Perpetual Investments

THOUGHTS ON THE MARKET

5th June 2020 - European policy makers over-deliver, but risk markets pause

SUMMARY

- The global sharemarkets took a breather overnight and in doing so broke a four-day win streak with investors potentially thinking the rally had gone too far despite new stimulus measures in Europe and some modestly encouraging economic data overnight. The recent market rally has pushed valuations to their highest since the dot.com boom in 2000 and moved technicals to over-brought levels. However, the overnight equity market losses were minor led by the US which dropped -0.3% which is a two-week low and most Northern Hemisphere markets joined in, but Asia rallied, and credit markets also continued their impressive rally.

  In other markets, 10-year Treasuries dropped sharply with yields up to 0.82% (10-week high) with the curve slope out to +0.68% (48-day high), gold fell -0.3% to USD1,714 per troy ounce, oil rallied +1.4% to USD37.33 per barrel and G10 currencies mostly rallied against the Greenback led by the Euro (+1.2%), AUD (+1.0% to 69.43 US cents) and Sterling (+0.2%), but the Yen (-0.2%) defied the broader trend for a fifth consecutive day.

- On the economic front, initial jobless claims data declined to 'only' +1.9 million suggesting that the economic damage is lessening, but the good news there was tempered by a rise in continuous claims to 21.5 million (mostly likely data noise) indicating that US unemployment will likely peak in May at just under 20%, but no one should under-estimate the challenge ahead as it may be 5 years before unemployment returns to pre-COVID-19 levels.

- In policy land, the European Central Bank made sure that it over-delivered on its asset purchase program which was boosted by €600 billion and extended to mid-2021 with maturities to be reinvested until end-2022. Meanwhile, the German coalition government agreed on a €130 billion fiscal stimulus including an immediate (but temporary) reduction in its Value Added Tax and additional infrastructure spending which is a good choice as it will have large multiplier effects in a recovery whereas cash payments do not.

- Although final numbers are not in for another 3.5 hours, the number of global cases of COVID-19 stands at 6.59 million with another +86.8k cases so far overnight (before Brazil, Mexico and some US states report their numbers) which means that Thursday was the 65th occasion in the past 66 days where daily increases have topped 70k, and it is likely to be the eighth day in the last 9 where cases have topped 100k). This means 3 countries have more than 400k cases, 7 countries have more than 200k cases, 14 countries have more than 100k cases, and 57 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, ten for the fifth million and 11 for the six million, and in the past 5 days another 591k cases have been confirmed. That said, the growth rate of daily confirmed cases is trending lower (+1.8% since Monday), deaths stand at 388.5k and the death rate dropped for a twenty ninth straight day to 5.74%.

FINANCIAL MARKETS

- **EQUITIES**
  - The MSCI World Index snapped a four-day win streak and closed -0.2% lower. There was mixed performance across the sectors with financials (+1.1%) the only sub-sector to rise as investors responded positively to re-opening efforts and a sizable steepening in the US yield curve (which is constructive for margins). The remaining cyclical sectors which have rallied strongly of late, took a break but losses here were minor with consumer discretionary (-0.5%) and energy (-0.4%) giving back only one-twentieth of their recent 8-session rally. The decline in cyclicals was not offset by defensive asset classes all of which declined led by healthcare (-0.8%) and utilities (-1.6%). The movements overnight kept financials (-20.9%)

