Perpetual Investments

# THOUGHTS ON THE MARKET

27th May 2020 - Geopolitical tensions limit risk market advances

## SUMMARY

- Global stocks rose overnight but closed well off their highs after news circulated that US officials are considering sanctions on Chinese officials. While economic data is still awful by any historical comparison, souring relations between the US and China is now the most prominent downside risk as investors seem unperturbed about still growing COVID-19 case numbers and very high valuations in several key markets. The overnight market rise was led by small caps and energy, which had previously lagged the recovery in mega-cap tech stocks and suggests investors now believe, rightly or wrongly, that the worst of the pandemic's dislocation will soon be over.

  In other markets, 10-year US Treasuries rose 4 points to 0.70% with curve steepening, gold was off -0.1% to USD1,727 per troy ounce, the US dollar deprecated against the Euro (-0.5%), Sterling (-1.0%) and AUD (-1.3%) and was steady against the Yen, and energy delivered a +2.8% price rise to AUD34.17 per barrel.

- The economic calendar with light yet again and there were few policy announcements, but PM Morrison yesterday provided some clarity on his next initiative called the JobMaker program which is designed to reduce supply side rigidities in the labour market to enhance productivity and the employment rebound. If reforms can be agreed on this will be a good initiative, but a more immediate issue for Australia is a large AUD90 billion household cashflow cliff coming around the end of the September quarter, which will need to be addressed before too long.

- Although final numbers are not in, the number of global cases of COVID-19 stands at 5.56 million with another +64.2k cases overnight. This means 3 countries have more than 350k cases, 6 countries have more than 200k cases, 12 countries have more than 100k cases, 36 over 20k cases and 49 over 10k. 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 and fifth million, and in the past 6 days another 559k cases have been confirmed. That said, the growth rate of daily confirmed cases (+1.8% since Saturday) is trending lower. Meanwhile, deaths stand at 348.6k and the death rate dropped for a twentieth straight day to 6.23%.

## FINANCIAL MARKETS

- **EQUITIES**
  - The MSCI World Index closed +1.6% higher and is now back to where it was at end-2018. Sectors leveraged to the re-opening and policy support themes outperformed after Germany announced that it was planning to lift travel restrictions for 31 European countries, and this sent price in financials (+4.5%), industrials (+3.1%) and consumer discretionary (+1.6%) up sharply. Energy (+1.9%) joined in the parade given another rise in the price of crude, but defensive sectors including consumer staples (+0.5%), telcos (+0.4%) and healthcare (-0.3%) lagged. The overnight rally left only three sectors in bear market territory (see chart).



