Perpetual Investments

THOUGHTS ON THE MARKET

2nd July 2020

Markets start the new financial year with modest gains despite a record surge in COVID-19 cases

SUMMARY

- Global risk markets were higher overnight, but it was far from a universal trend. The US sharemarket advanced for a third day and the NASDAQ leapt to a fresh record high as an early experimental drug from Pfizer and BioNtech SE helping patients produce COVID-19 antibodies which buoyed sentiment. But markets came off their session highs after California and Arizona reported their highest daily cases of COVID-19 and Houston's intensive care unit exceeded full capacity.

  In other markets, 10-year US Treasuries rose two points to +0.68% with curve steepening, commodities were unchanged with gold steady at USD1,770 per troy ounce and oil flat at USD39.71 per barrel, and all G10 currencies appreciated against the US dollar including the Yen (+0.2%), Euro (+0.4%), AUD (+1.0% to 69.14USC) and Sterling (+1.7%).

- Economic data on Wednesday was mixed with a strong bounce in the June US ISM manufacturing index which suggests that US earnings growth should return to modestly positive economic territory by end-2020. In contrast, yesterday's Australian housing data exhibited some cracks in the sector's previous resilience with declining house prices and building approvals. This suggests there are some potentially large downside risks to employment and growth from falling construction activity and it will require some form of policy response from the Morrison Government. Meanwhile, the PBoC eased some lending rates yesterday and the Fed minutes from its June indicated that market supports would remain in place for several years and would likely be augmented with outcome-based forward guidance.

- The number of global cases of COVID-19 is 10.64 million with a record +193.2k cases so far overnight (before Brazil, Mexico, Ecuador, France, Pakistan and 7 US states report their numbers) which means that Wednesday was the 34th occasion in the past 36 days where daily increases have topped 100k (and the other two were over 99k!). This means 3 countries have more than 650k cases, 14 countries have more than 200k cases (France (203.0k and Turkey (201.1k 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 3 days another +644k cases have been confirmed but more importantly, the growth rate of daily confirmed cases (+1.7% since Sunday) is rising despite the large base. Meanwhile, deaths stand at 514.5k and the death rate dropped for a fifty fifth straight day to 4.82%.

FINANCIAL MARKETS

- **EQUITIES**
  - **The MSCI World Index** closed +0.4% higher with defensive sectors rallying strongly after several weeks of underperformance. The gains were led by REITs (+1.8%) which recorded its second consecutive century advance despite an absence of sector news, and this was a similar story to telcos (+1.7%) which had its third successive 1%+ rise, and utilities (+1.3%) also rallied strongly. Meanwhile, healthcare (+0.5%) outperformed the broader index after Pfizer trials for a new Cov-19 treatment had positive results with patients producing some antibodies.

    In contrast, cyclical sectors lagged including industrials (-0.4%), financials (-0.7%) and energy (-1.1%) which suggests that investors remain unconvinced about the economic recovery even though the June US ISM manufacturing PMI signalled a return to expansion territory. The overnight moves, saw REITs (with a

