Perpetual Investments

THOUGHTS ON THE MARKET

22nd July 2020

Markets post modest gains as the latest US stimulus packages faces delays

SUMMARY

- Global risk markets rallied again overnight underpinned by sustained hope around fiscal stimulus and a COVID-19 vaccine, but both thematics have been driving markets for a while, so one wonders how much string is left in this bow. US Senate majority leader McConnell ® cast about whether a deal can be reached in time before some benefits expire in July and this saw US markets come well off their session highs. Meanwhile, factor and sector rotation continue to be in focus for investors and overnight the global sharemarket value/cyclicals subsectors significantly outperformed after lagging recently. So it seems that markets are priced for everything going right on either the virus or stimulus front, which is fine as long as things turn out as expected. But here in lies the problem, especially for a market with such rich valuations.

  In other markets, 10-year US Treasuries rallied -1 basis point to 0.60% with some curve flattening, commodities were upbeat with both oil (+2.8% to USD41.96 per barrel) and gold (+1.7% to USD1,842 per troy ounce) up strongly, and G10 currencies rallied with advances against a weaker Greenback led by the AUD (+2.0% to 71.30), Sterling (+1.0%), the Euro (+0.7%) and the Yen (+0.3%).

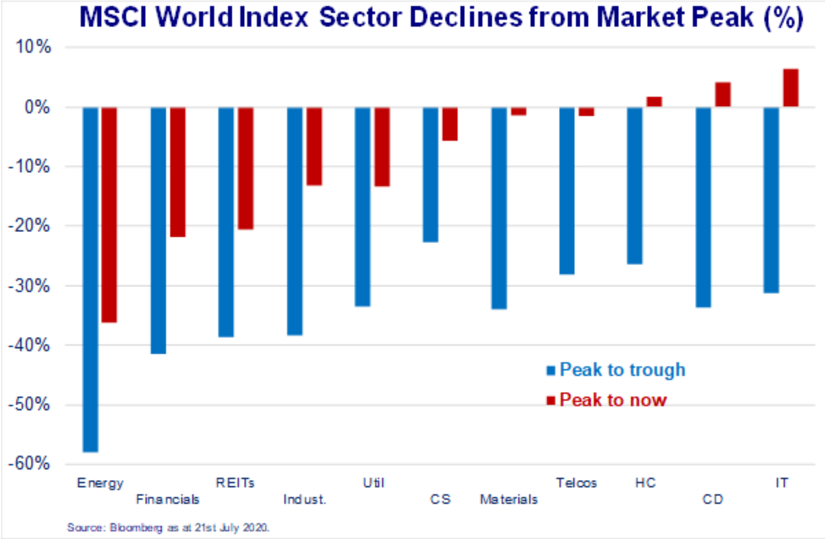
- The macro calendar was fairly empty yesterday but one of the bright spot over the past 6 weeks have been continued upbeat economic headlines as the global economy reopened and goods demand and industrial production came in stronger than initially thought. A key issue right now is the extent to which momentum in consumer goods spending may have slowed by negative coronavirus headlines and to what extent to which the modest lift in services demand has stalled. The earnings season is starting to pick up in volume, but only 11% of companies have reported so far, and the blended EPS growth for the quarter is still -44%, which is little changed from the end-June market estimate. On a positive note, firms are noting incremental improvements in demand trends, but this was before reopening plans were stalled or reversed.

- The number of global cases of COVID-19 is 14.85 million with another +167k cases so far overnight (but Chile, Brazil, Ecuador Peru and 6 US states have not reported their numbers) which means that Tuesday is the 29h occasion in the past 29 days where daily increases have topped 150k. This means 4 countries have more than 750k cases, 19 countries have more than 200k cases and 22 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, 6 days, 5 days, 5 days, 5 days and 4 days, and in the past 4 days another +840.5 cases have been confirmed. More importantly, the growth rate of daily confirmed cases (+1.5% since Saturday) is once again stabilising. Meanwhile, deaths stand at 613.7k and the death rate dropped for a seventieth sixth straight day to 4.14%.

