

# THOUGHTS ON THE MARKET

1<sup>st</sup> June 2020 - Trump sticks to the script, but the fiscal cliff still looms

## SUMMARY

- Stimulus has been attracting more headlines in the past 8 weeks than activity data and COVID-19 case numbers, as investors consider the latter two to be “temporary bad news”. What is clear is that increasingly unorthodox central bank policy can’t help the economy, but it is preventing the formation of second round negative feedback loops from financial market and funding channels. This means that fiscal policy is now the go to tool to boost growth and more work needs to be done here as there are large fiscal cliffs looming in numerous economies in H2 2020 as temporary support measures cease with government not keen to extend them. If this situation is not addressed, it could mean one very good quarter of growth (in September) followed by immediate weakness. This is a clear risk for markets.
- Risk markets were mixed on Friday with only US equity and US and European investment grade credit advancing as the world waited to hear what President Trump was going to say about China. While the leader of the free world blasted China regarding its actions in relation to both COVID-19 and Hong Kong, there was no draconian action and the Phase 1 trade agreement was left intact. The markets may have been relieved, but the world has no growth cushion to absorb any trade shock, unlike 2018.

In other markets, 10-yr Treasuries were firmer with yields down -4 points to 0.65% with curve flattening, Gold increased 0.4% to USD1730 per troy ounce, the US Dollar was weaker (given the riots) against the Euro (-0.9%, Sterling (-0.9%), AUD (-0.8% to 0.66.67) and Yen (-0.1%) and oil finished up +5.3% to 35.49 per barrel).

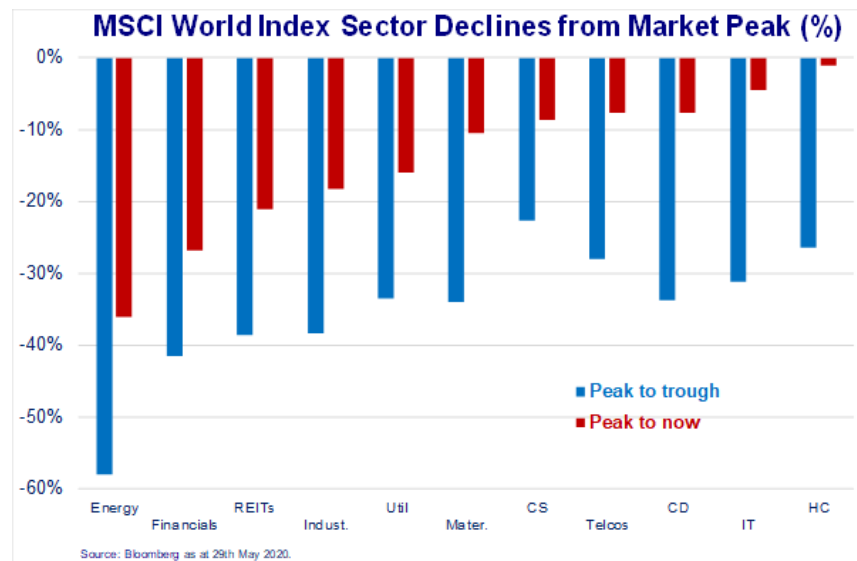
- Economic data on Friday was mostly from April and confirmed record monthly declines in US consumer spending, core PCE inflation and Australian credit growth, but the May China PMI reading signalled a slow manufacturing and services recovery despite a broader economic re-opening with particular weakness in employment and export orders.
- Stimulus is slowly being added by governments (China, EU and Japan recently) and markets are pushing higher. In the end, I remain very cautious on the medium and long-term outlook for markets as there is a very large disconnect around the world between sharemarket valuations and the underlying company fundamentals from both an earnings and balance sheet perspective. In the end, investors are not pricing in the fundamentals, but they are pricing in lower rates of future returns.
- Although final numbers are not in for another 3.5 hours, the number of global cases of COVID-19 stands at 6.13 million with another +71.3k cases so far overnight (before Brazil, Mexico and some US states have reported numbers) which means that Thursday was the 62nd occasion in the past 63 days where daily increases have topped 70k). This means 3 countries have more than 400k cases, 6 countries have more than 200k cases, 12 countries have more than 100k cases, 37 over 20k cases and 52 over 10k (Kazakhstan rose to +10.8k overnight). 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, ten for the fifth million and 11 for the sixth million, and in the past 30 hours another 131k cases have been confirmed. That said, the growth rate of daily confirmed cases is trending lower (+1.9% since Tuesday). Meanwhile, deaths stand at 371.1k and the death rate dropped for a twenty fifth straight day to 6.02%.