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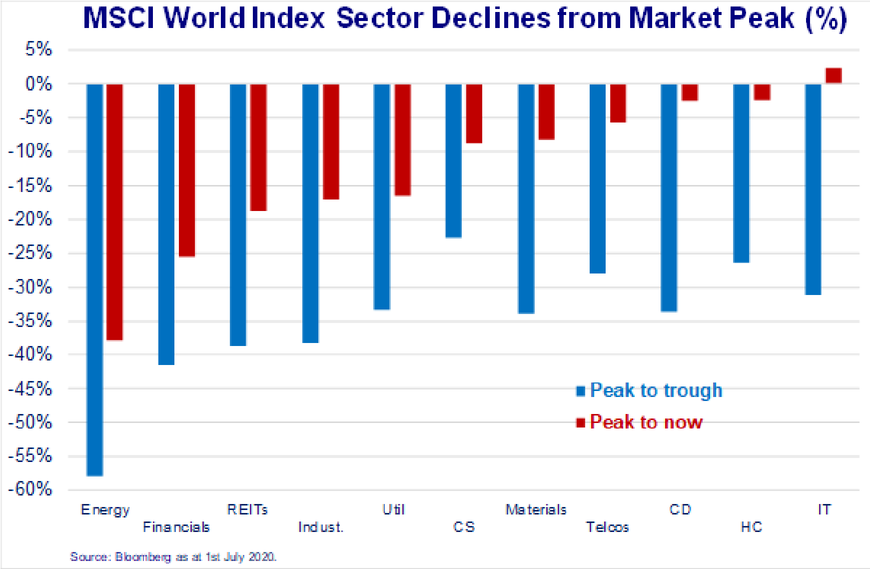
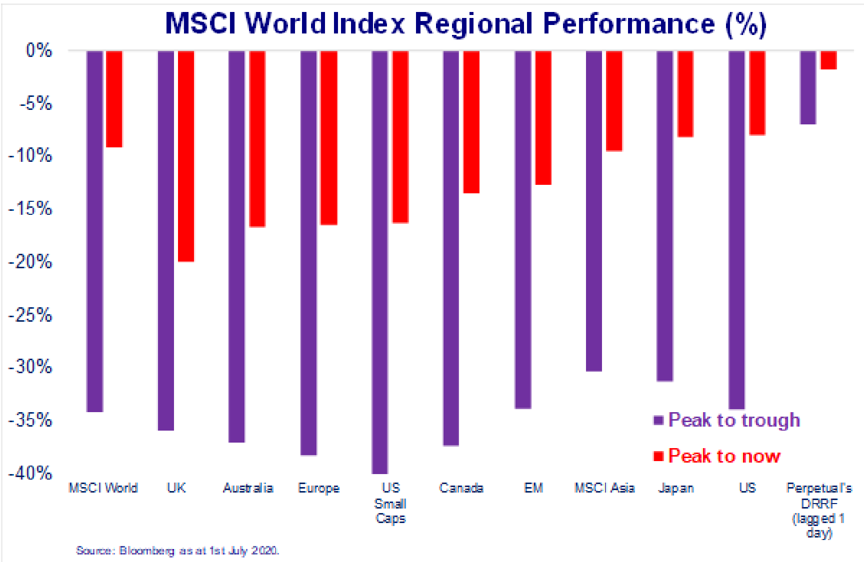
peak-to-now loss of -18.8%) leave bear market territory, whereas financials (-25.6%) and energy (-37.9%) are well entrenched, with industrials (-17.1%) potentially one bad day away from joining the group (see chart).



- **Among the regions**, performance was very mixed with US stocks rising for a third day as vaccine developments and a positive ISM manufacturing gauge tempering concerns about record daily case numbers in California and Arizona, with Houston reaching full capacity in its ICUs. Meanwhile, US tech outperformed and jumped to a fresh record high but gains here were concentrated around FANG, whereas Boeing (-1.6%) and Walgreens (-3.6%) weighed on the Dow. By the closing bell at the NYSE, the NASDAQ 100 (+0.9%) led the index advances, followed by the S&P 500 (+0.5%), whereas the Dow Jones Industrial Average declined (-77 points, -0.3% to 25,735) as did the Russell 2000 (-1.0%) in a bad day for small cap stocks.

