

THOUGHTS ON THE MARKET

11th May 2020 – US unemployment has not peaked

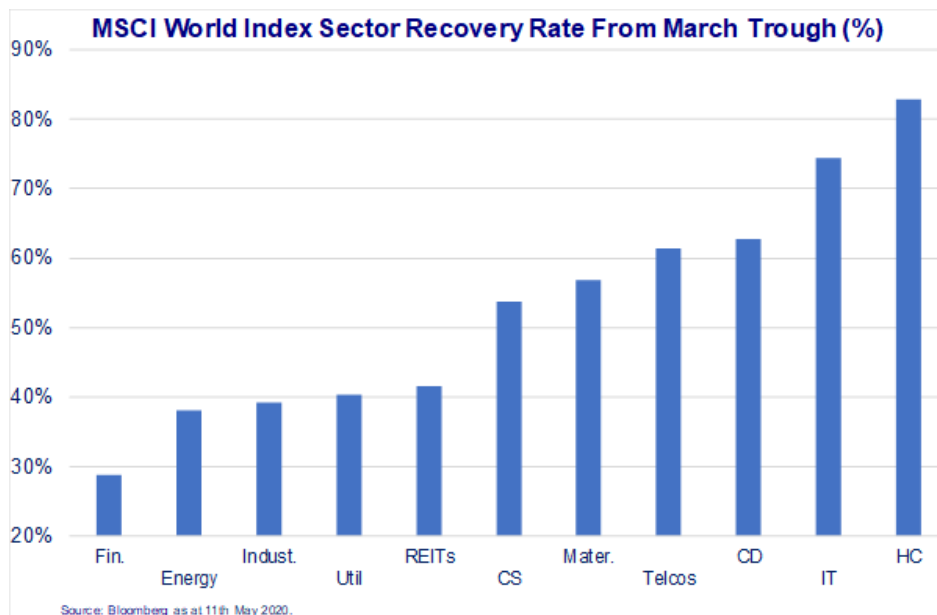
SUMMARY

- The primary market news out Friday was the April US non-farm payrolls which detailed official job losses of -20.5 million jobs since March with unemployment rising to 14.7%. As large as the losses are, the April data understates the total job destruction from COVID-19 for two reasons – namely, some people have incorrectly being classified as “employed, but not at work” and also the participation rate decline (-2.5% to 60.2%) meant people went from the workforce in February to outside the realm of the report by April.
- Were it not for these two quirks, the April US unemployment rate would be circa 23%. While April is likely to be the point of maximum economic contraction for gauges like retail sales and industrial production, unemployment is a lagging indicator and things will worsen in May for two reasons – firstly, those “employed but not at work” may be the result of a slow closedown and those jobs may disappear in coming months, and also the initial and continuing claims reports for the weeks after the April NFP report survey week (April 12th) have guided that there could be upwards of another 10 million jobs dislocated, which despite misclassification and some people falling outside of the survey, should get the U-3 rate close to 20%.
- Despite the woeful labour market statistics, equities rallied on Friday night as the White House said a fresh Cov-19 wave after re-opening won't require a shutdown and there was also a more constructive tone between US and China trade representatives who want to improve implementation of the Phase 1 agreement. This buoyed equities, but it did not flow through to credit markets which have remained subdued over the past month. In other markets, the US dollar was mixed (depreciating against the Euro (-0.4%) and AUD (-0.5%) but rising against Sterling (+0.3%) and the Yen (+0.1%)), gold was up (+0.5% to USD1703 per troy ounce), US 10-year Treasuries rose to 0.68% with curve steepening, and oil bounced another 5.1% (to USD24.74 per barrel).
- In COVID-19 news, the number of global cases of COVID-19 stands at 4.13 million with another +72.0k cases overnight which means 5 countries have more than 200k cases, 10 countries have more than 100k cases, 28 over 20k cases and 44 over 10k. It took 73 days to record 1 million cases, 13 days for the next million, 11 days for the third million and 12 days for the fourth million and in the past 2 days another 128k cases have been confirmed. That said, the growth rate of daily confirmed cases (+2.1% since last Thursday) is still coming down in a trend sense. Meanwhile, deaths rose +3.1k overnight to 284.5k, with the US now over 75k, the UK and Italy over 30k, with Spain and France over 25k, and the death rate sits at 6.9% (although final numbers are not yet in).

