Perpetual Investments

THOUGHTS ON THE MARKET

3rd July 2020 - The surge in US non-farm payrolls is not what it seems...

SUMMARY

- Global risk markets rallied overnight with modest price gains in credit and equity markets as a very strong, albeit distorted, June US non-farm payrolls report outweighed another poor set of COVID-19 numbers. As such, the market thematic remains one of an initial strong rebound supported by policy which seemingly limits to how far markets can decline, set against rich valuations, simmering US-China tensions and the potential private sector dislocation from a second wave of COVID-19 occurring at a time of diminishing fiscal support, which seemingly caps the upside. These offsetting forces underpin why very strong data is being tempered with modest gains in risk markets and this is likely to remain the case in the next few months by which time the shape of the economic recovery will be known.

  In other markets, 10-year US Treasuries declined -1 point with curve flattening, commodity markets were mixed with gold down -0.4% to USD1,775 per troy ounce and oil bounced +2.6% to USD40.29 per barrel, and in currency markets the Euro (+0.3%), AUD (+0.4% to USC69.22) and Sterling (+0.5%) rallied against a slightly weaker Greenback, but the Yen was unchanged.

- On the economic front, the US labour market delivered a +4.8 million surge in non-farm employment, with the official unemployment rate declining two percentage points to 11.1%, however, investors should not read too much into this as firms needed to rehire workers by end-June to quality for a waiver of the repayment of government assistance. Accordingly, this has not tempered my view of a slow recovery as most of the payroll increase reflected the flurry of rehiring in restaurants and retailers as state economies re-opened, with the lingering effect of the first wave and the potential damage of the second wave likely to weigh on private sector hiring and spending at a time where government's fiscal impulse is about to turn negative. This view is supported by initial and continuing US jobless claims moving sideways in late June.

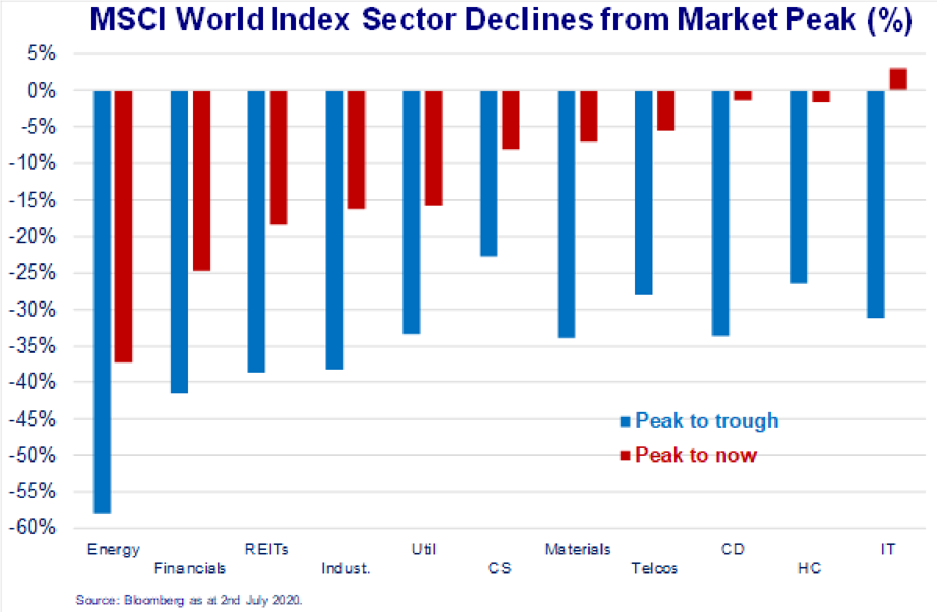
- Although final numbers are not in for another 5.5 hours, the number of global cases of COVID-19 was 10.64 million with a record +271.7k cases so far overnight (before Mexico and 5 US states report their numbers) which means that Thursday was the 35th occasion in the past 37 days where daily increases have topped 100k (and the other two were over 99k!). This means 4 countries have more than 600k cases, 14 countries have more than 200k cases and 20 countries have more than 100k cases (Colombia (102.3k joined this group overnight. 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 4 days another +940k cases have been confirmed but more importantly, the growth rate of daily confirmed cases (+2.1% since Monday) is rising despite the large base. Meanwhile, deaths stand at 519.9k and the death rate dropped for a fifty sixth straight day to 4.75%.

- I will be away on annual leave for most of next week and will update you on developments upon my return.

