Perpetual Investments

THOUGHTS ON THE MARKET

7th September 2020 -
The US labour market recovery is not as good as the headline suggests

SUMMARY

- Global risk markets solid off on Friday, led by declines in growth and momentum stocks, but the US market finished well off its session lows, suggesting that investors are somehow seeing opportunities in megacap tech stocks even though valuations remain very elevated. In other markets, EM fell for a third straight session and European and Asian shares slumped. The market drop took the focus off the August US non-farm payrolls report where the headline number was in line with the street, but its composition revealed some concerns about the nature of the labour market recovery

  In other markets, 10-year US Treasuries rose +8 points, with sizable curve steepening given a sharp reduction in US unemployment, commodities were mixed with gold (+0.2% to USD1,934 per troy ounce) outperforming oil (-3.9% to USD39.77 per barrel) which closed at an 8-week low, and G10 currencies were little moved against the Greenback with modest appreciations in the Yen, Euro and Sterling (all +0.2%), whereas the Australian Dollar (-0.2%) defied the regional trend and closed lower.

- The US labour market recovery both continued and it continued to slow in August with payrolls up +1.37 million, official unemployment declined to 8.4%, average hourly earnings growth was solid at 0.4% m/m and the average work week increased to 34.6 hours. While the headline summary sounds impressive, there are several are warning signs around the nature of the labour market recovery and what's ahead in that private sector payrolls (+1.03 million) continued to slow with 10.7 million workers still dislocated, despite the rapid increase since April. In sectors where activity has been robust and less impacted by mobility restrictions, anaemic payrolls growth suggests that firms either see recent activity as unsustainable, or are seeking ways to boost productivity, which indicates that a complete activity recovery is not aligned with a complete labour market recovery. Importantly, the number of permanent layoffs increased (+534k) and while this may be modest relative to the US labour force (around 160 million), if this trend continues the temporary damage from COVID-19 and mobility restrictions could become permanent, which would limit the speed of the recovery.

- The number of global cases of COVID-19 is 26.98 million with another +189.6k cases so far (but Brazil, Ecuador, France, Italy and Mexico and 8 US states have not reported their numbers) which means that Tuesday is set to be the 48th consecutive day where daily increases are greater than 200k. At present, 8 countries have more than 500k cases, 21 countries have more than 200k cases and 29 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, 6 days, 5 days, 5 days, 5 days, 4 days, 5 days, 3 days, 4 days, 4 days. 4 days, 4 days, 4 days, 4 days, 4 days, 4 days and 4 days. More importantly, the growth rate of daily confirmed cases (+1.0% since Thursday) is once again coming down. Meanwhile, deaths stand at 881.3k and the death rate has declined to 3.27% although the number of daily deaths remains elevated.

FINANCIAL MARKETS

- **EQUITIES**
  - **The MSCI World Index closed lower (-1.1%) for a second straight session on Friday night and in doing so locked in its worst weekly decline in the past 10 weeks, with ten sectors closing lower.** The market was led lower by growth and momentum names with losses led by communication services (-1.9%) as Google (-3.0%) and Facebook (-2.9%) continued to move lower, whereas softness in Microsoft (-1.4%) saw IT (-1.6%) record back-to-back losses for the first time in four weeks. Meanwhile, declines in Amazon (-