FINANCIAL MARKETS

• EQUITIES

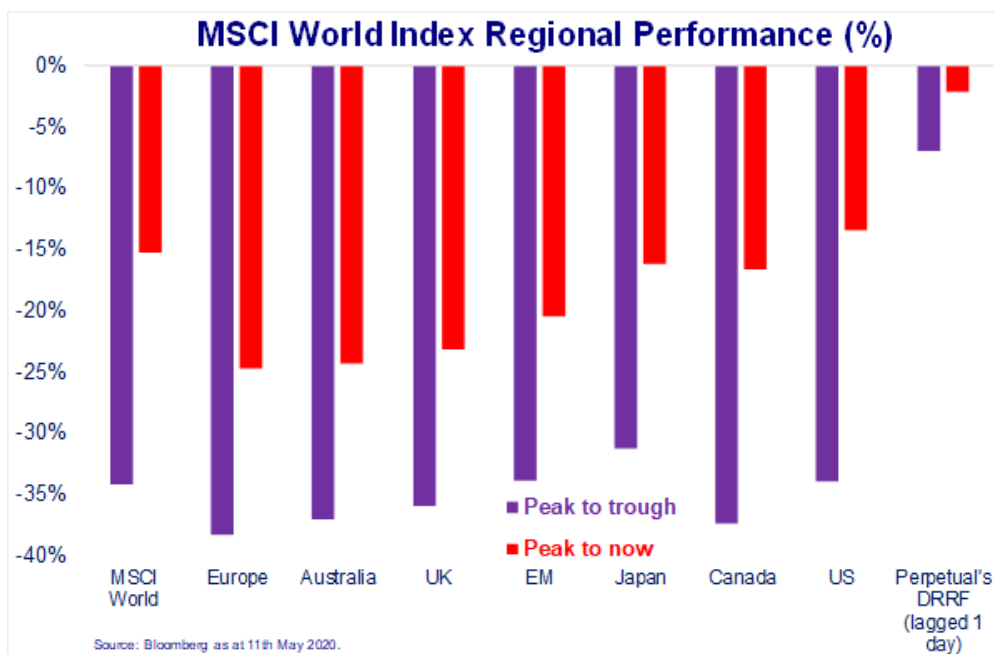
- The MSCI World Index rose +1.8% on Friday night (recovery rate up to 55%) with across the board gains in all regions and all sectors. Markets were led higher for a second consecutive session by rising energy stocks (+2.1%) as investors continue to expect economic re-opening to soak up the extra supply of crude which sent prices up by +5.1% to USD24.74 per barrel (which is a 3-week high). Other cyclical parts of the market also rally strongly including industrials (+2.3%), consumer discretionary (+2.0%) and financials (+1.5%). However, these traditional cyclical parts of the market continue to lag the recovery in areas such as tech (recovery rate of 74.4%) and biotech (which is in the healthcare sectors whose recovery rate is 82.9% - see chart).



Among the regions, gains were led by Japan (+2.6%) which had been closed for most of the week and had missed the advance in other regions, with markets supported by a modest depreciation of the Yen and the initiation of re-openings in the US, Chinese and European economies, which are key export destinations for the Nippon market. Other major Asian markets also posted gains with markets in Hong Kong and China (both +1.0%), South Korea (+0.9%) and Australia (+0.5%) closing in the black.

The positive Asian lead boosted Northern Hemisphere markets with the US (+1.7%) leading the pace of gains as old economy sectors such as energy (+2.0%), materials (+1.8%) and industrials (+1.6%) outperformed tech (+0.9%) and healthcare (+0.4%) which have had a great run in the past two months, and the daily move meant the NASDAQ (+1.6%) underperformed the Dow Jones (+1.9%) for one of the few times in recent weeks. Meanwhile, European markets performed solidly (+1.0%) as Sweden (+1.7%), with the UK (+1.4%) and Germany (+1.4%) outperformed France (+1.1%) and Spain (+0.8%) as re-opening boosted sentiment.

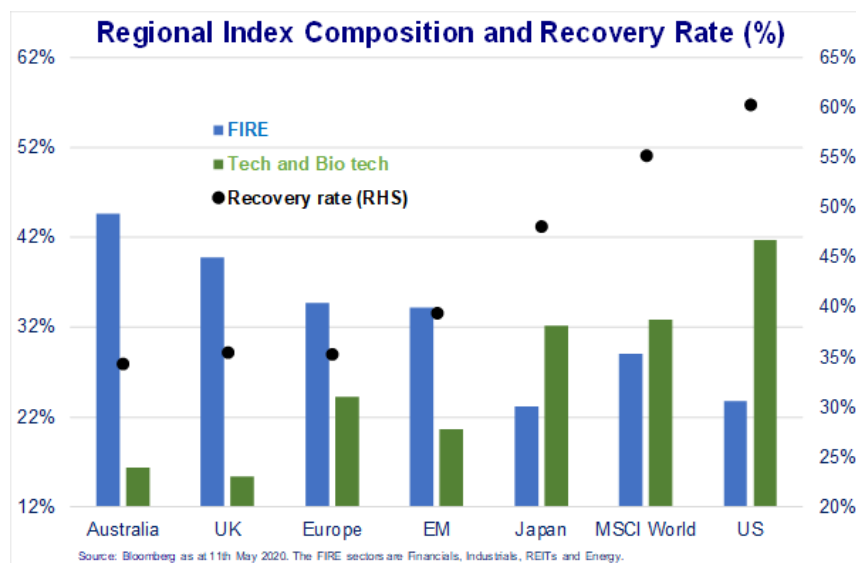
The Friday moves has seen recovery rates in Australia (34.3%), Europe (+35.3%), UK (35.5%) and EM (39.5%) lift to two-week highs but all of those markets remain in bear market territory, whereas Japan (+48.2%), Canada (55.7%) and the US (60% - see chart) have performed much stronger.



