Perpetual Investments

THOUGHTS ON THE MARKET

1st July 2020 - What's ahead for risk markets?

SUMMARY

- Last night was the last trading session of FY20 and markets had their usual end of year price rally with equity markets up sharply and credit markets ending a seven-day losing streak with modest advances. The charge higher was led by US equities where the S&P 500's overnight gains closed out the best quarterly return (+20.0%) in 22 years and the largest June quarter increase since 1938 - the NASDAQ also soared (+31% which is a 21-year high) and the Dow Jones's quarterly return (+18%, 33-year high) was also historic. Despite these eye-popping returns, the sustainability of the recovery has many dark clouds hanging over it given rising infection rates, the September cashflow cliff, a huge pending fiscal drag in FY21, deglobalisation, large labour market displacement and the US election which has the potential in current polls to deliver a Democrat clean sweep which is likely to lead to higher corporate taxes.

  In terms of what ahead, stocks moved in a second stage of recovery in June with more modest and more volatile price increases, but the most challenging stage is ahead as the market transitions from Fed-driven valuation expansion to an earnings recovery driving returns, and the latter has been priced to be a V-shape which itself requires a near-perfect hand over from fiscal income support to labour market recovery despite all the uncertainty ahead. Although there is large cash reserves sitting on the market sidelines, and policy maker's willingness to do whatever it takes which should culminate in market price decline being bought by investors, the question is at what level – -5%, -10%, -20%, something larger? And this is where investment management is more of an art than a science in terms of judging valuation and earnings potential, and risk.

  In other markets, 10-year treasuries rose three points with curve steepening, commodities were higher with oil up +3.5% to USD39.82 per barrel and gold up +0.5% to USD1,781 per troy ounce, and the US Dollar was mixed rising against the Euro (+0.5%) and Yen (+0.7%), but declining relative to Sterling (-0.6%) and AUD (-0.3% to USC69.02).

- The economic calendar was full yesterday with a 9-year high rise in US consumer confidence, some modest improvement in China PMIs, a decline in Japanese industrial production and subdued growth in Australian payrolls over the past two weeks. What is evident from the data is that the production side of the global economy is opening up much faster than the demand side, which will place further downward pressure on producer and consumer prices and hence earnings growth. In addition, given the rapid and massive dislocation in markets from lockdowns which are now reversing, the labour market has been mixed and risks are rising that it will be more prolonged and less egregious than what markets have priced.

- The number of global cases of COVID-19 currently stands at 10.4 million with another +120.1k cases so far overnight (before Brazil, Mexico, Ecuador, France, Pakistan and 10 US states report their numbers) which means that Tuesday was the 33rd occasion in the past 35 days where daily increases have topped 100k. This means 4 countries have more than 500k cases, 13 countries have more than 200k cases (France (202k) joined this group overnight) and 19 countries have more than 100k cases. 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 and 6 days. In the past 2 days another +400k cases have been confirmed but more importantly, the growth rate of daily confirmed cases (+1.7% since Friday) is rising despite the large base. Meanwhile, deaths stand at 508.4k and the death rate dropped for a fifty fourth straight day to 4.9%.

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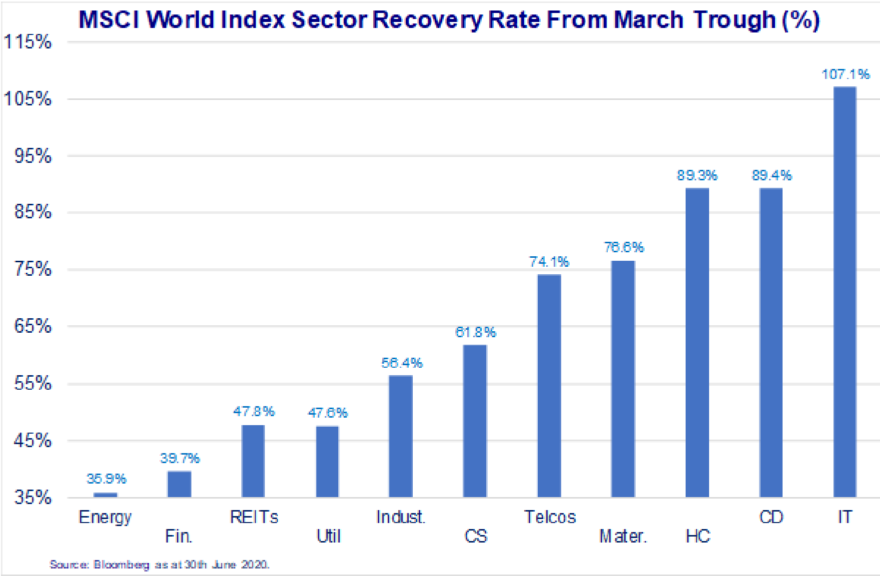
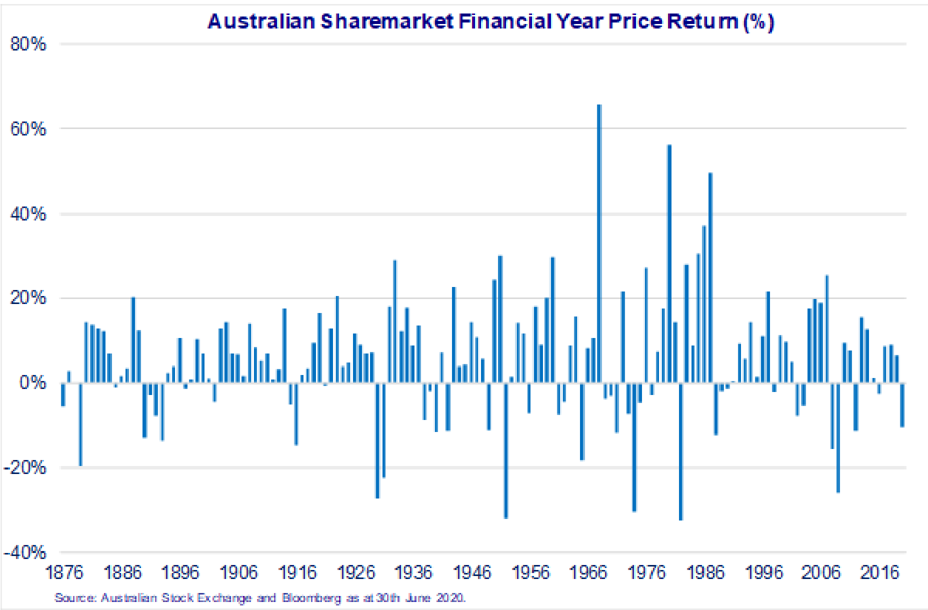
FINANCIAL MARKETS

