

# THOUGHTS ON THE MARKET

24<sup>th</sup> July 2020 - Australian Budget does a 180 (plus 6 billion for good measure!)

## SUMMARY

- Global equity markets declined overnight as concerns intensified about the sustainability of the global economic recovery. The selloff was concentrated in the sectors which had outperformed since May, namely consumer discretionary and tech, with market darlings including Alphabet, Amazon, Microsoft, Apple and Tesla all off more than -3%. In the past two months, risk markets have been supported by massive stimulus, vaccine rumours, favourable seasonality which has produced subdued case numbers (until recently), economic reopening, strong growth in goods demand and supply, and low expectations for corporate performance. However, within a few weeks all of those supports will lessen, and in August markets will once again be exposed to the economic reality of elevated virus numbers, the notion that the economy needs a lot more income support, and market valuations which have priced in a sustained strong rebound and a perfect handover from policy to the labour market.

In other markets, **10-year US Treasury yields declined** two point to 0.57% (which is very close to the March low of 0.54%) with curve flattening (0.46% which is a 98-day low), **commodities were indicative of risk off** with gold up (+1.6% to USD1888.12 per troy ounce (which is 6 cents away from an all-time high) and oil down (-2.0% to USD 41.12 per barrel), and **G10 currencies were mixed against the Greenback** with Sterling (+0.4%), the Euro (+0.3%) and Yen (+0.2%) all up, whereas the AUD (-0.7% to USC71.10) declined from its recent high.

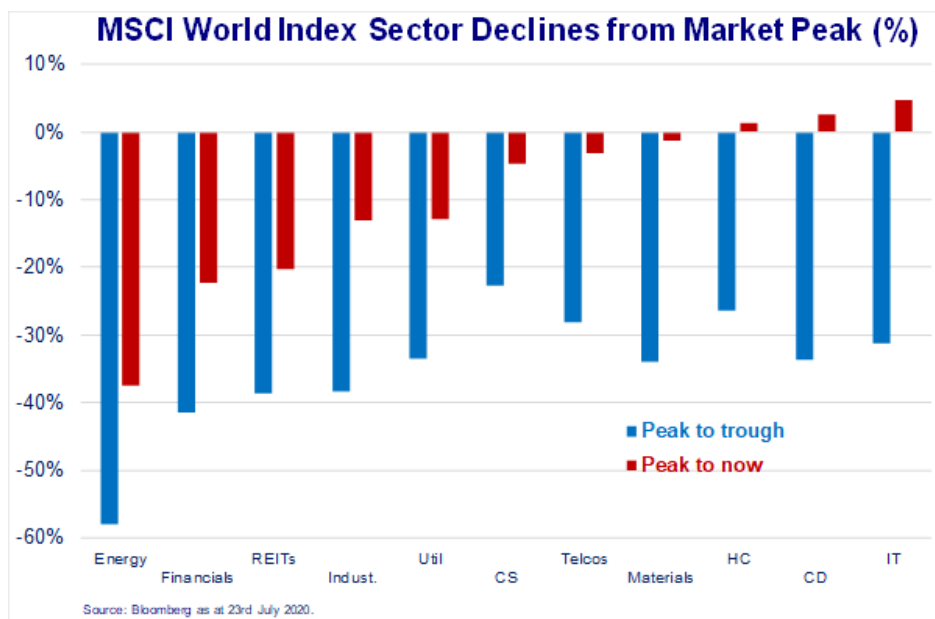
- The macro calendar overnight was light with the weekly US jobless claims providing a mixed signal with initial claims up for the first time since March, but continuing claims were lower which contrasted with other high frequency data such as the household pulse survey which detailed the losses on -6.7 million jobs in the past month. Putting all the reports together suggests that the US labour market recovery has, at best, stalled which is likely to weigh on consumers in the period ahead and this is coming at a time when the US Congress is negotiating a new relief package for millions of US citizens who are set to lose enhanced benefits at the end of July.
- Yesterday, the **Morrison Government released its updated Economic and Fiscal outlook** which detailed a net downgrade of AUD281.4 billion to the Budget underlying cash balances for the next two years, a forecast increase in unemployment to 9.25% by end-2020, record high debt (\$852 billion, 45.1% of GDP) and a 76-year high deficit (-9.7% of GDP), all of which is based on assumptions that the Melbourne lockdowns will cease in four week, no lockdowns elsewhere and the economy reopening in early 2021. With the fiscal cliff still very large, it is likely that the deficit for this year will rise to \$220 billion and unemployment will go double-digit. There are two key numbers for the Budget – the unemployment rate and how long the R-factor for COVID-19 is above one. Even if the best case scenario plays out the growth outlook is mediocre as the four pillars to the previous 29-year expansion are gone - namely, households taking on more leverage to generate a huge asset price boom, increased trade links with China boosting investment and employment, large-scale population growth resulting in a housing construction and price boom, and household's desire to live with a low savings rate. With those growth sources all stalling, our lack of major economic reforms for 16 years leaves the domestic economy highly vulnerable, and growth to be structurally weaker. Accordingly, it is very hard to see how the Budget deficit will decline to “only” \$35 billion in each of the next five years.
- The number of global cases of COVID-19 is 15.43 million** with another +251k cases so far (but Chile, France, Saudi Arabia, South Korea and 13 US states have not reported their numbers) which means that Thursday was 31st occasion in the past 31 days where daily increases have topped 150k. This means 4 countries have more than 750k cases, 19 countries have more than 200k cases and 23 countries have more than 100k cases (Iraq joined this group in the past 24 hours). 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, 4 days and 5 days. More importantly, the growth rate of daily confirmed cases (+1.7% since Monday) is once again starting to rise.