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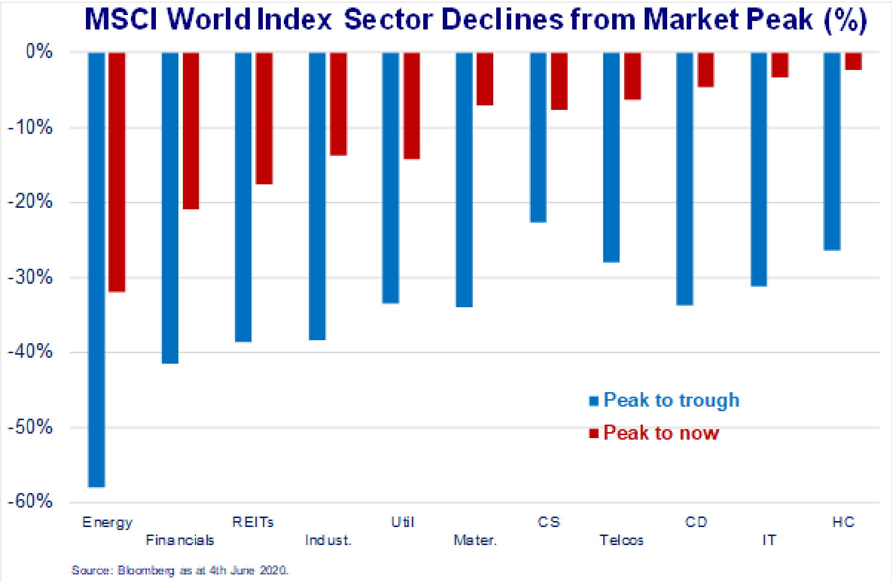
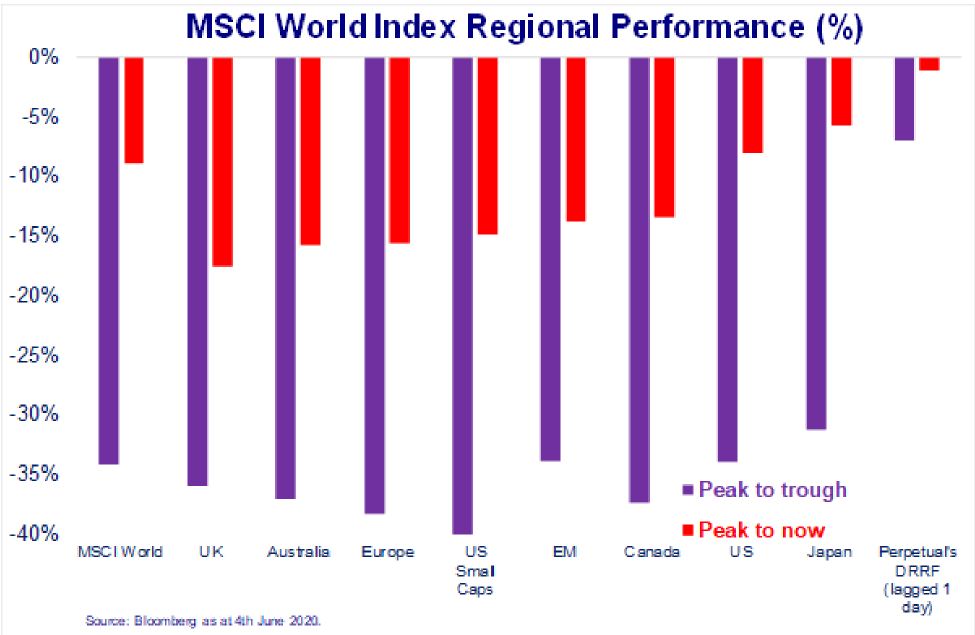
and energy (-31.9%) in bear market territory, but elsewhere sectors have recovered more than half of their losses (see chart).



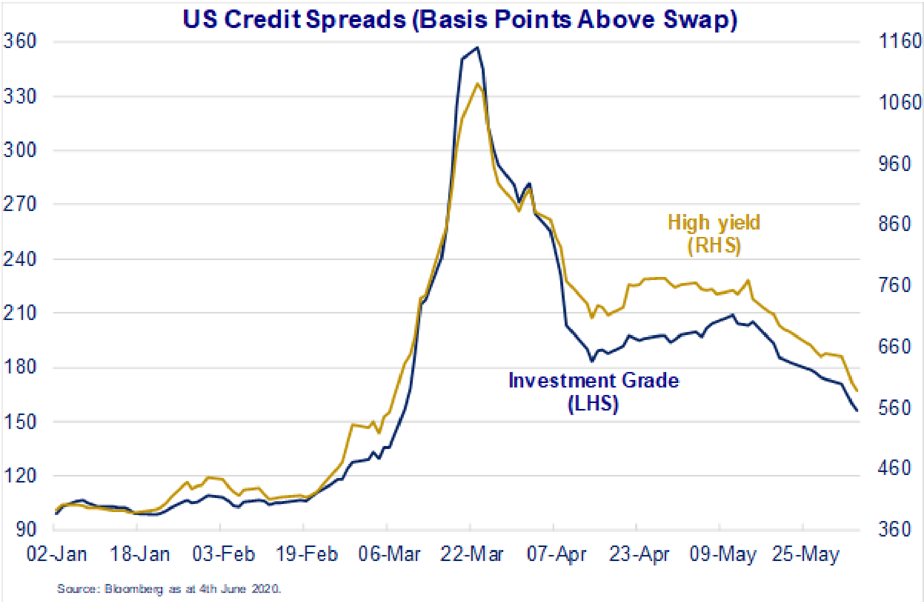
- Among the regions, losses were led by Europe (-0.3%) despite the ECB beating expectations by adding another €600 billion to its asset purchase program and Chancellor Merkel boosting fiscal support by €130 billion in a new stimulus package. The overnight decline is a sign that the rally may have become over-extended with regional losses led by Spain (+0.8%), the UK (-0.6%) and Germany (-0.4%), but other markets such as Italy and Portugal were unchanged on the day.

