Perpetual Investments

THOUGHTS ON THE MARKET

13th July 2020 - Why higher goods demand does not signal a V-shaped global recovery

SUMMARY

- Global risk markets rallied on Friday night as investors hopes grew that the world may be closer to an effective treatment for COVID-19, although it was hard to pinpoint what may have prompted that view. This optimism offset another poor day for infection rates in an otherwise quiet session which lacked major macro or policy news. The Friday night rally meant that the global sharemarket was able to record its first set of back-to-back weekly price increases in over a month with the gains in the past five session underpinned by consumer discretionary (+3.9% w/w) and IT (+2.8% w/w) stocks.

  In other markets, 10-year US Treasury yields increased +3 points to 0.64% with curve steepening, commodity markets were upbeat with gains in oil (+2.3% to USD40.55 per barrel) and profit taking in gold (-0.5% to USD1,799 per troy ounce) and most G10 currencies depreciated against a stronger Greenback including Sterling (-0.1%), the Euro (-0.2%), AUD (-0.4% to USC69.5), but the Yen (+0.4%) bucked the regional trend (as usual) and closed at a 12-day high of Y106.93.

- Last week was very quiet on the data front, which makes it a good time to take stock of where things are at. The H1 2020 economic contraction was unusual on many fronts but one of the unique factors was the decline in services activity which is expected to slump -16% h/ha relative to -4% h/ha in the two worst quarters during the GFC. While goods demand and industrial production has bounced strongly in May and June, that recovery is not indicative of a broad V-shape recovery in GDP as the bounce is being driven by transitory factors (pent up demand, elevated savings and government income support) all of which will fade in coming months, the services recovery is mediocre given social distancing requirements and increased consumer caution, and government income support will become more targeted which combined with a still depressed labour market to lower household income. These three factors underpin our view of an incomplete recovery (both economic and earnings) by end-2021 but this is not being priced by markets. This to us, is why regional equity markets have been marking time for over a month now outside of US tech and Chinese equities, and it is likely to remain the case, at best, for a while yet.

- The number of global cases of COVID-19 currently stands at 12.85 million with another +91.8k cases so far overnight (before Brazil, Mexico, Ecuador, Peru and 31 US states report their numbers) which means that Thursday is highly likely to be the 45th occasion in the past 47 days where daily increases have topped 100k (and the other two were over 99k!). This means 4 countries have more than 700k cases, 16 countries have more than 200k cases and 22 countries have more than 100k cases (Argentina joined this group overnight). It took 73 days to record 1 million cases, and after this each subsequent million has taken 13 days, 11 days, 12 days, 10 days, 11 days, 8 days, 8 days, 7 days, 6 days, 5 days and 5 days, and in the past 4 days another +859k cases have been confirmed. More importantly, the growth rate of daily confirmed cases (+1.8% since Thursday) is once again stabilising. Meanwhile, deaths stand at 568.0k and the death rate dropped for a sixty seventh straight day to 4.45%.

FINANCIAL MARKETS

- **EQUITIES**
  - The MSCI World Index increased +0.8% to close out the week and this enabled the market to record its first consecutive weekly advance in the past 5 weeks. There was little incremental news to alter the underlying narrative, so investors sought underperformers over the past month which enabled value and cyclical sectors to outperform. In particular, financials (+2.1%) top the sector scorecard, with strong gains in banks and insurance culminating in the sector's largest daily increase for a month, energy (+1.9%) was supported by a rising crude price and communication services (+1.5%) beat the tape as advances in