- **EQUITIES**
  - The MSCI World Index closed +1.2% higher underpinned by gains in all regions and sectors for a second consecutive day. Cyclical sectors again led the pace of advances in the world index led by consumer discretionary (+1.5%) with optimism boosted by continued economic reopening around the world and associated economic recovery which underpinned the largest June quarter bounce for US stocks in this sector. Elsewhere, financials were bid probably on a financial year-end basis (i.e. given their losses), and healthcare (+1.0%) and Tech (+1.8%) rallied with investors unperturbed about valuations. The overnight moves, meant that energy (-37.2%), financials (25.0%) and REITs (-20.2%) remain in bear market territory, and utilities (-17.5%) and industrials (-16.7%) in correction territory with all other sectors recovering over 60% of their March quarter decline (see chart).

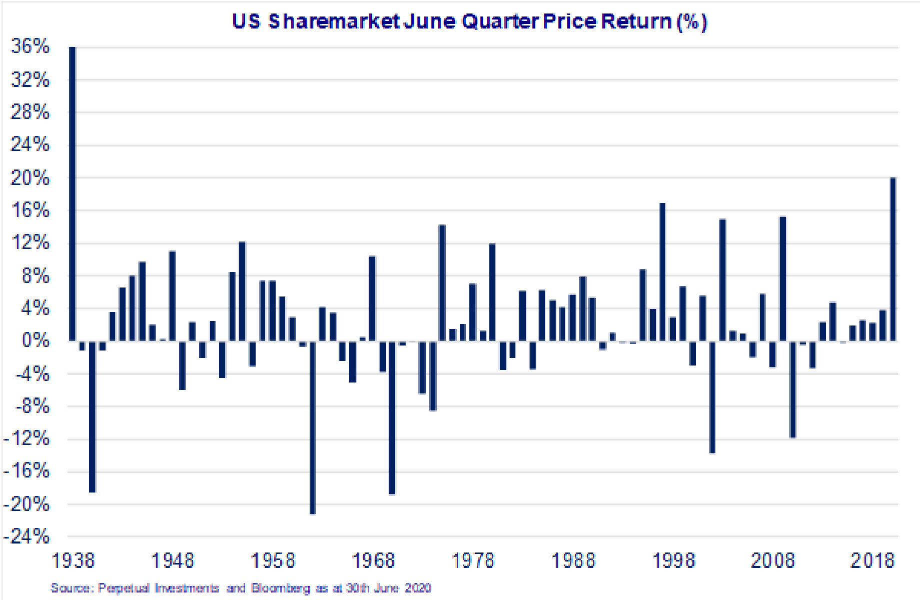


  - Among the sectors, the MSCI Asia Pacific index rebounded +0.6% yesterday with advances in Hong Kong (+0.5%), Korea (+0.7%), China (+1.3%), Japan (+1.3%) and Australia (+1.4%) with most bourses following a positive Wall Street lead as financial year end approached. The Australian sharemarket returned -10.4% in price terms in the FY20 which is an 8-year low, the seventh year in a row where price returns were in single digit territory, and the 43rd occasion that returns were negative since 1876 (see chart). Given the Australian economy is set to record its first recession in 29 years, and the growth drag from the virus is still festering, it is not surprising that markets like Australia where over 40% of capitalisation is in cyclical sectors (such as financials, industrials, REITs and energy) have underperformed, especially given the weaker recoveries in these sectors as seen in the chart above.

