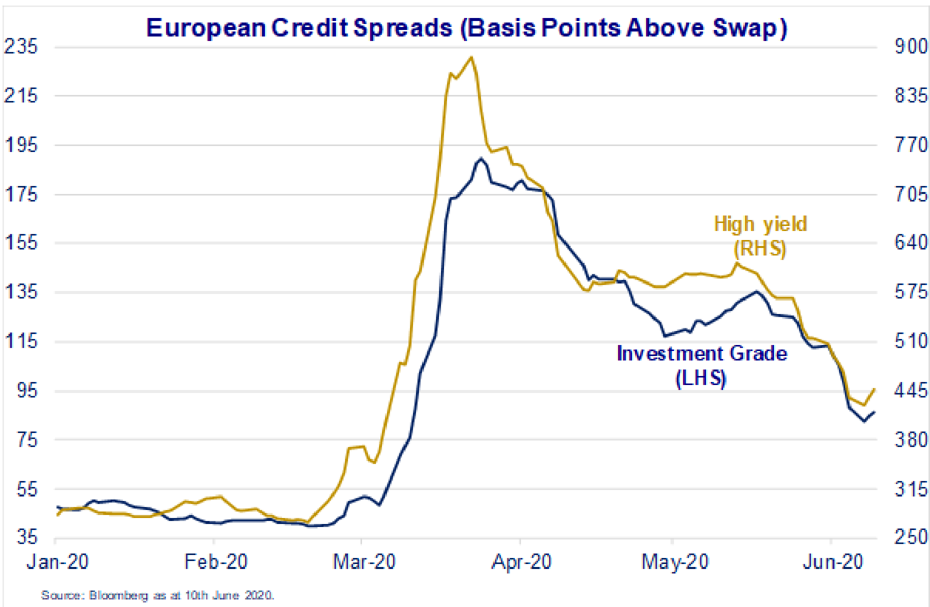


Futures markets suggest a weak opening in Asia with losses slated for China (-0.1%), Hong Kong (-0.3%), Japan (-0.8%) and Australia (-1.1%).

- ## CREDIT MARKETS
    - Regional credit indices declined for a second consecutive session, Spreads in the US investment grade universe increased 1 point to +150 bpts, which kept the recovery rate at 82%. Risk premiums rose in 10 of the 11 sectors led with the largest declines reserved for value sectors which had rallied strongly in recent weeks such as subordinated financials (+3 points, +183 bpts, 81%), energy (+3 points, +199 bpts, 89%) and consumer discretionary (+1 point, +181 bpts, 81%). In the high yield universe, spreads widened +15 points for a second consecutive session to +576 bpts (see chart), which lowered the recovery rate 3 notches to 76%. All sub-sectors recorded double digit increases in spreads led by healthcare (+20 points, +506 bpts, 76%), industrials (+16 points, +675 bpts, 52%) and consumer discretionary (+15 points, +558 bpts, 67%).



    - European credit markets sold off for a second consecutive day with spreads in the investment grade universe expanding +2 points to +87 bpts, which lowered the recovery rate to 69%. Like their US peers, all sub-sectors in this universe recorded modest gains with cyclical sectors underperforming led by consumer discretionary (+5 points, +109 bpts, 74%), subordinated financials (+5 points, +175 bpts, 70%) and energy (+2 points, +71 bpts, 69%). In the high yield universe, risk premiums increased considerably more with spreads up another +10 points to +447 bpts (see chart), which lowered the recovery rate to 71%. Seven of the 11 subsectors recorded double-digit spread increases led by subordinated financials (+19 points, +477 bpts, 69%), energy (+15 points, +548 bpts, 72%) and consumer discretionary (+15 points, +546 bpts, 73%) as investors switched out of value/cyclical play into defensive and growth sub-sectors.