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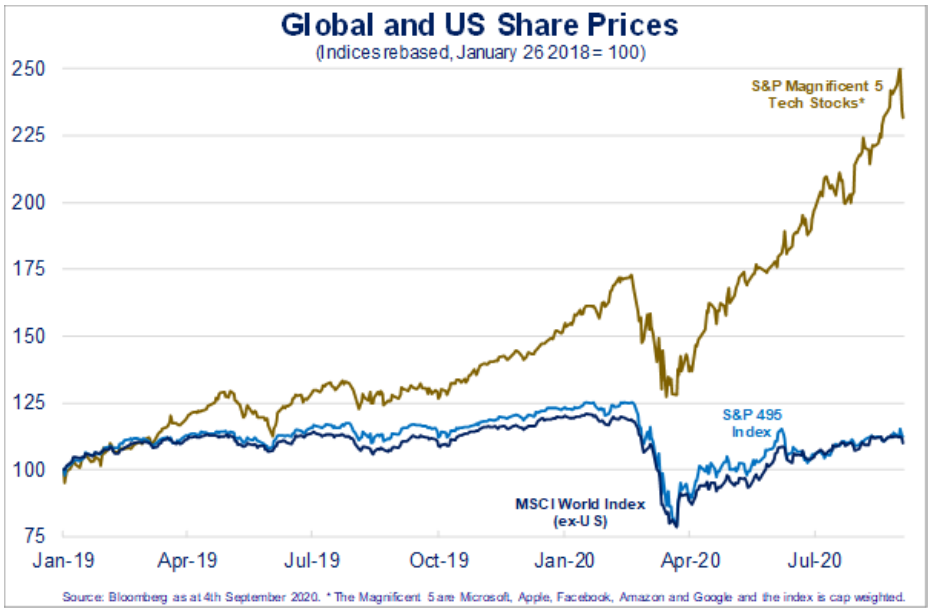
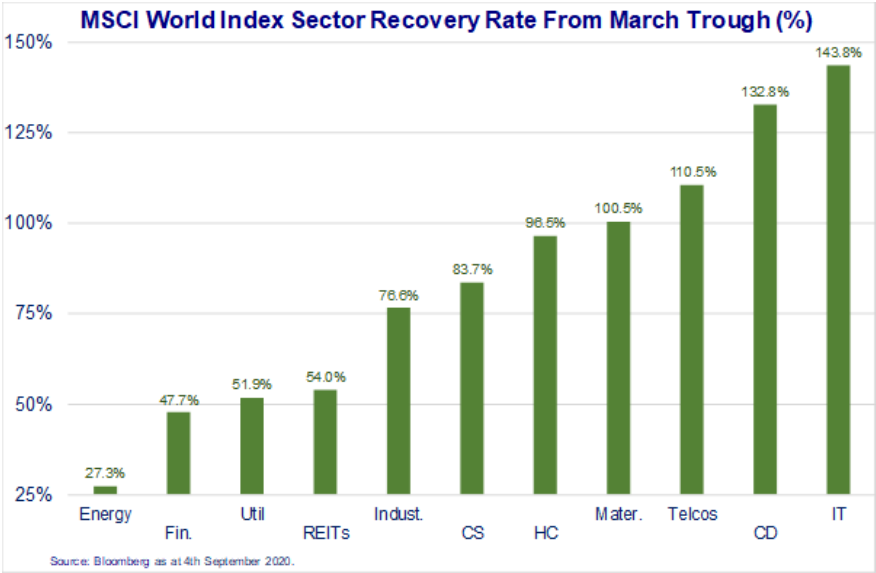
2.2%) led consumer discretionary (-1.0%) lower and took the two-day loss for our Magnificent 5 tech stock index to -7.4% (see chart). Outside these 5 stocks the remaining S&P495's recovery rate from its February peak has slipped six percentage points to 71.9%, which is very similar to the MSCI World ex-US (74.0%). The catalysts for the tech sell off have included unsustainable valuations and crowded positioning, but an FT article that Softbank purchases of stock options had 'juiced-up' the recent rally certainly didn't help cushion the downside.



- **The primary difference for Friday's performance relative to the previous session was a clearer rotation toward cyclical names,** most of which still declined but considerably less than the tech-exposed sectors and less than Thursday's decline. Indeed, sectors such as industrials (-0.3%) and materials (-0.2%) beat the market tape, but energy (-0.7%) continued its 5-day losing streak with the sector now down -10.0% in the past 17 sessions, within which is has declined on 15 occasions. The one bright spot was financials (+0.1%) which was boosted by the steepening US yield curve which sparked gains in regional and money-centre banks.

  By the close of trading for the week, the recovery rate of energy (with a peak to now decline of -42.2%) declined to 27.3%, where healthcare (99.1%) fell below the complete recovery level and REITs (-17.8% from February) moved closer to bear market territory, with the recovery rate declining to 54.0% (see chart).