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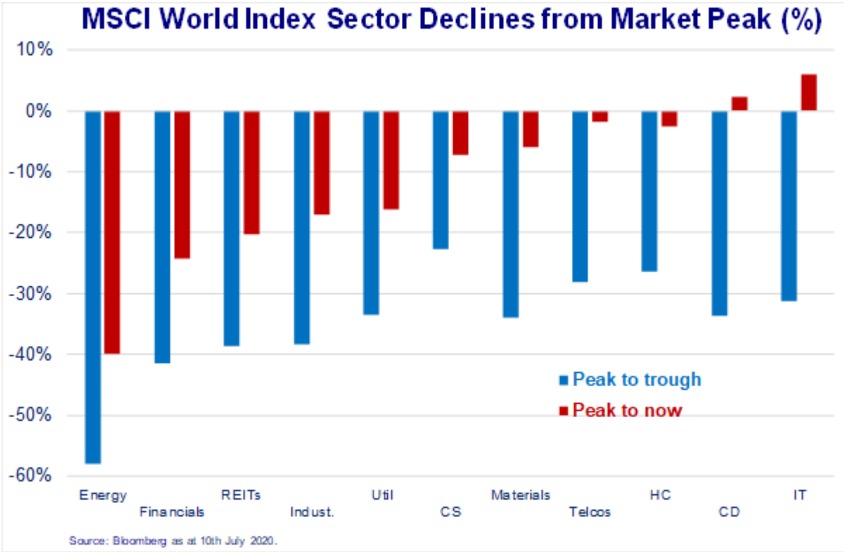
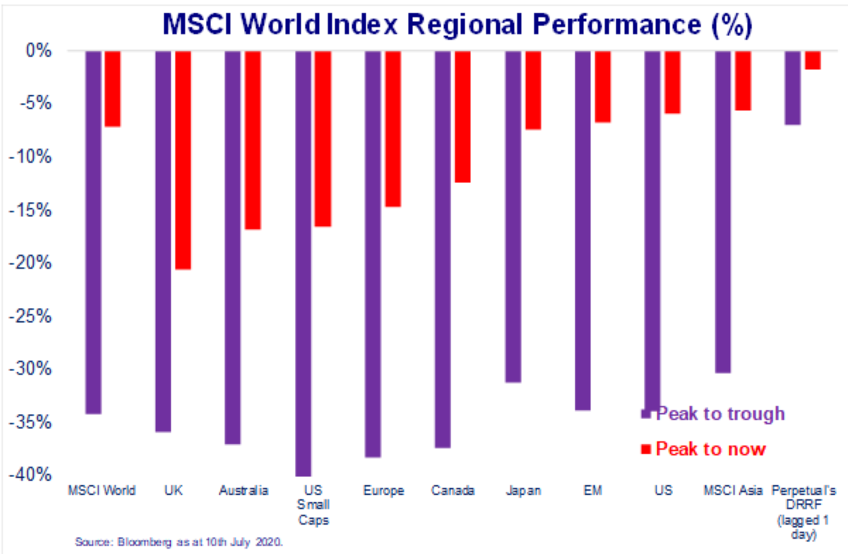
entertainment stocks offset some weakness in content providers and this flowed through to software providers which weighed on IT (-0.1%) which had only second down day in the past two weeks. The Friday movements saw energy (peak to trough of -40%), financials (-24.3%) and REITs (-20.3%) remain in bear market territory (see chart below).



- **Among the regions**, century advances in both the US and Europe offset losses in Japan and EM. The MSCI Asia Pacific index (-1.0%) started the last trading session for the week in a negative frame of mind following a weak lead from Wall Street on Thursday night which ended China's (-1.8%) eight-day win streak as the state owned China Economic Times talked about the dangers of a "crazy bull market", with losses also in Hong Kong (-1.8%), Japan (-1.1%) and Australia (-0.6%). This flowed through to Europe (+1.1%) which opened lower, but it didn't take long for markets to catch a bid and the market outperformed its peers led by Italy (+1.3%), Spain (+1.2%), Germany (+1.2%), France (+1.0%) and UK (+0.8%).