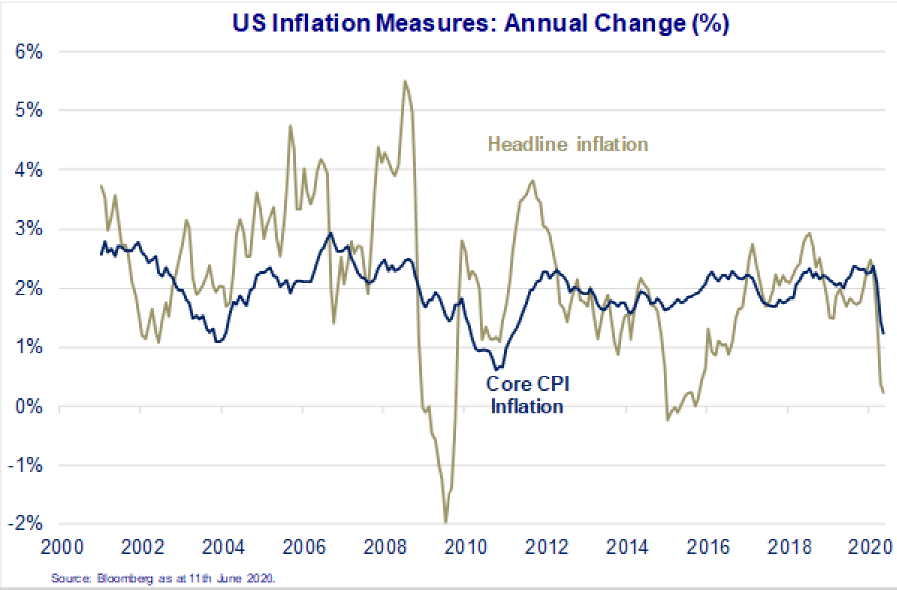


THE GLOBAL ECONOMY

- **The May US headline consumer price index** fell -0.1% m/m (third consecutive monthly decline) which saw the annual rate drop to +0.1% y/y, but when food (+0.7% m/m) and energy (-3.5% m/m) were excluded the remaining core reading dropped -0.1% m/m which pulled the annual rate down to a 9-year low of +1.2% y/y (see chart). Among the sectors, airfares (-4.9% m/m, -28.8% y/y), car insurance (-8.9% m/m, -14.3% y/y), hotel lodging (-1.8% m/m, -17.3% y/y), and apparel (-2.3% m/m, -7.9% y/y) continued to suffer from excess capacity, but this situation should stabilise by the end of the August.

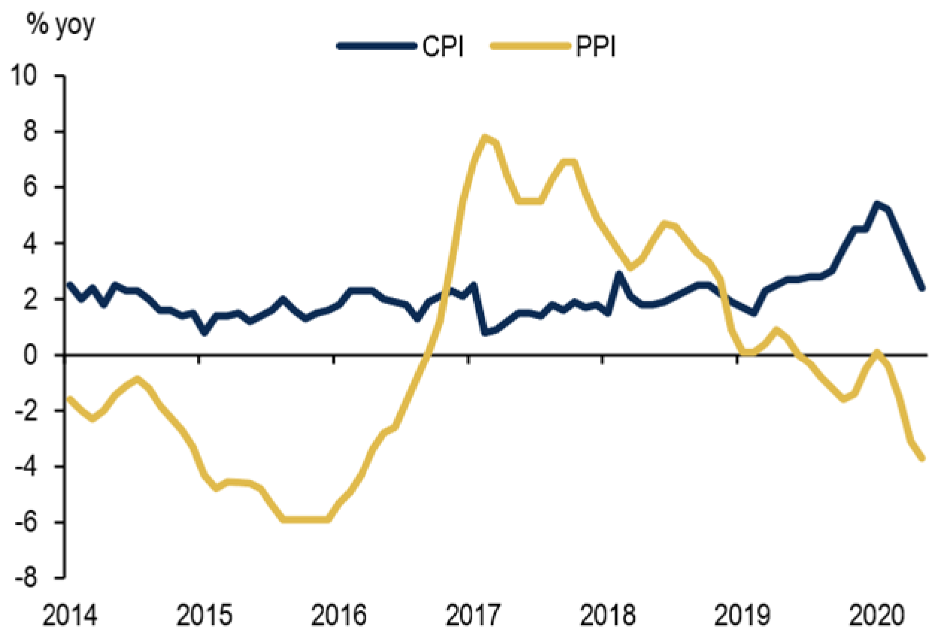
  In contrast, the shelter categories surprisingly accelerated (owners' equivalent rent +0.26% m/m, +3.1% y/y) rent of primary residence +0.27% m/m, +3.5% y/y)) despite risks from rent forgiveness and tenant delinquency. Elsewhere, medical care services prices showed another solid rise (+0.6% m/m, +5.9% y/y), new car prices lifted (+0.3% m/m, -0.3% y/y) as dealerships reopened and auto sales partially recovered, but used car prices declined (-0.4% m/m, -0.4% y/y).