FINANCIAL MARKETS

- **EQUITIES**
  - **The MSCI World Index rallied +0.7%** with advances in all regions and industries. Gains were led by traditional cyclical sectors including consumer discretionary (+1.2%), financials (+1.1%), materials (+1.3%), energy (+1.0%) and industrials (+0.9%) which simply offset yesterday's declines. The rally here was underpinned by strong June labour market results in both the US and Europe which signalled that the labour recovery came earlier and was stronger than initially expected, although the key question remains about its shape and durability. The overnight movements left only energy (with a peak-to-now decline of -

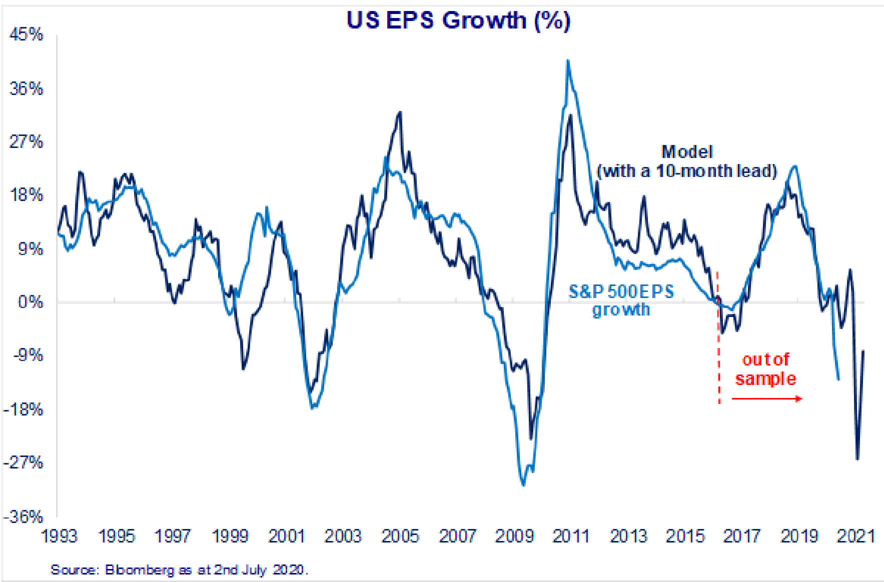
37.2%) and financials (-24.8%) in bear market territory with IT extending its surge beyond the previous February peak (see chart).



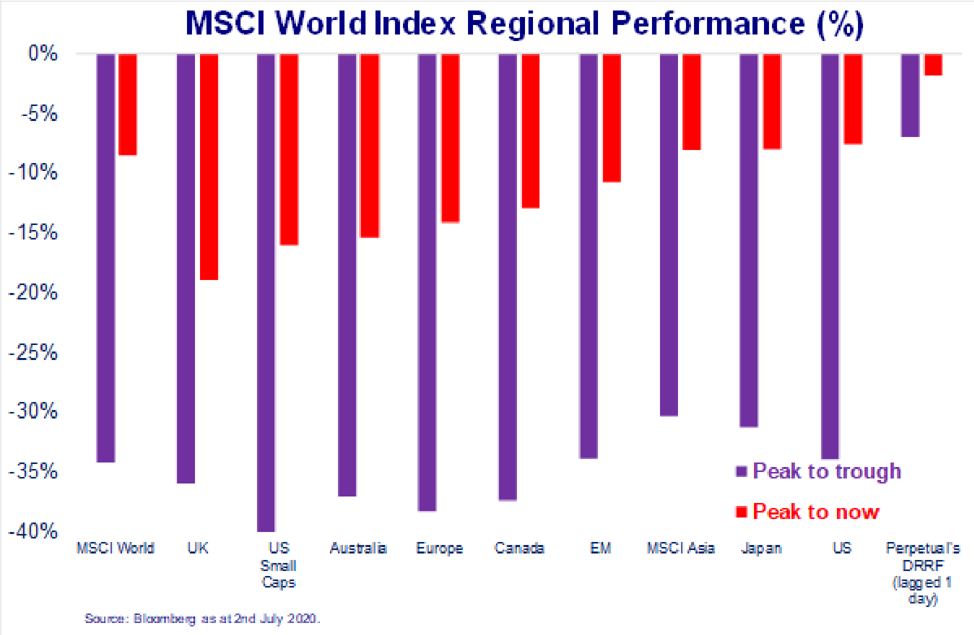
- **Among the regions**, there were strong advances led by Asia where the MSCI Asia Pacific index closed +1.6% higher yesterday with gains in Hong Kong (+2.9%), China (+2.1%) and Australia (+1.7%) following a positive lead from Wall street, whereas Japan (+0.1%) lagged given the rising Yen. This market momentum was evident in Europe where all regional bourses recorded century advances underpinned a lower-than-expected regional unemployment rate which gave investors hope than the earnings dislocation may be smaller and shorter than expected. The rally was widespread led by Spain (+3.8%), Italy (+2.9%), Germany (+2.8%), France (+2.5%), Sweden (+1.7%) and the UK (+1.3%).

  In the US, markets opened positively with a very strong June non-farm payrolls boosting sentiment, but stubbornly high jobless claims data and another strong set of daily COVID-19 numbers in several key states slowly eroded gains as the day progressed and the S&P 500 closed up +0.5% which was close to its intraday low. Meanwhile, the NASDAQ 100 index (+0.5%) posted another fresh record high, the Dow Jones Industrial Average rose +92 points (+0.4%) to 28,827 and the Russell 2000 index (+0.3%) was the laggard.