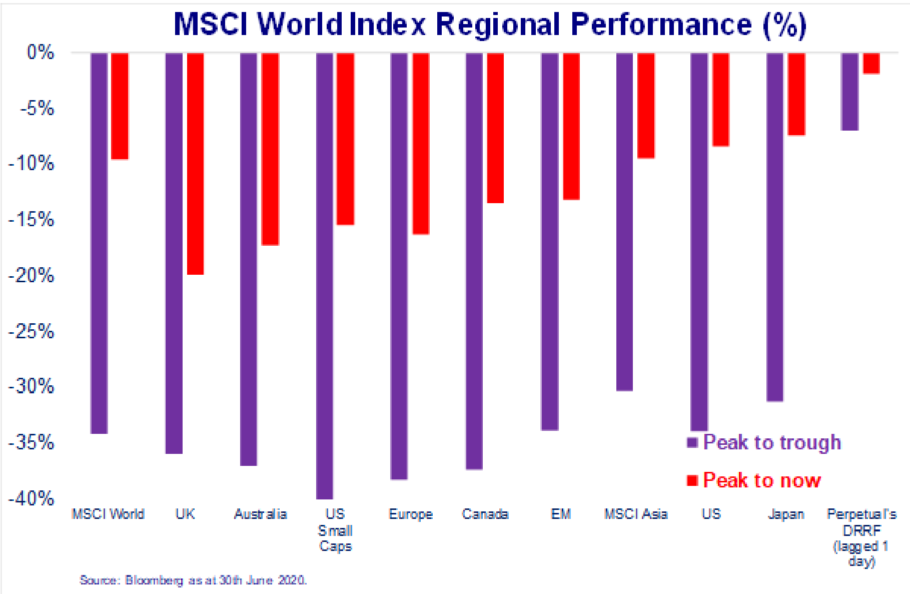


In Europe markets opened lower and it was quiet for most of the session but a positive opening in the US saw markets rally strongly in the final hour with the regional gauge (+0.1%) reaching positive territory by the bell. The regional index was held up by a rally in German equities although it was hard to pinpoint the catalyst, but in other markets the mood was less buoyant with losses in France (-0.2%), Sweden and Italy (both -0.4%), Spain (-0.6%) and the UK (-0.9%).

In the US markets, indices surged higher on the last 30 minutes of the financial year with the NASDAQ (+1.9%), S&P 500 (+1.5%) and Dow Jones (+0.9%, +217 points, to 25,813) all posting strong daily gains The S&P 500's overnight advance closed out the best quarterly return (+20.0%) in 22 years, and the largest June quarter increase since 1938 (see chart). Over the quarter, the NASDAQ also soared +31% (21-year high) and the Dow Jones lifted +18% (33-year high).



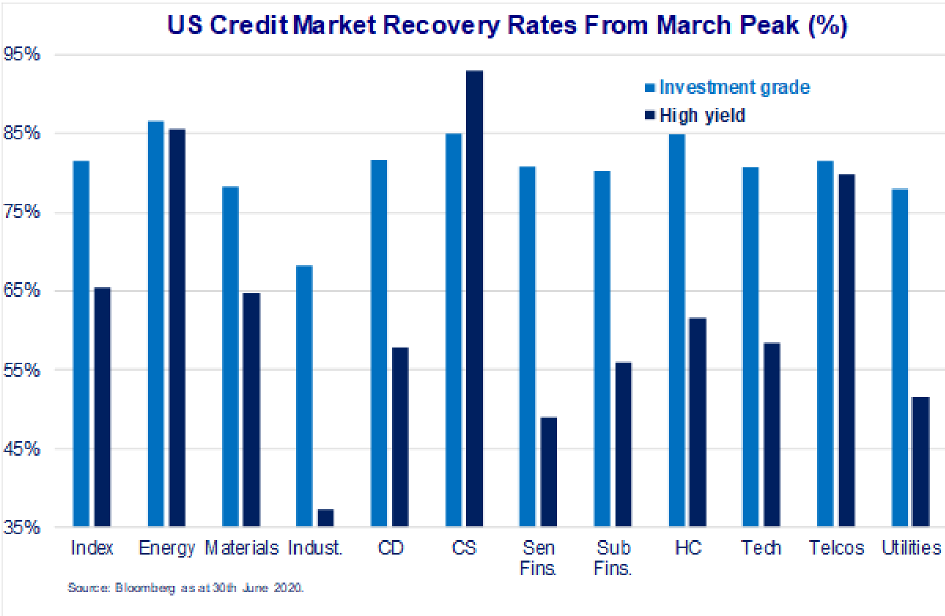
The overnight price moves meant that the UK market (-19.9% form peak to now) has just avoided re-entering bear market territory, with the US market now out of correction territory (see chart).



- Futures markets suggest the new financial year should begin with subdued returns with opening bell losses in Australia (-0.1%) and Hong Kong (-0.4%) and a modest advance in Japan (+0.2%).