  Overall, the recent rise in oil prices is starting the flow through the US economy which should see headline inflation gradually rise in coming months, but core CPI is likely to decline further although outright core deflation is highly unlikely in the absence of another Cov-19 case spike. Using data from today's CPI we estimate that the core PCE prices will rise +0.05% m/m in May which will take the annual rate down to a ten-year low of +0.9% y/y.

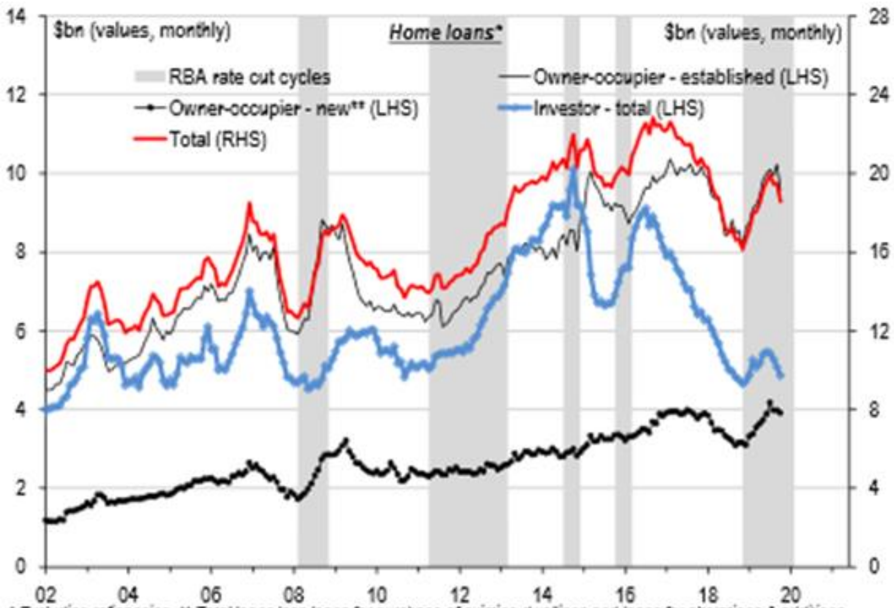


- **China inflation** declined -0.8% m/m in May which pulled the annual rate down to +2.4% y/y (1-year low). Among the components, food declined -3.5% m/m which took the annual rate down (-4.2%) to +10.6 y/y on base effects, with pork prices down -8.1% m/m given increased domestic production, higher US imports and lower consumption growth, whereas non-food inflation was flat and +0.4% y/y. Outside food and energy, the core inflation rate was steady on the month and at +1.1% y/y. Meanwhile, corporate inflation declined -0.4% m/m in May and -3.7% y/y (4-year low, see chart, April was -3.1% y/y) with declines in all major producer categories.

  Looking ahead, falling consumer and producer inflation despite economic re-opening points to weak domestic demand, and consumer inflation is expected to continue declining in the months ahead given challenging base effects, lower food (i.e. pork) prices, rising job pressures and modest income growth. Meanwhile, corporate deflation is likely to persist on weak global demand and increased caution in the manufacturing sector. The combination of weak pressure pressures in both sectors, and more visible signs of activity growth falling short of expectations, should lead to more monetary easing in the September quarter.



- **Australian housing finance** dropped -4.8% m/m in April with pulled the annual rate down to +11.2% y/y. This was the first month of full mobility restrictions and households accessed lower interest rates to boost their disposable income and continued to increase their average loan size (+20% over the past year for owner occupiers) to build a cash buffer. Among the sectors, owner-occupiers retraced (-5.0% m/m, +14.8% y/y as did investors (-4.2% m/m, +2.4% y/y – see chart), but renovations bounced sharply (+7.8% m/m, +3.1% y/y) and this should continue given the Morrison Government's recent grant for new construction. Meanwhile, loans were extremely weak for both business (-15.7% m/m, -12.9% y/y) and personal (-17.0% m/m, -25.5% y/y), suggesting weaker credit growth is ahead.