Meanwhile, deaths stand at 631.7k and the death rate dropped for a seventieth eighth straight day to 4.09% although the number of daily deaths hit a record high of 9.5k overnight.

## FINANCIAL MARKETS

### • EQUITIES

- The **MSCI World Index** closed **-0.8% lower** with losses in 10 of the 11 sub-sectors which is the worst breadth of declines in four weeks. There wasn't much in terms of incremental developments with the macro calendar quite empty and mixed earnings reports which gave no firm leads, but the market decline came after four days of gains during which time questions about the state of the recovery and the timing of stimulus had intensified. Although 10 sectors were lower, 7 on them beat the tape with losses largest in IT (-2.3% with Alphabet (-3.1%), Amazon (-3.7%), Microsoft (-4.4% after cloud growth slowed) and Apple (-4.6%) all down more than -3%, and Tesla (-5.0%) slid even after beating estimates). Elsewhere, telcos dropped (-1.6%) although it was hard to pinpoint the reason, and consumer discretionary (-1.5%) fell for a third consecutive session as questions grew about valuations and earnings sustainability given surging case numbers, but consumer staples (+0.8%) closed higher as investors sought stocks with low exposures to economic deltas. By the bell, sector positions and proximity to bear market territory were unchanged (see chart).

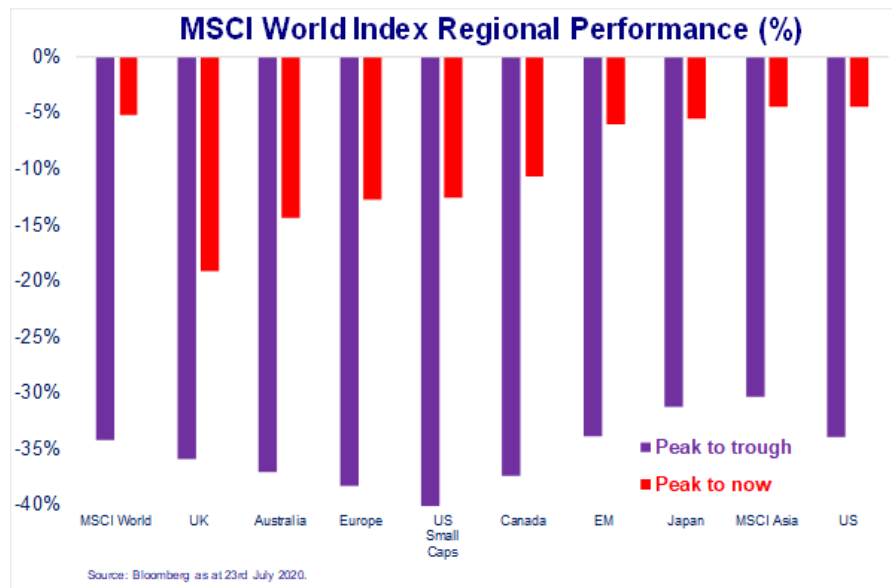


- **Among the regions, Asian equities** finished higher with the MSCI Asia Pacific Index increasing +0.2%, but there was mixed performance across the region with increases in Hong Kong (+0.8%) and Australia (+0.3%) and declines in China (-0.04%), Taiwan (-0.5%) and South Korea (-0.6%), with Japan closed for national holidays. The market narrative was generally bearish given the uncertainty over the next round of US stimulus, a bleak Australian Budget update, Korea recording below consensus June quarter growth given a plunge in exports and increased geopolitical tensions between the US and China.