FINANCIAL MARKETS

- **EQUITIES**
  - **The MSCI World Index closed +0.4% higher overnight** with strong gains in traditional value/cyclical sectors offset by a weakness in growth/momentum stocks. The standout performer was energy (+4.5%) which got back all of the losses from the prior session (-1.7%) and then added some more on top as oil prices recorded its best day for the month which took crude prices up to a 4-month high. Meanwhile, financials (+1.5%) added for the first time in four session after a raft of regional bank reports which seemingly pleased investors, whereas industrials (+0.7%) were supported from gains in machinery (+1.5%)

and aerospace and defense (+2.3%). As these lagging cyclical sectors rallied, stocks which had led the recovery over the past month took a breather with communication services (-0.2%) lower with large drags from Facebook (-1.5%), Netflix (-2.5%) and eBay (-3.2%), with consumer discretionary (-0.3%) and IT (-0.9%) also lower. The overnight moves saw three sectors remain in bear market territory and three recording a complete recovery (see chart) from their March quarter losses.

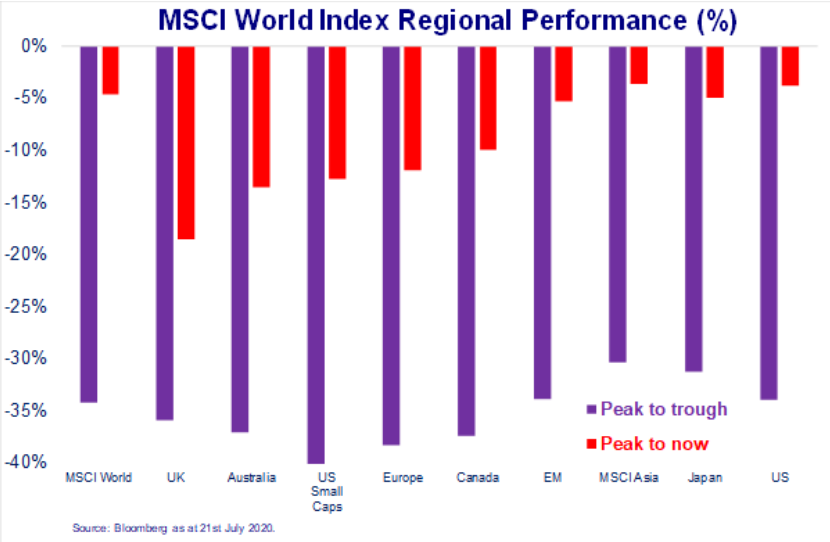


- **Among the regions**, gains were led by **Asia** with the MSCI Asia Pacific Index up +1.7% in a quiet session on the headlines front, which meant stimulus and coronavirus vaccine hopes remained the primary market supports. This helped investors overlook the fact that regional companies are scrapping or cutting dividends are their fastest rate since 2009 and we are not at the end of that process. Fortunately, the stimulus front was upbeat given the EU breakthrough on its €750 billion regional recovery fund, and after this the Australian Government answered calls to extend its employment support scheme into 2021 which buoyed domestic sentiment. By the regional bell, all bourses were higher led by Australia (+2.6%), Hong Kong (+2.3%), Korea (+1.4%), Japan (+0.7%) and China (+0.2%).

The positive vibe from Asia hit **European** markets (+0.5%) at the bell but the strong early gains were whittled away as the session progressed and by the close of trading, bourses had mostly posted modest gains in a complete data vacuum. The standout was Germany (+0.9%) which was the only bourse to beat the regional tape, but it was hard to pinpoint why they outperformed other markets including Italy (+0.49%), France (+0.2%), Spain (+0.2%), the UK (-0.1%), Switzerland (-0.3%) and Sweden (-0.5%).