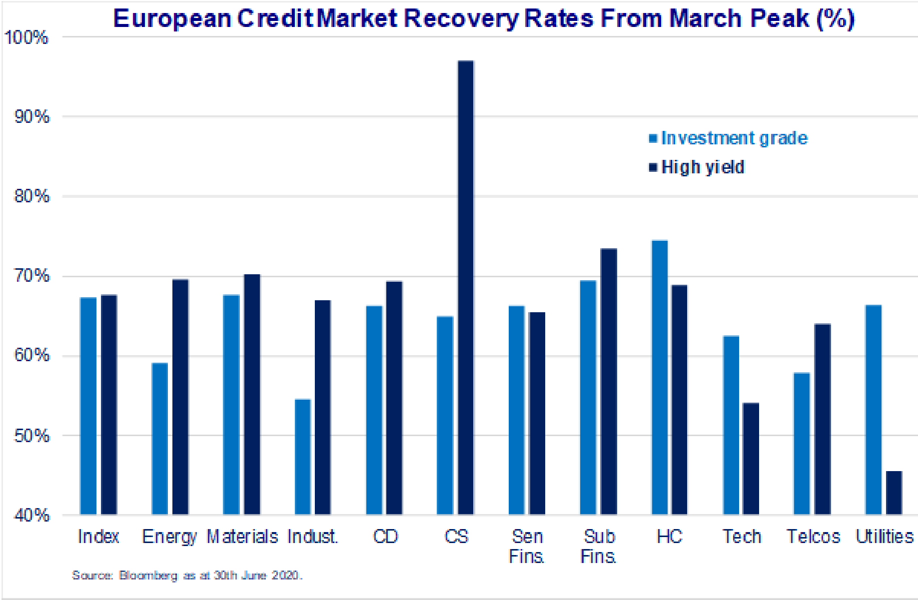
- **CREDIT MARKETS**
  - Regional credit indices were mixed overnight with spreads in the US investment grade market ending a 6-day losing streak by declining -3 points to +150 bpts, which lifted the recovery rate two notches to 82%. There were spread declines of 3 to 4 points in every sector led by tech (-4 points, +123 bpts, 81%), energy (-4 points, +209 bpts, 87%) which liked the sound of rising crude prices, and industrials (-4 points, +165 bpts, 68%) as investors priced in a bit of optimism to close out the year. In the high yield space, spreads broke an 8-day losing streak and decreased -1 point to +546 bpts which kept the recovery rate at 65%. Eight of the 11 sub-sectors recorded declines, but these were minor led by tech (-6 points, +556 bpts, 58%), energy (-5 points, +998 bpts, 86%) and industrials (-2 points, +774 bpts, 37%) and sectors with spread increases only saw fractional increases which could not be rounded up to +1 point!.

    Interestingly, the recovery rate for the 11 sub-sectors have on the whole been higher in the investment grade space which has been directly supported by the US Fed's balance sheet, whereas investors have been more wary of exposure high yield given higher threat of default and rising concern that not all the corporate balance sheet danger has passed. In fact US companies have filed for bankruptcy at the fastest pace since 2013 with 3,427 companies filing for Chapter 11 bankruptcy so far this year and this is very close to the 3,491 filings in the first 6 months of, which surged afterwards 2008 (to 8,614 and rose to 12,644 in 2009) as firms buckled under their inability to roll over debt. The COVID-19 lockdowns has exposed cracks in highly leveraged balance sheets by sapping them of much needed revenue and a second wave of COVID-19 infections could be a serious challenge for corporate survivorship.



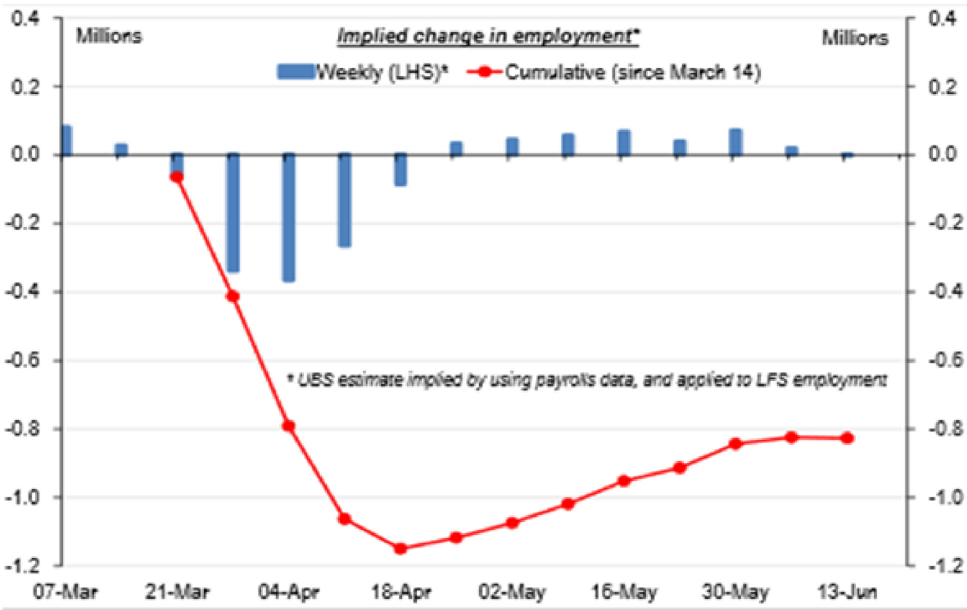
  - European credit markets closed lower overnight with spreads in the investment grade universe up +0.5 of a point to +89 bps, which lowered the recovery rate one notch to 68%. In contrast to the US investment grade space, there were a whole bunch of minor spread increases with the largest being industrials (+1 point, +93 pts, 55%) and utilities (+1 point, +59 bpts, 66%) and these were partially offset by a decline in subordinated financials (-3 points, +176 bpts, 69%) which defied the broader market trend for a second consecutive day. In the high yield universe, spreads increased +1 point to +470 bpts, which kept the recovery rate at 68%. More sectors (6) recorded lower spreads than increases (5) led by senior financials (-3 points, +3.71 bpts, 73%) and consumer staples (-3 points, +480 bpts, 97%), but these were outweighed by the market size of consumer discretionary (+3 points, +578 bpts, 69%).