## FINANCIAL MARKETS

### • EQUITIES

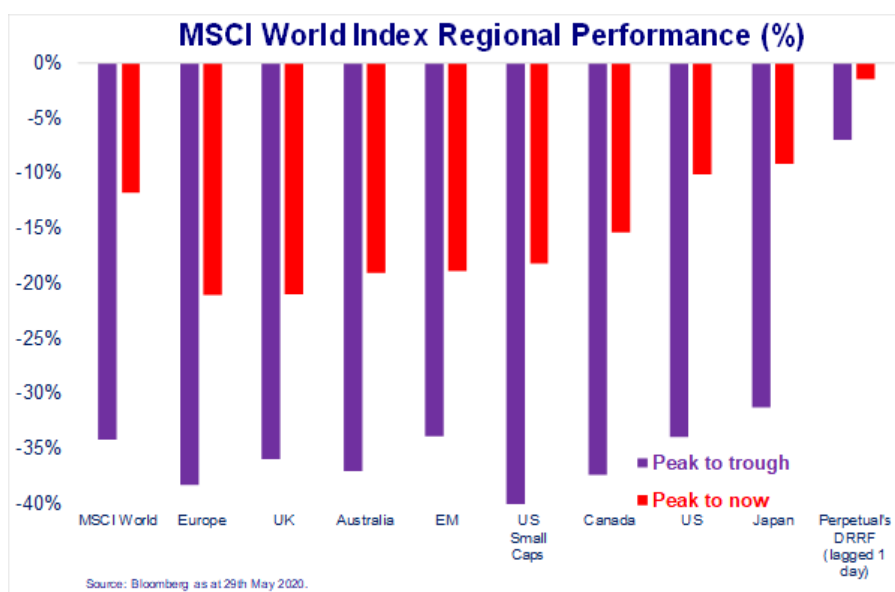
- The MSCI World Index was steady on Friday night and closed out a second consecutive month where the index and every sector closed higher. Stocks saw some weakness early on Friday night but when President

Trump did not announce any change to the Phase 1 trade agreement with China, investors pushed prices higher given the reopening push, massive fiscal and monetary policy stimulus, and improvement in high-frequency data. In contrast, they continue to ignore the earnings outlook and valuations which are usually to bulwark of asset prices. On the day, four sectors rallied led by IT (+1.0%) and healthcare (+0.8%) which already had the highest recovery rate but seem less sensitive to thoughts of a weak recovery, whereas the recent outperformers such as REITs (-0.7%), industrials (-1.1%) and financials (-1.9%) were sold down as risk aversion increased. The decline in REITs saw it fall back into bear market territory, but healthcare has the recovery line in its sights (see chart).



- **Among the regions**, the US (+0.5%) was the only market to advance as re-opening prospects seem to be overwhelming every other downside risk with President Trump seemingly sticking with the script and saying many of the logical things people are upset with, without announcing any ramp-up in draconian actions. The rally capped off a second consecutive month of advances (+4.5% m/m) for the US market although its improvement was slightly less than the global average (+4.6% m/m).

Europe (-1.4% d/d) was the major underperformer for the session as the market dropped by the most in two weeks. Losses were widespread and consistent between countries led by the UK (-2.3%), Spain (-1.8%) and Sweden and Germany (both -1.7%), but Italy (-0.8%) held up well given the prospect of tighter fiscal integration. Earlier, the MSCI Asia Pacific index closed -0.2% lower with gains in China (+0.3%) and Korea (+0.1%) outweighed by declines in Japan (-0.2%), Hong Kong (-0.7%) and Australia (-1.4%). The movements on Friday took Europe (-21.1%) and the UK (-21.0%) back into bear market territory with Australia (-19.1%) and EM (-18.9%) not far away (see chart).