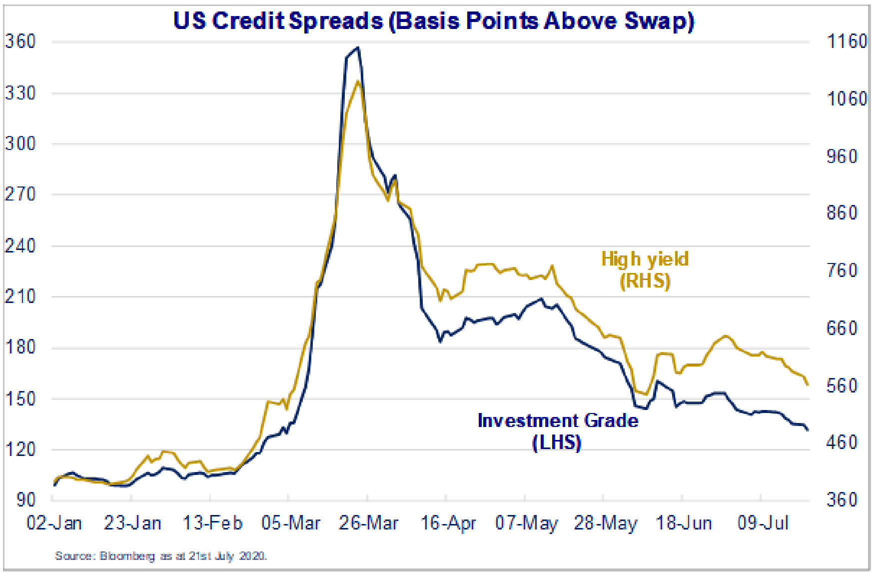
US markets mostly advanced but finished well off their session highs as Senator Mitch McConnell cast doubt on reaching a fresh rescue bill before some current benefits expire including the final payments of unemployment insurance (USD116 billion was paid in June) and rental assistance payments (which is supporting 23 million households). In the absence of any material macro data, or corporate news of note, these concerns prompted some profit taking from investors and by the bell the Russell 2000 (+1.3%) outperformed the Dow Jones (+160 points, +0.6%, 26,840), the S&P 500 (+0.2%) and NASDAQ 100 (-0.8%).

The overnight moves had no impact on market locations in our bear market/correction chart where the US leads and the UK lags (see chart).

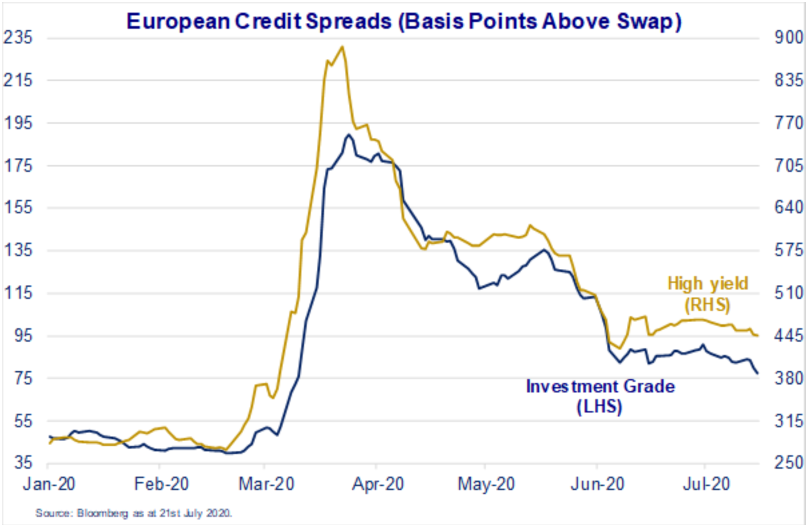


- Futures markets suggest a weak opening in Asia with Australia (-1.1%), Japan (-0.5%) and Hong Kong (-0.3%) set to open lower.

- **CREDIT MARKETS**
    - Regional credit indices rallied overnight but the gains continue to be modest. **In the US investment grade** universe, spreads came in a further -3 points, to +132 bpts which lifted the recovery rate one notch to 89% with advances in all 11 subsectors. However, the only notable sector movement was energy (-2 points, +184 bpts, 92%) with all other movements at or below -1 basis point. In the high yield space, spreads came in -14 points to +563 bps, which saw the recovery rate lift 2 notches to 78% with gains in all 11 subsectors. Leading the charge today was IT (-16 points, +469 bpts, 74%) despite weakness in equities, healthcare (-13 points, +517 bpts, 74%) and materials (-11 points, +456 bpts, 79%) which liked the sound of higher commodity prices.