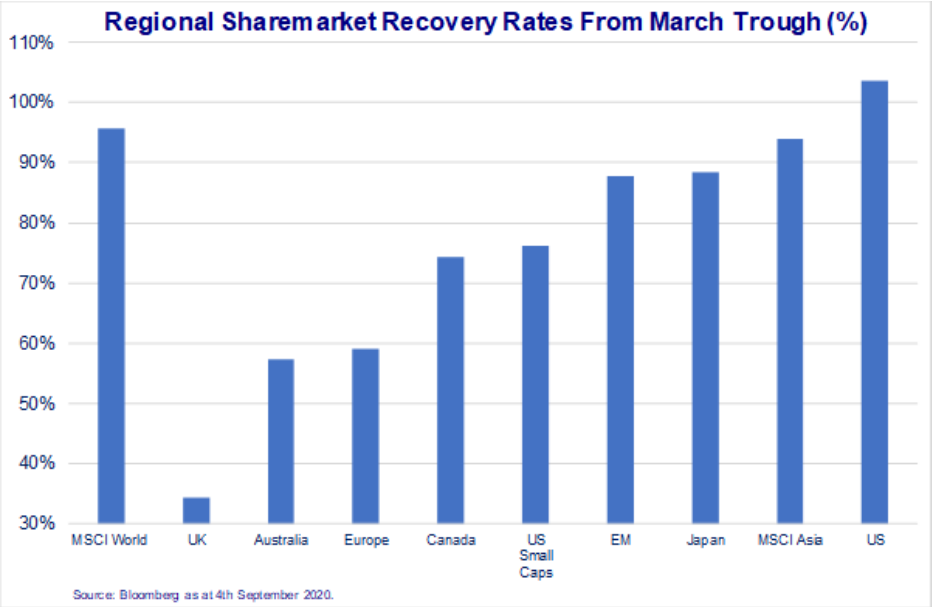
- **Among the regions, the losses were steepest in Asia (-1.3%)** with markets down across the board for the first time in over a month. The broad weakness reflected the US decline on Thursday, which sparked concerns this is the start of a phase rather than a one-off, thereby placing timing into the mix of the recent

"buy the dip mantra" from sell-side analysts. There was no macro data of note, but newswires were drowned in articles discussing the implications of US-China tensions, but nothing here changed the market narrative. Meanwhile, in COVID-19 news, there were falling case trends in Australia, Japan, South Korea and New Zealand. By the closing bell in Mumbai, the regional weakness was most acute in Australia (-3.1%), which saw major losses in almost every sector, with India (-1.6%), Hong Kong (-1.3%), Japan (-1.3%), South Korea (-1.2%) and Japan (-1.2%) all scoring century losses. where mainland China (-0.97) and Taiwan (-0.94%) just missed out.

Europe (-1.3%) followed the negative lead from Asia, and the US declines on Thursday, and closed out its worst daily decline in five weeks. The losses were clearly US driven, but regional data did not soften the impact with German factory orders rising for a third straight month, but they fell short of expectations (+2.8% m/m against the street at +5.0% m/m) as did the German construction PMI (48.0 versus 49.1) which exhibited a smaller amount of contracting firms. Meanwhile, BOE committee member Saunders said its likely additional easing will be needed in a sign that the recovery lacks voracity. There wasn't much else and by the closing bell, there were losses in Germany (-1.7%), France (-0.9%), the UK (-0.9%), Italy (-0.8%), Switzerland (-0.7%) and Spain (-0.2%), but Sweden (+0.1%) defied the regional pessimism and closed higher.

The US market (-0.8%) also closed in the red, although it was well off its worst levels of the day (-2.5%) as growth and momentum names clawed back some ground in afternoon trading. The Friday loss reflected ongoing concerns about crowded positions and stretched valuations and took the focus off the highly anticipated August non-farm payrolls report where the headline employment growth (+1.37 million) was fractionally below consensus (+1.40 million) and unemployment fell sharply (8.4%), although the composition detailed a less egregious recovery. Meanwhile, US Senate Majority Leader Mnuchin and House Majority leader Pelosi have agreed to focus on a clean stopgap measure to avoid risk of another government shutdown. That was about it and by the closing bell at the NYSE, declines in growth and momentum stocks saw the NASDAQ 100 (-1.3%) lead the pace of losses for a second straight session (although it was down -5.0% at one stage), with the S&P 500 (-0.8%) underperforming the Russell 2000 (-0.6%) and the Dow Jones (-0.6%, -159 points, 28,133).