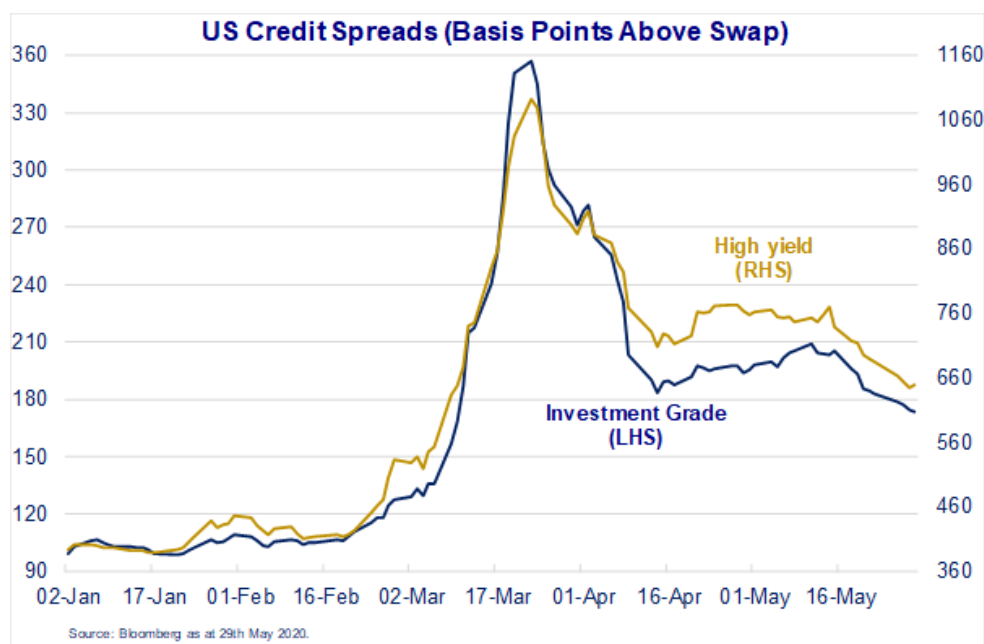


**Futures markets** suggest a mixed opening in Asia on Monday morning with Australia (-0.4%) set to open lower, but there are expected to be improvements in China (+0.1%), Hong Kong (+0.6%) and Japan (+0.8%).

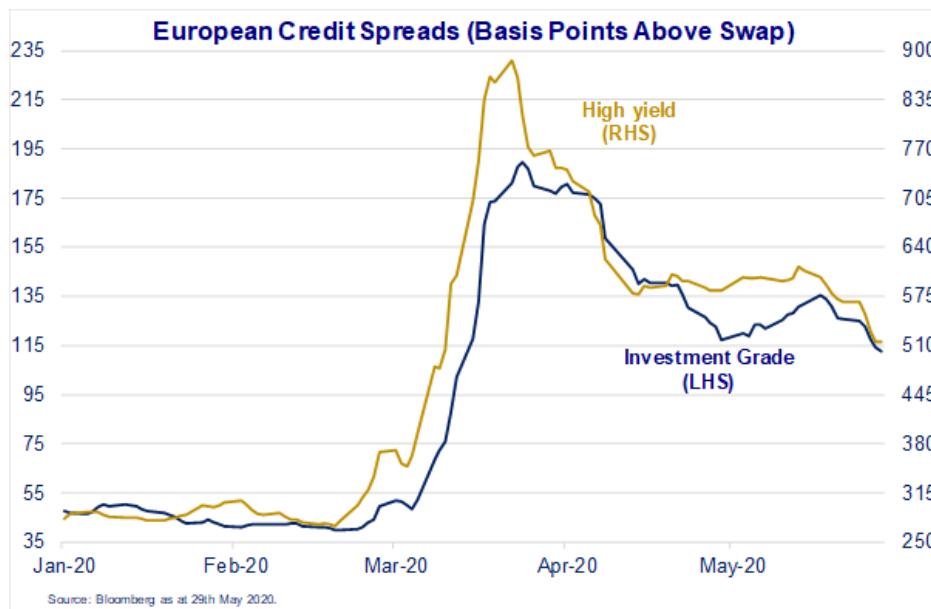
## • CREDIT MARKETS

- Regional credit indices were mixed on Friday as investors worried about the potential impact that rising geopolitical tensions may have on the price of risk. In the US investment grade universe, spreads declined -1 basis point (two-week low) to +173 bpts, which increased the recovery rate to 72%. All sectors recorded lower risk premium during the session led by energy (-2 points to +237 bpts, 80%) which rallied behind another +5% rise in the crude price, with tech (-2 point to +135 bpts, 75%) and senior financials (-2 points, +163 bpts, 67%).

In contrast, spreads in the high yield universe widened by +5 points to +650 bpts, which lowered the recovery rate to 65% (its first decline in two weeks - see chart). Among the sectors, risk premium increases were led by energy (+9 points, +1027 bpts, 84%) telcos (+7 points, +467 bpts, 86%), subordinated financials (+7 points, +716 bpts, 45%) and these increases were partially offset by a spread contraction in senior financials (-9 points, +472 bpts, 48%) although it was hard to determine what set this sector apart from its peers.