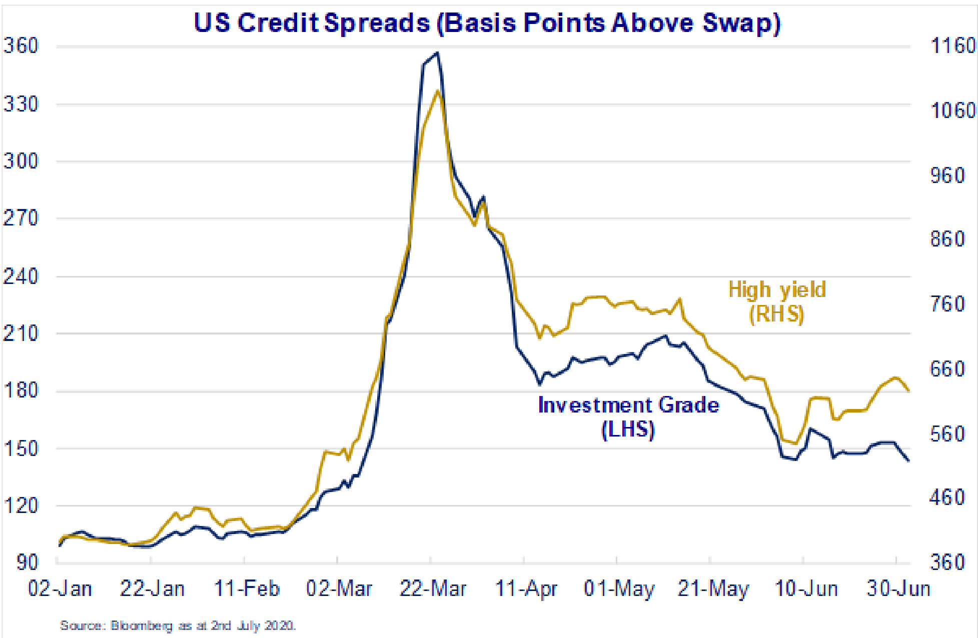
  So at present, the US market has recovered 78% of its March quarter loss, but the recovery in the US economy is likely to level off before too long as the easy labour market gains are being seen, the government is set to become a large drag and the private sector is not in a strong enough shape to fill the growth hole. As such, the earnings recovery should begin to flatten out to despite a V-shape currently being shown in our model (see chart).



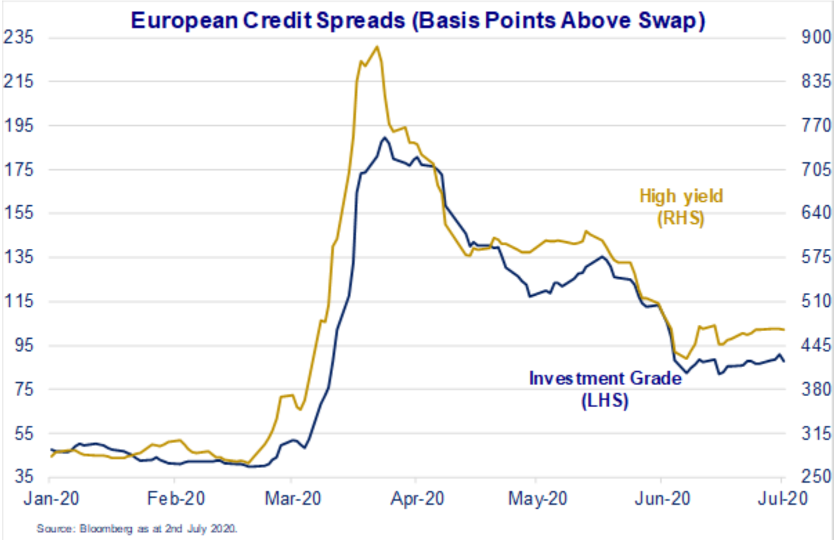
- The overnight moves saw the UK leave official bear market territory (see chart) and futures markets suggest gains at the bell in Sydney (+0.5%) and Tokyo (+0.5%).



- **CREDIT MARKETS**
  - Regional credit indices rallied overnight with spreads in the US investment grade universe declining -3 points to +144 bpts which increased the recovery rate to 84% from the March peak. The overnight decline meant the market has fully recovered the increase in risk premiums recorded in June, and spreads fell in all 11 sub-sectors led by energy (-5 points, +200 bpts, 89%) which responded positively to another rise in crude prices, telcos (-4 points, +165 bpts, 85%) and subordinated financials (-4 points to +178 bpts, 83%). In the high yield universe, spreads contracted for a third consecutive day, this time by -10 points to +628 bpts, which increased the recovery rate to 68%. Like their IG peers, all 11 sectors recorded lower risk premiums led by the cyclical sectors including industrials (-17 bpts, +748 bpts, 41%), tech (-13 points, +536 bpts, 62%) and energy (-13 points, +979 bpts, 87%).