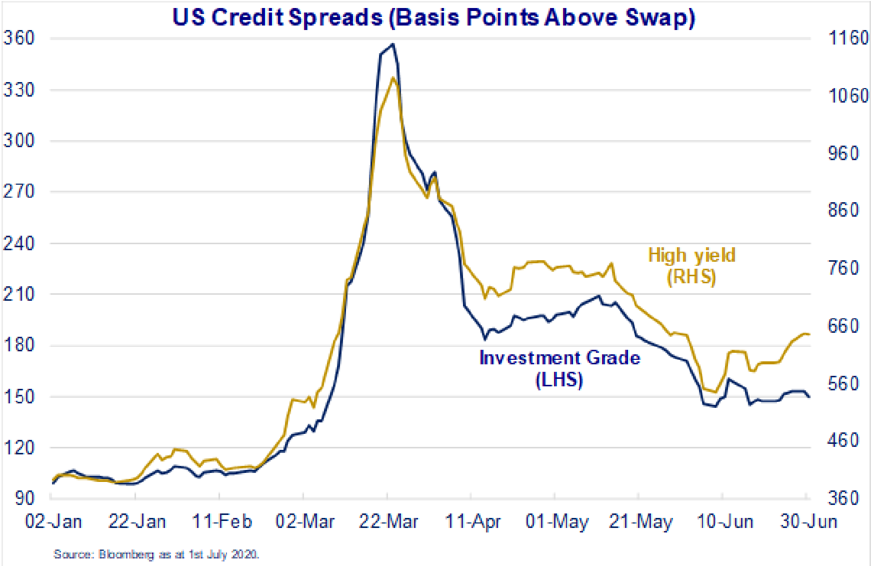
  Earlier European markets overcame some sharp early losses and closed only fractionally lower (-0.2%) with modest declines in most bourses including Germany (-0.4%, which underperformed as the labour market recovery came in well short of street estimates (+60k relative to consensus at +100k)), Italy (-0.2%), UK (-0.2%), France (-0.2%), Spain (-0.1%), with Switzerland (+0.4%) and Sweden (+0.6%) closing in the black. Elsewhere, the MSCI Asia Pacific index closed steady as advances in China (+2.0%), Australia (+0.6%) and Hong Kong (+0.5%) were offset by a decline in Japan (-0.8%) given the higher Yen. The moves yesterday took the UK (with a peak-to-now decline of -20.0%) back into bear market territory, but there were no notable changes outside this (see chart).



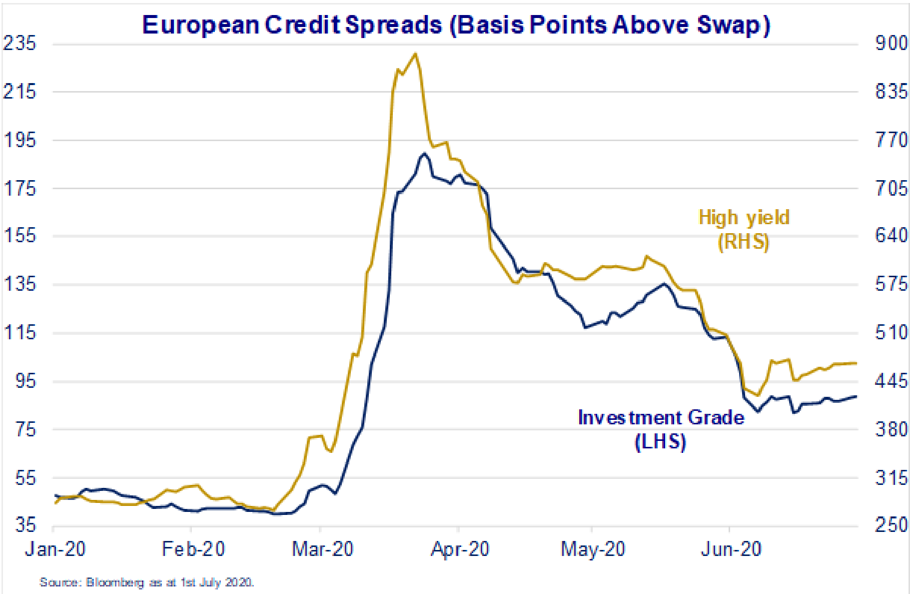
- Futures markets suggest a positive opening in Asian trade this morning with advances priced in for Japan (+0.5%) and Australia (+0.7%).