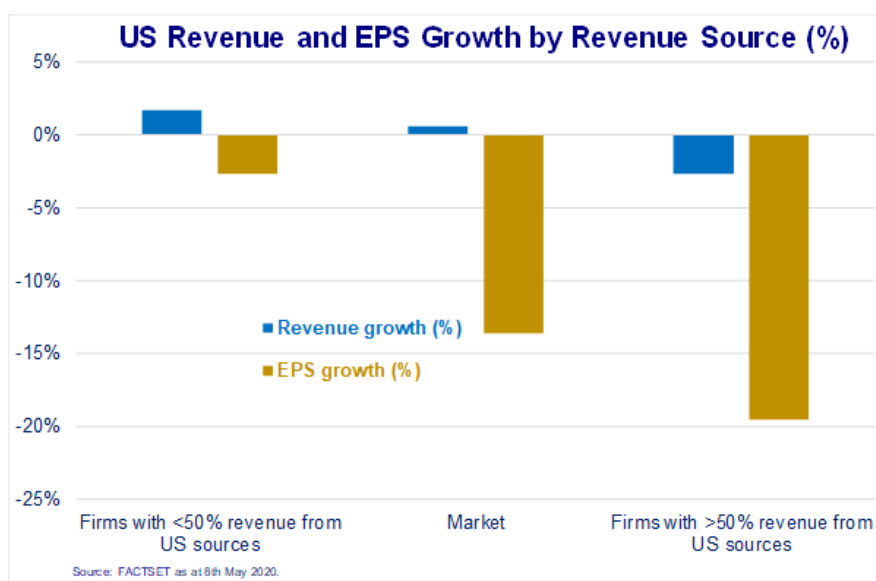
- The disparity between regional recovery rates partly reflects each region's sector composition with those with higher exposure to the FIRE sectors (financials, industrials, REITs and energy) who have been at the forefront of the earnings displacement adjustment from lower oil prices, rising default rates, upcoming deleveraging and businesses moving to on-line sales underperforming. In contrast, those with commensurate higher exposures to Tech and Biotech (the TBIT sectors) stocks which are benefitting from increased on-line sales and drug manufacturing have tended to outperform and have recorded much higher recovery rates (see chart below).

For example, Australia and the UK are the only two markets where over 40% of capitalisation is in the FIRE sectors and only 15% is in TBITs, and these two markets have recorded recovery rates of just 35% of their losses from February and early March. In contrast, the two markets with the lowest exposure to FIRE (the US and Japan at 23% and 24%, respectively) and highest exposure to TBITs (32% and 42%, respectively) have recorded the highest recovery rates (48% and 60%, respectively).

- Futures markets suggest this performance is likely to continue at the opening bell with the Australian market set to open 3 points higher (+0.1) and Japan to be up 90 points (+0.45%) at the bell.

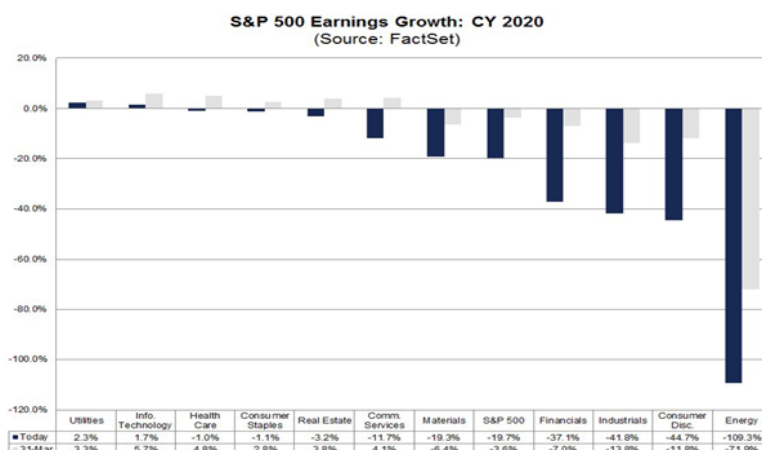


- **The US reporting season** has seen 86% of companies deliver results which have culminated in a quarterly revenue rise of +0.6% q/q in Q1 and an EPS decline of -13.6% q/q (expectations were -6.9% q/q at the end of March) which both metrics unchanged over the past week. However, US-based firms have fared much worse with companies where at least half their revenue comes from domestic sources have weaker EPS growth (-19.5% q/q) and revenue growth (-2.7% q/q) relative to their global-based peers (-2.7% q/q and +1.7% q/q, respectively – see chart).



If the market's overall blended corporate bottom line is unchanged by the end of this reporting season, EPS growth will be the lowest since the September quarter 2009 (-15.7% q/q). So far, 66% have beaten street estimates on earnings and 58% on revenue (both of which are below their respective 5-year averages) and those numbers are unlikely to change much as the last 70 companies report in the next two weeks.