  The broad US sharemarket followed the weak Europe lead and closed -0.3% lower as large cap tech lagged with the NASDAQ off -0.6%, but the small cap Russell 2000 was steady, and the Dow Jones inched out a 12-point rise (+0.1%) to 26,282. The move in the S&P500 took the 50 trading day return to +37.7% which is the largest 10 week rally in the history of the US sharemarket and on every other occasion where the market rise had been over 25%, the US market has always been higher in six and twelve months' time. Indeed, the average six-month return was +10.2% while average one-year return was +17.3%.

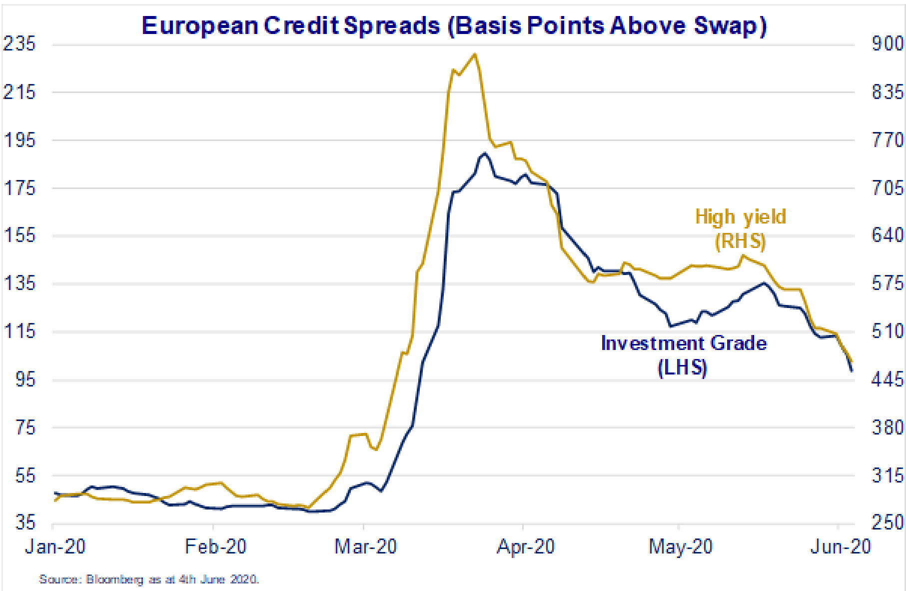
  Earlier in Asian trading the MSCI Asia Pacific Index was +0.4% higher with gains in Australia (+0.9%), Japan (+0.4%) and Hong Kong (+0.2%) offset by a modest decline in China (-0.04%). The overnight moves meant the UK (-17.6%) is the worst performing market during the crisis and recovery closely followed by Australia (-15.8%) which is not surprising as they have very similar index compositions. Futures markets suggest losses at the bell in Japan (-0.2%), Australia (-0.3%), China (-0.3%) and Hong Kong (-0.4%).



- ## CREDIT MARKETS
  - Regional credit indices defied the equity weakness and rallied strongly overnight with spreads lower in every market and every sector. In the US investment grade space, spreads contracted a further -4 basis points to +156 bpts (12-week low), which increased the recovery rate to 79%. The risk premium decline was universal and led yet again by cyclical sectors including subordinated financials (-6 points, +195 bpts, 77%), energy (-6 points, +210 bpts, 86%) and senior financials (-5 points, +142 bpts, 75%). In the high yield space, spreads came in a further -12 points to +589 bpts (see chart), which increased the recovery rate to 74%. Like in the IG space, it was the previously unloved cyclicals which led risk premiums lower led by industrials (-26 points, +677 bpts, 52%), materials (-18 points, +499 bpts, 72%) and subordinated financials (+17 points, +643 bpts, 55%).