    Overall, European credit markets have recovered less of their capital losses from the March quarter as their initial declines were smaller than the US, and there has been less central bank support as their credit markets are much smaller than the US. That said, like the US, the best recoveries have been recorded in defensive sectors given their lower correlation with trends in the broader economy.



THE GLOBAL ECONOMY

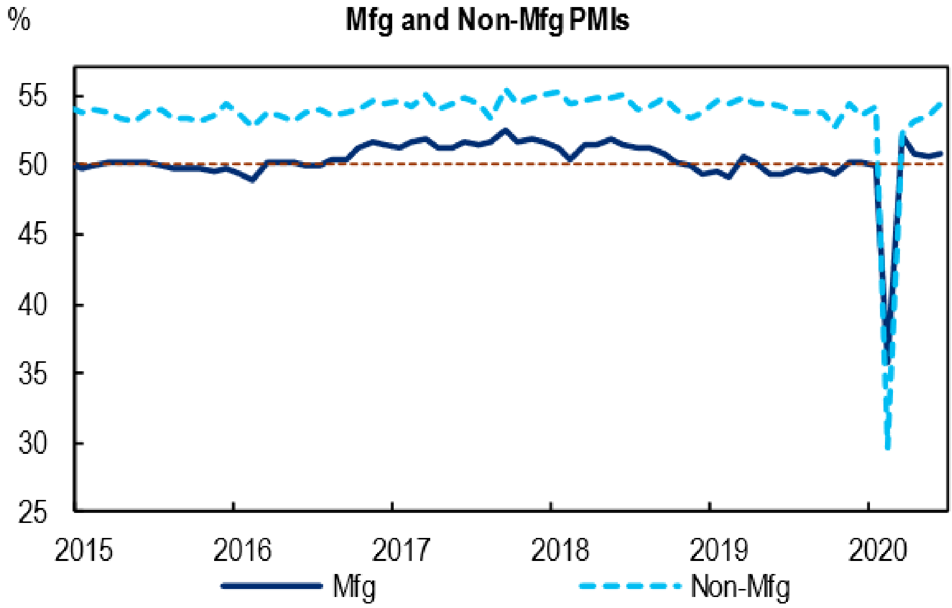
- **Australian payrolls data** yesterday disappointed with the total up only +0.1% in the 2 weeks to June 13, despite the ongoing easing of mobility restrictions and re-opening of the economy, which was a sharp slowing from a lift of +1% in the prior two periods. Accordingly, the total cumulative peak-to trough fall was -8.8% and the total recovery from the trough is now +2.7%. The totals here imply a total employment drop of -827k which is very similar to the Labour force survey which showed employment fell by -838k in the 3 months to May. Meanwhile, wages increased only +0.5% in the last 2 weeks, despite JobKeeper ramp-up. So overall, the data showed a better recent trend for wages than payrolls, but wages are down by a collective -6.3% since the March peak which is very similar to the payrolls decline and this suggest broadly flat income growth over this time and highlights the need for a quick recovery in the labour market to offset upcoming declining government income support.