* Excluding refinancing, ** Total loans less loans for purchase of existing dwellings and loans for alterations & additions

- **The Westpac-Melbourne Institute measure of Australian consumer sentiment** rebounded +6.4% to 93.7 in June and is now around the levels seen before COVID-19 hit the local economy (see chart). While sentiment is at levels which is normally positive for consumer spending, and AUD15 billion has been withdrawal of local superannuation which will temporarily boost household income, household spending in the June quarter will fall sharply, but it may be the case that the decline is less than expected, adding some upside to GDP growth (-9.5% q/q). Rising confidence also makes households more likely to spend recent stimulus when the labour market rebounds, but the timing here is unknown. That said, the restart of the AFL season tonight and a likely Collingwood victory would see confidence bounce even more.

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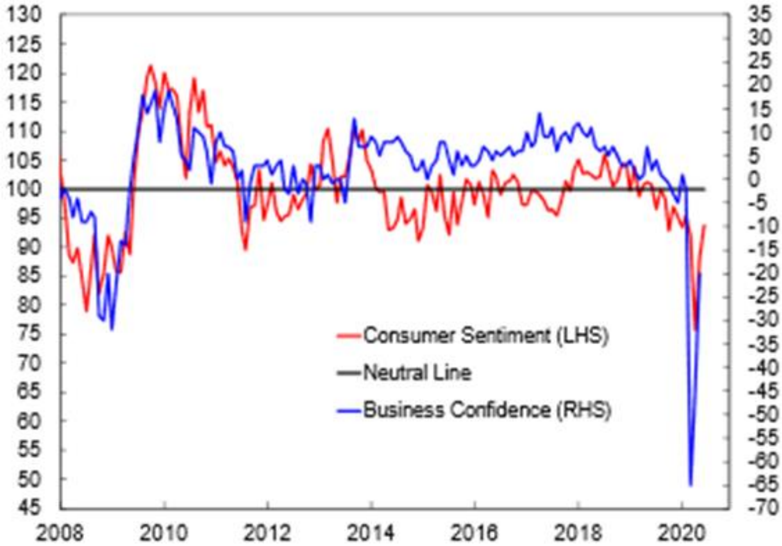
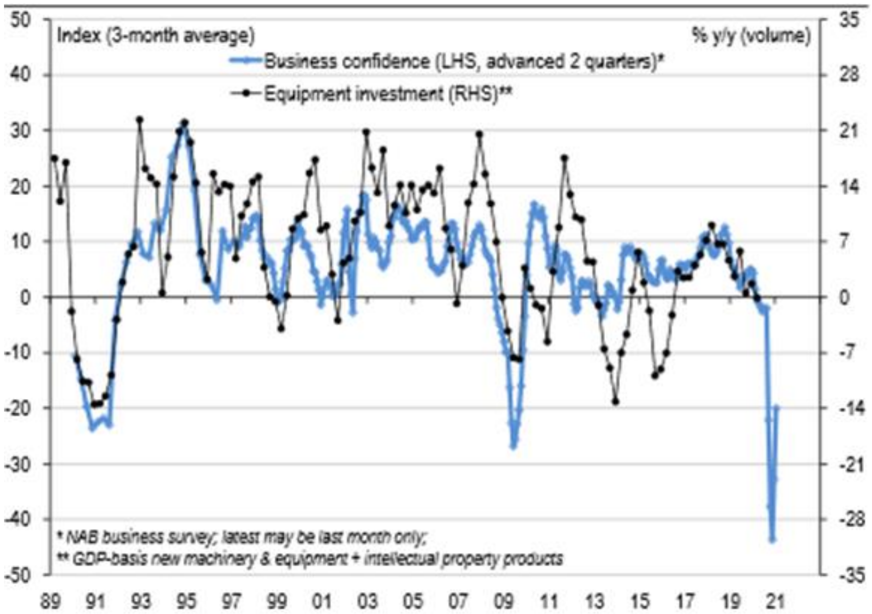


- **The NAB survey of business conditions** rebounded solidly in May (+10.3 to -20) which is still around the worst levels since the 1991 recession. Meanwhile, business confidence lifted sharply (-25.7 to -20.0 (was -65.4 in March)) but it is still around levels seen during the GFC and implies a -15% collapse of business equipment spending (see chart). Meanwhile, employment intentions still imply a modest -2% decline in employment ahead and while capacity utilisation bounced, it still suggests that the unemployment rate will spike above 10%. Elsewhere, business selling prices remain negative and consistent with inflation falling more than 1% from here. Despite policy support, credit conditions for businesses tightened to the most difficult since the GFC, which along with a likely sharp drop in business investment, suggests business credit will contract over the coming year.