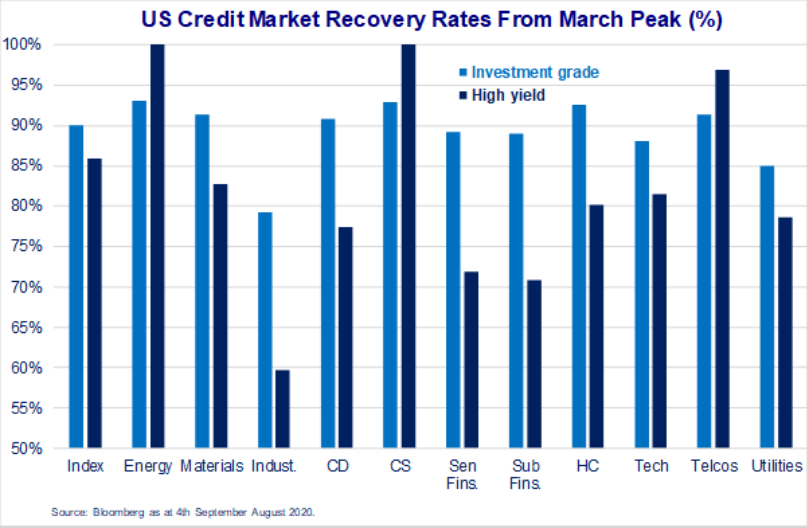
By the close of trading for the week, the UK (with a peak-to-now decline of -23.6% fell deeper into bear market territory and) saw its recovery rate slip to just 34.4%, whereas the US small cap space slipped back into correction territory as its recovery rate declined to 76%, with the 96% figure for the MSCI World Index indicating that it now sits below its February peak (see chart).



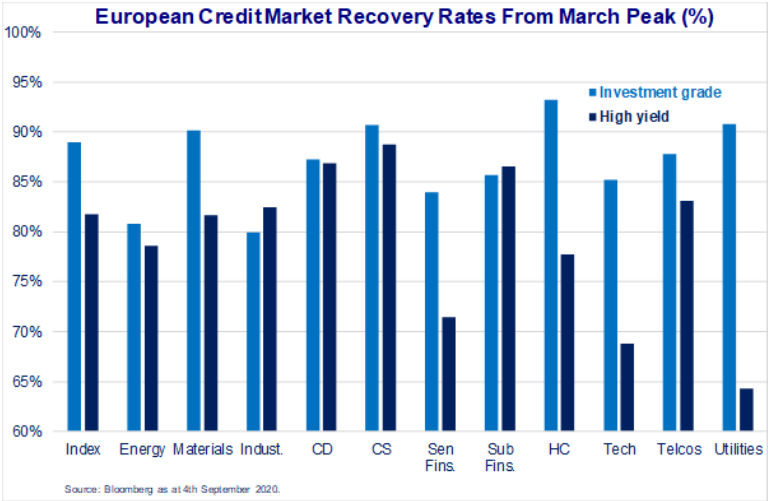
Futures markets suggest a mixed opening in Asia with Australia (-0.6%) priced for a sharp decline, whereas Hong Kong (-0.1%) and Japan (+0.1%) all pointing to modest movements at the bell.

- **CREDIT MARKETS**
  - **Regional credit indices were mostly lower with spreads in the US investment grade universe widening (for a second day) by +3 points** to +128 bpts, which lowered the recovery rate one notch to 90%. There were capital losses in ten of the 11 subsectors led by +5 point widenings in utilities (to +136 bpts, 85%) given its highly indebted balance sheets, tech (to +107 bpts, 88%) reflecting weak sentiment to the sector, and consumer staples (to +120 bpts, 93%). Meanwhile, spreads also increased by +3 points in the high yield sector where many of the same concerns festered and this saw 9 sectors incur capital losses which pushed spreads out to +507 bpts but the recovery rate was steady at 86%. The largest spread increases were in utilities (+21 points, +418 bpts, 79%), tech (+13 points, +430 bpts, 81%) and energy (+11 points, +770 bpts, 100%) as oil fell to an 8-week low.