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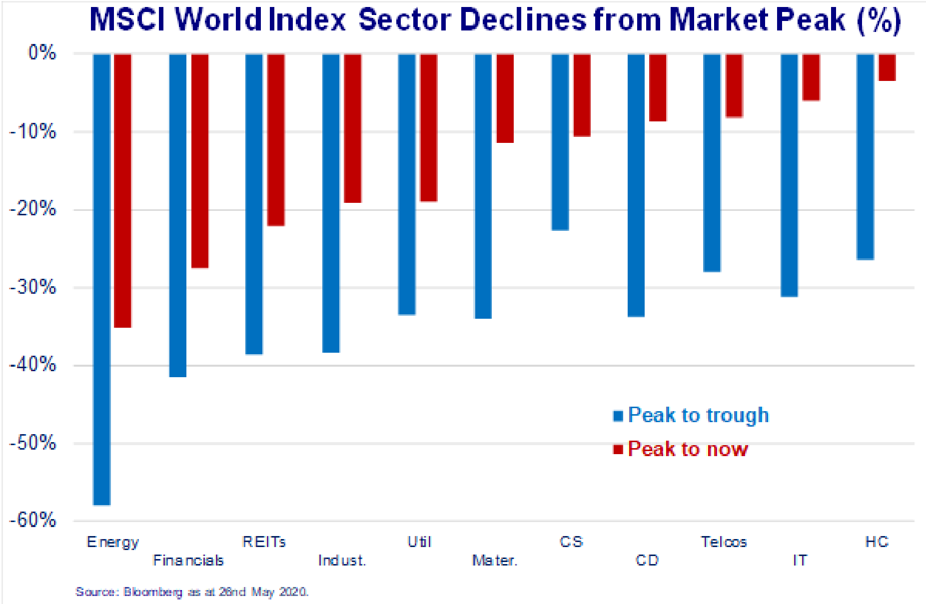
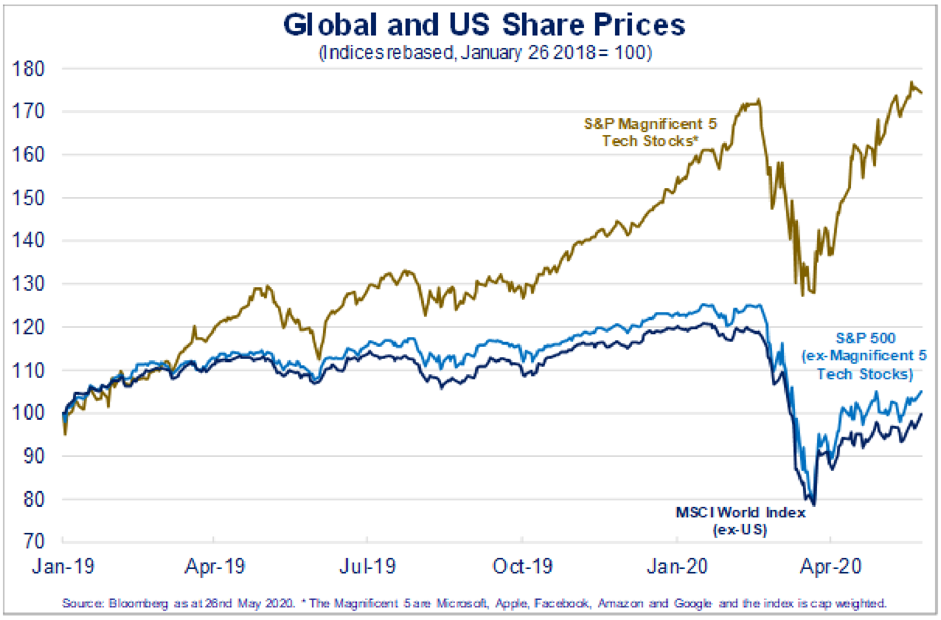



Among the regions, Australia (+2.9%) led the gains in Asian markets (+2.2%) as PM Morrison announced plans to address the supply side rigidities in the labour market by bringing business leaders, unions and other key groups into the policy discussion tent to address issues around low productivity and maximising the employment rebound. Meanwhile, Japan (+2.6%) rallied as PM Abe details plans about economic reopening led by Tokyo with other regions to join in when performance hurdles are met. Elsewhere shares in Hong Kong (+1.9%) and China (+1.1%) underperformed their peers as geopolitical tensions festered.

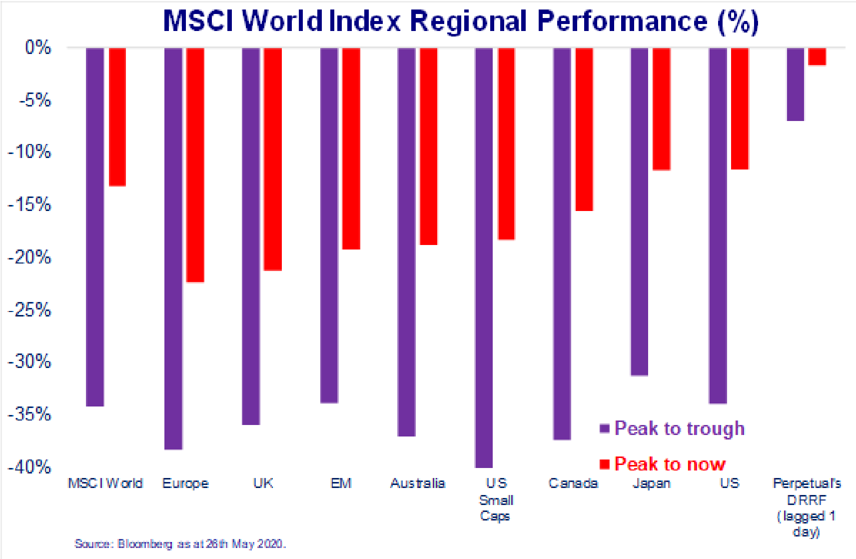
Europe (+0.9%) responded positively to the Asia lead, with prices rallying on news that Germany is opening up its economy more with advances led by the periphery including Spain (+2.2%) and Italy (+1.5%), and this was joined by core markets including France (+1.5%) and Germany (+1.0%), as COVID-19 infection rates dropped again. The UK (+1.2%) was also upbeat after PM Johnson announced non-essential stores will be able to reopen from June 15th.