- European credit markets followed a very similar trend to the US in that investment grade spreads came in -1 point to +113 bpts, which increased the recovery rate to 51%. Among the sub-sectors, tech (-2 points, +62 bpts, 49%), senior financials (-2 points, +126 bpts, 49%) and industrials (-2 points, 122 bpts, 34%) outperformed in contrast to the past two months, as can be seen by their respective lower recovery rates. In the high-yield universe spreads widened by +0.2 points (first time they have not contracted is just over two weeks) to +515 bpts with the recovery rate unchanged. Nine of 11 subsectors defied the headline result and saw lower spreads led by subordinated financials (+8 points, +452 bpts, 58%) and utilities (-4 points, +319 bpts, 30%), but these gains were swamped by a sharp rise for healthcare (+12 bpts, +348 bpts, 35%) although one could not pinpoint the rationale.



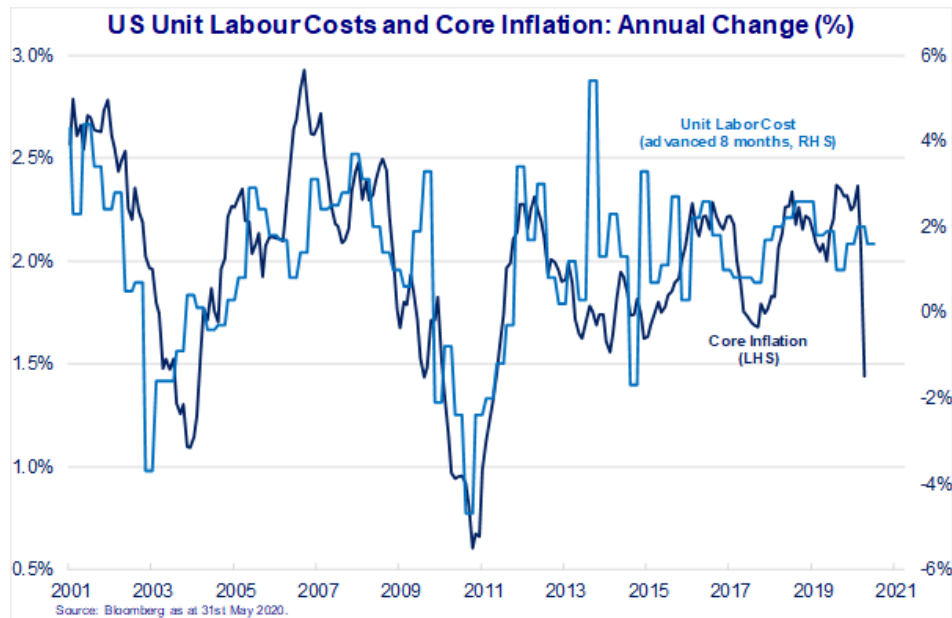
## THE GLOBAL ECONOMY

- Nominal US personal spending** plunged -13.6% m/m in April as a decline in goods (-16.5% m/m – which was similar to that of retail sales (-16.2% m/m)) outpacing that of services (-15.0% m/m). There were few surprises across the sectors with live entertainment off -99.9% y/y, air transportation -94.0% y/y and hotels -79.1%, but declines in healthcare spending (-40% y/y) and restaurant spending (-47.0%) were less egregious despite non-essential services being shut across most of the US, as business adapted.

Meanwhile, personal income increased an impressive +10.5% m/m rise in April largely owing to government transfers which ballooned +89.6% m/m with unemployment transfers up 520% m/m, which added about USD250 billion to income over the month. The combination of government income support and limited avenues for spending meant the household savings rate skyrocketed to 33% (record high). Trends for here on, will depend on the speed at which rehiring proceeds as rehired workers will be in a better balance sheet position than pre-crisis (thereby setting up the potential for a strong rebound in spending), whereas those permanently displaced from jobs will continue to weigh on growth as government payments are wound back.