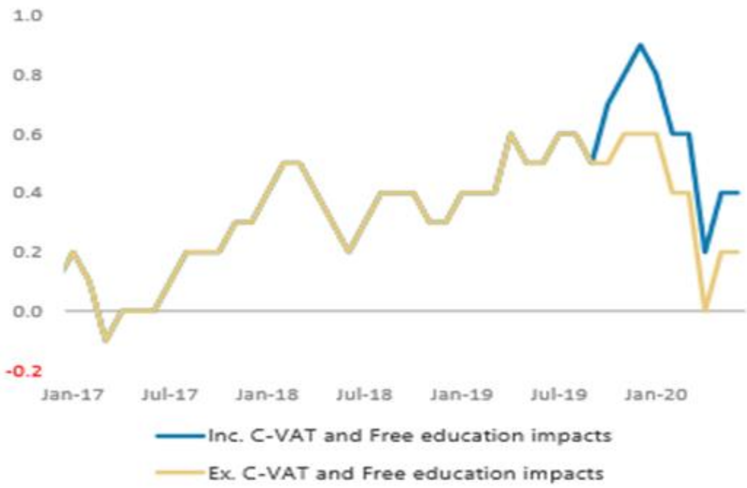


    - **European credit markets** were more subdued than their US peer with investment grade spreads contracting another -3 points to +71 bpts, which increased the recovery rate two notches to 79%. Although all 11 subsectors rallied, there was a bit more action at the sector level with the decline in risk premiums underpinned by the agreement of the €750 billion rescue fund, which led to price advances in subordinated financials (-6 points, +155 bpts, 78%), consumer discretionary (-6 points, +94 bpts, 80%) and consumer staples (-3 points, +55 bpts, 79%). In the high yield space, spreads came in -7 points to +431 bpts which increased the recovery rate one notch to 74%. Among the gainers were healthcare (-22 points, +313 bpts, 71%), senior financials (-11 points, +524 bpts, 76%) and energy (-10 points, +561 bpts, 71%) given higher crude prices.



THE GLOBAL ECONOMY

- **Japanese inflation** remained subdued in June with a flat reading at the headline rate as increases in the annual change in energy (+1.4% to -5.3% y/y) were offset by annual declines in numerous service sectors. However, nationwide Japan-style core for June (excluding fresh food) rose +0.2% to a flat reading which topped forecasts (-0.1% y/y) and the core core (ex-food and energy) reading was steady at +0.4% y/y which declined to +0.2% y/y when the impact of last October's consumption tax rise is extracted (see chart). So, it seems for the time being that not much has changed in Japan from an inflation point of view, but the Nippon recovery appears subdued and it may be a while before we can identify the impact on the economy's inflation rate.



POLICY

- The timing of the fifth US coronavirus package may have slipped until early August with the White House and Republicans reportedly divided on President Trump's long-sought payroll tax cut, and on additional funding for coronavirus testing. However, Republicans appear to be on board with another round of $1,200 stimulus checks sought by Democrats although the income threshold is expected decline from the $75K in the March bill. Elsewhere, the level of enhanced unemployment benefits is expected to be a key area of contention with Democrats demanding an extension of the current $600-per-week of additional benefits while Republicans are reportedly targeting a figure closer to $200. Meanwhile, Republicans are not expected to include any additional funds for state and local governments in their proposal after House Democrats authorised nearly $1 trillion in their bill.

- There were three important changes the Morrison Government's JobKeeper scheme which currently pays AUD1,500 per fortnight per employee to all eligible firms and covers 3.5 million workers but was due to be wound up in end-September.

    1. The scheme will be extended to March 31st 2021 given the weak state of the recovery and also resurgent case numbers;
    2. The program has been tapered with the level of payment lowered from the existing flat AUD1,500 per fortnight. After September a two-tier system will be adopted in the December quarter where those working more than 20 hours per week will see payments of AUD1,200 per fortnight and those working less hours will have a benefit of $750 per week. In the March quarter 2021 these payments are reduced again to $1,000 and $650, respectively. So, the government is trying to reduce the additional payments in a progressive manner which smooths the impact on the household and corporate income, but which doesn't endanger the recovery. The government is also trying to end the 'overcompensated' manner than all part time and fulltime workers are given AUD1,500 regardless of their level of earnings and hours worked; and
    3. Lastly, the business eligibility test was tightened and moved from an automatically qualified based on projected turnover to a new quarterly assessment based on actual turnover. That said that threshold amounts are unchanged at -15% for Not-for-Profit firms, -30% for small businesses with annual turnover of $1billion or less; and -50% for large businesses with turnover in excess of $1 billion. This should ensure that only those businesses that remain under turnover pressure will remain eligible.