  - European credit markets were also upbeat with spreads in the investment grade space down a further -7 points, to +99 bpts (11-week low) which took the recovery rate up to 61%. Risk premiums declined in every sub-sector led by consumer discretionary (-12 points, +129 bpts, 65%), senior financials (-8 points, +106 bpts, 61%) and energy (-8 points, +86 bpts, 58%) which was supported by a further modest rise in the crude price. In the high yield space, spreads came in another -12 points to +469 bpts (12-week low), which increased the recovery rate to 68%. Among the sub-sectors, the strongest decline was in healthcare (-26 bpts, +302 bpts, 73%) which had lagged the cyclical sectors of late, but they were not to be denied with consumer discretionary (-24 points to +578 bpts, 69%) and senior financials (-15 points +438 bpts, 61%) benefiting from increased investor risk appetite.



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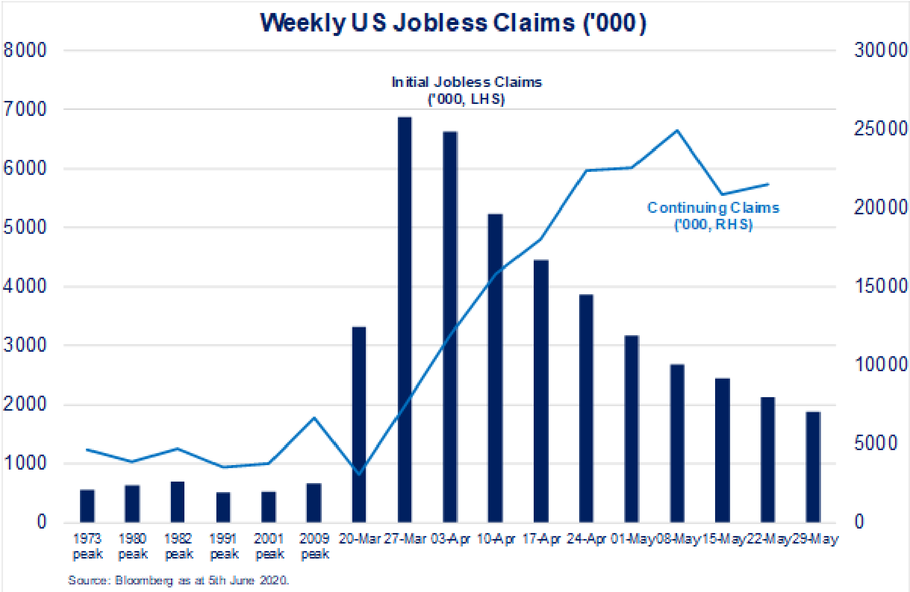
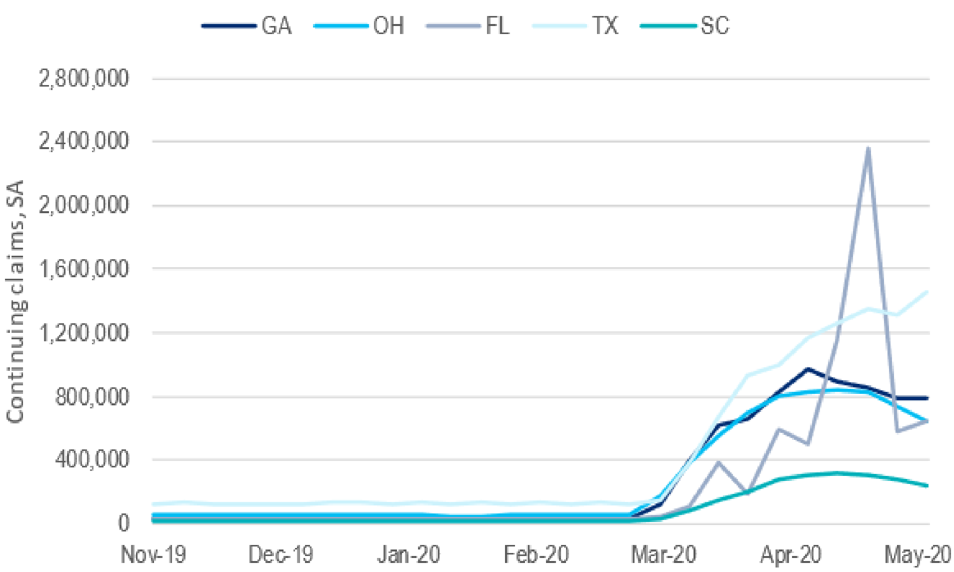
THE GLOBAL ECONOMY

- **US weekly initial jobless claims** declined to 1.88 million for the week ending 29th May, which was above consensus (1.8 million) for a 11th straight week and brought the total claims increase since the beginning of lockdowns to 42.6 million. During the week of May 16th, 10.7 million people continued to claim Pandemic Unemployment Assistant (PUA), up from 7.7 million during the week of May 9, but most of these are unlikely to show up as a reduction in payrolls as by definition they do not qualify for standard unemployment benefits.