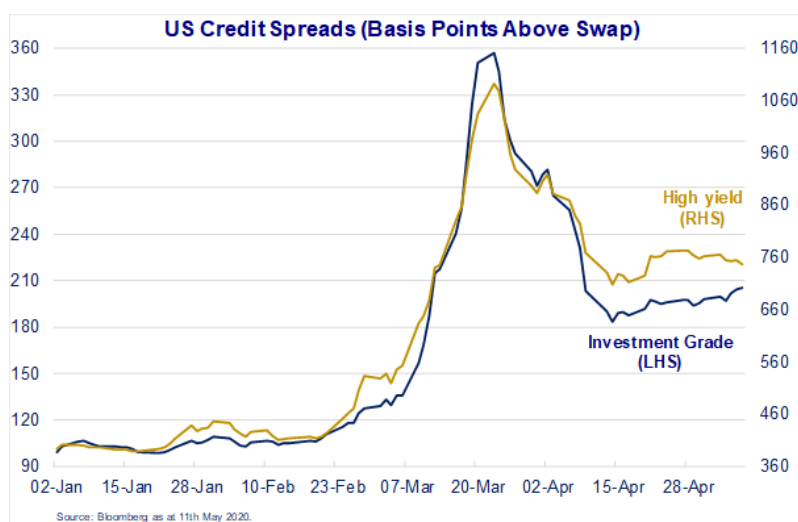
Although only 32 firms have provided specific June quarter guidance, analysts have been busy downgrading EPS estimates to -40.6% for June which is extremely large as over the past 20 quarters the average first month downgrade for the next quarter has been -1.9% q/q. The forecast for calendar year 2020 is now a revenue decline of -3.4% y/y and an EPS moderation of -19.7% y/y with the largest downgrades to 2020 EPS growth being in consumer discretionary (-7% to -44.7%) and materials (-4% to -19.3%) and while these are moving closure to reasonable expectations, to me they remain far too high and the rate of downgrades need to double.



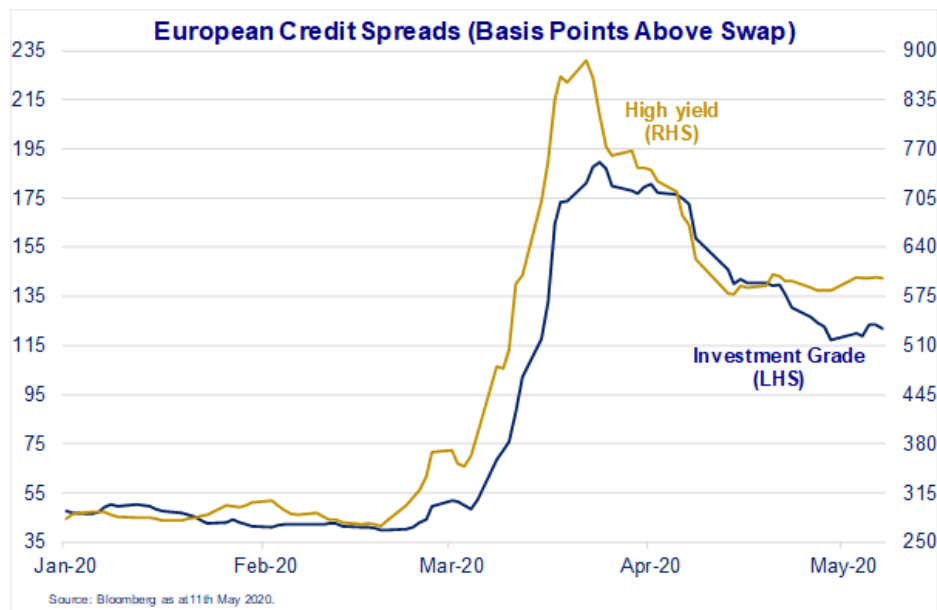
• CREDIT MARKETS

- The positive sentiment from equities did not flow through the regional credit markets despite tentative signs of economic re-opening and data which was better-than-feared at the headline number. Indeed, spreads in the US investing grade universe widened a further +1.3 points to 206 bpts (3-week high), which pulled the recovery rate down to 59.6% with 9 of the 11 sectors recording wider spreads, with increases largest in defensive sectors including telcos (+3 points to +229 bpts, 61%), healthcare (+2 points to +170 bpts, 67%) and consumer staples (+2 points to +186 bpts, 64%). Conversely, energy (-2 points to +324 bpts, 60%) and consumer discretionary (-1 point to +254 bpts, 61%) both saw lower risk premiums as economic data lifted sentiment.

In the high yield space, yields came in -7 points to +747 bpts, which increased the recovery rate to 50% which is a 2-week low. Spreads contracted in 10 of 11 sectors led by subordinated financials (-14 points to +788 bpts, 32%) and energy (-13 points to 1266 bpts, 67%), but after these there will little to be excited about.