  US markets rallied from the get-go as investors reacted to speculation that the world could be closer to an effective treatment for COVID-19 which blunted concerns that a rising number of cases will weigh on the global economic recovery. There was a lack of meaningful data and investors seemingly bid underperforming sectors and offered recent market leaders and this saw the broad Russell 2000 (+1.7%) and S&P 500 indices (+1.1%) outperform the NASDAQ 100 (+0.7%) for the first trading session in two weeks, with the Dow (+369 points, +1.4%, to 26075) also outperforming the tech giant.

  The moves on Friday left the UK (-20.6% from the market peak in February) in bear market territory, whereas the US (-5.9%) is the closest individual market to achieving a full recovery (see chart).



- Futures markets suggest a positive opening in Asian trade today with advances expected in Hong Kong (+0.3%), Japan (+1.4%) and Australia (+1.5%).

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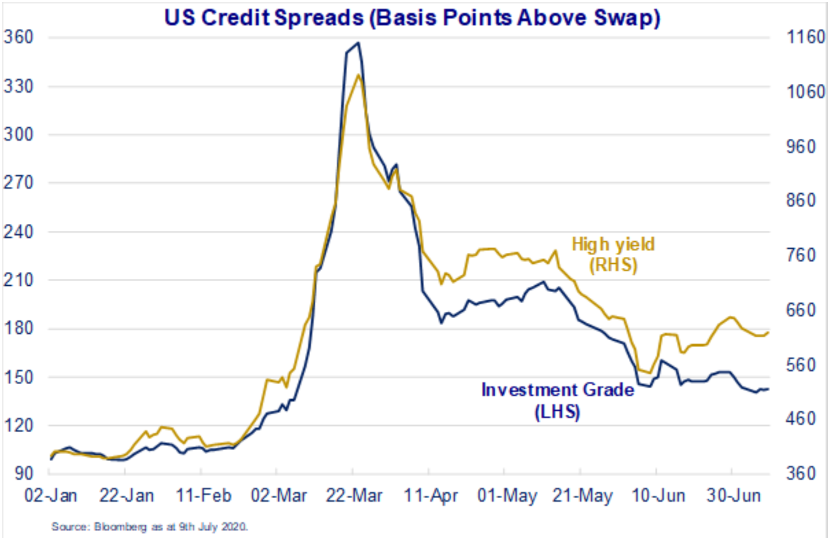
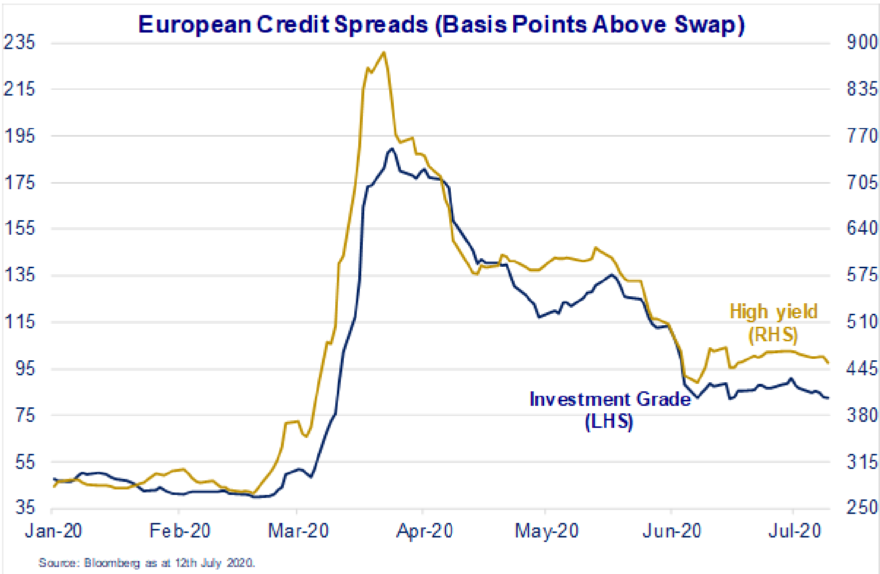
- **CREDIT MARKETS**
  - Regional credit indices marked time overall on Friday night, although there was better performance in the high-yield space. **In the US**, spreads in the investment grade universe were steady at +142 bpts which kept the recovery rate at 84%. Seven of the 11 sectors recorded lower spreads led by energy (-5 points, +199 bpts, 89%) as investors responded positively to a higher crude price, with consumer discretionary (-3 points, +168 bpts, 85%) also outperforming but tech (+3 points, +119, 83%) and telcos (+4 points, +167 bpts, 84%) did not share in the joy.