**European markets** closed flat in a whipsawing session which saw early advances evaporate given a weak regional consumer confidence report and a negative opening on Wall Street. There wasn't any top tier macro data for the session, so the market narrative was ambiguous other than indices having rallied a long way in recent months with risks for economic data and market pricing being to the downside. Accordingly, after a positive opening, then range trading for most of the session, bourse headed lower coming to the bell and most fell below the breakeven line led by Italy (-0.7%), Switzerland (-0.5%), Spain (-0.1%), France (-0.1%), Germany (-0.01%), but Sweden (+0.1%) and the UK (+0.1%) hung on for each to post a positive session.

**US markets** recorded their worst daily price decline so far this month following a four day streak of gains with growth and cyclical sectors pulling back with the first rise in initial jobless claims since March providing more context to the recent market narrative about the recovery losing momentum. In addition,

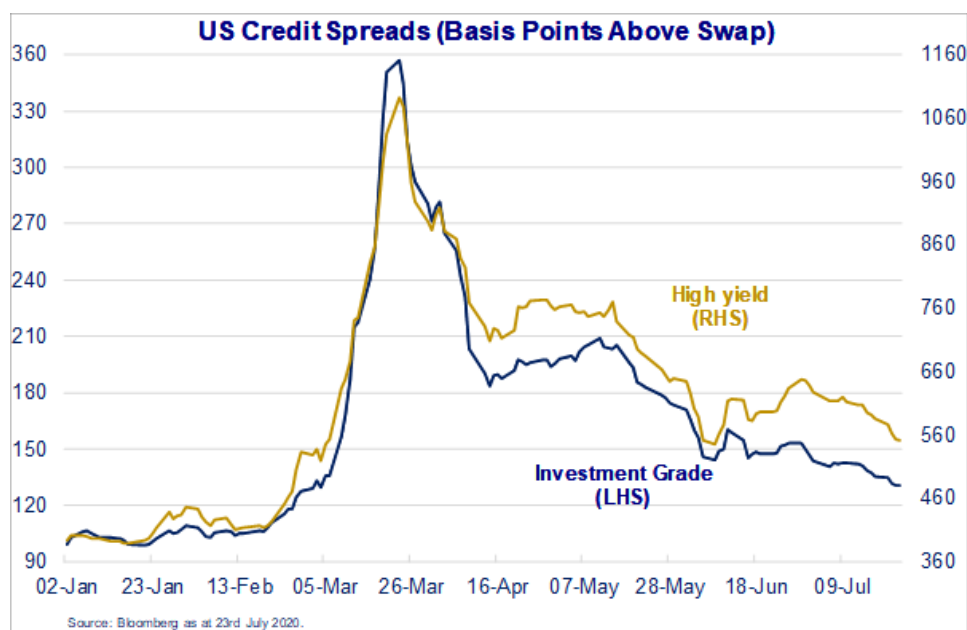
it appears that the US Congress will not be able to pass legislation in time before stimulus payments cease, which could see some further dislocation for household income. The earnings season continued but the thematic remains intact with thematic centred on the huge earnings dislocation, solid beat rates and lifting demand into June given reopenings, but few firms are willing to provide specific guidance. By the bell at the NYSE, all indices were lower led by NASDAQ 100 (-2.3%), the Dow Jones Industrial Average (-354 points, -1.3%, 26,652), the S&P 500 (-1.2%).