Elsewhere, the US market (+1.2%) opened strongly at +2% but in the last hour of trade news that the Trump Administration is considering sanctions on Chinese officials saw investors trim gains although the market closed the session at an 11-week high. Interestingly, the NASDAQ (+0.2%) lagged the broader market with the Magnificent 5 tech stocks down -0.7% (see chart below) as China-exposed stocks and chipmakers tumbled at the end of the session.



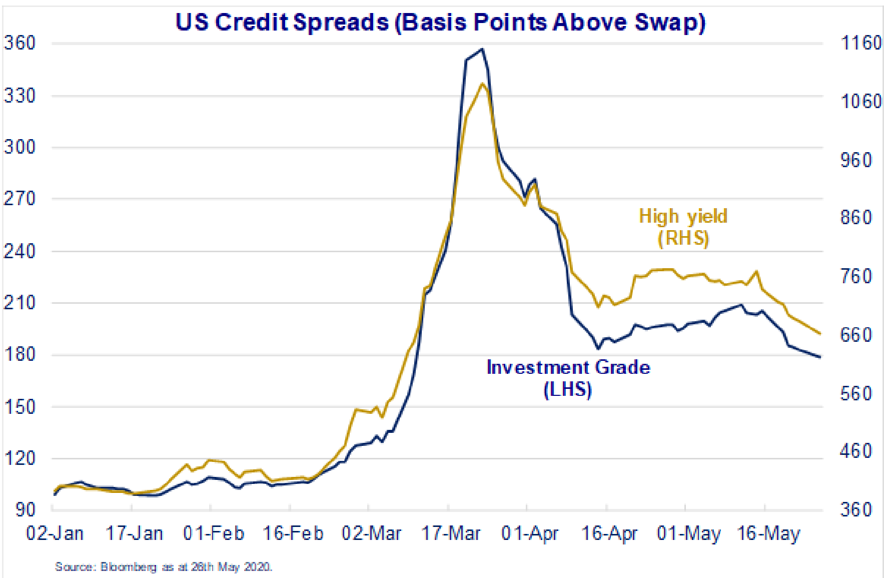
The overnight rallies pulled Australia (-18.8%) and EM (-19.2%) out of official bear market territory (see chart below), with only the UK (21.2%) and Europe (-22.4%) remaining. Interestingly, Japan has now caught up with the US and is only -12% below its February peak (see chart).

Futures markets suggest a mixed opening in Asia on Wednesday with Australia (-1.0%) set to open lower with flat movements in both Hong Kong and Japan at the bell.