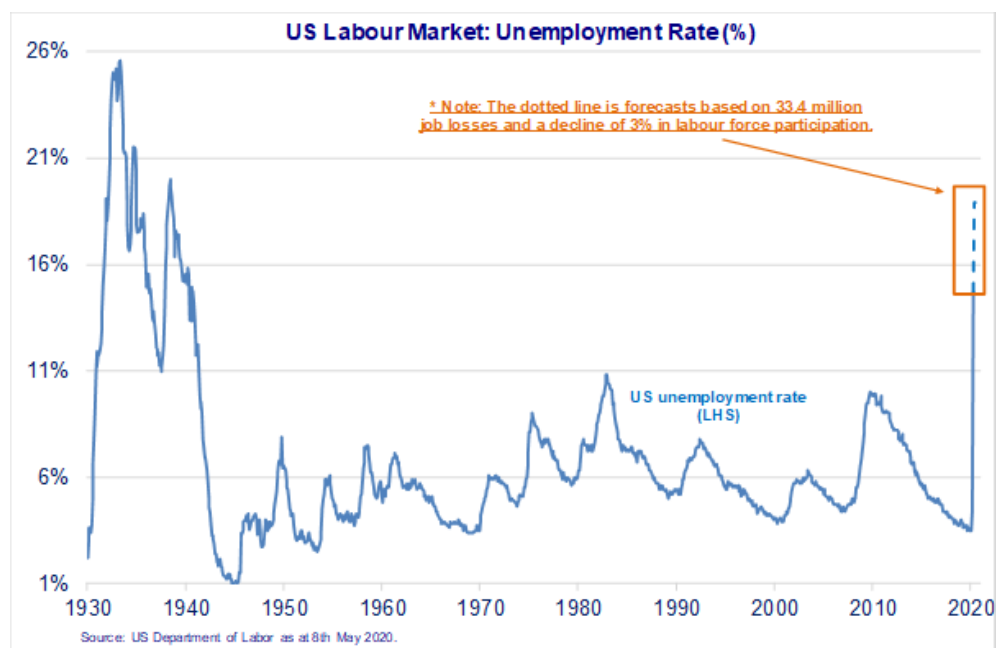


- European credit markets were little moved in the absence of major economic data or policy announcements. Spreads in the regional investment grade universe fell -1 point to +122 bpts which increased the recovery rate to 45% with declines in all sub-sectors led by senior financials (-2 points to +137 bpts, 42%) and energy (-2 points to +125 bpts, 29%). In the high yield space, spreads were flat at 599 bpts (see chart), which kept the recovery rate at 47% with spread contraction in 8 sectors and expansion in the remaining three, but movements here were modest across the board with the largest being senior financials (-3 points to +508 bpts, 47%) and energy (-3 points to +759 bpts, 50%), whereas consumer discretionary (+1 point to +786 bpts, 45%) recorded the largest expansion.



THE GLOBAL ECONOMY

- Markets had expected a record plunge in the April US non-farm payrolls and the BLS did not disappoint with total employment declining -20.5 million, which was very close to street estimates. This was enough to have the U-3 unemployment rate rise from 4.4% in March to 14.7% four weeks later which is its highest level since May 1940 (see chart), whereas the U-6 unemployment rate rose from March's reading of 8.7% to 22.8%.



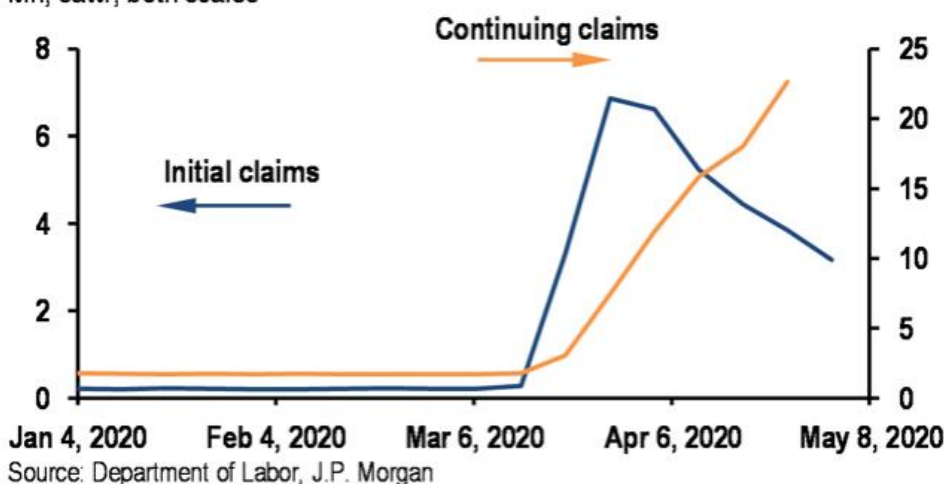
Among the sectors, one-third of the job losses came from restaurants and hotels (-6.3 million) which was to be expected as were declines in retail (-2.1 million), arts & entertainment (-1.3 million), manufacturing (1.3 million), construction (-1.0 million) and government (-1.0 million), but the decline in healthcare (-2.1 million) was a surprise even though a large portion of this would be the cancellation of elective surgery.

As large as the job losses are, the April data understates the labour market dislocation from Cov-19. Indeed, the BLS indicated that for a second straight month some people who lost their jobs because of the virus spread are incorrectly being classified as “employed, but not at work” which the Bureau estimated could be making the unemployment rate about 5 percentage points too low. In addition, the labour market contracted for a second straight month with the participation rate declining -2.5% to 60.2% which is biasing the unemployed statistic lower by around -3.5%. Were it not for these two factors, US unemployment would be circa 23.0%.