    In terms of the laggards in the recovery, they are centred in the cyclical sub-sectors such as industrials and financials, irrespective of their investment universe, whereas defensives such as consumer staples and telcos have outperformed (see chart below).



  - **European credit markets were a bit mixed by also exhibited modest movements in risk premiums.** Spreads in the investment grade space increased +1 point and by doing so they snapped a three-day win streak which had seen spreads decline to a post-February low. Spreads ended the week at +56 bpts, with the recovery rate down one notch to 89% as ten sectors recorded a modest increase in risk premiums. However, the moves were minor led by subordinated financials (+3 points, +138 bpts, 86%) which gave back some of its gains in the past week, whereas consumer discretionary (-2 points, -78 bpts, 87%) defied the trend of its peers and is now at its lowest risk premia since the first week of March. Meanwhile, the high yield sector closed out a four-day win streak with spreads coming in -1 point to +384 bpts, but the recovery rate was unchanged at 82%. There was some price action at the sub-sector level where 4 sectors rallied led by consumer discretionary (-19 points, +524 bpts (6-month low), 89%), but there was partially offset by blow outs in both subordinated financials (+13 points, +458 bpts, 71%) and consumer staples (-+20 points, +524 bpts, 89%).



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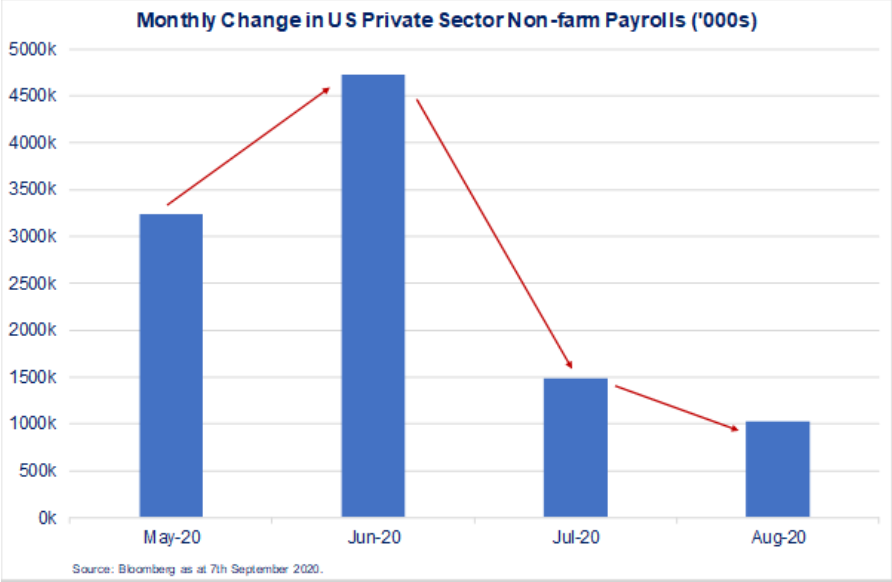
THE GLOBAL ECONOMY

- **The US labour market recovery both continued and it continued to slow in August with payrolls up +1.37 million which was marginally below the street** (+1.40 million). Meanwhile, unemployment declined sharply (-1.8% to 8.4%), the participation rate (61.7%) remains well down from its February levels (63.0%), wages growth was solid at 0.4% m/m (a second straight month of moderate to solid increases with the annual rate now up +4.7% y/y) and the average work week increased +0.1 to 34.6 hours. While the headline summary sounds impressive, there are several warning signs around the nature of the labour market recovery and what's ahead:

    1. **The composition was weak** in that the headline number was artificially boosted by a temporary hiring of Census workers, which meant that private sector payrolls (+1.03 million) continued to slow (the street was at 1.33 million and July was 1.48 million – see chart) and they remain -8% below the February levels with 10.7 million workers still dislocated, despite the rapid increase since April. Accordingly, I would put more weight on the lower private sector payrolls growth than lower unemployment.