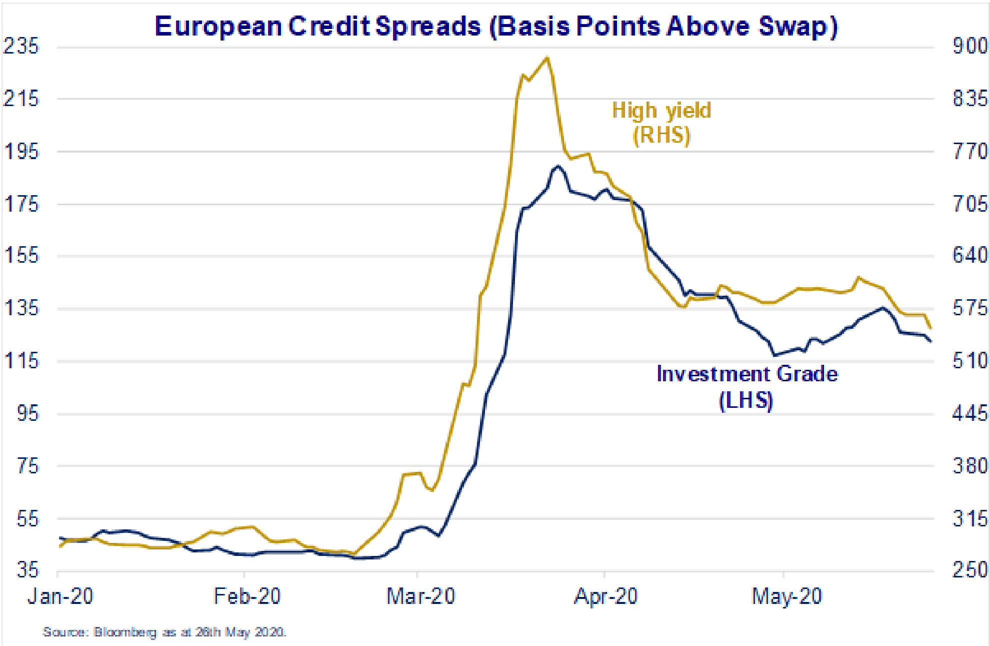



- **CREDIT MARKETS**
  - US credit markets rallied overnight with spreads contracting in every sector. In the investment grade universe, spreads came in another -4 points to +179 bpts, which is a fresh record low since the March peak which saw the recovery rate rise to 70%. The decline in risk premiums was led by energy (-10 points, +249 bpts, 77%) as crude prices rose, which flowed through to other cyclical plays including consumer discretionary (-6 points, +225 bpts, 64%) and senior financials (-4 points, +169 bpts, 65%), which in the absence of data is a confirmation that markets believe, rightly or wrongly, that the worst of the economic dislocation is behind them as the US slowly reopens.

    In the high yield universe, spreads declined a more impressive -21 points, to +664 bpts (see chart), which raised the recovery rate to 63% which is also a post-March peak. The decline in spreads was widespread led by consumer discretionary (-30 points, +681 bpts, 51%), industrials (-27 points, +799 bpts, 33%) and subordinated financials (-27 points, +741 bpts, 41%) as investors embraced some portfolio rotation with defensive sectors underperforming.



- European credit markets were also in a 'risk-on' mood with investment grade spreads coming in -2 points to +123 bpts, which increased the recovery rate to 43%. Among the sectors, cyclicals and lagging sectors rallied strongest led again by consumer discretionary (-9 points, +175 bpts, 41%), energy (-6 points to +117 bpts, 31%) and subordinated financials (-6 bpts, +209 bpts, 52%). In the high yield space spreads contracted a further -16 points to +551 bpts which is a post-March peak low (see chart), which lifted the recovery rate to 52%, with improvements led by subordinated financials (-20 points, +664 bpts, 39%), materials (-19 points, +505 bpts, 52%) and energy (-16 points, +656 bpts, 59%).




## THE GLOBAL ECONOMY

- There were no material economic releases overnight.

## POLICY

- Prime Minister Morrison unveiled a new JobMaker program (JMP) yesterday which in some way echoes the Price and Income Accord from the 1980s which was highly successful at boosting Australian productivity and reducing unemployment. Such results will be harder to achieve in the 2020s as back then Australia was an industrial dinosaur economy, where reforms were much easier to implement and where even small policy changes delivered a large growth dividend. The JMP is not the next wave of stimulus payments, but instead it appears to be centred on reducing supply side rigidities in the labour market with more investment in skills to enhance productivity, and potentially industrial relations reforms to make it easier for cautious firms to hire displaced workers.

  There are five key areas flagged for review:

  1. Award simplification;
  2. enterprise agreement making;
  3. Casuals and fixed-term employees;
  4. Compliance and enforcement; and
  5. Greenfield agreements for new enterprises.

  The working groups on these five issues will comprise unions, employers and industrial bodies and will be overseen by the Industrial Relations Minister Christian Porter. The groups have until September to resolve some of the outstanding industrial relations issues, but given the high unemployment rate and challenges ahead, the hurdle for agreement should be lower than in recent years.