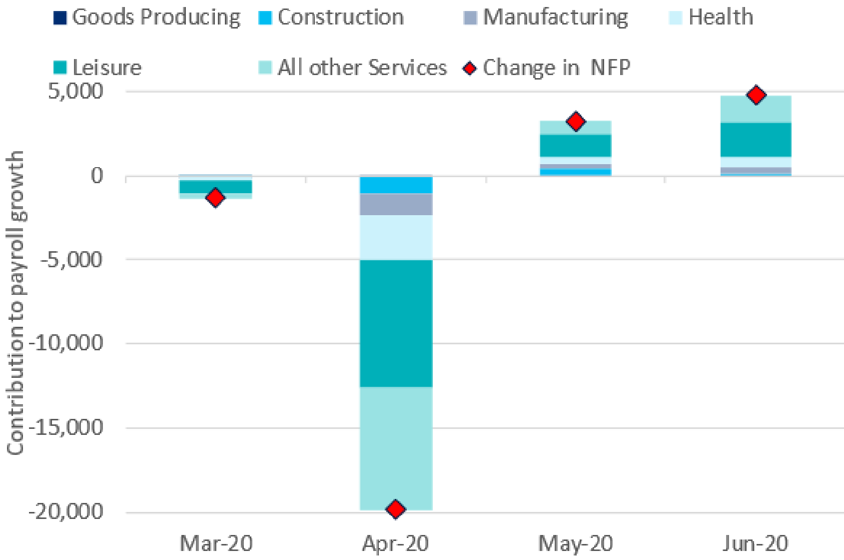


  - European credit markets rallied modestly overnight with the investment grade universe snapping a 3-day losing streak by contracting -3 points to +82 bpts which increased the recovery rate to 68%. Risk premiums declined in all 11 sub-sectors led by consumer discretionary (-4 points, +124 bpts, 67%), senior financials (-4 points, +72 bpts, 65%) and tech (-4 points, +47 bpts, 63%). In the high yield sector, spreads declined a disappointing -1 point (to +468 bpts, 68%) which suggests the lack of a central bank backstop is hindering the market's ability to fully recovery. Nonetheless, 10 of the 11 sub-sectors recorded lower risk premia led by consumer discretionary (-7 points, +571 bpts, 70%) and consumer staples (-6 points, +1474 bpts, 98%), but these capital gains were offset by a sharp rise in the senior financials spread (+35 points, 401 bpts, 68%) as investors took profits on their recent price appreciation.



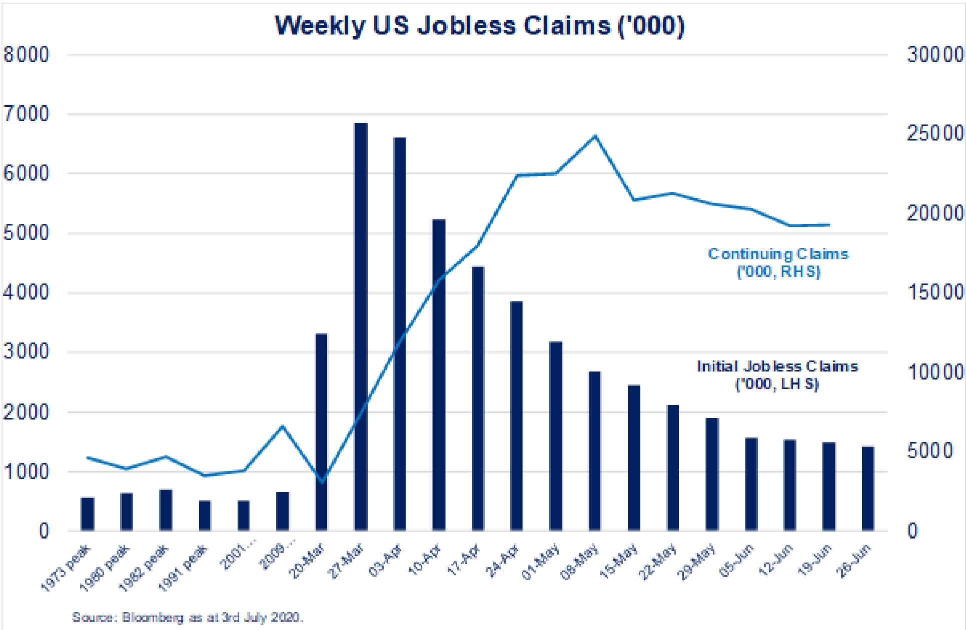
THE GLOBAL ECONOMY

- **The June US non-farm payrolls** detailed another strong +4.8 million rise in hiring after an upwardly revised +2.7 million gain in May, however investors should not be too excited about the rise as it partially reflected firms having to rehire workers by end-June to qualify for a waiver in relation to the repayment of government assistance. Among key industries, there was broad based improvements led by services where restaurants (+1.5 million) rose for a second consecutive month, retail (+740k) doubled its gains from May and healthcare (+358k) maintained its pace of recovery, but manufacturing (+356k) and construction (+158k) somewhat weaker than expected and government hiring was modest (+33k). Among the key metrics, the unemployment rate dropped by -2.2% to 11.1% despite a further recovery in labour force participation (+0.7% to 61.5% which has now reversed more than half its decline) and average hours (-0.6% to 34.7 hours) and earnings (-1.2% m/m) both fell due to the compositional shift in employment and the rehiring of the lower-wage workers.