    2. Increases at the industry level are centred in industries like "leisure" where employment remains very depressed (-24% below pre-COVID-19 levels, despite +174k in August), but in sectors where activity has been robust and less impacted by mobility restrictions, such as manufacturing (+29k) and construction (+16k) the payrolls rise remained anaemic, suggesting that firms are either seeing recent activity as unsustainable, or they are seeking ways to boost productivity – neither of which is good for the labour market. Indeed, the goods sector's payrolls remain 6% below February levels, which indicates **that a complete activity recovery is not aligned with a complete labour market recovery.**

    3. **August recorded a rise in the number on permanent layoffs** and while this could be considered moderate (+534k) given the size of the US labour force (circa 160 million), it occurred as total unemployment declined. It always takes longer for the permanently laid off to find work again, and if this trend continues then **the temporary damage from COVID-19 and mobility restrictions could become permanent, and this will limit the speed of the economic rebound.**

    4. Retail employment shows the impacts of shifts in spending patterns in that non-auto retail employment were only -4% below February levels, but furniture is down -13%, electronics -9%, health and personal care -8%, and apparel -29%. In contrast, online employment is surprisingly little changed from the February level which highlights that the more these firms dominate the market, the less jobs are available, thereby leading the much more longer-term unemployed.

    So overall, despite some upbeat headline numbers, the composition of the US labour market rebound was a bit underwhelming and at present, it seems to be a long and winding road ahead,

POLICY

- There were no major policy announcements on Friday.

VIRUS UPDATE

- The number of global cases of COVID-19 is 26.98 million with another +189.6k cases so far (but Brazil, Ecuador, France, Italy and Mexico and 8 US states have not reported their numbers) which means that Tuesday is set to be the 48th consecutive day where daily increases are greater than 200k. At present, 8 countries have more than 500k cases, 21 countries have more than 200k cases and 29 countries have more than 100k cases.

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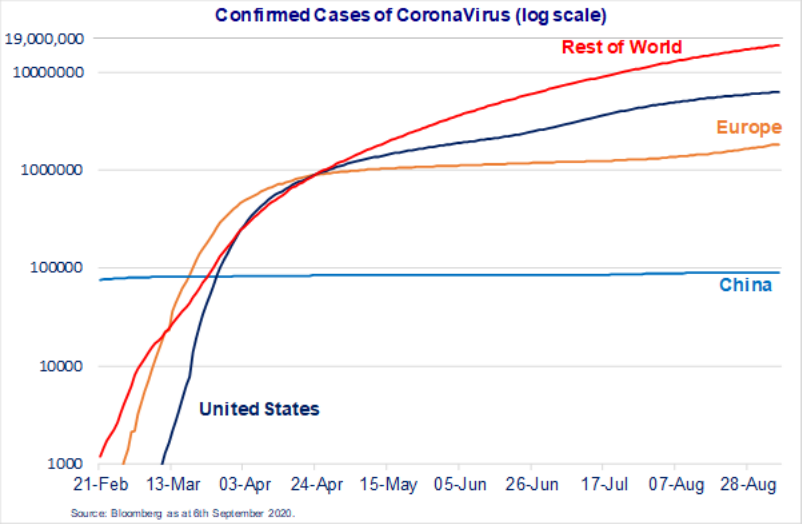
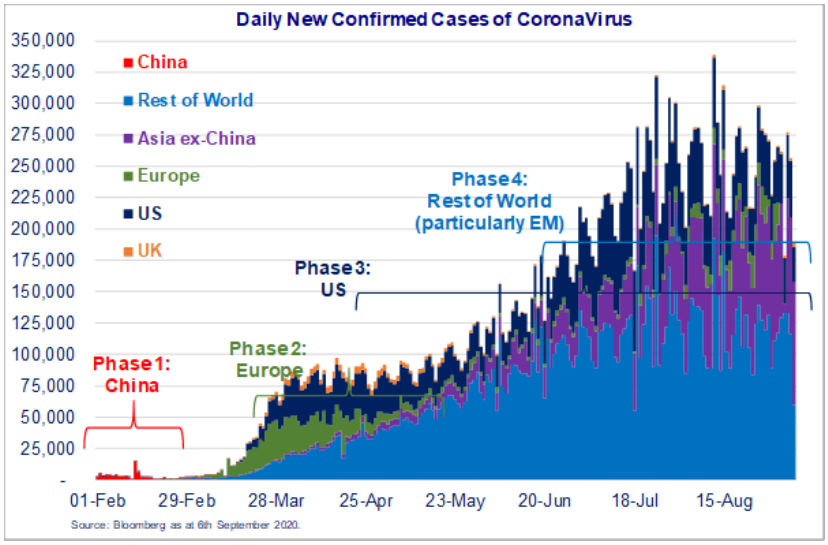