In relation to tonight's non-farm payrolls, continuing claims is the more important indicator to watch as initial claims tend to overstate the number of people who are unemployed as there are duel filings for those with more than one job. The peak in continuing claims is a first sign that the economy is transitioning from net job losses to net job gains as businesses reopen and rehire displaced workers. While continuing claims surprisingly rose +650k last week to 21.5 million given continued reopening of state economies, but it remained below its early May peak which suggests that re-hiring activity has picked up. There was mixed reporting around early re-opening states with Florida up +80k after a decline of -1.8 million on the prior week, whereas Ohio (-90k after -70k) and South Carolina (-20.1k, -15k) declined for a third week, but Texas (+157k, -28k) rose for a ninth week of the last ten (see chart), so there is no universal trend at present.

The May non-farm payrolls released tonight will show job loss of around -8.3 million and a likely peak of unemployment at 18.8%, but there is much uncertainty here as some businesses are still laying off employees while some others start rehiring. Lower continuing claims over the coming weeks will further confirm our base case that unemployment peaked in May but no one should underestimate the challenge ahead as it may be 5 years before unemployment returns to pre-COVID-19 levels.



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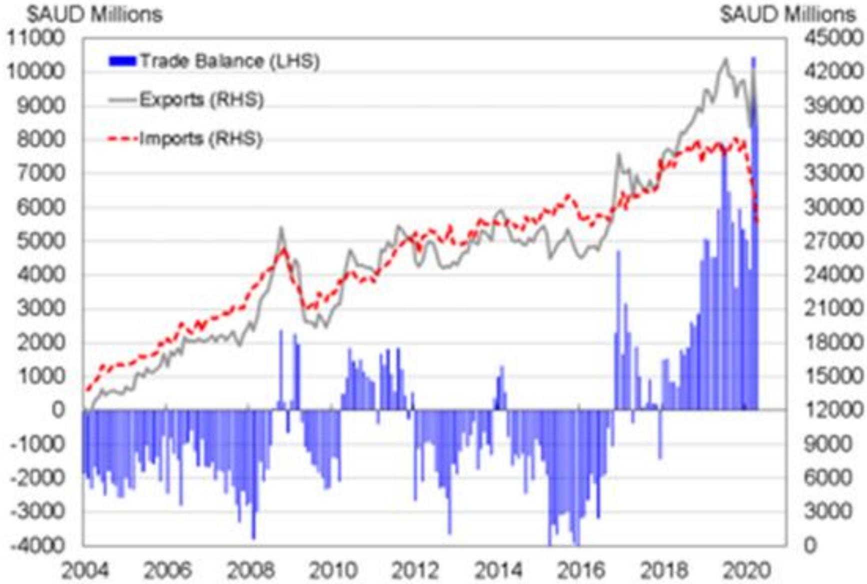
- Australia's trade balance declined by -AUD1.6 billion to a surplus of AUD8.8 billion and both exports (-11%) and imports (-10%) dropped sharply (see chart). Among the export components there was an untick in rural goods exports (+0.9% m/m) but this was more than offset by a sharp decline in non-rural exports (-8.0% m/m – which partially reversed the sharp increase of +12% the month prior) but amazingly, services exports only declined by -13% which is stunning considering Australia had implemented tight border closures with only Australians allowed in to the country.



Source: ABS and Citi Research

On the import ledger, intermediate imports fell by -4.9% m/m and services collapsed -42.5% m/m, but this was partially offset by a rise in consumption goods (+4%) and capital goods (4.3%). Despite the positive trade balance which is expected to persist and contribute positively to GDP, overall two-way trade (exports & imports) is down by almost -15% compared to the end of 2019. Looking ahead, we should see the trade surplus persist in the coming months, but exports are likely to decline by -15% in 2020 and imports by -17%, so the trade balance is likely to decline.

- In other news, European retail sales came in much better than expected in April at -11.7% m/m although it was still stronger than the March result. This pulled the annual rate down to -19.6% y/y.