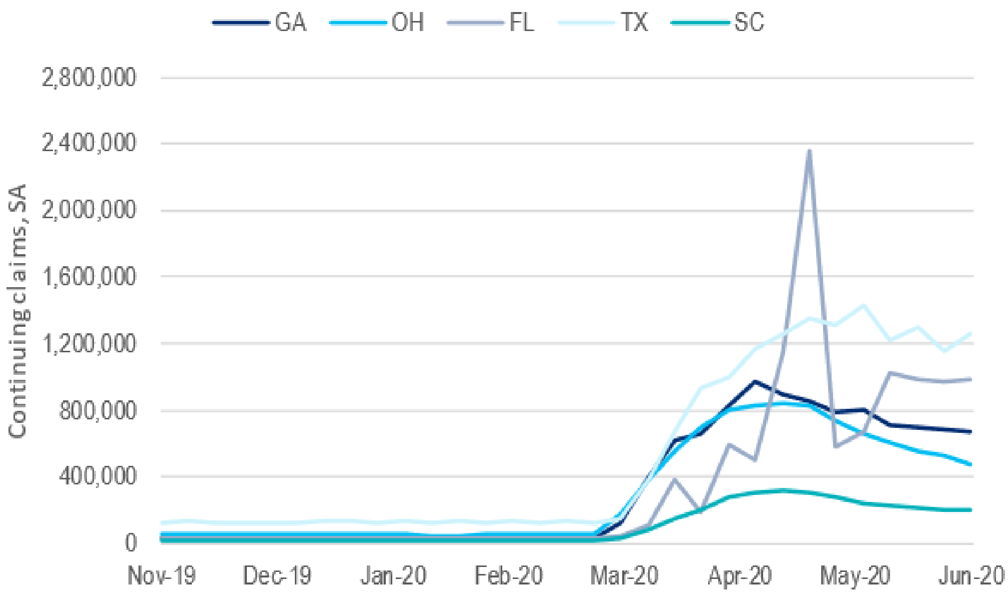


While the payroll increase was impressive and the largest on record, it must be remembered that total employment is down a massive -9.6% (or -14.7 million) since February and in some industries, the damage remains far worse. For example, leisure still has payrolls down -29% from its February trough, and many areas of retail show similarly large gaps. Importantly, the payrolls gains reflect a snapshot of the mid-month flurry of rehiring in restaurants and retailers and this was before these reopenings screeched to a half given rising COVID-19 numbers around the US which is likely to either slow or stall the rate of improvement. For policy, the stronger-than-expected jobs report reduces the likelihood and the size of further fiscal stimulus and it will encourage the Fed's 'patience'.

- A separate weekly report showed initial jobless claims remained very elevated at 1.43 million for the week ending 27th June which is still double the peak of previous recessions. Meanwhile, the number of continuing claims rose to 19.3 million in the previous week (see chart), was seems at odds with surging employment from the payrolls report, but a state breakdown shows that these claims fell in the median state.



As such, the nation-wide number was boosted by large increases in California (+150k) and Oregon (+147k), whereas early reopening states such as Texas (+110k) and Florida (+23k) moved sideways, whereas Georgia (-23k) and Ohio (-48k – see chart) declined further (see chart). Overall, it is hard to make sense of these statistics, given the disruptions from rule changes such as people not having to find work to receive benefits, others falling completely out of the labour market, and workers not knowing which box to tick if they have been displaced by COVID-19. Accordingly, claims might only become a better gauge of employment trends once extended unemployment benefits (an extra USD600 per week) expire at the end of July. In the meantime, we will watch for potentially rising initial claims in states which have partially closed to see how much the labour market recovery is impacted.