    The government estimates that the extended phase of JobKeeper should cover 1.4 million employees in Q4, and 1 million in the March quarter 2021 and the additional cost to the Budget is $10 billion and $6 billion, respectively, in the next two quarters. Meanwhile, the JobSeeker supplement (which is additional to their $550 payment) will also be reduced from $550 to $250 per fortnight from September 25, but recipients will be allowed to earn up to $300 per fortnight before facing a reduction in their primary JobSeeker allowance. This is designed to entice people back into the labour force or take on additional work as the economy recovers and the total Budget cost here is $4 billion.

    So, the total new cost to the Budget is $20 billion which is front loaded over two quarters ending March 31st 2021. That still leaves a large cliff to navigate and I would argue that the Government will have no choice but bring forward tax cuts to lessen the cliff, but that will at least double the Budget hit. The Budget update is provided later this week and the growth and revenue hit from COVID-19 is likely to be scaled back, but I would argue that the JobKeeper scheme is poorly designed for a W-type recession given its eligibility requirements that revenue has to have declined in every prior quarter. This means virus evolution and economic lockdowns are key risks.

VIRUS UPDATE

- The number of global cases of COVID-19 is 14.85 million with another +167k cases so far overnight (but Chile, Brazil, Ecuador Peru and 6 US states have not reported their numbers) which means that Tuesday is the 29h occasion in the past 29 days where daily increases have topped 150k. This means 4 countries have more than 750k cases, 19 countries have more than 200k cases and 22 countries have more than 100k cases.