- ## CREDIT MARKETS

  - Regional credit indices were mostly higher overnight with spreads in the US investment grade universe declining for a second consecutive day by -3 points, to +147 bpts which lifted the recovery rate to 83%.There were lower risk premiums in all sectors and again movements were quite consistent across sub-sectors. The spread decline was led by telcos (-5 points to +169 bpts, 83%) which had underperformed of late, energy (-4 points, +205 bpts, 87%) and materials (-4 points, +187 bpts, 80%) as Dr copper rose to its highest levels since January. In the high yield space, the risk premium declined -8 8 points to +639 bpts, which increased the recovery rate to 67%. All 11 sub-sectors recorded lower spreads led by healthcare (-18 points, +577 bpts, 65%) which responded positively to some solid trial of COVID-19 vaccines by Pfizer and several of its peers, industrials (-9 points, +765 bpts, 39%) given the very solid ISM manufacturing gauge and also consumer staples (-8 points, +476 bps, 95%).

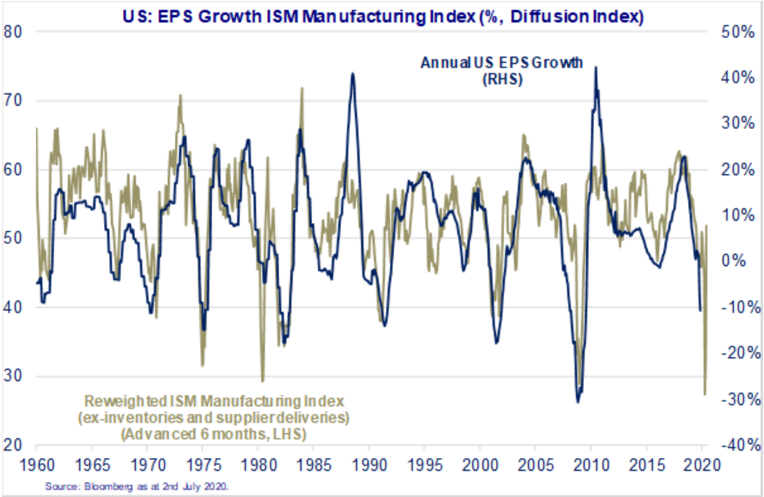


  - **European credit markets** were mixed with spreads in the investment grade universe expanding for a third consecutive day, +2.2 points to +91 bpts (4-week high) which lowered the recovery rate one notch to 66%. Risk premia rose in 10 of the 11 sectors led by healthcare (+4 points, +54 bpts, 71%), materials (+3 points +83 points, 66%) and industrials (+3 points, +97 bpts, 53%). In contrast, spreads in the high yield space broke a 5-day losing streak and declined -1 point to +469 bpts, which left the recovery rate at 68%. Risk premiums fell in 8 of the 11 sectors, led by senior financials (-6 points, +365 bpts, 74%) as investors sought assets higher in the capital structure and sold down their subordinated peer (+2 points, +501 bpts, 65%) in the process, with telcos (-2 points, +379 bpts, 64%) also benefitting from increased investor interest.