- We break the infections into four groups – the US, Europe, China and 'others' and the rest of the world outside the G3 economies now has the most total cases (+157.4k to 23.8 million) and highest daily new cases (and by a considerable margin) followed by the US (+28.3k to 6.27 million, although 8 states are yet to report). 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 (+2.8k to 1.81 million - see chart) which is the only region with an R-factor above 1.0 which indicates that the infection rate (1.03) is high, but it has been moderating.



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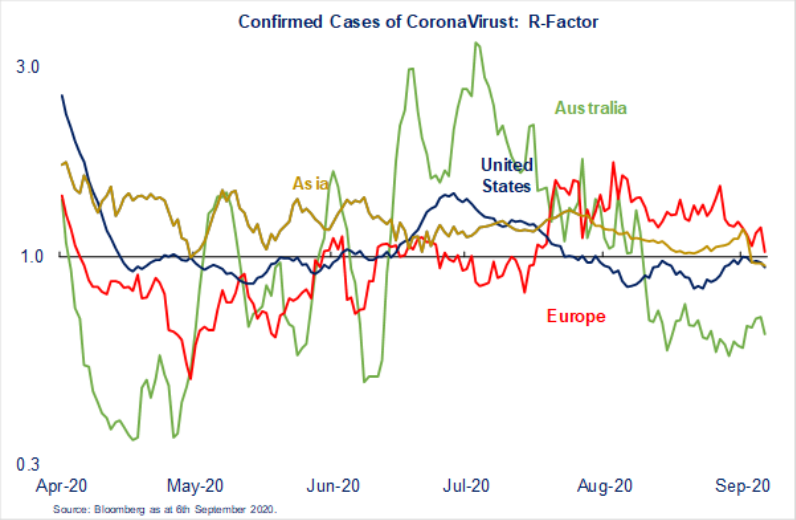
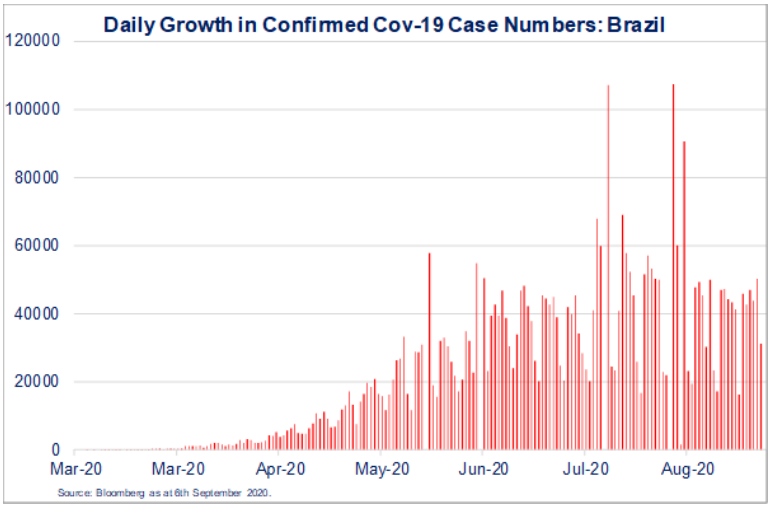
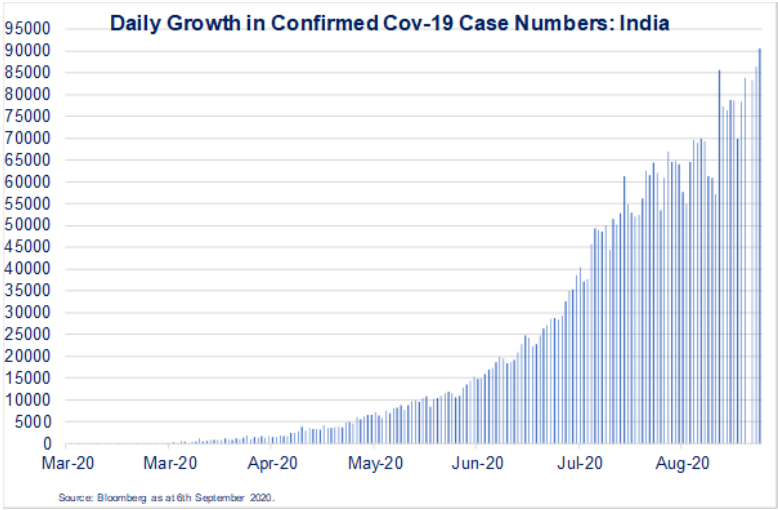