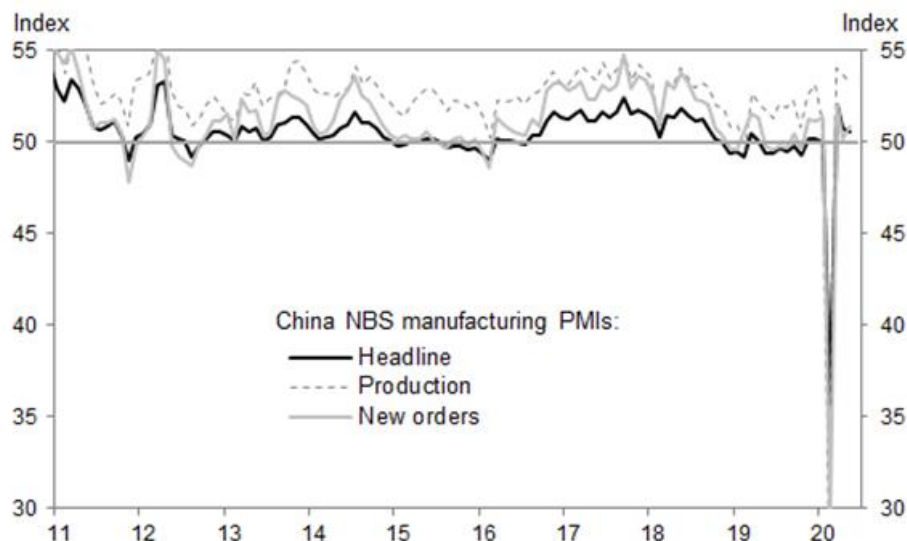
- April PCE inflation** excluding food and energy (the Fed's preferred core inflation gauge) fell -0.4m/m which pulled the annual rate down to just +1.0% y/y (see chart) which is the lowest since 2011. Headline PCE inflation printed -0.5% m/m which pulled the annual rate down to +0.5% y/y, driven by a -9.2% m/m decline in energy prices.



Sharp declines in both headline and core inflation have been seen in every advanced economy in the past three months, but that is no surprise as we're in a recession. While medium term inflation dynamics will be driven by the relative recoveries of demand and supply, history has repeatedly demonstrated that recessions are disinflationary events even when they generate supply-side damage as is the case of COVID-19, and despite the flattened of the Phillips curve, our anticipated incomplete recovery in private sector demand will weigh on business pricing power for an extended period, which will not only have advanced economy core inflation at half-century lows by early 2021, but it will also weigh heavily on corporate earnings which will limit the extent of re-hiring.

#### In other economic releases:

1. The official **China Manufacturing PMI** slipped -0.2 in May to 50.6, underlying a slow pace of recovery after the March quarter slump, which raises questions about the sustainability of the China industrial recovery in the wake of global pent up demand. Among the components, employment declined (-0.8 to 49.4), production slowed (-0.5 to 53.2) but new orders rose (+0.7 to 50.9) even though new export orders (+1.8 to 35.3) remaining firmly in contraction territory. Meanwhile, the services sector improvement was also underwhelming (+0.2 to 52.3). So, the summary here is that activity improved, but one would have suggested considerably better numbers given the broad re-opening of economies.



2. **Japanese industrial production** declined for a third straight month in April with a -9.1% m/m moderation (9-year low) which pulled the annual rate down to -14.4% y/y (lowest since 2009). The decline was especially steep for transport equipment ex-autos (-30.5% m/m) as one-off demand for aircraft-related parts dropped out and global lockdowns affected parts supply and sparked production halts.



Meanwhile demand for industrial inputs such as iron and steel (-16.9% m/m), and electrical machinery (-12.9% m/m) also fell; and

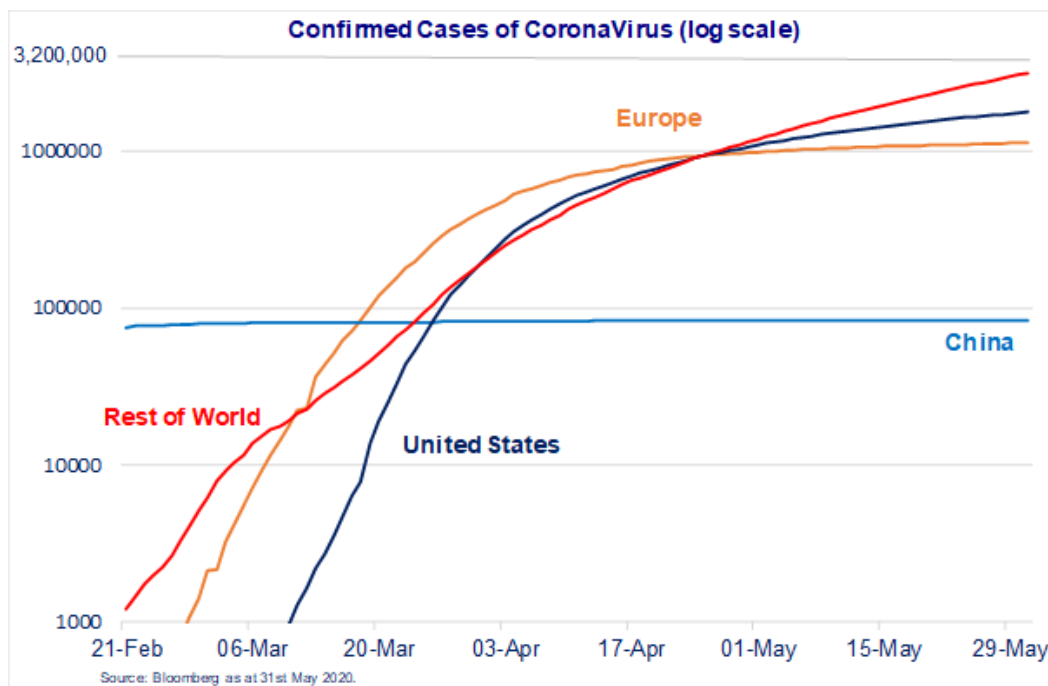
3. **Australian private sector credit** was flat in April, which pulled the annual rate down to +3.6% y/y. Among the components, housing credit decelerated to +0.2% m/m (+3.1% y/y) given investor housing credit dropped -0.2% m/m, whereas owner occupied was steady at +0.5% m/m despite increased mortgage payment deferrals. Meanwhile, personal credit contracted -3.0% m/m and is now -9.3% lower which exceeds the GFC trough. Elsewhere, business credit improved +0.1% m/m (+6.7% y/y) but this is driven by firms drawing down credit lines to ensure balance sheet resilience in what may be an extremely tough earnings environment