    In the high yield universe risk premiums fell -7 points, to +612 bpts, which raised the recovery rate one notch to 70%, with 6 of the 11 sub-sectors recording lower spreads. Among the outperformers was energy (-57 points, +918 bpts, 91%) which recorded its largest capital gain in the past 5 weeks, with other cyclical sectors such as industrials (-19 points, +712 bpts, 46%) and subordinated financials (-17 points, +646 bpts, 55%) outperforming as investors switched portfolios and sold down tech (+16 points, +546 bpts, 60%) and healthcare (+22 points, +579 bpts, 64%).

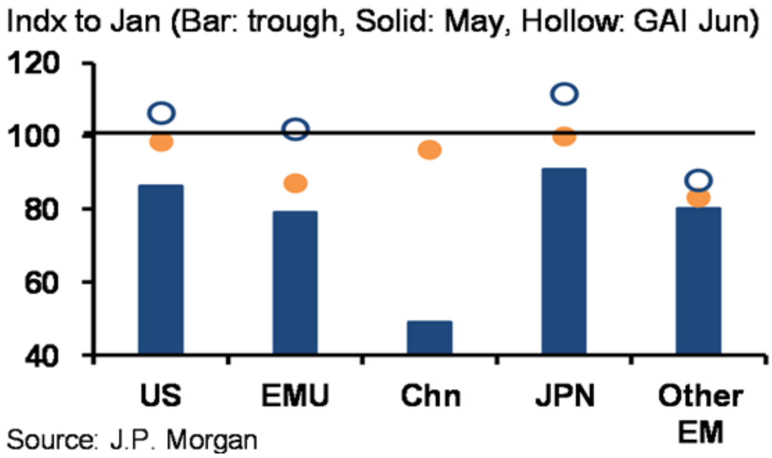


  - **European credit markets** recorded similar trends to the US market with spreads in the investment grade steady at +82 points (extremely close to a 4-month low) which kept the recovery rate at 72% with 7 out of 11 sub-sectors recording lower risk premiums led by energy (-1 point, +76 bpts, 65%) , but these were offset by widenings in the spread for healthcare (+2 points, +48 bpts, 76%) and tech (+6 points, +48 bpts, 62%). In the high yield universe, spreads decreased -8 points (4-week low) which brought the total down to +454 bpts (3-week low) and the recovery rate up to 70%. Among the sectors there were spread increases in six of the 11 sub-sectors led by energy (+15 points, +589 bpts, 68%) and healthcare (+12 points, +332 bpts, 68%), but these were outweighed by a -68-point (5-week low) decrease in risk premia for subordinated financials although it was hard to pinpoint the catalyst here.



THE GLOBAL ECONOMY

- There were no major economic releases on Friday night.
- Last week was very quiet on the data front which makes it a good time to take stock of where things are at. The H1 2020 economic contraction was unusual on many front but one of the unique factors was the decline in services activity is expected to slump -16% h/ha relative to -4% h/ha in the two worst quarters during the GFC, whereas the industry contractions were quiet similar (-22% h/ha and -27% h/ha, respectively). However, goods demand and production have bounced strongly in May and June and are close to recovering levels from January underpinned by re-opening, fiscal stimulus and some modest employment gains. This combination has boosted nominal global retail spending by +9.4% m/m in May and the Google Activity Index suggests a similar bounce in June (see chart) which will culminate in a complete retail spending recovery in the US, Europe and Japan, but not EM which is lagging primarily due to LatAm, and to a lesser Eastern Europe.