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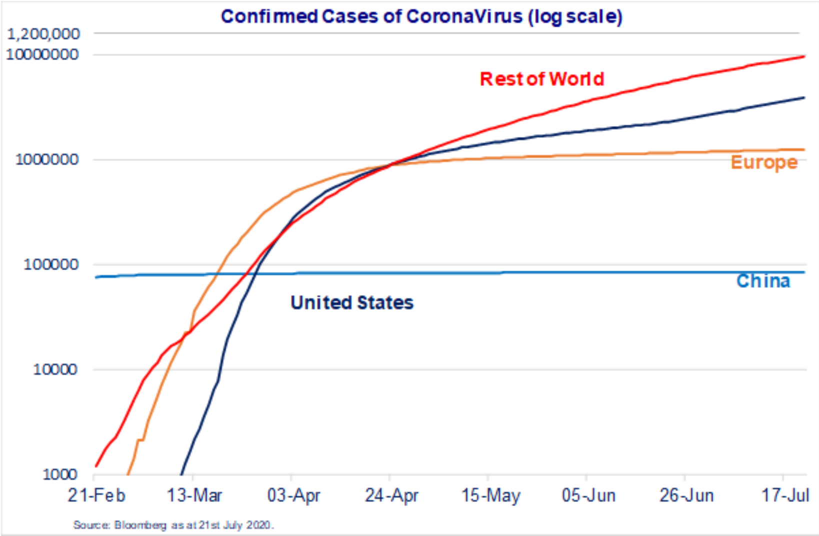
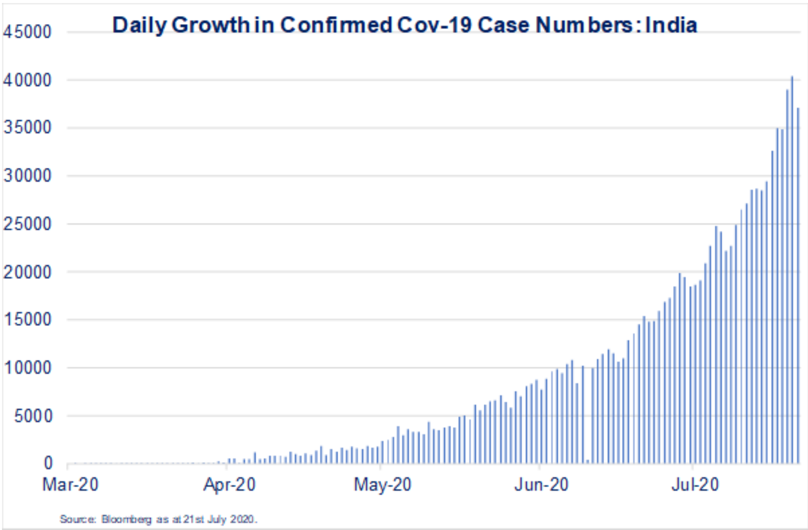
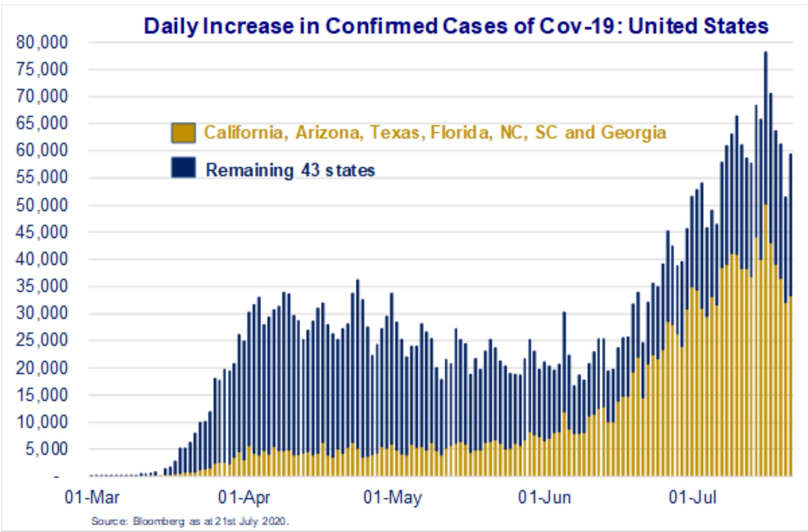
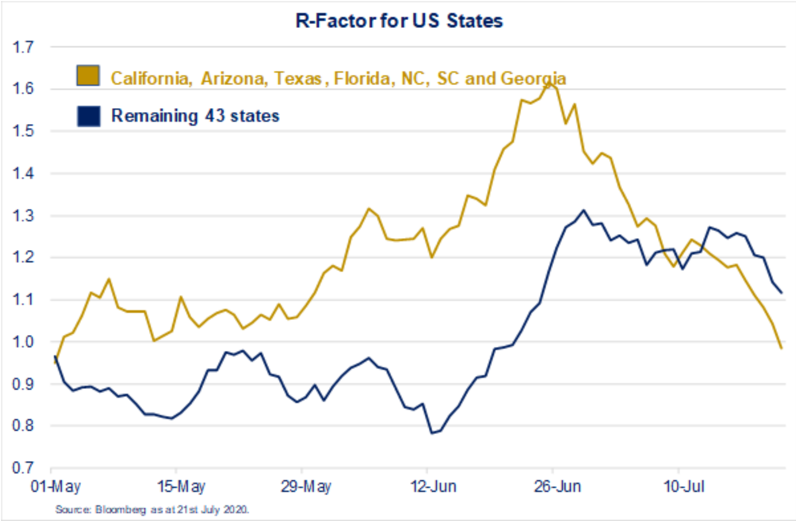


- We break the infections into four groups – the US, Europe, China and 'others' and the rest of the world outside the G3 economies now has the most total cases (+59.7k to 9.6 million) and US cases overnight increased +60.0k to 3.89 million (although 6 states are yet to report with 2 already reporting record numbers (Pennsylvania and Wisconsin) but the R-factor here continues to decline and is close to 1 which indicates a flattened curve, and Europe (+3.3k to 1.26 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, 2.12 million, which is the second highest in the world), India (+37.2k to 1.16k) and Russia (+5.8k to 782.0k, fourth highest) (see charts below).