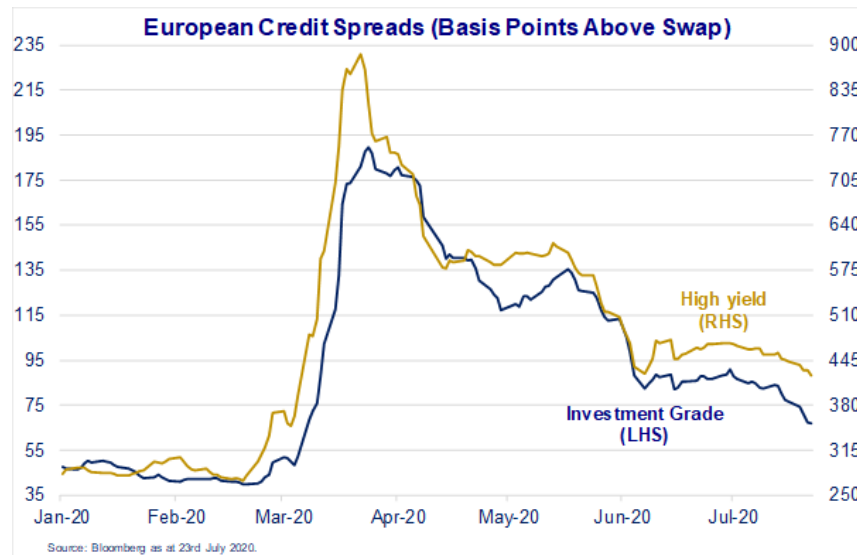
- Futures markets suggest Asian markets are poised to follow US equities lower with markets priced for declines at opening led by Hong Kong (-1.2%), and Australia (-0.8%) with Japan closed for national holidays.

## • CREDIT MARKETS

- Regional credit indices closed fractionally higher. In the **US investment grade space**, spreads were unchanged at +130 bps with the recovery rate at 89%. Seven of the 11 sub-sectors recorded lower risk premiums, but movements were kept to less than one basis point with no movements of note. In the **US high yield universe** things were also quiet with spreads contracting -2 points to +551 bps, with the recovery rate unchanged at 79%. Nine of the 11 sub-sectors recorded price gains but movements were capped at 5 basis point led by subordinated financials (-5 points, +5578 bps, 65%), utilities (-5 points, +412 bps, 80%) and tech (-4 points, +455 bps, 77%).

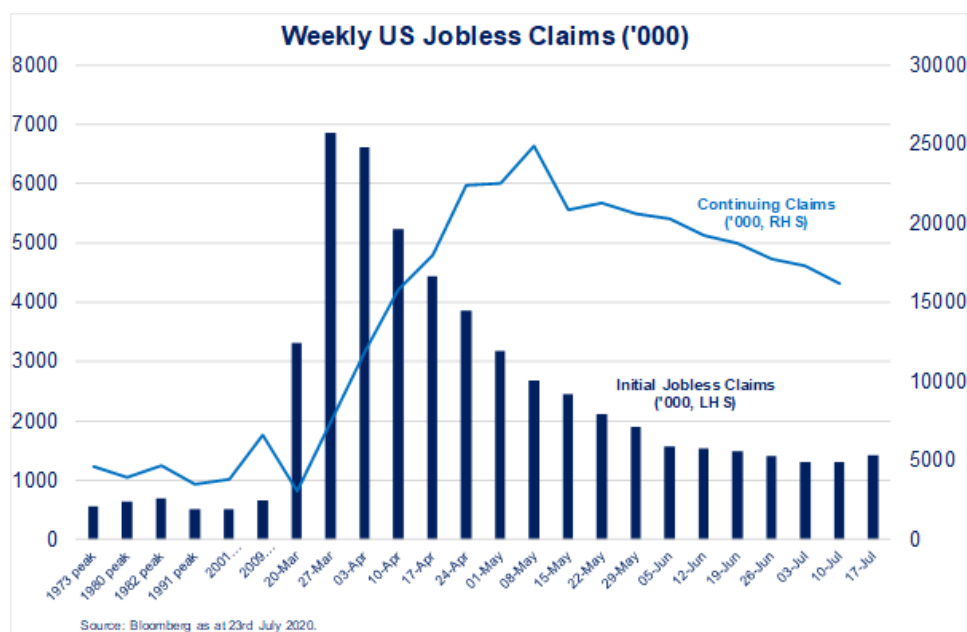


- **European credit markets** were also reasonably quiet even though both universes inched out price gains. In the investment grade space, spreads were unchanged at 67 bpts and an 82% recovery rate. There were spread increases in 6 of the 11 subsectors led by subordinated financials (+3 points, +155 bpts, 78%) and healthcare (+1 point, +37 bpts, 86%), whereas price advances were led by energy (-1 point, +64 bpts, 74%) which defied the lower oil price. In the high yield universe, spreads declined -7 points, with nine of the 11 sub-sectors recording lower risk premiums led by energy (-11 points, +547 bpts, 72%) despite the lower oil price, materials (-10 points, +380 bpts, 75%) which benefited from further gains in key commodity markets, and telcos (-10 points, +331 bpts, 75%).