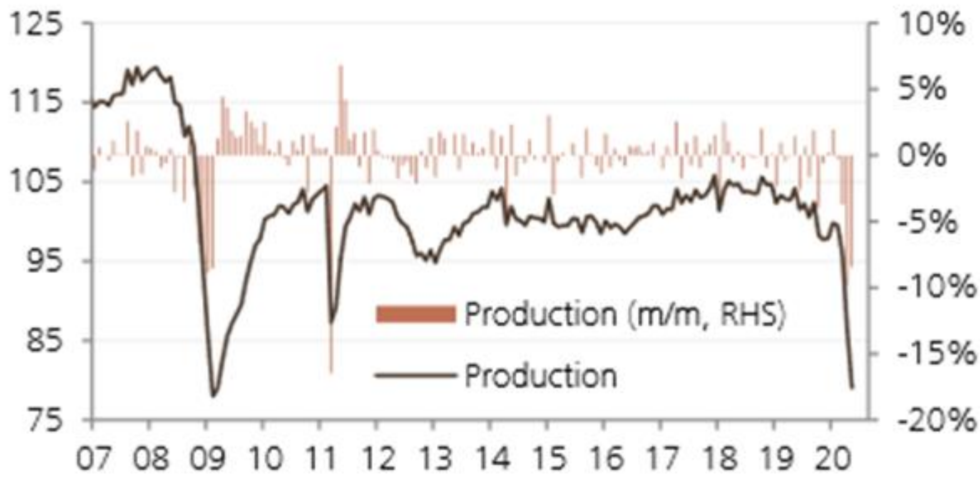
Source: ABS, UBS

- **China's NBS reported that the official manufacturing PMI** was 50.9 in June which represented a modest expansion overall and a moderate acceleration from May (50.6). Among the components, the overall rise was underpinned by increases in production (+0.7 to 53.9) and new orders (+0.5 to 51.4, with new export orders up sharply (+7.3 to 42.6) even though it remained well below the key 50 level), but this did not flow through to employment (-0.3 to 49.1) which remained in contraction territory.

- **Meanwhile, China's non-manufacturing PMI** lifted (+0.8 to 54.4 – see chart) with gains in most key components although employment (+0.2 to 48.7) remained in contraction territory which suggests that the activity improvement has been achieved without labour market expansion which is a worry for all countries as employment needs to ratchet higher to absorb declining government income support. In light of China's second (but modest) Cov-19 breakout, it will be interesting to observe if this impacts the labour market recovery. Another issue for China is that the normalisation of its production sector has considerably outpaced nominal retail sales (which has averaged +0.65% m/m in the four months after posting a -10.1% decline in January) and this disconnect could weigh down producer and consumer inflation, thereby undermining the sustainability of the recovery's momentum.



- **Japan industrial production** dropped -8.4% m/m in May which was similar to its April decline (-9.8% m/m) and took the annual rate down to -25.9% y/y which is the lowest since 2009 (see chart), with the May contraction reflecting the impact of global lockdowns and also Japan's state of emergency announcement. While output was lower for all component industries, with autos (-29.1% m/m) particularly eye-popping, the contraction is a known rear-view mirror situation. Survey projections from the Ministry of Employment, Trade and Industry point to gains of +5.7% m/m in June which would leave June quarter production down a sharp -15.6% q/q.



POLICY

- There were no major policy announcements overnight.

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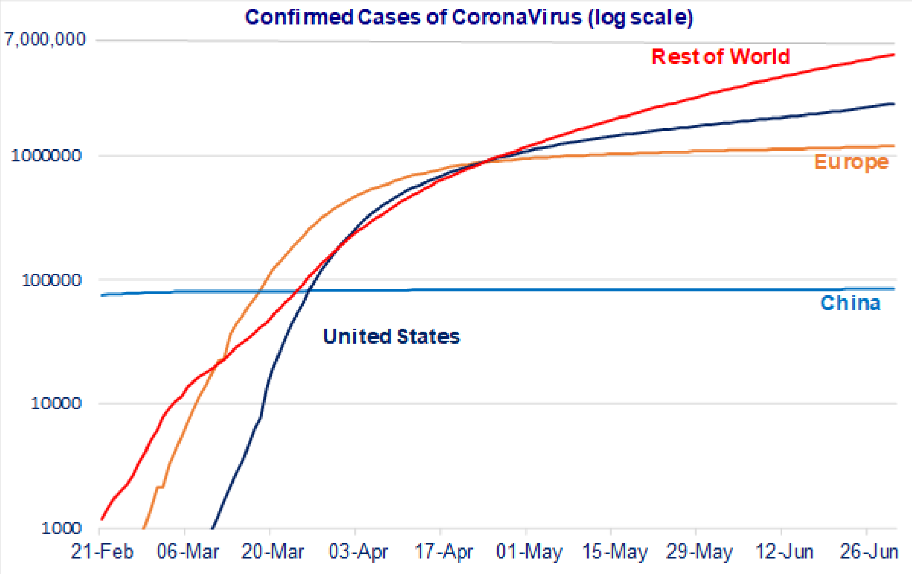
VIRUS UPDATE