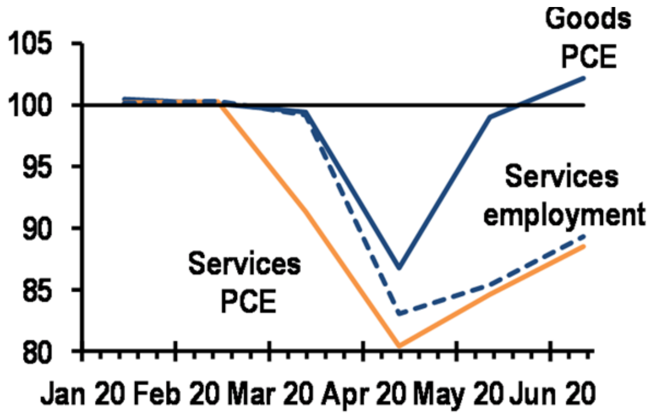


The boost to goods spending will have also sparked a sizable recovery in industrial production which should be confirmed this week when data for the US (June) and Europe (May) are released. However, the bounce in retail sales and industrial production in the past two months certainly does not signal a V-shape recovery in GDP for three key reasons:

a. The **recovery in retail spending is being driven by transitory factors** such as pent up demand, elevated savings and government income support all of which will fade in coming months;

b. The service sector recovery has to date been more constrained given **social distancing requirements** and these are likely to remain in place given rising COVID-19 case numbers in most major economic regions in recent weeks. While any restriction from a second wave of COVID-19 will be less draconian that those implemented in March and April, it will nonetheless **weigh on those firms which rely on large volumes for their surplus cashflow, and many of these are services based and simply won't recover all of their lost activity**; and

c. **Government fiscal policy**, which has been instrumental is providing cash flow support for households during lockdown and which has underpinned the largest fiscal impulse to the global economy is over 50 years, are set to diminish and turn into a growth drag in the second half of 2020 which will weigh heavily on household income given the labour market is still depressed. We expect a fourth round of US fiscal support to be announced in the next two weeks totalling USD1 trillion and this be increasingly more targeted at vulnerable groups and getting impaired industries moving again, but fiscal support will fade after this.



We think it's fair to say that outside US tech and Chinese equities, the remainder of regional equity indices have been marking time over the past month and aside from rising COVID-19 case numbers. Our two primary concerns are that government policy withdrawal will weigh on household income and white goods demand growth will ease back as transitory factors transpire and are not replaced. This means our view of an incomplete recovery (both economic and earnings) by end-2021 remains intact, but this is not being priced by equity markets, which may explain their underwhelming performance over the past month.