## THE GLOBAL ECONOMY

- **US jobless claims** increased by 0.1 million to 1.4 million which is the first rise since March but there may be an issue around the seasonal adjustment around the 4th July holiday which will push numbers higher in the next few weeks making interpretation more arduous. Importantly, the initial claims gave an offsetting signal relative to other to high-frequency data such as the Census Bureau's Household Pulse survey which yesterday detailed a loss of -6.7 million jobs. Put together these reports show that, at best, the labour market recovery has stalled with the ceasing or reversal of reopening plans. However, we have been closely monitoring the initial claims in states such as California (-5k), Texas (-9k) and Florida (-13k), where parts of the reopening plans were reversed, but so far there is no clear signs of another wave of layoffs.

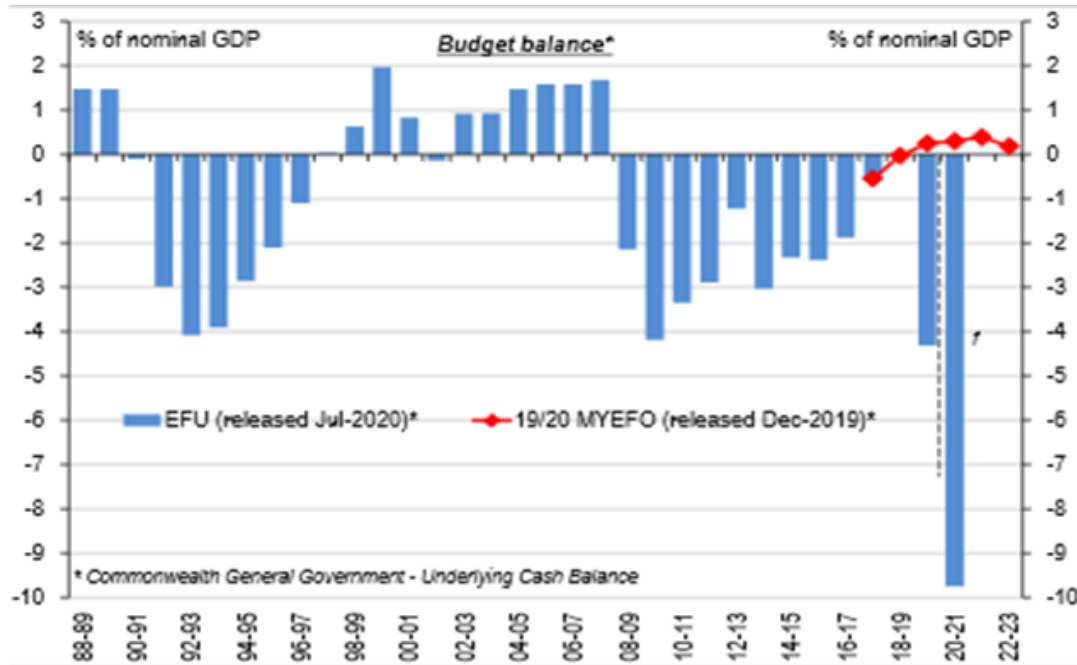


Meanwhile, continuing claims fell -1.1 million to 16.2 million suggesting modest net hiring in July. A key question is whether the initial claims of continuing claims is giving the best signal about the US labour market and we will find that out in 14 days' time when the July non-farm payrolls are released, but the debate comes as Congress negotiates a new relief package for millions of US citizens who are set to lose enhanced benefits at the end of July. It is no exaggeration to say that the US labour market is very fragile and delicately poised, and this is likely to weigh on consumer spending.

## POLICY

- The Morrison Government released its Economic and Fiscal Update for FY20 and FY21.** which detailed a net downgrade of AUD281.4 billion to the Budget underlying cash balances for the next two years. The forecast balance in now -AUD86 billion (-4.3% of GDP) for FY20 which more than doubles to -AUD185 billion for FY21 (-9.7% of GDP) with growth this calendar year expected to decline -3.75% and unemployment to peak at 9.25% at end-2020. The higher deficits means that gross Commonwealth debt rises to \$852 billion (45.1% of GDP) but there are some heroic forecasts here including, Melbourne being locked down for only another 4 weeks, no outbreaks anywhere else and the Australian economy reopening in January 2021 all of which are highly questionable and which if proven to be inaccurate will see weaker growth, higher deficits and higher unemployment. The other thing to note here also is that the fiscal cliff is still large, and while the Government has announced increases to JobSeeker and JobKeeper totalling \$20 billion and yesterday announced an extension in the access to superannuation, but those only reduce the cliff to \$75 billion (15% of quarterly Australian GDP) and even is that is halved with further policy announcements, it will be very large hit to the economy, and as such the FY21 Budget deficit could easily increase to \$220 billion.