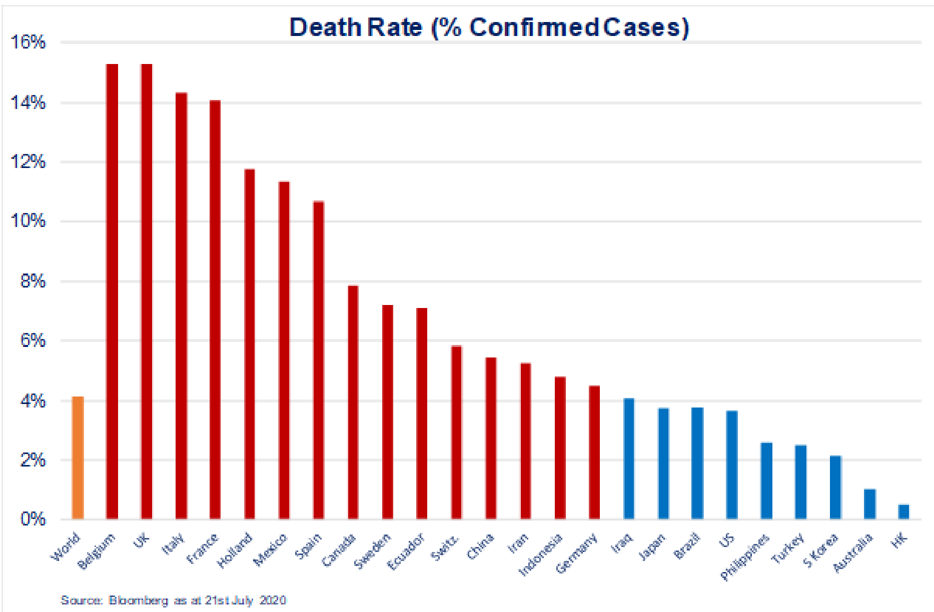




- Among countries, the most cases are in the US (+60.0k (so far) to 3.89 million, with 6 states yet to report and 2 already reporting record increases), Brazil (not reported, 2.12 million, India (+37.1k to 1.16k), Russia (+5.8k to 782.0k), South Africa (+8.2k to 381.8k), Peru (not reported, +362.1k), Mexico (+6.8k to +356.3k), the Chile (+3.8k to 334.7k), United Kingdom (+0.4k to 297.4k), Iran (+2.6k to 278.8k), Pakistan (+1.0k to +266.1k), Spain (+1.3k to 266.2k), Saudi Arabia (+2.5k to 255.8k), Italy (+0.1k to 244.8k), Turkey (+0.9k to 221.5k), France (+0.6k to 214.6k), Bangladesh (+2.5k to 210.5k) and Germany (+0.4k to 203.7k). Australia confirmed cases rose +359 to 12,428 yesterday which placed us 72nd in terms of total infections.

  Elsewhere, Singapore recorded +0.4k new cases to 48.4k 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 89.9k) is now on the rise and has the most cases in the region, and the Philippines (+1.9k to 70.8k) is also on an upward trend.

- Although final numbers are not in until 1pm AEST, the global death rate declined for a seventieth sixth straight day to 4.14% with the global total to 613.7k after another 4.0k deaths overnight, so far. The US (+0.9k so far) has the most deaths at +141.8k, with Brazil (not reported, 80.1k), the UK (+0.1k to 45.5k), Mexico (+0.9k to +40.4k), Italy (+0.02k to 35.1k) and France (+0.03k to 30.2k) all over +30k. The death rate is highest in European countries where the health systems had collapsed led by Belgium (-0.1% to 15.3%), the UK (-0.1% to 15.3%), Italy (steady at 14.3%), France (steady at 14.1%), the Netherlands (-0.1% to 11.8%), Spain (-0.2% to 10.7%) and Sweden (-0.1% to 7.2%). However, several emerging markets are now on the leader board including Mexico (-0.1% to 11.3k), Ecuador (-0.1% to 7.1%), Indonesia (-0.1% to 4.8%) and Brazil (-0.1% to 3.8%).



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Yours sincerely,

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