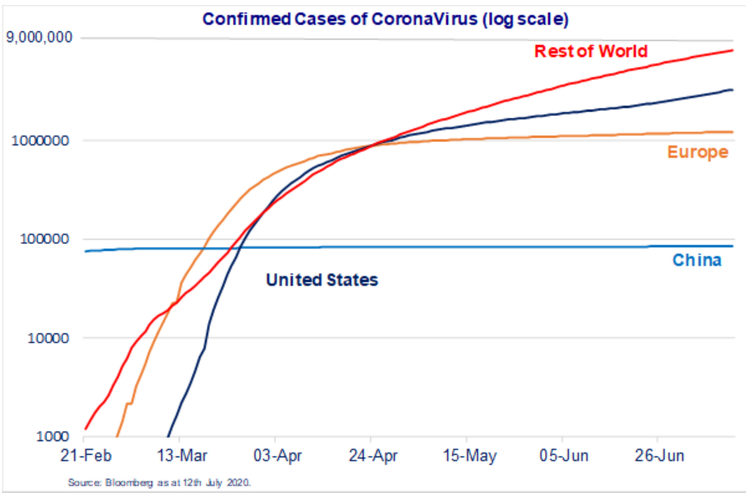
POLICY

- There were no major policy announcements on Friday, however, the Fed's balance sheet shrank (for a fourth straight week) by USD-88 billion (11-year low) to USD6.92 trillion with the total 4-week contraction now at USD250 billion. The primary source of the decline were repos with banks not needing to tap the central bank for funding for the week, which is another indication of the central bank's success in repairing market functioning. Elsewhere, Treasury holdings increased USD18 billon to USD.23 trillion and MBS purchases increased fractionally to USD1.9 trillion.

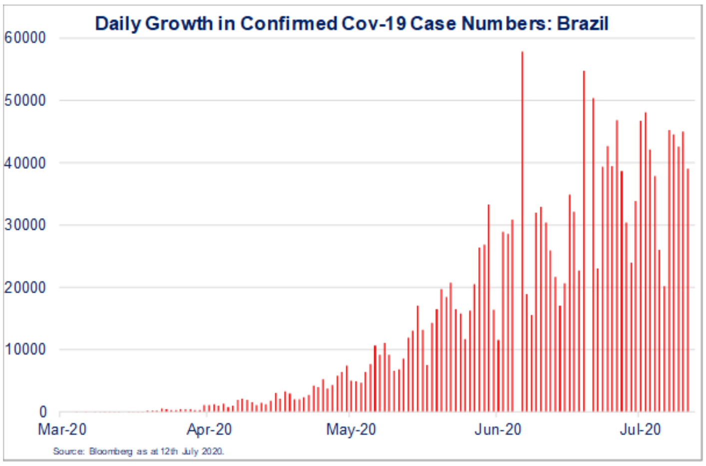
VIRUS UPDATE

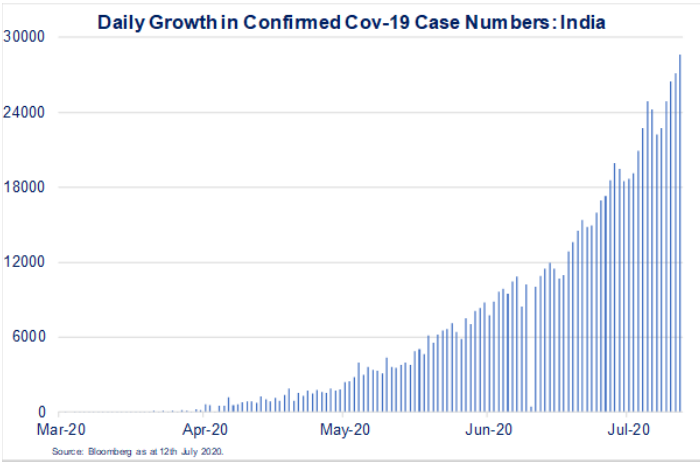
- Although final numbers are not in for another 5.5 hours, the number of global cases of COVID-19 was 12.87 million with another +91.8k cases so far overnight (before Brazil, Mexico, Ecuador, Peru and 31 US states report their numbers) which means that Thursday is highly to be the 45th occasion in the past 47 days where daily increases have topped 100k (and the other two were over 99k!). This means 4 countries have more than 700k cases, 16 countries have more than 200k cases and 22 countries have more than 100k cases (Argentina joined this group overnight).