No matter which way you look at this the outlook is underwhelming with and we expect fiscal tightening will be very difficult in the next half decade as our four large growth engines for the economy in the past 25 years have completely broken down – namely, households taking on more leverage to generate a huge asset price boom, increased trade links with China boosting investment and employment, large-scale population growth resulting in a housing construction and price boom, and household's desire to live with a very low savings rate. With growth to be structurally weaker, it is very hard to see how the Budget deficit will not be greater than \$35 billion in each of the next five years.



Source: Australian Government (Commonwealth Treasury), UBS



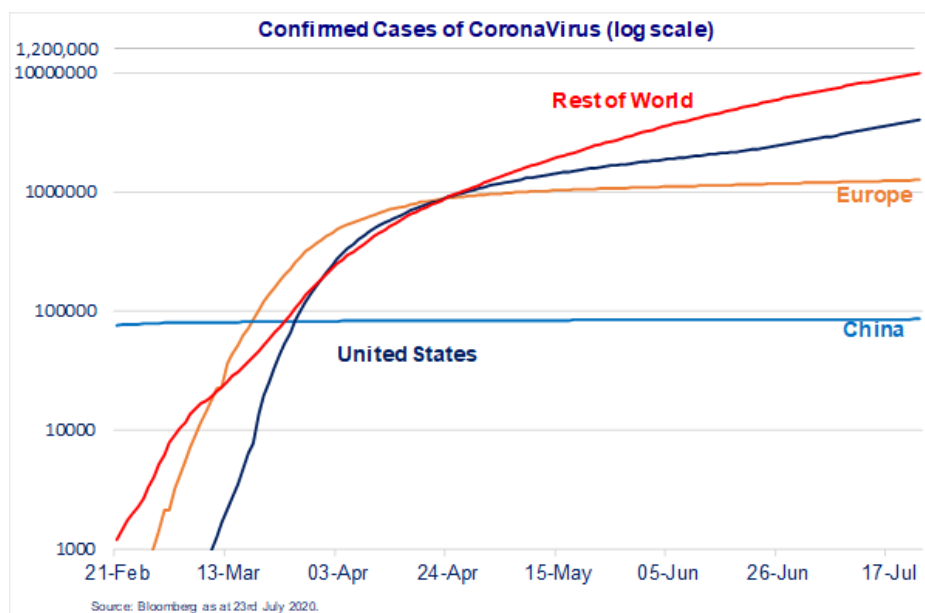
	2018/19		2019/20		2020/21	
	MYEFO	EFU	MYEFO	EFU	MYEFO	EFU
Real GDP(% y/y)	2.00	2.00	2.25	-0.25	2.75	-2.50
Employment (% y/y)	2.50	2.50	1.75	-4.40	1.75	1.00
Unemployment rate (%)	5.20	5.20	5.25	7.00	5.25	8.75
WPI (%)	2.30	2.30	2.50	1.75	2.50	1.25
CPI (% y/y)	1.60	1.60	2.00	-0.25	2.25	1.25
Nominal GDP (% y/y)	5.30	5.30	3.25	2.00	2.25	-4.75

Source: Australian Government (Commonwealth Treasury), UBS \* Real and Nominal GDP are year average. CPI and employment are through the year. The unemployment rate is the rate in the June quarter of the financial year

## VIRUS UPDATE

- The number of global cases of COVID-19 is 15.43 million with another +251k cases so far (but Chile, France, Saudi Arabia, South Korea and 13 US states have not reported their numbers) which means that Thursday was 31st occasion in the past 31 days where daily increases have topped 150k. This means 4 countries have more than 750k cases, 19 countries have more than 200k cases and 23 countries have more than 100k cases (Iraq joined this group in the past 24 hours).