An extension of JobKeeper remains unlikely despite the shock AUD60 billion Budget windfall, but the program could be tweaked to improve delivery. Alternatively, if the program was extended it would most likely to limited to severely vulnerable industries (tourism, hospitality and so on), but this would most likely require a largescale second wave of infections.

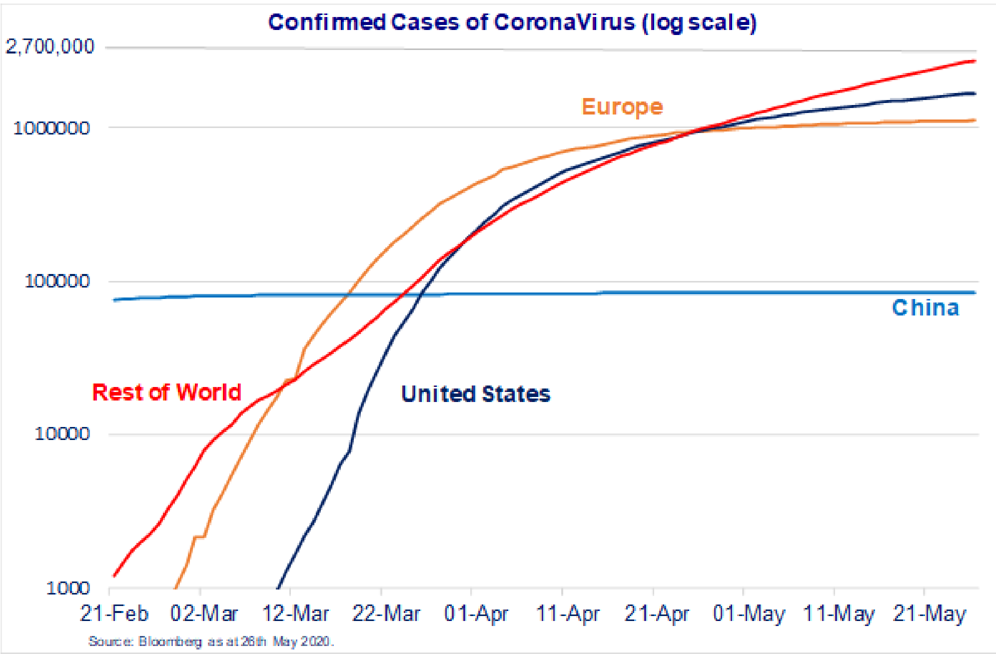
- The JobKeeper forecast error was undoubtedly positive economic news as it meant that the labour market and Federal Budget is in a better state than previously thought, but it doesn't negate the large-scale household cashflow cliff that is coming towards the end of the September quarter. On present policy settings AUD90 billion of policy support will end in Q3 which is one-fifth of total quarterly spending. The cashflow drainage comes from:

    - 3.5 million workers coming off JobKeeper;
    - 1.6 million adults coming of the doubling of the JobSeeker allowance;
    - AUD10 billion of early superannuation withdrawals that won't be repeated; and
    - Loan deferrals on circa AUD220 billion of debt repayments will end (although some may be allowed to move to interest only loans).