POLICY

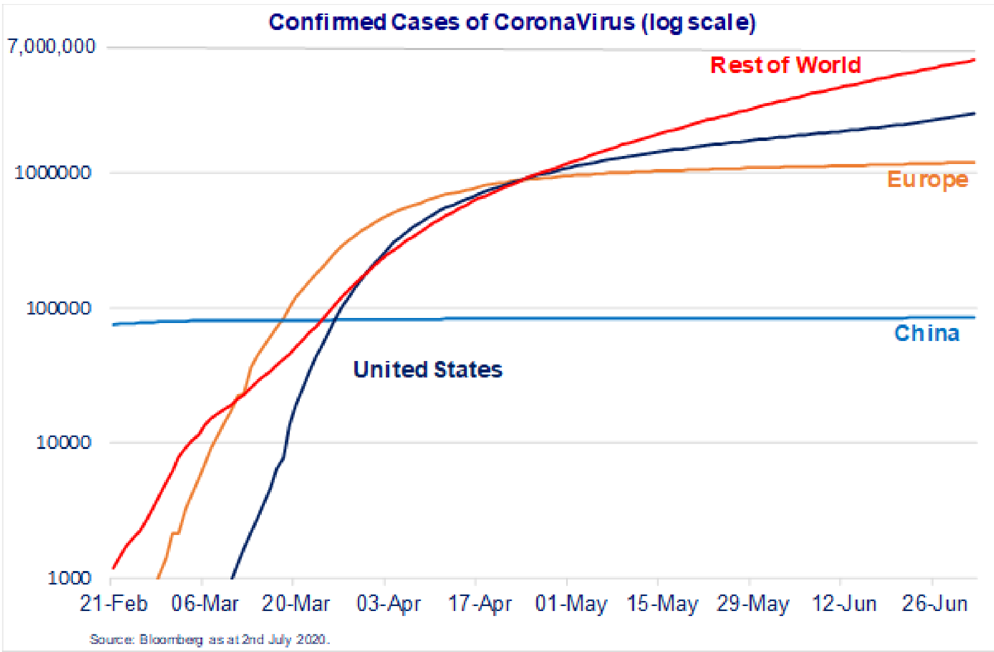
- Hong Kong police arrested more than 300 people after protesters defied new security laws imposed by China. Meanwhile, the US Senate passed a sanctions measure (approved yesterday in the House) that would penalise banks doing business with Chinese officials who implemented that national security law.

- Five US airlines (including American Airlines, Hawaiian Airlines, Sky West Airlines, and Spirit Airlines) struck agreements with the Treasury Department for portions of a USD25 billion in federal loans which have been provided to address balance sheet issues from the COVID-19 pandemic, with agreements for other airlines expected soon. In exchange for the funding, airlines were required to put up equity, warrants, or senior debt to compensate taxpayers.

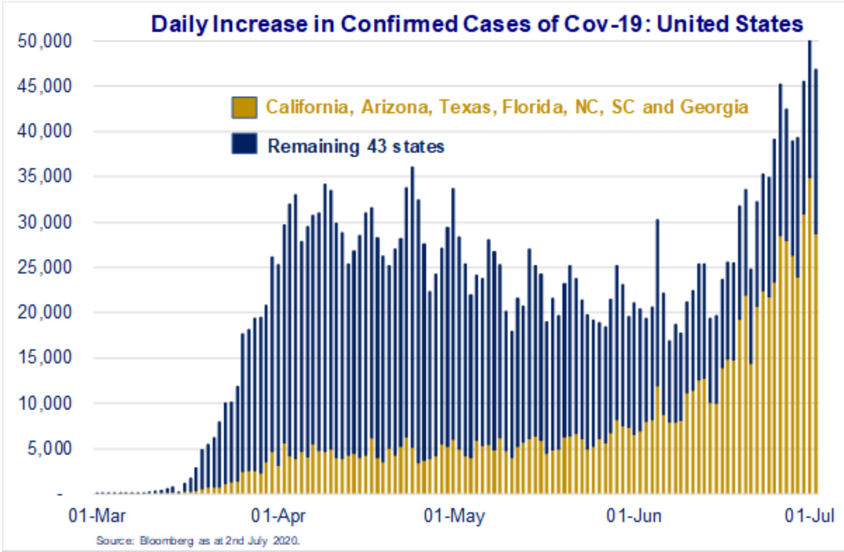
VIRUS UPDATE

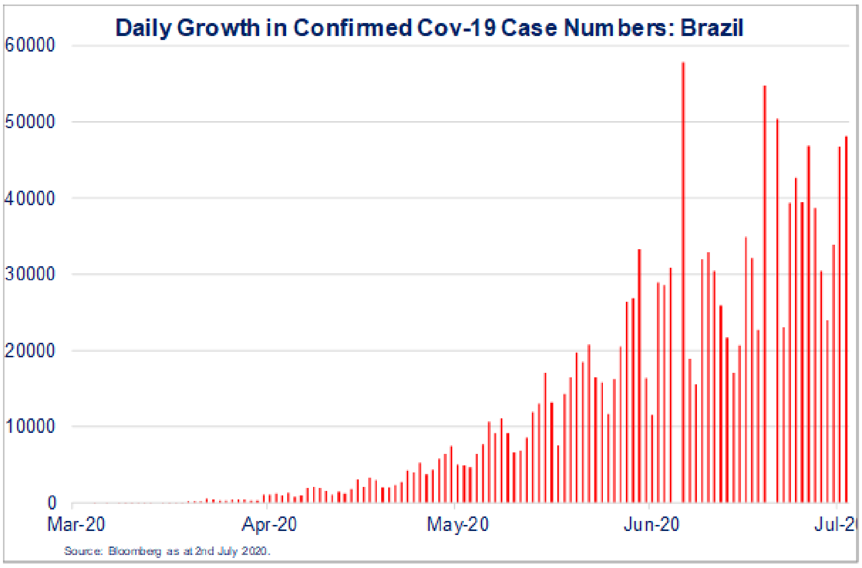
- Although final numbers are not in for another 5.5 hours, the number of global cases of COVID-19 was 10.84 million with +147k cases so far overnight (before Mexico and 5 US states report their numbers) which means that Thursday was the 35th occasion in the past 37 days where daily increases have topped 100k (and the other two were over 99k!). This means 4 countries have more than 600k cases, 14 countries have more than 200k cases and 20 countries have more than 100k cases (Colombia (102.3k joined this group overnight.