## POLICY

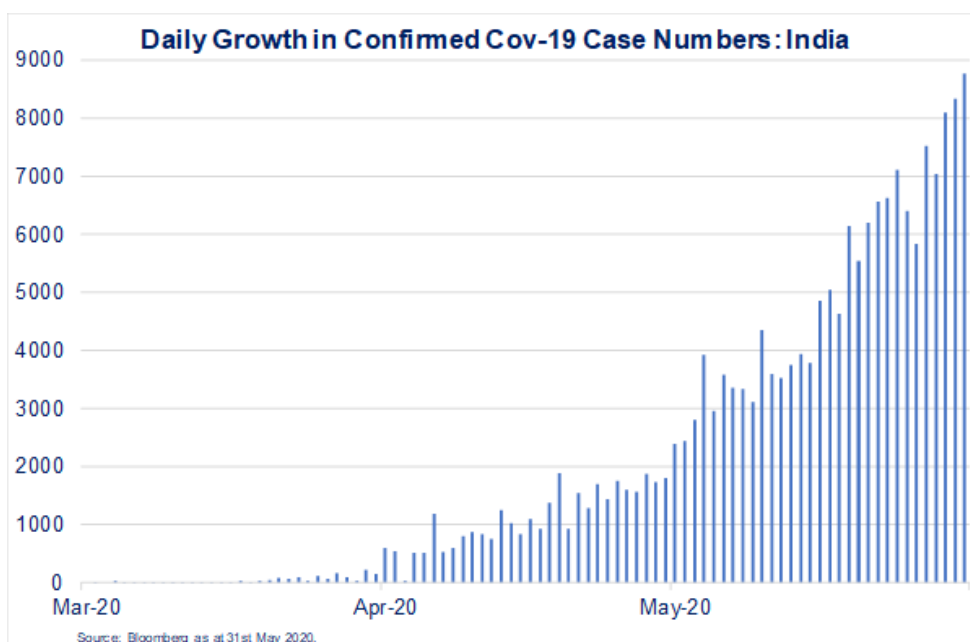
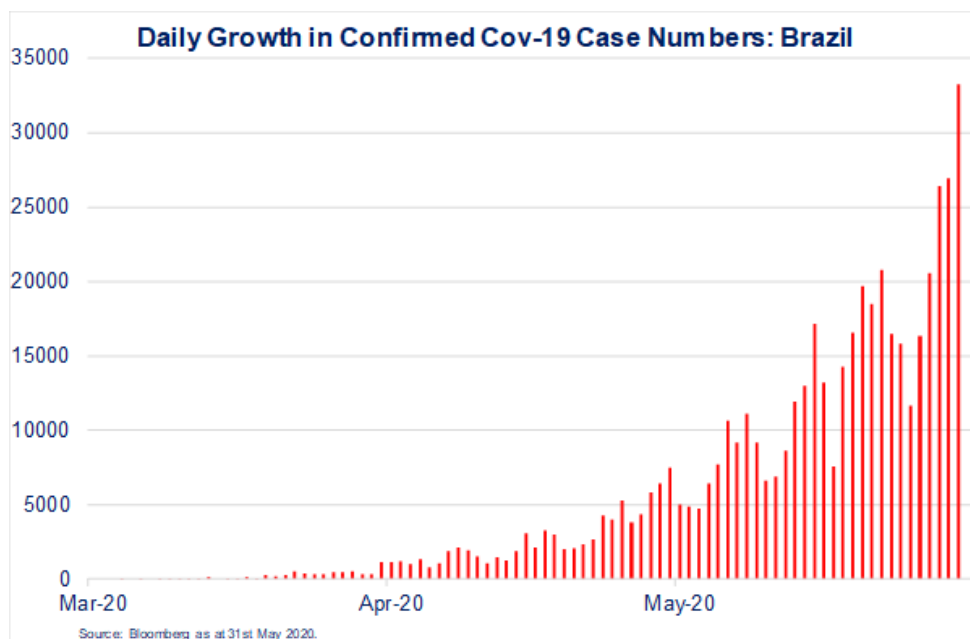
- In his press conference in which he took no questions, President Trump highlighted recent anticompetitive and security efforts by China, including its ongoing crackdown in Hong Kong. He stated that China has consistently violated its promises, which cannot be swept aside. He also made several policy statements, including the US terminating its relationship with the World Health Organisation, limiting the entry to the US for certain student visa holders, examining the listing requirements for Chinese companies on US exchanges, pursue removing a range of policy exemptions related to Hong Kong, and issuing travel guidance for Hong Kong reflecting its control by mainland China. However, he did not walk away from the Phase 1 agreement with China, hence the market reaction was muted.