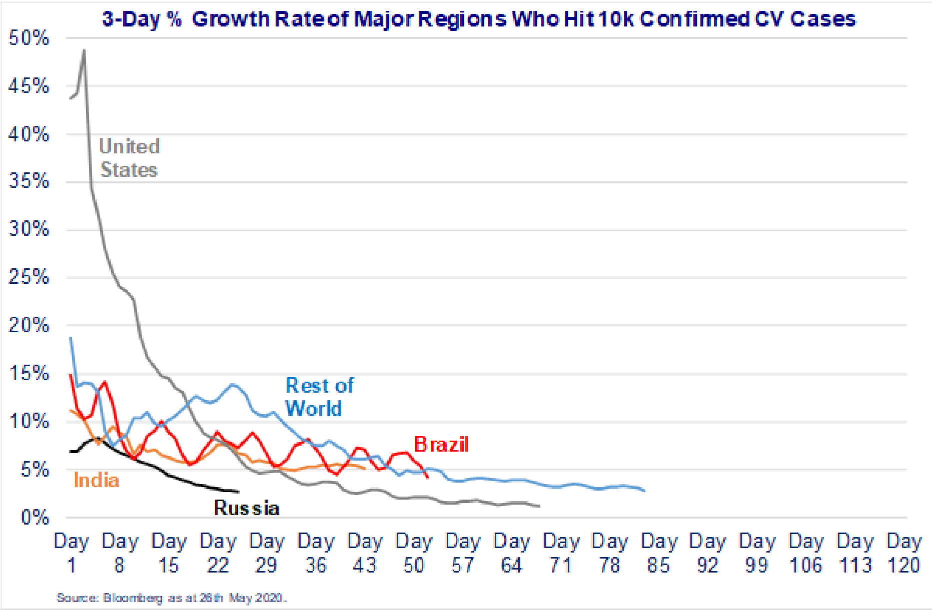
  This could create a huge cashflow cliff for the government to manage, but there is more fiscal policy flexibility to phase out the stimulus over several quarters and to prevent a double-dip downturn. While other things like housing programs, economic recovery and lower mobility restrictions can assist, we suspect more fiscal support will be required.

## VIRUS UPDATE

- Although final numbers are not in for another 3.5 hours, the number of global cases of COVID-19 stands at 5.56 million with another +64.2k cases overnight (before Brazil and Mexico report, and the US completes its numbers) which means that Tuesday is likely to be the 57th occasion in the past 58 days where daily increases have topped 70k). This means 3 countries have more than 350k cases, 6 countries have more than 200k cases, 12 countries have more than 100k cases, 36 over 20k cases and 49 over 10k. 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 and fifth million, and in the past 6 days another 559k cases have been confirmed. That said, the growth rate of daily confirmed cases is trending lower (+1.8% since Saturday). Meanwhile, deaths stand at 348.6k, with the US now over 90k (28.4% 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 twentieth straight day to 6.23%.

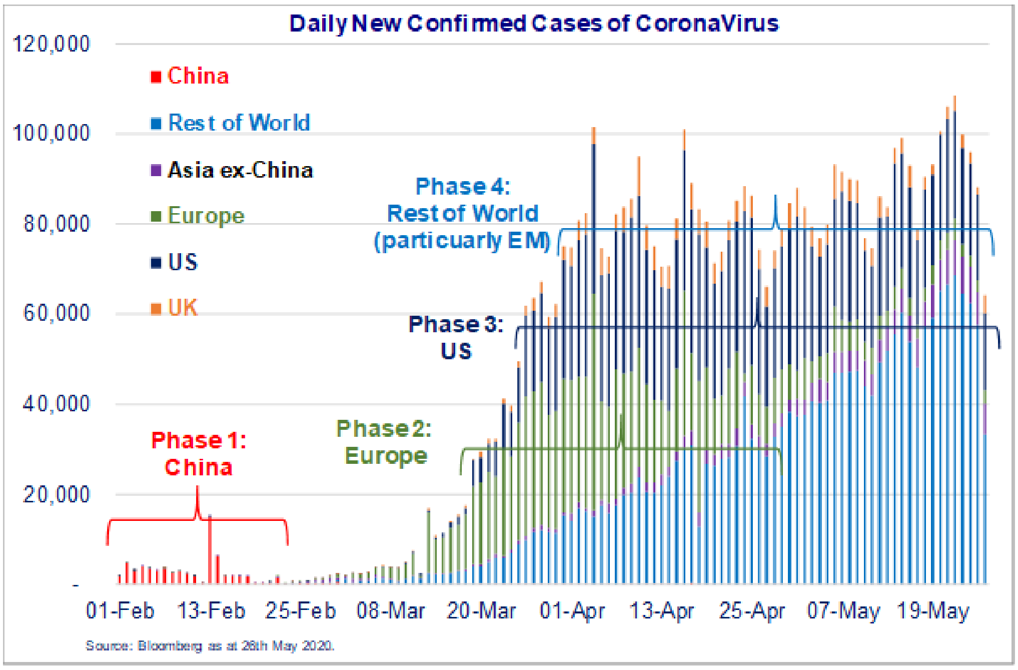


- We break the infections into four groups – the US, Europe, China and 'others' and the rest of the world outside the G3 economies now has the most total cases (+33.4k to 2.72 million) and highest daily new cases (and by a considerable margin) followed by the US (+17.1k (9-week low) to 1.68 million) and Europe (+3.0k to 1.11 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 (who has not reported but have 375k cases which is the second highest in the world), +Russia (+8.9k to 362.3k, third highest) and India (+5.8k to 150.8k, tenth highest).