POLICY

- **The May FOMC meeting** left the funds rate target range unchanged at 0%-0.25%, made no change to its forward guidance and kept asset purchases stable at around USD120 billion per month (USD80 billion a month for purchases of Treasuries and about USD40 billion of mortgage-backed securities). On rates, the committee noted that it expects "*to maintain this target range until it is confident that the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals*." with the median dots confirming expectations of no movement in the Fed Fund Rate through 2022, although one participant had four hikes in that year.

The accompanying statement characterised the current economic situation much like it was in April which suggests the shock recovery in hiring in May has not altered the committee's view, noting the '*tremendous human and economic hardship" caused by the virus outbreak*', but they acknowledged that financial conditions had eased and that credit access had improved.

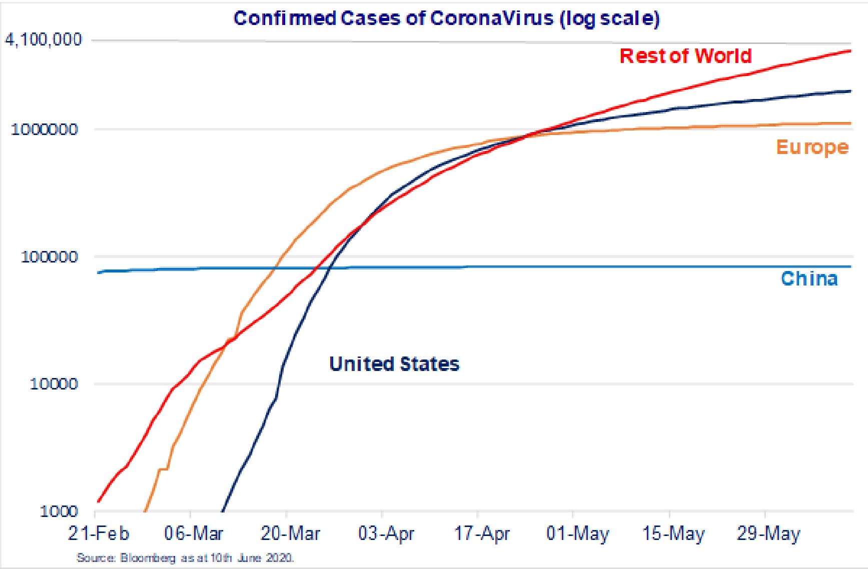
The committee released its summary of economic projections for the first time since December 2019:

1. Median 2020 **GDP growth** projection at -6.5% (Q4/Q4) which is considerably below consensus expectations (-4.5%), with a +5.0% recovery in 2021 which would confirm our "*shock, bounce and incomplete recovery*' thesis, with +3.5% for 2022.
2. Estimates for **unemployment** at the end of this year varied widely, from 7%-14%, with the median 9.3% close to our estimate (9.8%) and this then falls to 6.5% in 2021 and 5.5% by the end of 2022 (although the range here is between 4% and 12%).
3. For inflation, the median projections for core **PCE inflation** for 2020 is +0.8% y/y and remains below +2.0% for 2021-22 at +1.6% and +1.7% respectively.

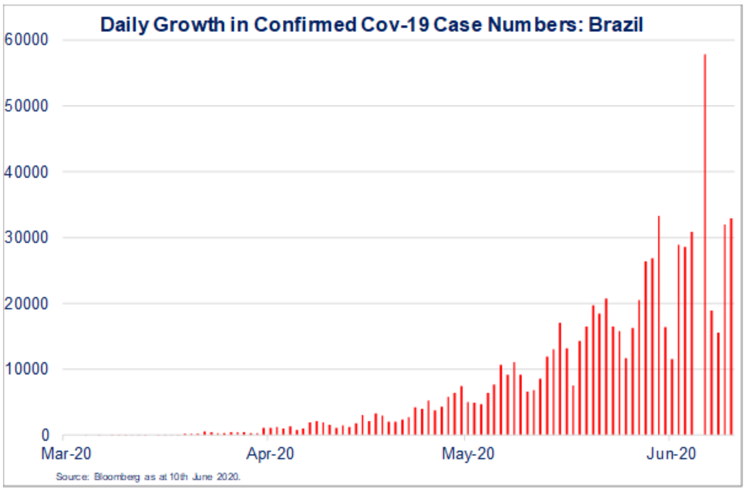
At his press conference Power reinforced all the recent messages and stated that the committee discussed yield-curve-control and forward guidance but would make a decision at "upcoming meetings." We expect the Fed to announce data-based guidance, coupled with a commitment to keep very front-end yields consistent with the implied policy path, at its policy meeting in 17-18 September.