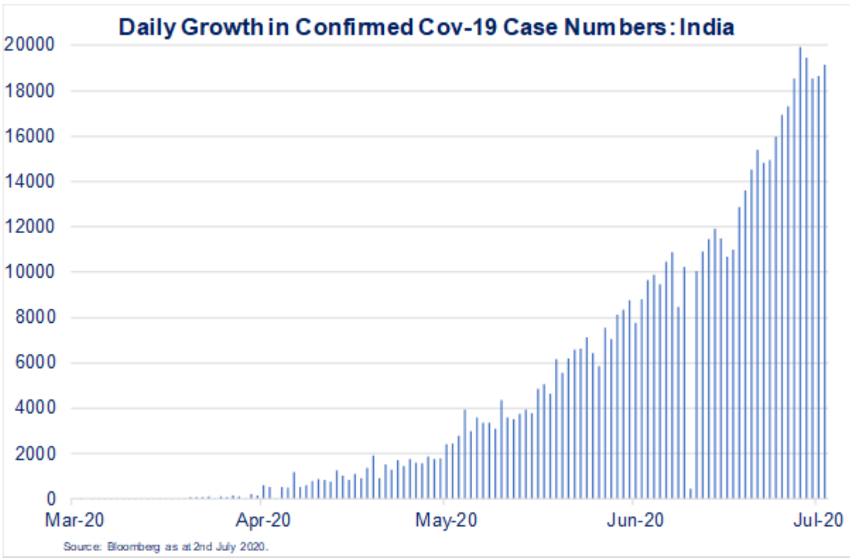
  It took 73 days to record 1 million cases, and after this each subsequent million has taken 13 days, 11 days, 12 days, 10 days, 11 days, 8 days, 8 days, 7 days and 6 days. In the past 4 days another +840k cases have been confirmed but more importantly, the growth rate of daily confirmed cases (+1.8% since Monday) is rising despite the large base. Meanwhile, deaths stand at 520.6k, with the US now over 125k (24.7% of global deaths even though they have only 4% of the global population), Brazil (61.9k), the UK (44.1k) and Italy (34.8k) all over 30k, with France (29.9k), Mexico (28.5k) and Spain (28.4k) over 25k, and the death rate dropped for a fifty sixth straight day to 4.80%.



- 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 (+109.5k to 6.9 million) and highest daily new cases (and by a considerable margin) followed by the US (+46.4k to 2.73 million) and Europe (+3.5k 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) and this saw 7 states overnight have record increases in cases including Florida (+10.1k to +169k) and Georgia (+3.4k to 87.7k). This means 44 of America's 50 states now have a virus reproduction rate above 1.0 and 12 have a rate above +1.5 which means it is spreading quite rapidly. Within the rest of the world, the three concerns here are Brazil (+48.1k (record high to +1.5 million, which is the second highest in the world), Russia (+6.8k to 653.5k, third highest) and India (+19.1k to 604.6k, fourth highest – see charts below).