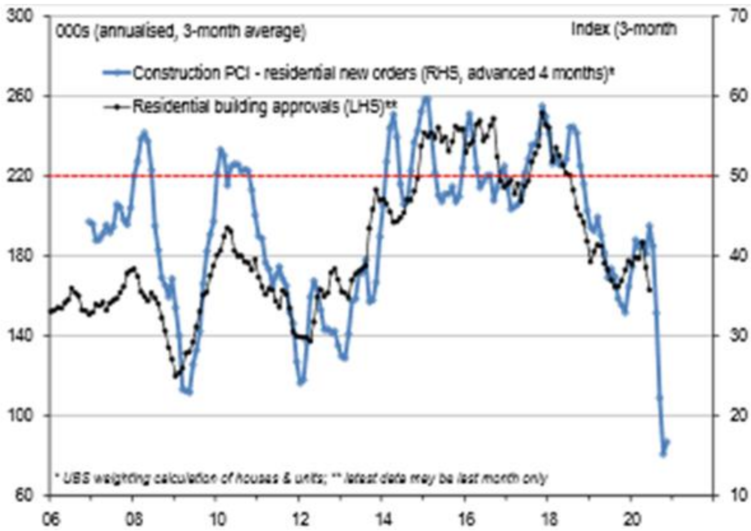
THE GLOBAL ECONOMY

- **The June US ISM Manufacturing Index** was upbeat with the PMI rising +9.5 points to 52.6. Among the key components, new orders surged +24.6 points to 56.4 as the economic lights went back on (and new export orders rose +8.1 points but remained in contraction territory at 47.6), production (+24.1 to 57.3) was also upbeat and while employment rose +10 points to 42.1, it remained firmly in contraction territory despite a decline in continuous jobless claims in recent weeks. So overall, the report indicated expansion in the economy and normally it would be expected to accelerate from here, but new cases of COVID-19 could see a deviation from this path. Meanwhile, our reweighted ISM which excludes inventories and supplier delivery times also returned to positive territory at 51.9 and this suggests US earnings growth should have returned to positive territory by the end of 2020 (see chart).



- After 4 months of resilience, **Australian housing data is starting to show signs of strain** with house prices down -0.7% m/m in June and residential building approvals dropping (third month in succession) by -16.4% m/m (largest in two years) to 153k (8 year low). The latter was driven by sharp drops in the volatile 'other'/multi's (namely, apartments) sector (-34.9% m/m which took the annual rate down to -30.6% y/y), but detached dwellings also fell back (-4.4% m/m and -0.4% y/y) and renovations were flat (-0.0% m/m, -8.4% y/y). Looking forward, the residential new orders to sales ratio from the construction PCI suggests that approvals could fall by another -33% to around +100k (see chart – which would be below the trough from the 1990/91 recession) in the coming four months which will place significantly more pressure on the domestic construction sector than the Government's highly conditional grants program will ease. The final number could be a bit higher than 100k as units are being more cut than housing, but the potential upside risk is modest.

  Under such a scenario, dwelling investment could decline -40% y/y which would detract about -0.25% off GDP by December 2020, and could pull unemployment up +1.5%. This all assumes no second round effects for the labour market for JobKeeper which is ending in September and could by itself see another 3% of job losses as firms cut payrolls to align costs with a weaker revenue line, taking the official unemployment rate to 10% and the official rate to about 16%. Clearly the Federal and State governments need to do a lot to support construction as the RBA is out of growth bullets (they have market bullets left, but rates are at the effective lower bound).



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POLICY

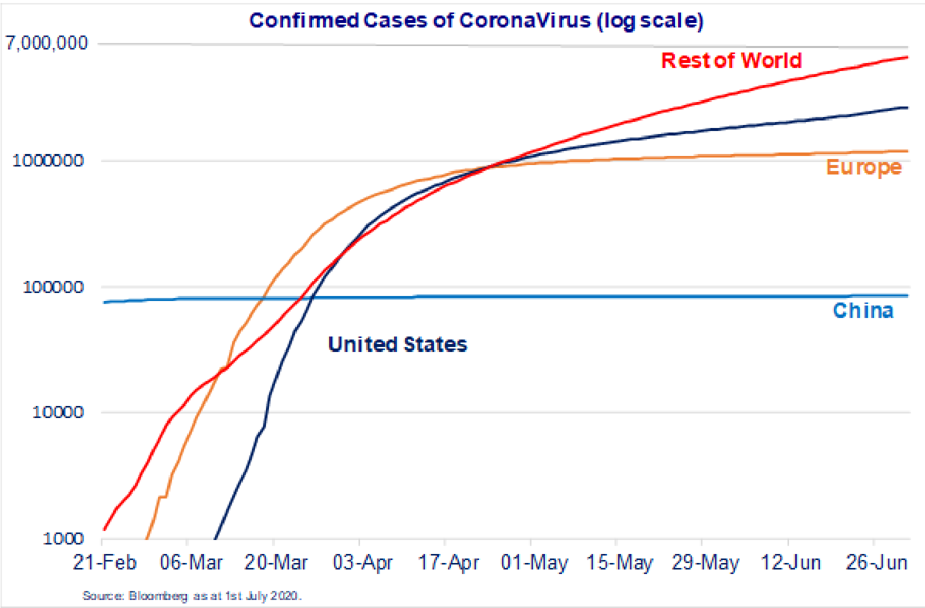
- **The PBOC** announced lower interest rates on loans supporting the agriculture and small firms by -25 bpts, as well as rediscount rates by 25 bpts to 2%, effective yesterday. In addition, the Bank said it will lower interest rates of financial stability refinancing loans by -50 bpts to 1.75% and repeated its commitment to interest rate reforms given Governor Yi last month expressed concerns about the potential "hang over" from rapid easing, warning some pullback would be needed down the line. We would argue his views are consistent with policymakers' repeated aversion to flooding the system with liquidity.