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, 4 days and 5 days. More importantly, the growth rate of daily confirmed cases (+1.7% since Monday) is once again starting to rise. Meanwhile, deaths stand at 631.7k and the death rate dropped for a seventieth eighth straight day to 4.09% although the number of daily deaths hit a record high of 9.5k overnight.

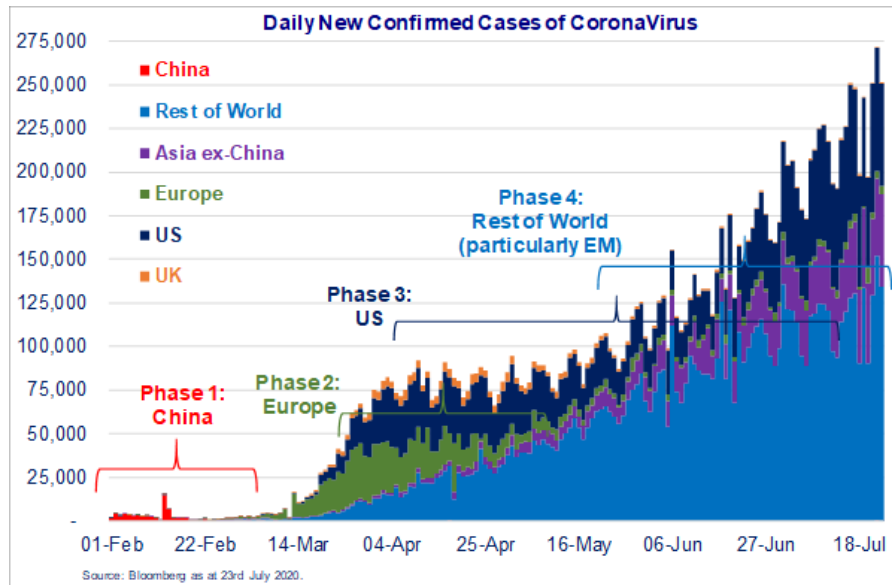


- We break the infections into four groups – the US, Europe, China and ‘others’ and the rest of the world outside the G3 economies now has the most total cases (+134.3k to 10.05 million) and highest daily new cases (and by a considerable margin) followed by the US (+58.9k to 4.03 million, although 13 states are yet to report). More worryingly, the Cov-19 reproduction rate is rising in the North East, not the South West (which is now declining on the whole, see chart) which is a sign that things are spreading quickly. The issue for the US is that they never flattened their curve which means economic opening has not been associated with lower case numbers, and rising case numbers are also evident in Europe (+4.4k to 1.27 million - see chart).