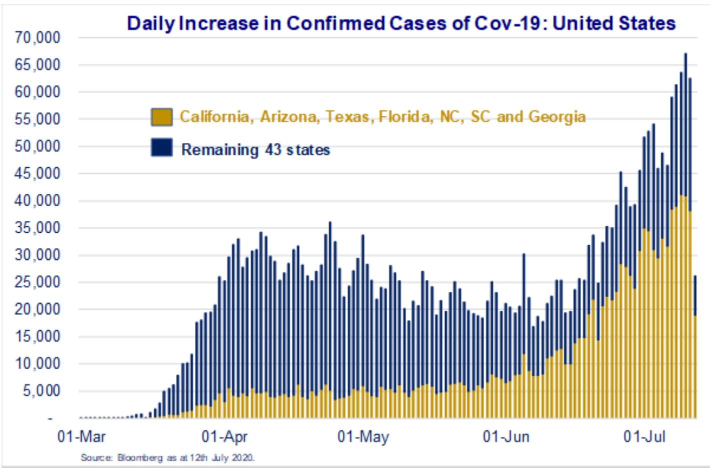
  It took 73 days to record 1 million cases, and after this each subsequent million has taken 13 days, 11 days, 12 days, 10 days, 11 days, 8 days, 8 days, 7 days, 6 days, 5 days and 5 days, and in the past 4 days another +859k cases have been confirmed. More importantly, the growth rate of daily confirmed cases (+1.8% since Thursday) is once again stabilising. Meanwhile, deaths stand at 568.0k and the death rate dropped for a sixty seventh straight day to 4.45%.



- 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 (+30.9k to 8.19 million) and highest daily new cases (and by a considerable margin) followed by the US (+25.6k to 3.30 million, although 31 states are yet to report) and Europe (+1.2k to 1.23 million - see chart). The issue for the US is that they never flattened their curve which means economic opening has not been associated with lower case numbers. Within the rest of the world, the three concerns here are Brazil (not reported, 1.86 million, which is the second highest in the world), India (+28.6k (record high) to 850k) and Russia (+6.6k to 726.0k, fourth highest) (see charts below).