POLICY

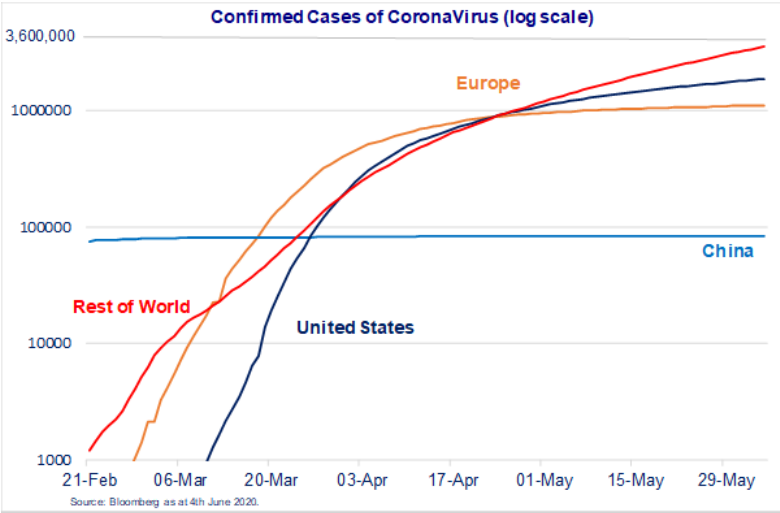
- At its June policy meeting, the ECB governing council boosted its Pandemic Emergency Purchase Program (PEPP) by €600 billion which was more than street estimates (€500 billion) and extended the program until June 2021 (end-2020). In addition, maturing securities under its PEPP will be reinvested until at least the end of 2022. As expected, the committee left its key deposit rate unchanged at -0.5%, while guiding for rates at present or lower levels until it meets its inflation aim (which it has not met since 2003).

- The German coalition government agreed on a €130 billion fiscal stimulus (the street was at €90 billion) package to boost consumer spending and business investment. The package included an immediate but temporary reduction in the Value Added Tax and some infrastructure spending with funds allocated to build out its 5G data networks, improve railways and doubled incentives for electric vehicles. The positive part of the Budget boost was the spending on infrastructure which has largely been ignored by Government's in 2020 and these are important as they can have large multiplier effects in a recovery whereas cash payments do not

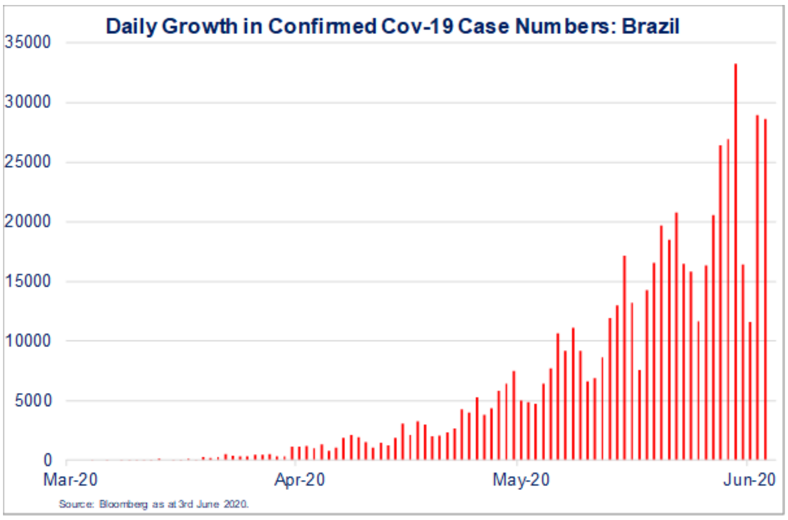
- Bloomberg reported White House is targeting up to $1 trillion for a fifth coronavirus support package, but Republican Senate Majority Leader McConnell does not want the bill to exceed that target. However, the planned meeting this week to discuss stimulus has been postponed given the focus on civil unrest. House Democrats already passed a USD3.5 trillion bill that included another round of USD1,200 stimulus checks, an extension of enhanced unemployment benefits, and nearly USD1 trillion for state and local governments, but this will be voted down by the US Senate.

VIRUS UPDATE

- Although final numbers are not in for another couple of hours, the number of global cases of COVID-19 stands at 6.60 million with another +86.8k cases so far overnight (before Brazil, Mexico and some US states report their numbers) which means that Thursday was the 62nd occasion in the past 63 days where daily increases have topped 70k and is also likely to be the eighth day in the last 9 where cases have topped 100k). This means 3 countries have more than 400k cases, 7 countries have more than 200k cases, 14 countries have more than 100k cases (Mexico joined this group yesterday), and 57 over 10k (Nigeria, Serbia and Armenia joined this group overnight). 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, ten for the fifth million and 11 for the six million, and in the past 5 days another 591k cases have been confirmed. That said, the growth rate of daily confirmed cases is trending lower (+1.8% since Monday). Meanwhile, deaths stand at 388.5k, with the US now over 100k (28.6% 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 twenty ninth straight day to 5.74%.