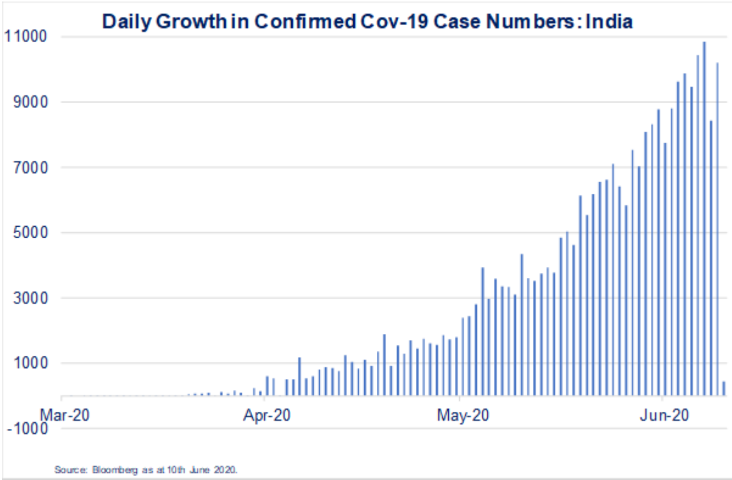
VIRUS UPDATE

- Although final numbers are not in for another 5.5 hours, the number of global cases of COVID-19 stands at 7.35 million with another +114.1k cases so far overnight (before Brazil, Mexico and some US states report their numbers) which means that Wednesday was the 72nd occasion in the past 73 days where daily increases have topped 70k). This means 3 countries have more than 400k cases, 8 countries have more than 200k cases (Peru joined this group overnight with a rise to 208k), 16 countries have more than 100k cases, and 59 over 10k. It took 73 days to record 1 million cases, 13 days for the next million, 11 days for the third million, 12 days for the fourth million, ten for the fifth million, 11 for the six million and 8 days for the seventh million, and in the past 3 days hours another +347k cases have been confirmed. More importantly, the growth rate of daily confirmed cases (+1.6% since Sunday) has ceased declining having been close to 1.8% for the past 20 days. Meanwhile, deaths stand at 415.2k, with the US now over 110k (27.2% of global deaths even though they have only 4% of the global population), the UK, Italy and Brazil over 30k, with Spain and France over 25k, and the death rate dropped for a thirty fifth straight day to 5.63%.



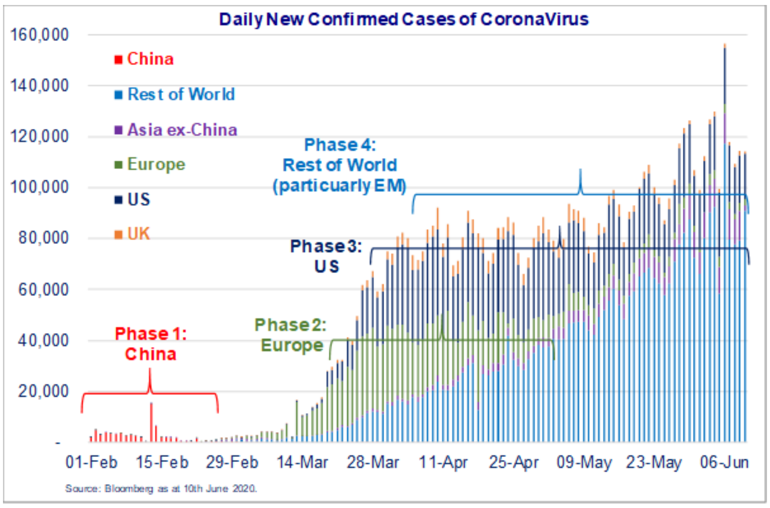
- We break the infections into four groups – the US, Europe, China and 'others' and the rest of the world outside the G3 economies now has the most total cases (+57.8k to 4.11 million) and highest daily new cases (and by a considerable margin) followed by the US (+17.5k to 1.99 million) and Europe (+2.7k to 1.13 million), with the latter's daily increases, in terms of percentages, grinding lower which shows that social isolation works to reduce the spread of the virus, even though it comes at an enormous economic cost. In the rest of the world, the three concerns here are Brazil (+32.9k, +772.4k, which is the second highest in the world), Russia (+8.4k to 493.0k, third highest) and India (+0.4k to 276.6k, fifth highest).