## VIRUS UPDATE

- Although final numbers are not in for another couple of hours, the number of global cases of COVID-19 stands at 6.13 million with another +71.3k cases so far overnight (before Brazil, Mexico and some US states report their numbers) which means that Sunday was the 62nd occasion in the past 63 days where daily increases have topped 70k). This means 3 countries have more than 400k cases, 6 countries have more than 200k cases, 12 countries have more than 100k cases, and 52 over 10k (Kazakhstan rose to +10.8k overnight). 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, ten for the fifth million and 11 for the sixth million, and in the past 30 hours another 131k cases have been confirmed. That said, the growth rate of daily confirmed cases is trending lower (+1.9% since Tuesday). Meanwhile, deaths stand at 371.1k, with the US now over 100k (28.1% of global deaths even though they have only 4% of the global population), the UK and Italy over 30k, with Spain and France over 25k, and the death rate dropped for a twenty fifth straight day to 6.02%.

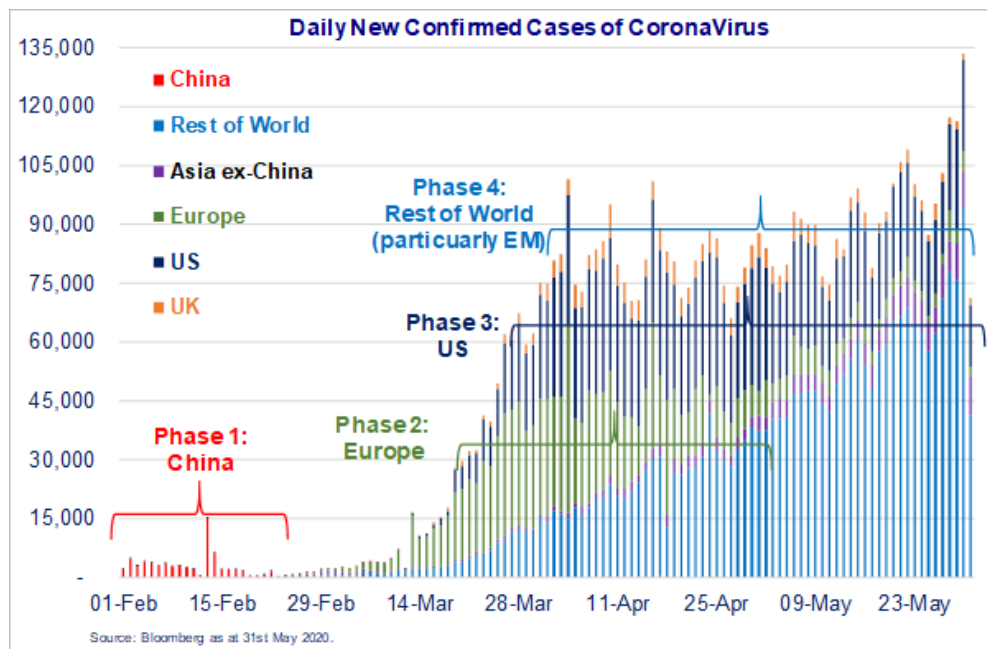


- We break the infections into four groups – the US, Europe, China and ‘others’ and the rest of the world outside the G3 economies now has the most total cases (+41.4k to 3.2 million) and highest daily new cases (and by a considerable margin) followed by the US (+15.6k to 1.79 million) and Europe (+2.3k to 1.13 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 three concerns here are Brazil (not reported, +498.4k, which is the second highest in the world), Russia (+9.3k to 405.8k, third highest) and India (+8.8k (record high) to 190.6k, seventh highest).