- 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 (+51.9k to 3.53 million) and highest daily new cases (and by a considerable margin) followed by the US (+18.6k to 1.87 million) and Europe (+3.4k to 1.1 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 (not reported, +584.0k, which is the second highest in the world), Russia (+8.8k to 440.54k, third highest) and India (+9.9k (record high) to 226.7k, seventh highest).



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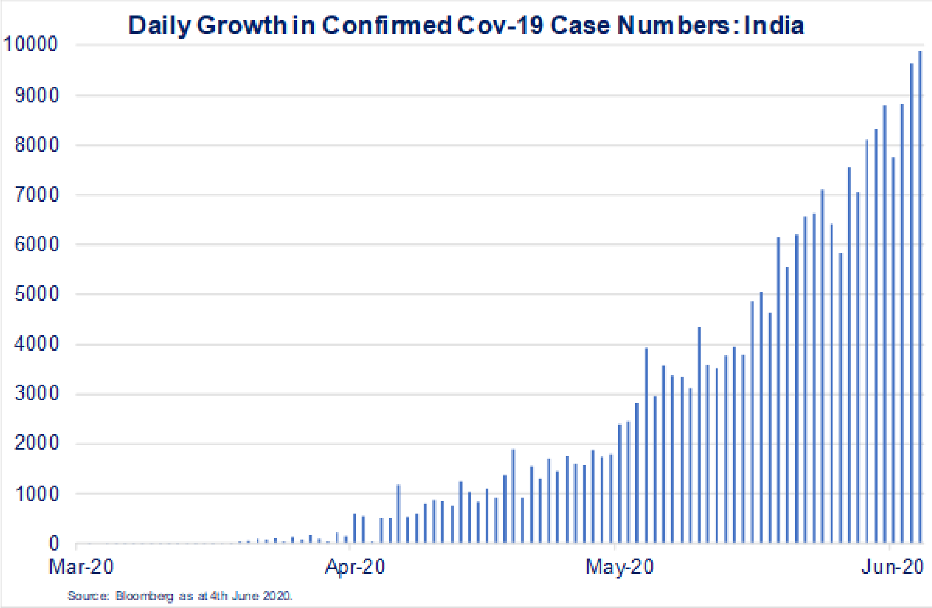
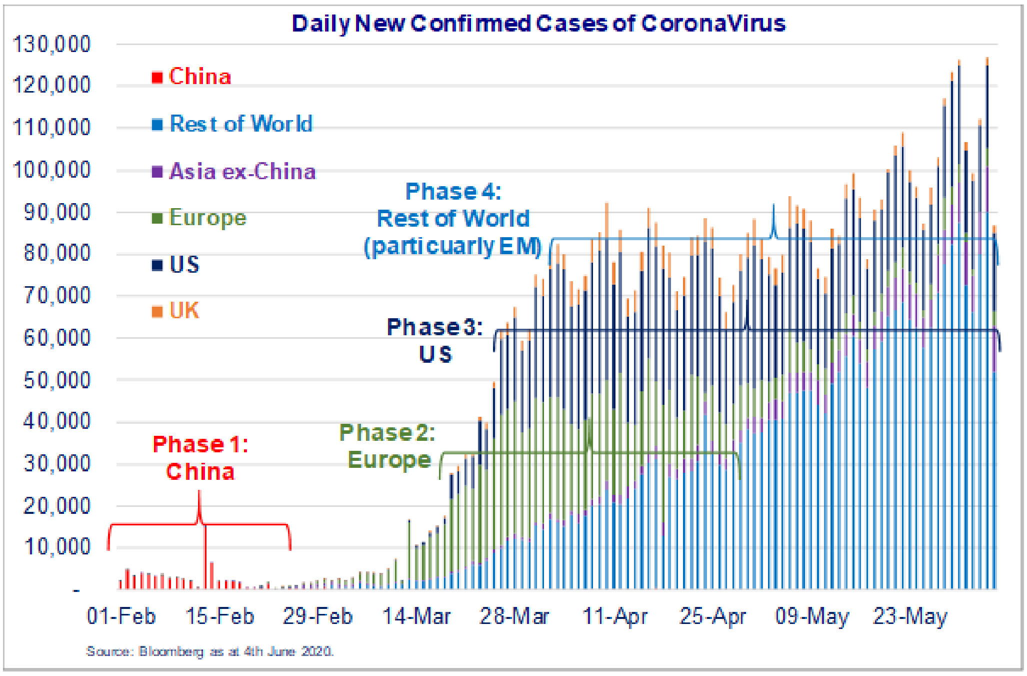
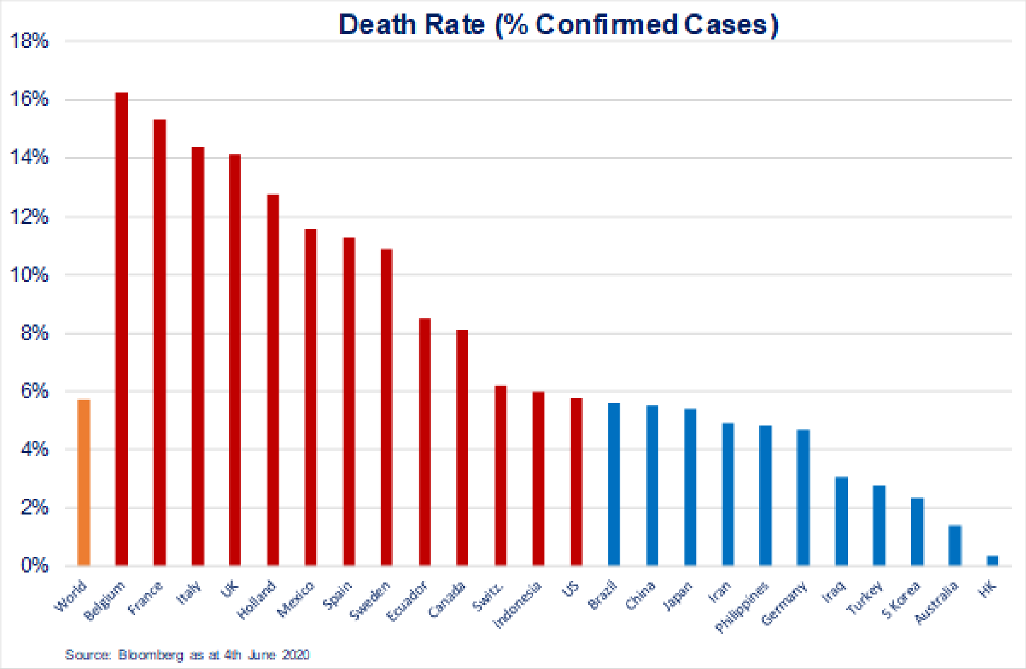