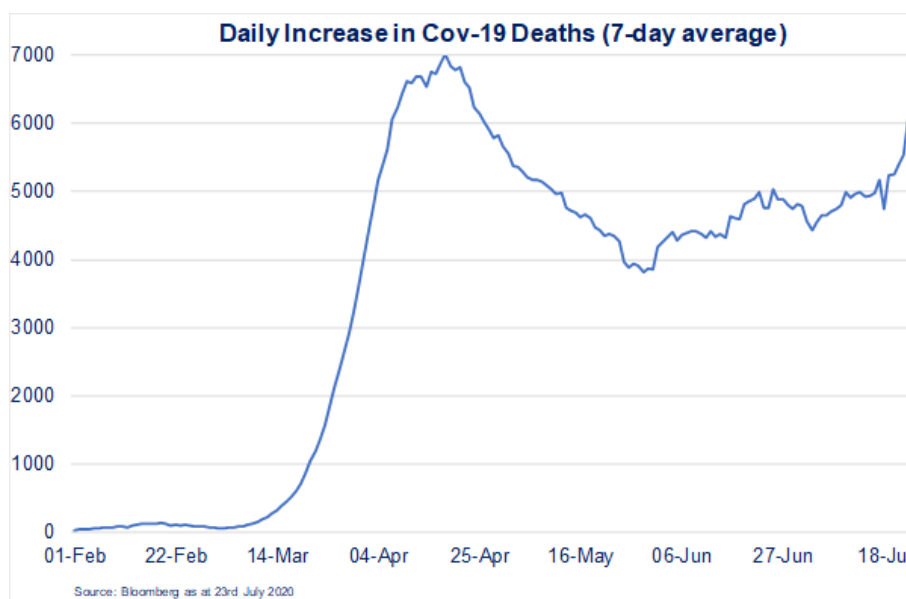


- Among countries, the most cases are in the US (+58.9k (so far) to 4.05 million, with 13 states yet to report), Brazil (+60.0k (second highest day on record) to 2.3 million), India (+45.7k (record high) to 1.24k), Russia (+5.8k to 793.7k), South Africa (+13.1k (second highest) to 408.1k), Peru (+4.5k to +371.1k), Mexico (+8.4k (record high) to +370.7k), Chile (not reported, 334.7k), United Kingdom (+0.8k to 298.7k), Iran (+2.6k to 284.0k), Pakistan (+1.8k to +269.2k), Spain (+2.6k to 270.2k), Saudi Arabia (not reported, 260.4k), Italy (+0.3k to 245.3k), Turkey (not reported, 223.3k), France (not reported, 216.7k), Bangladesh (+2.8k to 216.1k) and Germany (+0.6k to 205.0k). Australia confirmed cases rose +412 to 13,306 yesterday which placed us 70th in terms of total infections.

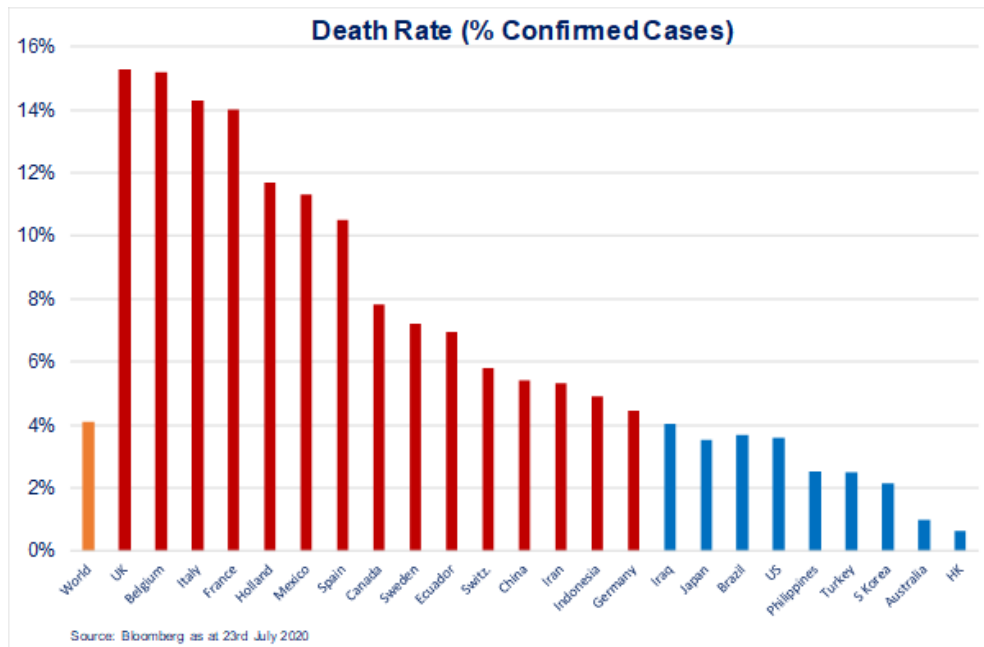
Elsewhere, Singapore recorded +0.4k new cases to 49.1k most of which are linked to foreign workers who are forced to live in crowded dormitories, with the countries having the largest case numbers in South East Asia, but Indonesia (+1.9k (record high) to 93.7k) is now on the rise and has the most cases in the region, and the Philippines (+2.1k to 74.4k) is also on an upward trend.



- Although final numbers are not in until 1pm AEST, the global death rate declined for a seventy eighth straight day to 4.09% with the global total to 631.7k after another record 9.5k deaths overnight, so far, which indicates the daily average deaths is increasing again (see chart). The US (+0.9k so far) has the most deaths at +144.1k, with Brazil (+1.3k, 84.1k), the UK (+0.1k to 45.7k), Mexico (+0.7k, +41.9k), Italy (+0.01k to 35.1k) and France (+0.0003k to 30.2k) all over +30k. The death rate is highest in European countries where the health systems had collapsed led by the UK (steady at 15.3%), Belgium (-0.1% to 15.2%), Italy (steady at 14.3%), France (steady at 14.0%), the Netherlands (-0.1% to 11.7%), Spain (-0.2% to 10.5%) 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 7.0%), Indonesia (+0.1% to 4.9%) and Brazil (-0.1% to 3.7%).







Yours sincerely,



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