Although April is likely to represent the trough of economic gauges such as retail sales and industrial production, the labour market is a lagging indicator and we sense we are not at peak unemployment despite parts of the US economy having tentative re-openings. We believe there are two-sided risks for those “employed but not at work” with the left tail risk being these people may not have a job to come back to when states reopen. Meanwhile, the initial and continuing claims reports for the weeks after the April NFP report survey week (April 12th) have guided that large employment losses will continue in the May NFP report – potentially another 10 million, which despite misclassification and some people falling outside of the survey, should get the U-3 rate close to 20%.

Figure 4: Initial and continuing jobless claims

Mn, sawr, both scales



POLICY

- There were no major policy announcements on Friday, and there were few surprises in the [RBA's May Quarterly Statement on Monetary Policy](#) which detailed large downgrades to its key macro forecasts with GDP expected to contract -10% in the first half of 2020 (driven by a -15% decline in consumer spending and a -8% decline in business investment) and this will underpin a -5% y/y output decline for 2020 which will be partially recovered in 2021 (+4.1% y/y). The Bank also expects unemployment to peak at 10% in the June quarter (seems too low) before coming down to 8.5% by June 2021 and 6.5% by June 2022. Meanwhile, headline deflation occurs in the June quarter 2020 (-1.0% y/y) driven by lower oil prices and free child support, but this doesn't last long with the rate expected to rise to +0.25% by end-2020, but underlying inflation (1%-1.5%) is half the official target across the entire forecast period.

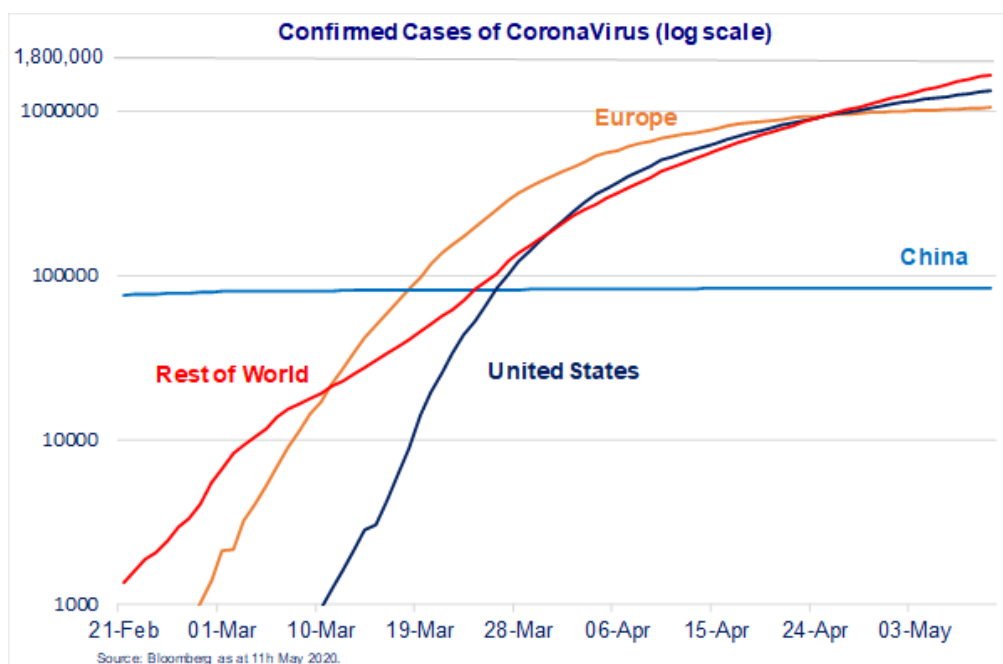
In terms of asset purchases, the Bank noted it had purchased around AUD50 billion of AGS and semis, and had injected AUD50 billion of additional liquidity through repos where the average maturity of its book had increased by around 10 weeks (from an average of one week in recent years). On mortgage stress, the Bank noted that around 9% of borrowers have applied to defer their loan payments for up to six months with others tapping into equity or offset accounts to support cashflows.

- [Prime Minister Morrison](#) announced a 3-phase plan to relax COVID-19 restrictions with an aspirational target of July for a complete reopening the Australian economy, although State Premiers will determine the precise timings:

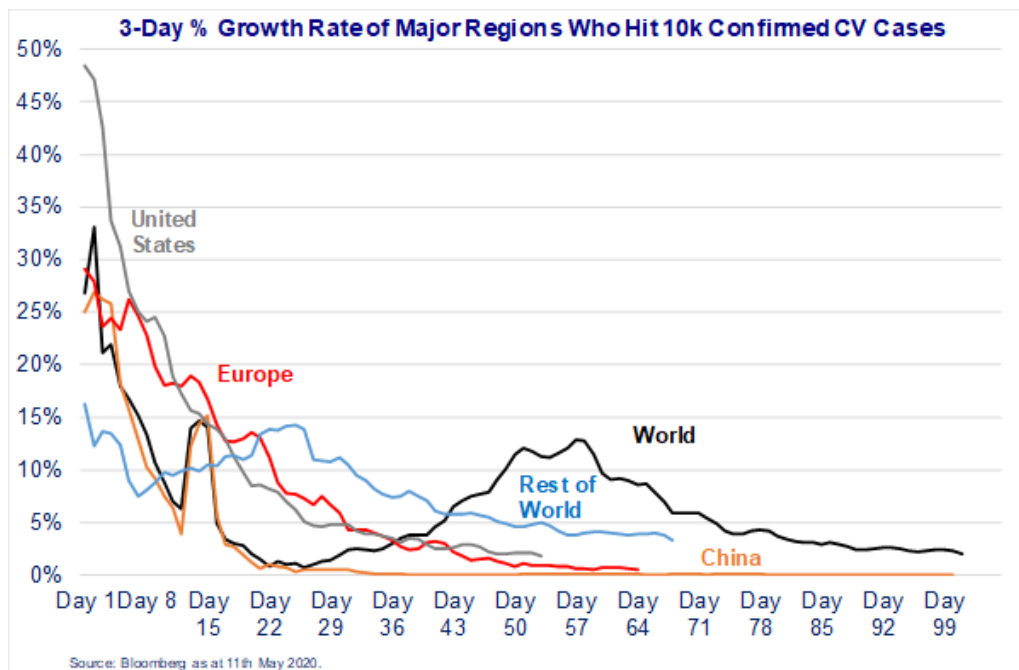
- **Phase 1** - will allow gatherings up to 10 people including five guests in a dwelling as well as the reopening of schools, playgrounds, golf, swimming pools, boot camps at parks, retail and small cafes/restaurants. However, given the required social distancing, the latter are likely to maintain their take-away status;
- **Phase 2** allows gatherings up to 20 people in places such as cinemas, galleries, organised community sport and beauty parlours; and
- **Phase 3** will allow gatherings of 100 people, most workers to return to their workplace, interstate travel to be reopened as will be pubs, clubs and potentially some gaming venues.

VIRUS UPDATE

- The number of global cases of COVID-19 stands at 4.13 million with another +72.0k cases overnight (which is the 40th day out of the past 41 where daily increases have topped 70k). The increase means 5 countries have more than 200k cases, 10 countries have more than 100k cases, 28 over 20k cases and 44 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, and in the past 2 days another 128k cases have been confirmed. That said, the growth rate of daily confirmed cases has just started to increase (+2.1% since last Thursday) but is still coming down in a trend sense. Meanwhile, deaths rose +3.1k overnight to 284.2k, with the US now over 75k, the UK and Italy over 30k with Spain and France over 25k, and the death rate sits at 6.9% (although final numbers are not yet in).

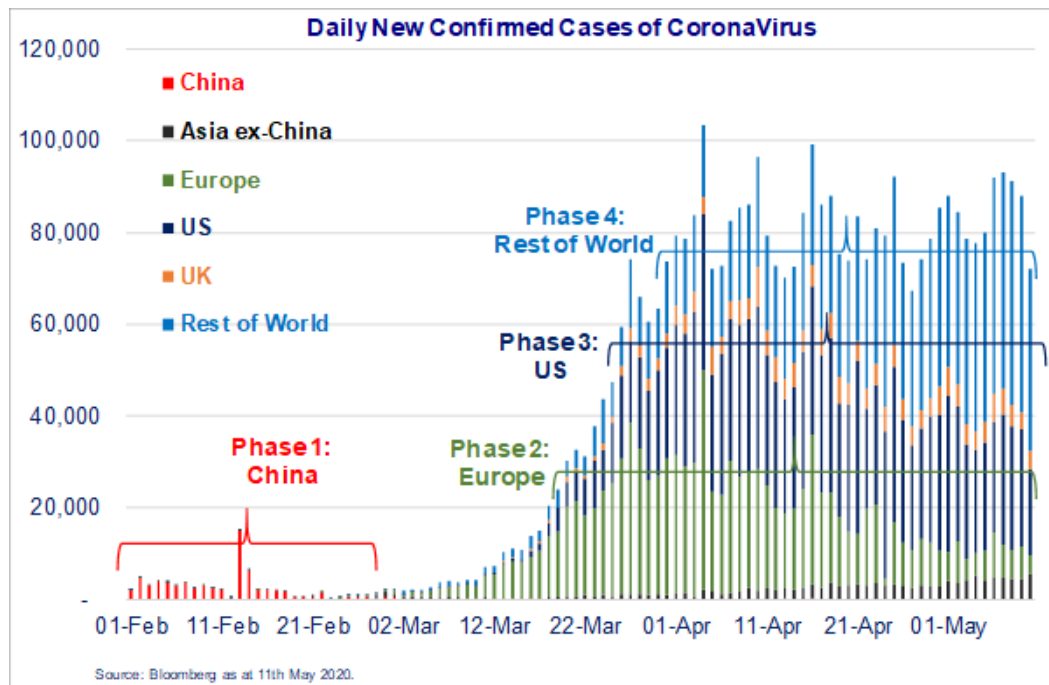


- We break the infections into four groups – the US, Europe, China and ‘others’ and the rest of the world outside the G3 economies now has the most total cases (+34.4k to 1.67 million) and highest daily new cases (and by a considerable margin) followed by the US (+18.2k to 1.33 million) and Europe (+4.1k to 1.05 million), with the latter two’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 two concerns here are Russia (+11.0k (record high) to 210.0k) and Brazil (+1.6k to 157.7k).