- Minutes of the **June US FOMC meeting** revealed discussions of the US economic situation where views remained highly cautious despite some data suggesting consumer spending had rebounded and other activity data indicating stabilisation at a low base. There was also an extensive discussion about issuing more explicit forward guidance and potentially instituting yield-curve targets with the former most likely to be done on an outcome's basis, centred around inflation including a modest temporary overshoot. The committee though that if this became credible, the yield target would be unnecessary.

VIRUS UPDATE

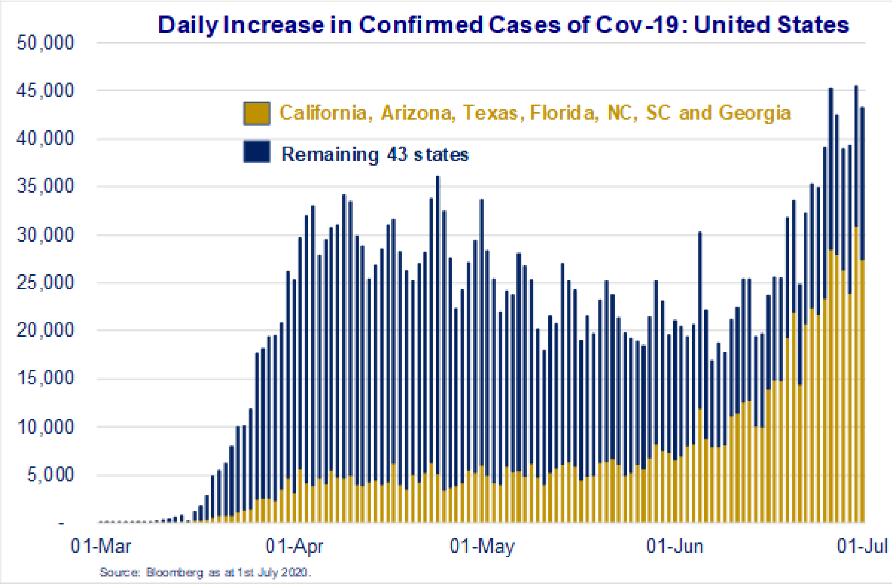
- Although final numbers are not in for another 5.5 hours, the number of global cases of COVID-19 was 10.64 million with a record +193.2k cases so far overnight (before Brazil, Mexico, Ecuador, France, Pakistan and 7 US states report their numbers) which means that Wednesday was the 34th occasion in the past 36 days where daily increases have topped 100k (and the other two were over 99k!). This means 3 countries have more than 650k cases, 14 countries have more than 200k cases (France (203.0k and Turkey (201.1k joined this group overnight) and 19 countries have more than 100k cases.