- Among countries, the most cases are in the US (+17.5k (so far) to 1.997 million), Brazil (+32.9k to 772.4k), Russia (+8.4k to 493.0k), the United Kingdom (+1.0k (20-day low) to 291.6k), India (+0.4k to 273.6k), Spain (+0.3k to 242.3k), Italy (+0.2k to 235.5k), Peru (+8.1k (third highest) to 207.8k) France (+0.5k to 192.1k), Germany (+0.02k to 186.5k), Iran (+2.0k to 177.9k) and Turkey (+0.9k to 173.0k). Australian confirmed cases rose +2 to 7,276 yesterday which placed us 66th in terms of total infections.

  Elsewhere, Singapore recorded +0.5k new cases to 39.0k most of which are linked to foreign workers who are forced to live in crowded dormitories, with the countries having the largest case numbers in South East Asia after overtaking Indonesia (+1.2k to 34.3k) and the Philippines (+0.7k to 23.7k). Note final numbers for yesterday at not in yet so these numbers can rise.



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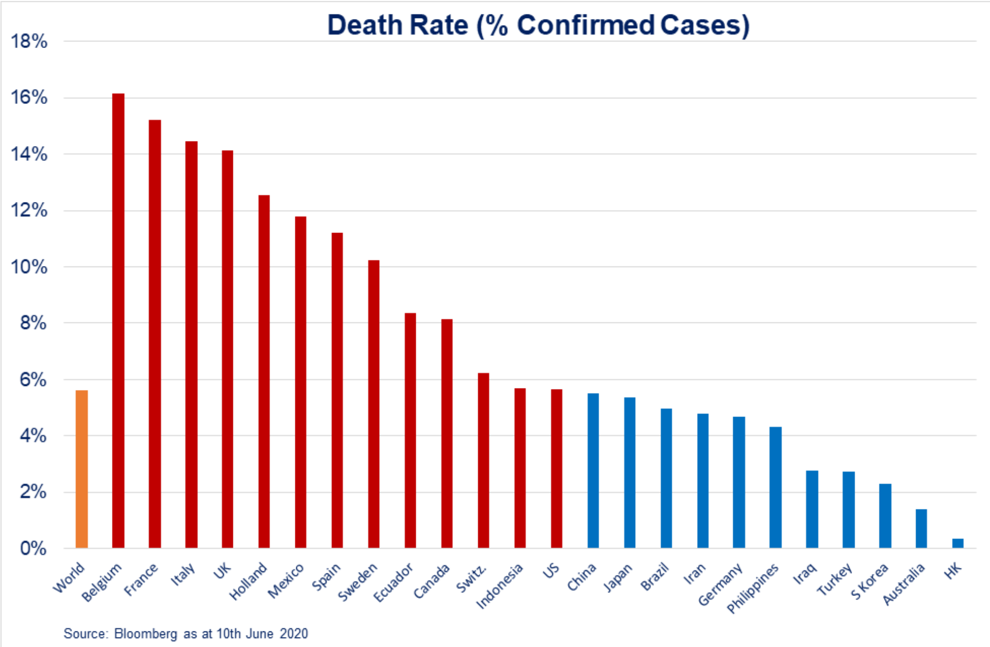
- Although final numbers are not in until 11am AEST, the global death rate declined for a thirty third straight day to 5.63% with the global total to 415.2k. The US (+0.7k) has the most deaths at +112.7k, with the UK (+0.2k to 41.2k), Italy (+0.1k to 34.1k), Spain (steady at 27.1k) and France (+0.02k to 29.3k) all over +25k. The death rate is highest in European countries where the health systems have collapsed led by Belgium (steady at 16.2%), France (steady at 15.2%), Italy (+0.1% to 14.5%), the UK (steady at 14.1%), the Netherlands (steady at 12.6%), Spain (-0.1% to 11.2%) and Sweden (-0.2% to 10.4%). However, several emerging markets are now on the leader board including Mexico (+0.1% to 11.8%), Ecuador (steady at 8.4%), Indonesia (-0.2% to 5.7%) and Brazil (-0.2% to 5.0%).



Yours sincerely,

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