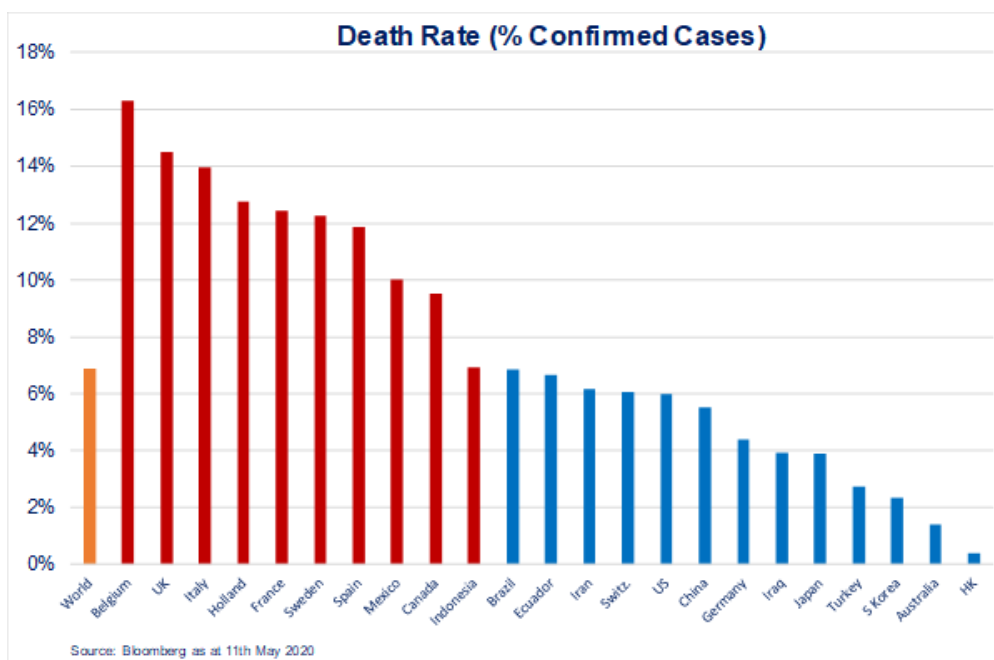
- Among countries, the most cases are in the US (+18.7k to 1.33 million), Spain (+0.7k to 224.4k), the United Kingdom (+3.9k to 220.4k), Italy (+0.8k (9-week low) to 219.1k), Russia (+11.2k (2nd highest in the past 10 weeks) to 209.7k), France (+0.5k to 177.1k), Germany (+0.5k to 171.8k), Brazil (+1.6k to 162.7k), Turkey (+1.5k to 138.7), Iran (+1.4k to 107.6k) and China (+4 to 84.0k). Australia confirmed cases rose +2 to 6,941 yesterday which placed us 50th in terms of total infections.

Elsewhere, Singapore recorded +876 new cases to 23.3k 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 (+387 to 14.0k) and the Philippines (+184 to 10.8k). Note final numbers for yesterday at not in yet so these numbers can rise.



- The global death rate was steady at +6.9% with another +3.1k fatalities overnight bringing the global total to 284.2k. The US (+0.7k) has the most deaths at +79.5k, with the UK (+0.3k to 31.9k), Italy (+0.2k to 30.6k), Spain (+0.1k to 26.6k) and France (+0.1k to 26.4) all over +25k. The death rate is highest in European countries where the health systems have collapsed led by Belgium (steady at 16.3%), the UK (-0.1% to 14.5%), Italy (steady at 13.9%), the

Netherlands (-0.1% to 12.8%), France (steady at 12.4%), Sweden (-0.1% to 12.3%), and Spain (+0.1% to 11.9%). However, several emerging markets are now on the leader board including Mexico (steady at 10.0%), Indonesia (-0.1% to 6.9%) and Brazil (steady at 6.8%).



Yours sincerely,



MATT SHERWOOD
Head of Investment
Strategy, Multi Asset



MICHAEL O'DEA
Head of Multi Asset

This document has been prepared by Perpetual Investment Management Limited (PIML) ABN 18 000 866 535, AFSL 234426. It is general information only and is not intended to provide you with financial advice or take into account your objectives, financial situation or needs. You should consider, with a financial adviser, whether the information is suitable for your circumstances. To the extent permitted by law, no liability is accepted for any loss or damage as a result of any reliance on this information. The PDS for the Perpetual Diversified Real Return Fund, issued by PIML, should be considered before deciding whether to acquire or hold units in the fund.

The PDS can be obtained by calling 1800 022 033 or visiting our website www.perpetual.com.au. No company in the Perpetual Group (Perpetual Group means Perpetual Limited ABN 86 000 431 827 and its subsidiaries) guarantees the performance of any fund or the return of an investor's capital. Past performance is not indicative of future performance.

MORE INFORMATION

Perpetual Investments 1800 062 725

Email investments@perpetual.com.au

www.perpetual.com.au/investments