- Among countries, the most cases are in the US (+18.6k (so far) to 1.87 million), Brazil (not reported, 584.0k), Russia (+8.8k to 440.5k), the United Kingdom (+1.8k to 283.1k), Spain (+0.3k to 240.7k), Italy (+0.2k to 234.0k), India (+9.9k (record high) to 226.7k), France (+0.8k to 189.6k), Germany (+0.4k to 184.5k), Turkey (+1.0k to 167.4k), Peru (+0.2k to 183.2k) and Iran (+3.5k (record high) to 164.3k) and Australia confirmed cases rose +3 to 7,195 yesterday which placed us 63rd in terms of total infections.

  Elsewhere, Singapore recorded +0.5k new cases to 36.9k 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 (+0.6k) to 28.8k) and the Philippines (+0.6k to 20.4k). 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 twenty ninth straight day to 5.74% with the global total to 388.5k. The US (+0.9k) has the most deaths at +108.1k, with the UK (+0.2k to 40.0k), Italy (+0.1k to 33.7k), Spain (+5 to 27.1k) and France (+0.04k to 29.1) all over +25k. The death rate is highest in European countries where the health systems have collapsed led by Belgium (steady at 16.2%), France (steady at 15.3%), Italy (steady at 14.4%), the UK (steady at 14.1%), the Netherlands (-0.1% to 12.7%), Sweden (-0.2% to 10.9%) and Spain (-0.1% to 11.3%). However, several emerging markets are now on the leader board including Mexico (+0.4% to 11.6%), Ecuador (steady at 8.5%), Indonesia (-0.1% to 6.0%) and Brazil (steady at 5.6%).



Yours sincerely,

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