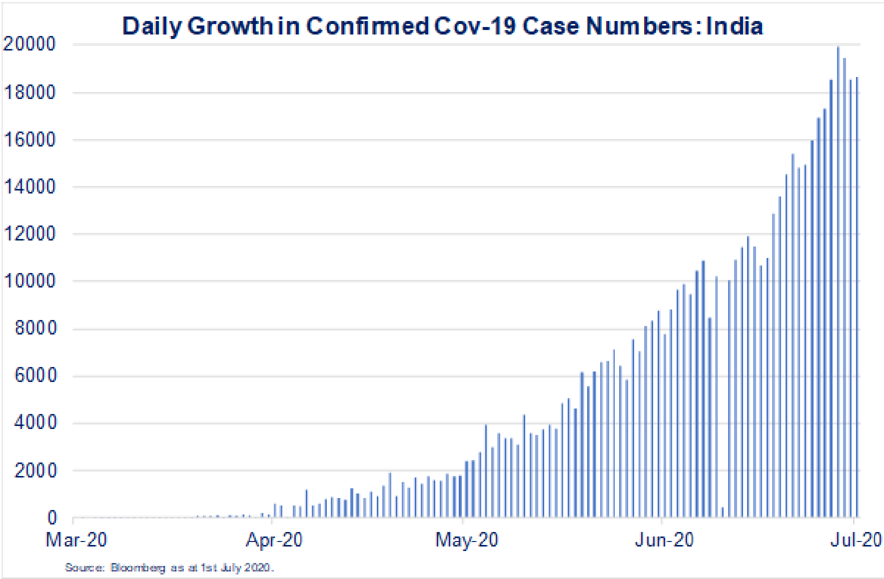
  It took 73 days to record 1 million cases, and after this each subsequent million has taken 13 days, 11 days, 12 days, 10 days, 11 days, 8 days, 8 days, 7 days and 6 days. In the past 3 days another +644k cases have been confirmed but more importantly, the growth rate of daily confirmed cases (+1.7% since Sunday) is rising despite the large base. Meanwhile, deaths stand at 514.5k, with the US now over 125k (24.9% of global deaths even though they have only 4% of the global population), Brazil (60.6k), the UK (44.0k) and Italy (34.8k) all over 30k, with France (29.9k) and Spain (28.4k) over 25k, and the death rate dropped for a fifty fifth straight day to 4.82%.



- 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 (+119.5k to 6.69 million) and highest daily new cases (and by a considerable margin) followed by the US (+42.7k to 2.68 million) and Europe (+4.6k to 1.20 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,

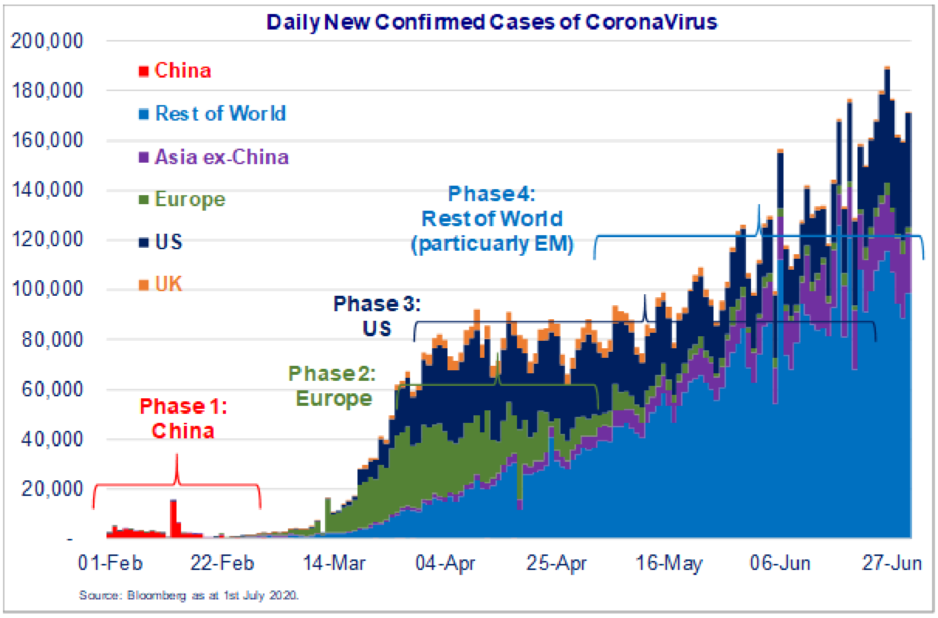
+1.45 million, which is the second highest in the world), Russia (+6.6k to 653.5k, third highest) and India (+18.6k to 585.5k, fourth highest – see charts below).