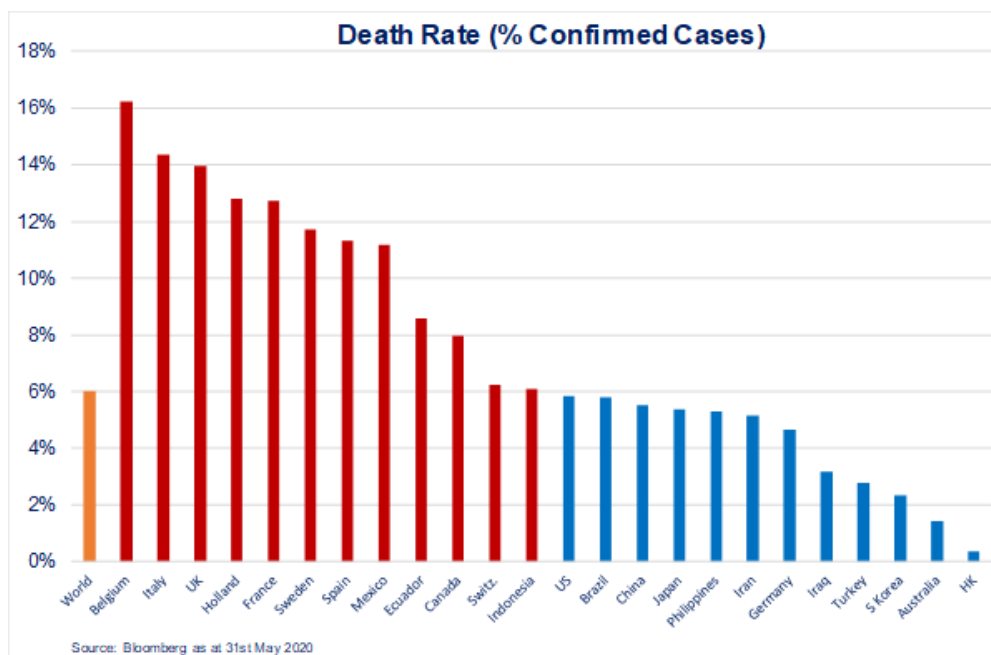


- Among countries, the most cases are in the US (+15.6k (so far) to 1.786 million), Brazil (not reported, 498.4k), Russia (+9.3k to 405.8k), the United Kingdom (+1.9k to 276.2k), Spain (+0.3k to 239.5k), Italy (+0.3k to 233.0k), India (+8.8k to 190.6k), France (+0.3k to 189.0k), Germany (+0.2k to 183.4k), Turkey (+0.8k to 163.9k), Peru (+0.2k to 155.7k) and Iran (+2.5k to 151.5k) and Australia confirmed cases rose +3 to 7,195 yesterday which placed us 63rd in terms of total infections.

Elsewhere, Singapore recorded +518 new cases to 34.9k 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 after overtaking Indonesia (+700 (third highest) to 26.5k) and the Philippines (+862 (second highest) to 18.1k). Note final numbers for yesterday at not in yet so these numbers can rise.



- Although final numbers are not in until 11am AEST, the global death rate declined for a twenty fifth straight day to 6.02% with the global total to 371.1k. The US (+0.5k) has the most deaths at +104.2k, with the UK (+0.1k to 37.9k), Italy (+0.1k to 38.6k), Spain (+2 to 27.1k) and France (+0.03k to 28.8) all over +25k. The death rate is highest in European countries where the health systems have collapsed led by Belgium (steady at 16.2%), Italy (steady at 14.3%), the UK (steady at 14.0%), the Netherlands (steady at 12.8%), France (-0.1% to 12.7%), Sweden (-0.2% to 11.7%) and Spain (-0.1% to 11.3%). However, several emerging markets are now on the leader board including Mexico (+0.2% to 11.2%), Ecuador (steady at 8.6%), Indonesia (-0.1% to 6.1%) and Brazil (steady at 5.8%).





Yours sincerely,



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