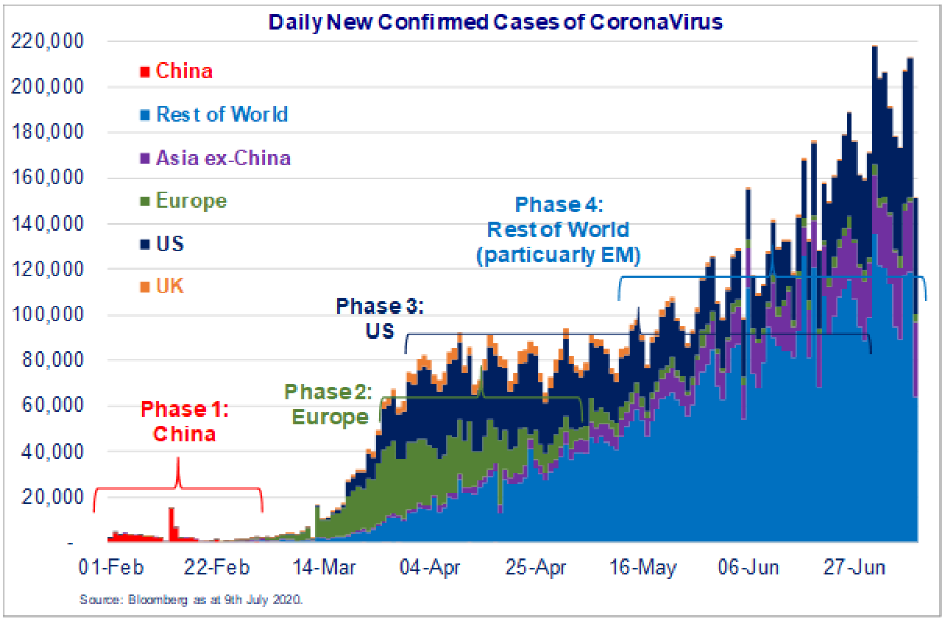




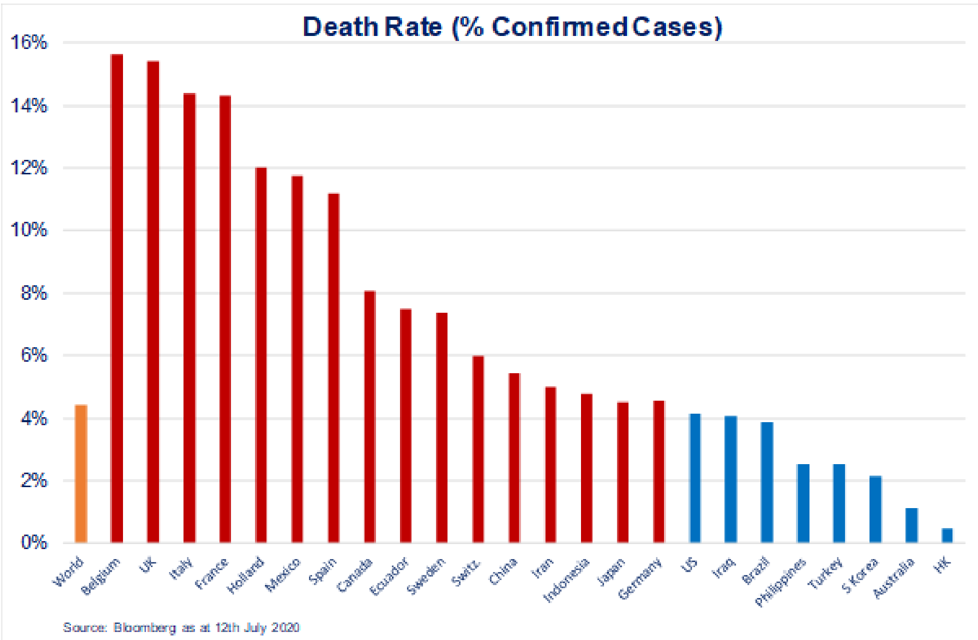


- Among countries, the most cases are in the US (+25.6k (so far) to 3.30 million, with 9 states yet to report), Brazil (not reported, 1.86 million), India (+28.6k to 850.0k), Russia (+6.5k to 726.0k), Peru (not reported, +326.3k), Chile (not reported, 315.0k), Mexico (not reported, +295.3k), the United Kingdom (+0.7k to 291.2k), South Africa (not reported, 276.2k), Iran (+2.2k to 257.3k),Spain (not reported, 253.9k), Pakistan (+2.5k to +248.9k), Italy (+0.2k to 243.1k), Saudi Arabia (+2.8k to 232.5k), Turkey (not reported, 213.0k) and France (not reported, 208.0k). Australia confirmed cases rose +247 to 9,797 yesterday which placed us 71st in terms of total infections.

Elsewhere, Singapore recorded +0.2k new cases to 46.0k 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, but Indonesia (+1.7k to 75.7k) is now on the rise and has the most cases in the region, and the Philippines (not reported, 54.2k) is also on an upward trend.



- Although final numbers are not in until 1pm AEST, the global death rate declined for a sixty seventh straight day to 4.45% with the global total to 568.0k after another 1.5k deaths overnight, so far. The US (+0.1k so far) has the most deaths at +134.9k, with Brazil (not reported, 72.1k), the UK (+0.02k to 44.9k), Italy (+0.009k to 34.9k), Mexico (not reported, +34.7k) and France (not reported, 30.0k) all over +30k. The death rate is highest in European countries where the health systems had collapsed led by Belgium (-0.1% to 15.6%), the UK (-0.1% to 15.4%), Italy (steady at 14.4%), France (steady at 14.3%), the Netherlands (-0.1% to 12.0%), Spain (-0.1% to 11.2%) and Sweden (-0.1% to 7.4%). However, several emerging markets are now on the leader board including Mexico (-0.1% to 11.8k), Ecuador (-0.1% to 7.5%), Indonesia (-0.1% to 4.8%) and Brazil (-0.1% to 3.9%).



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Yours sincerely,

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