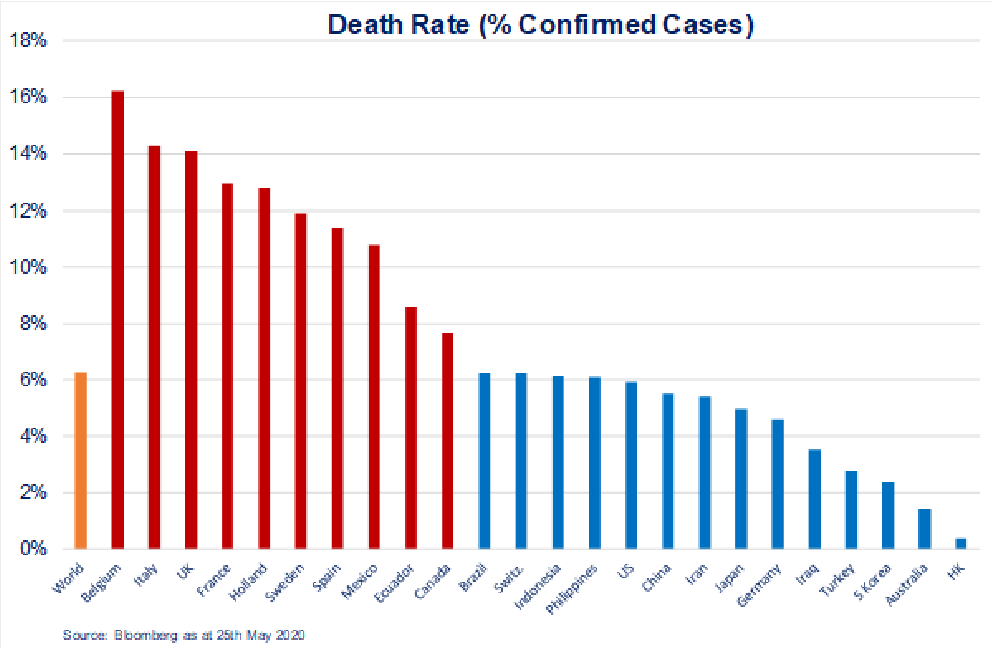



- Among countries, the most cases are in the US (+14.1k (9-week low) to 1.68 million), Brazil (not reported, 375k), Russia (+8.9k to 362.3k), the United Kingdom (+4.0k (10-day high) to 266.6k), Spain (+0.9k to 236.3k), Italy (+0.4k to 230.6k), France (not reported, 183.0k), Germany (+0.6k to 181.2k), Turkey (+1.0k to 158.8k), India (+5.8k to 150.8k), Iran (+1.8k to 139.5k) and China (steady at 84.1k). Australia confirmed cases rose +11 to 7,133 yesterday which placed us 61st in terms of total infections.

  Elsewhere, Singapore recorded +383 new cases to 32.3k 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 (+415 to 23.2k) and the Philippines (+0.4k to 14.7k). 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 twentieth straight day to 6.23% with the global total to 348.6k. The US (+0.6k) has the most deaths at +98.8k, with the UK (+0.1k to 37.1k), Italy (+0.1k to 33.0k), Spain (+0.3 to 27.1k) and France (+0.1k to 28.5) 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 14.1%), France (+0.1% to 12.9%), the Netherlands (steady at 12.8%), Sweden (+0.1% to12.0%) and Spain (+0.1% to 11.5%). However, several emerging markets are now on the leader board including Mexico (-0.1% to 10.7%), Ecuador (+0.1% to 8.6%), Brazil (+0.1% to 6.3%) and Indonesia (-0.1% to 6.1%).




Yours sincerely,

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## MORE INFORMATION

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