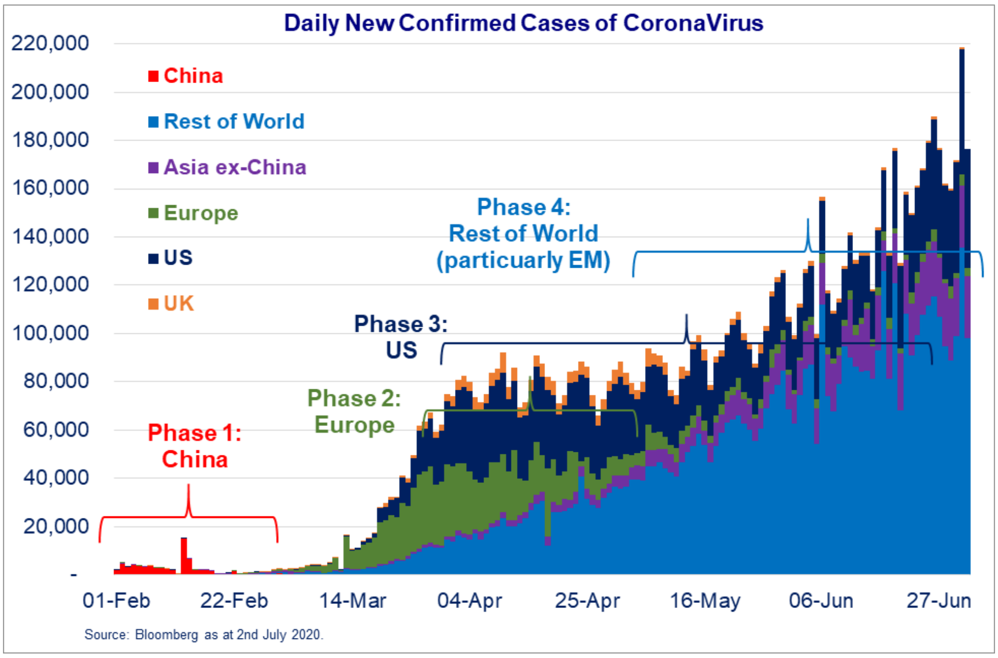




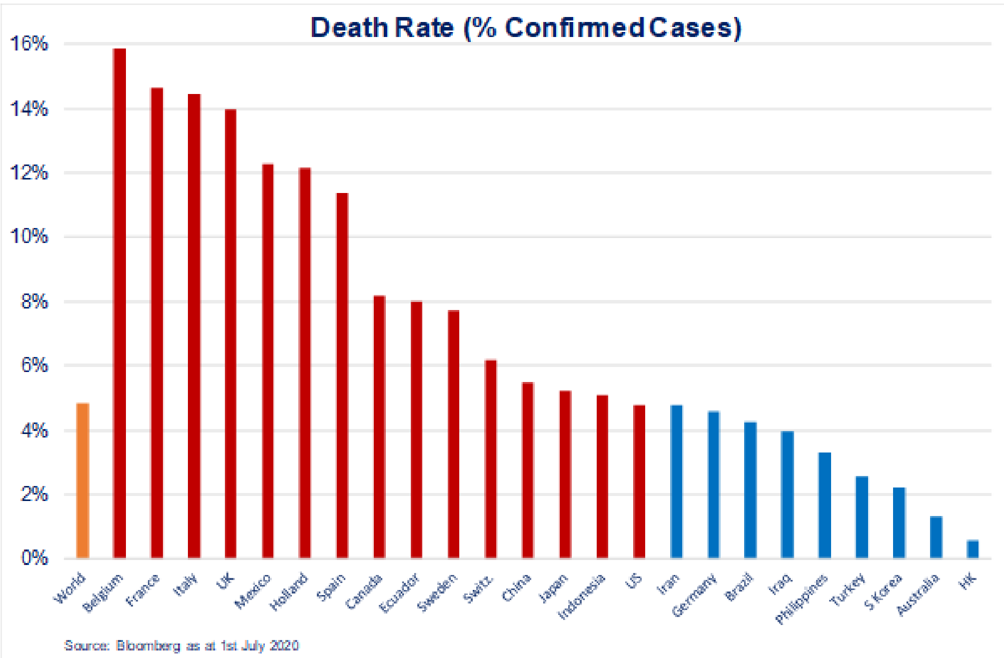
- Among countries, the most cases are in the US (+46.4k (so far, second highest) to 2.73 million), Brazil (+48.1k 1.50 million), Russia (+6.8k to 660.2k), India (+19.1k (third highest) to 604.6k), the United Kingdom (not reported, +285.3k), Peru (+3.5k to +292.0k), Chile (+2.5k to 284.5k), Spain (+0.4k to 250.1k), Italy (+0.2k to 241.0k), Iran (+2.7k to

232.9k), Mexico (not reported, +231.8k), Pakistan (+3.3k to +217.8k), France (+0.7k to 203.6k) and Turkey (+1.2k to 202.3k). Australia confirmed cases rose +81 to 8,001 yesterday which placed us 72nd in terms of total infections.

Elsewhere, Singapore recorded +0.2k new cases to 44.3k 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, but Indonesia (+1.6k (record high) to 59.4k) is now on the rise and has the most cases in the region, and the Philippines (+0.3k to 38.8k) is also on an upward trend.



- Although final numbers are not in until 1pm AEST, the global death rate declined for a fifty sixth straight day to 4.80% with the global total rising to 520.6k after another +3.9k deaths overnight. The US (+0.6k so far) has the most deaths at +128.7k, with Brazil (+1.3k to 61.9k), the UK (+0.1k to 44.1k), Italy (+0.03k to 34.8k), France (+0.01k to 29.9k) and Spain (+4 to 28.4k) all over +25k. The death rate is highest in European countries where the health systems had 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%).



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Yours sincerely,

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