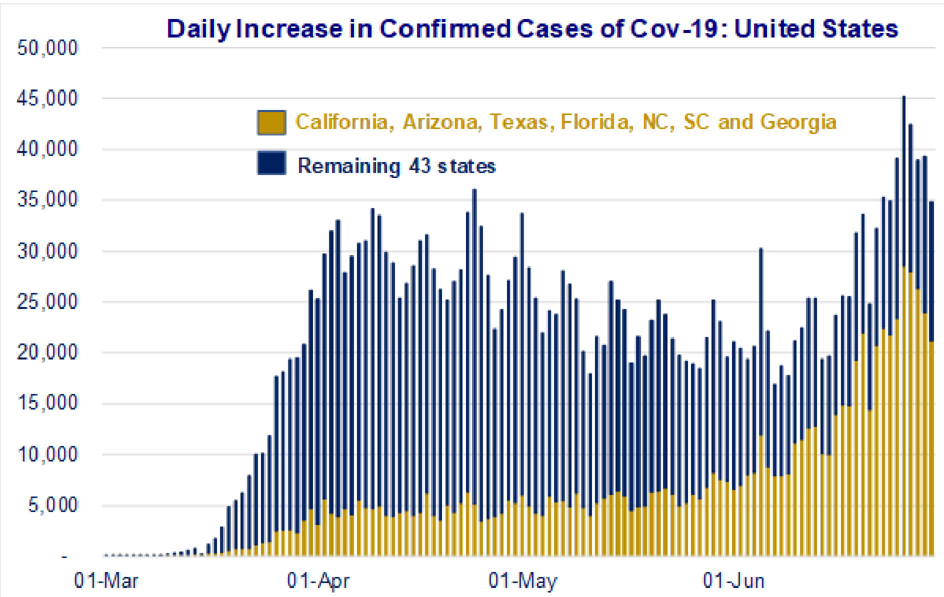
- Although final numbers are not in for another 5.5 hours, the number of global cases of COVID-19 was 10.4 million with another +120.1k cases so far overnight (before Brazil, Mexico, Ecuador, France, Pakistan and 10 US states report their numbers) which means that Tuesday was the 33rd occasion in the past 35 days where daily increases have topped 100k (and the other two were over 99k!). This means 4 countries have more than 500k cases, 13 countries have more than 200k cases (France (202k) joined this group overnight) and 19 countries have more than 100k cases.

  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 and 6 days. In the past 2 days another +400k cases have been confirmed but more importantly, the growth rate of daily confirmed cases (+1.7% since Friday) is rising despite the large base. Meanwhile, deaths stand at 508.4k and the death rate dropped for a fifty fourth straight day to 4.9%.



Source: Bloomberg as at 30th June 2020.

- 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 (+52.9k to 6.49 million) and highest daily new cases (and by a considerable margin) followed by the US (+34.6k to 2.63 million) and Europe (+2.1k to 1.19 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 (see chart). Within the rest of the world, the three concerns here are Brazil (not reported, +1.37 million, which is the second highest in the world), Russia (+6.7k to 646.9k, third highest) and India (+18.5k to 566.8k, fourth highest – see charts below).