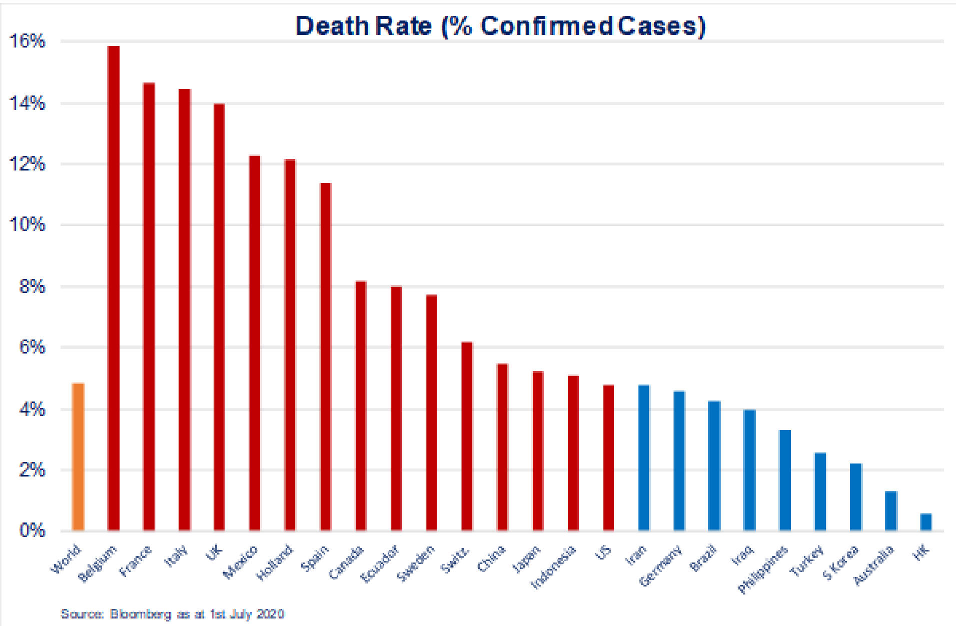


- Among countries, the most cases are in the US (+42.7k (so far, third highest) to 2.68 million), Brazil (not reported, 1.49 million), Russia (+6.6k to 653.5k), India (+18.6k (third highest) to 585.5k), the United Kingdom (+0.8k to 315.0k), Peru (+3.3k to +288.5k), Chile (+2.7k to 2782.0k), Spain (+0.4k to 249.7k), Italy (+0.2k to 240.8k), Iran (+2.5k to 230.2k), Mexico (not reported, +226.1k), Pakistan (+4.1k to +213.5k), France (+1.6k (second highest in 4 weeks) to 203.0) Turkey (+1.2k to 201.1k). Australia confirmed cases rose +86 to 7,920 yesterday which placed us 71st in terms of total infections.

  Elsewhere, Singapore recorded +0.2k new cases to 44.1k 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 (+1.4k (record high) to 57.8k) is now on the rise and has the most cases in the region, and the Philippines (+1.0k to 38.5k) is also on an upward trend.



- Although final numbers are not in until 1pm AEST, the global death rate declined for a fifty fifth straight day to 4.82% with the global total to 514.5k after another +2.8k deaths overnight. The US (+0.52k so far) has the most deaths at +127.9k, with Brazil (not reported, 60.6k), the UK (+0.2k to 44.0k), Italy (+0.02k to 34.8k), France (+0.02k to 29.9k) 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 (-0.1% to 14.7%), Italy (-0.1% to 14.4%), the UK (steady at 14.0%), the Netherlands (-0.1% to 12.2%), Spain (-0.1% to 11.4%) and Sweden (-0.1% to 7.7%). However, several emerging markets are now on the leader board including Mexico (steady at 12.3%), Ecuador (steady at 8.0%), Indonesia (steady at 5.1%) and Brazil (steady at 4.3%).



Yours sincerely,

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MORE INFORMATION

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