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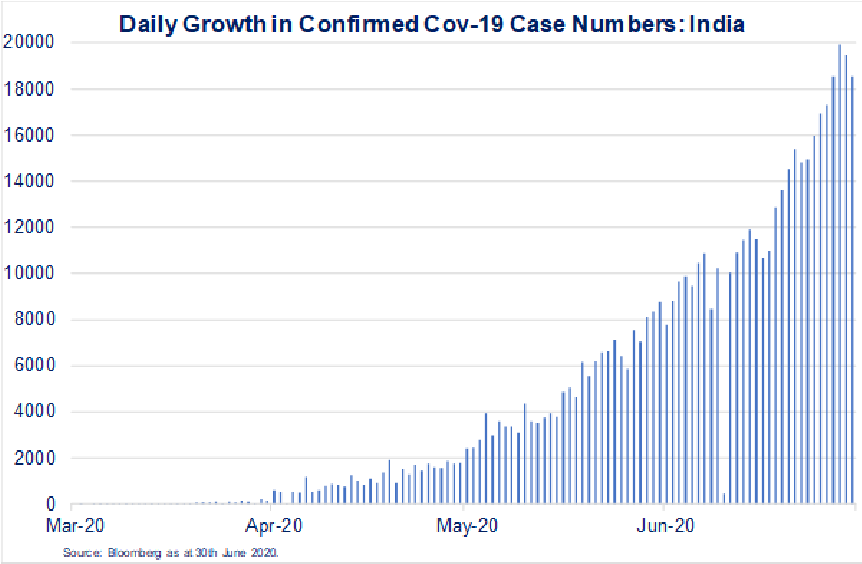
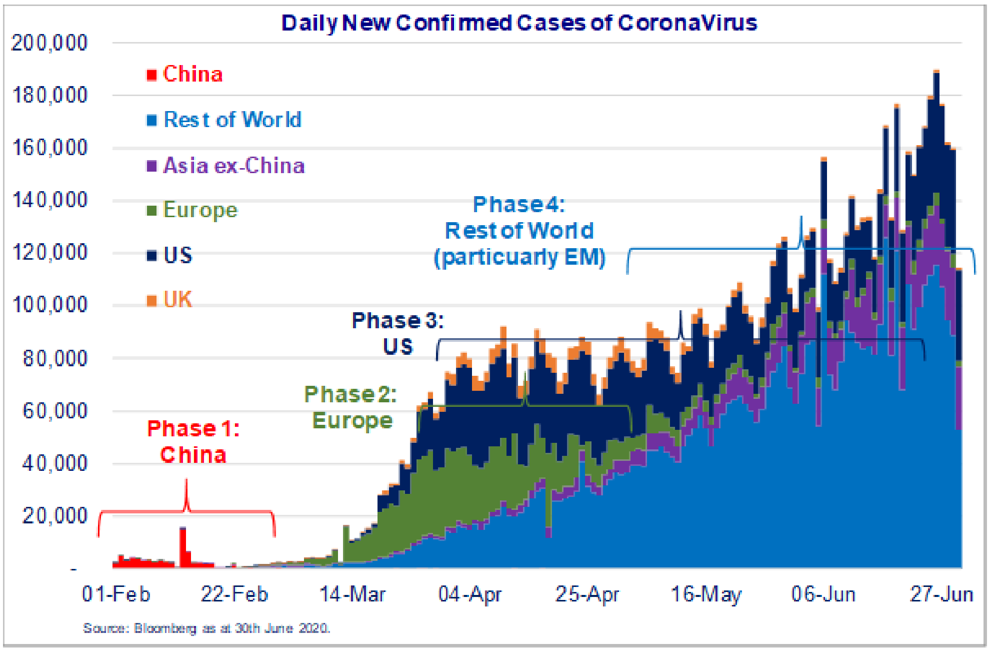
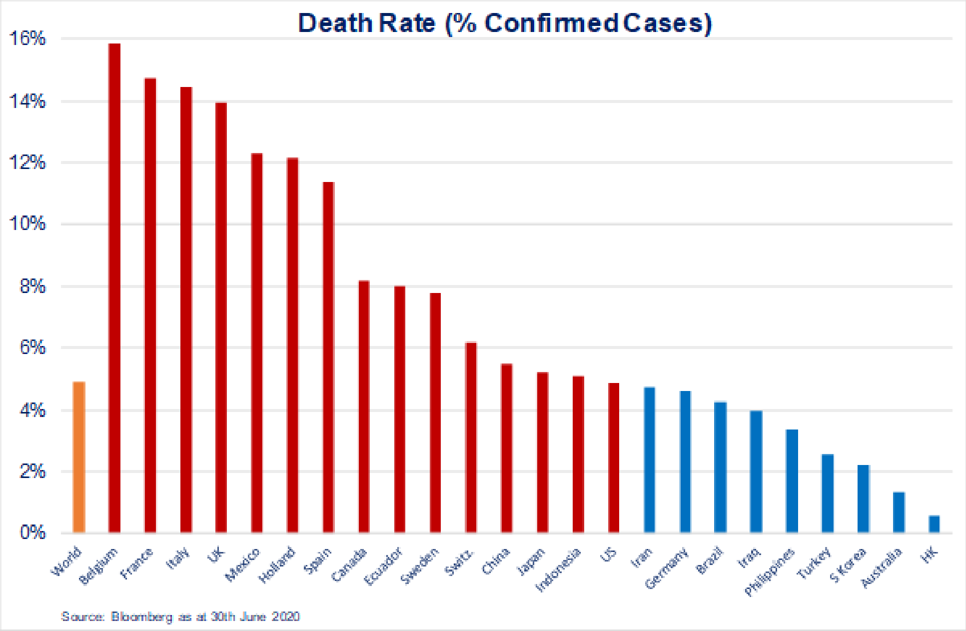


- Among countries, the most cases are in the US (+34.6k (so far) to 2.63 million), Brazil (not reported, 1.37 million), Russia (+6.7k to 646.9k), India (+18.5k to 566.8k), the United Kingdom (+0.7k to 314.2k), Peru (+2.8k to +285.2k), Chile (+3.4k to 279.4k), Spain (+0.3k to 249.3k), Italy (+0.1k to 240.6k), Iran (+2.5k to 227.7k), Mexico (not reported, +220.7k), Pakistan (+2.8k to +209.3k), France (not reported, 202.1k) and Turkey (+1.3k to 199.9k). Australia confirmed cases rose +67 to 7,834 yesterday which placed us 70th in terms of total infections.

  Elsewhere, Singapore recorded +0.2k new cases to 43.9k 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 (+1.3k to 56.4k) is now on the rise and has the most cases in the region, and the Philippines (+1.1k to 37.5k) is also on an upward trend.



- Although final numbers are not in until 1pm AEST, the global death rate declined for a fifty fourth straight day to 4.89% with the global total to 508.4k after another +3.5k deaths overnight. The US (+1.1k so far) has the most deaths at +127.3k, with Brazil (not reported, 58.3k), the UK (+0.2k to 43.8k), Italy (+0.02k to 34.7k), France (+0.03 to 29.8k) and Spain (+9 to 28.4k) all over +25k. The death rate is highest in European countries where the health systems have collapsed led by Belgium (steady at 15.9%), France (steady at 14.8%), Italy (steady at 14.5%), the UK (steady at 14.0%), the Netherlands (steady at 12.2%), Spain (-0.1% to 11.4%) and Sweden (-0.3% to 7.8%). However, several emerging markets are now on the leader board including Mexico (-0.1% to 12.3%), Ecuador (-0.1% to 8.0%), Indonesia (steady at 5.1%) and Brazil (-0.1% to 4.3%).



Yours sincerely,

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MORE INFORMATION

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