- Among countries, the most cases are in the US (+28.3k (so far) to 6.27 million, with 8 states yet to report), Brazil (not reported, 4.12 million), India (+90.6k (record high) to 4.11 million), Russia (+5.1k to 1.022 million), Peru (+6.9k to 683.7k), South Africa (+1.6k to 638.5k), Colombia (+8.4k to 658.5k), Mexico (not reported, 629.4k), Spain (not reported, 498.9k), Chile (+2.1k, 422.5k), Iran (+2.0k to 386.7k), United Kingdom (+3.0k to 349.5k), Bangladesh (+2.2k to 325.2k), Saudi Arabia (+0.8k to 320.7k) and Pakistan (+0.5k to +298.5k). Australia confirmed cases rose +71 to 26.3k yesterday which placed us 67th in terms of total infections.

  Elsewhere, Singapore recorded +40 new cases to 57.0k most of which are linked to foreign workers who are forced to live in crowded dormitories, but Indonesia (+3.4k to 194.1k) is now on the rise and has the second most cases in the region behind only the Philippines (+2.8k to 237.4k).





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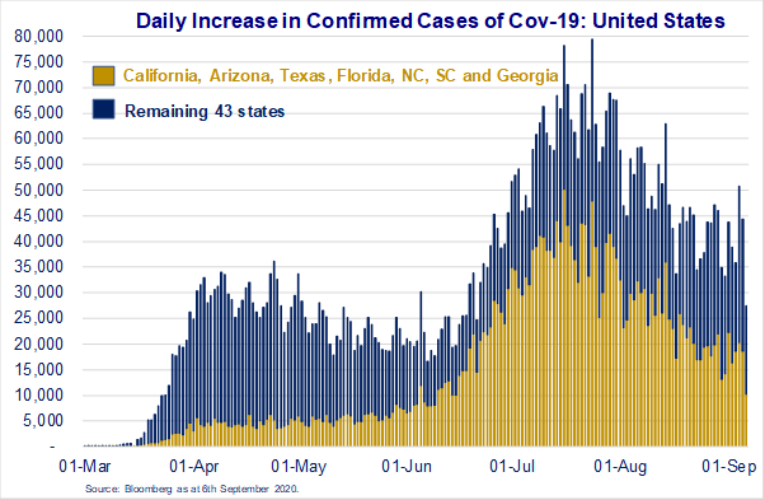
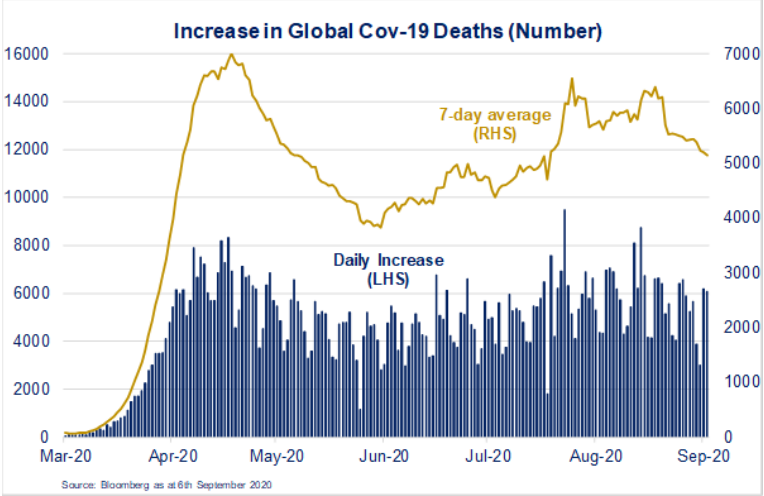
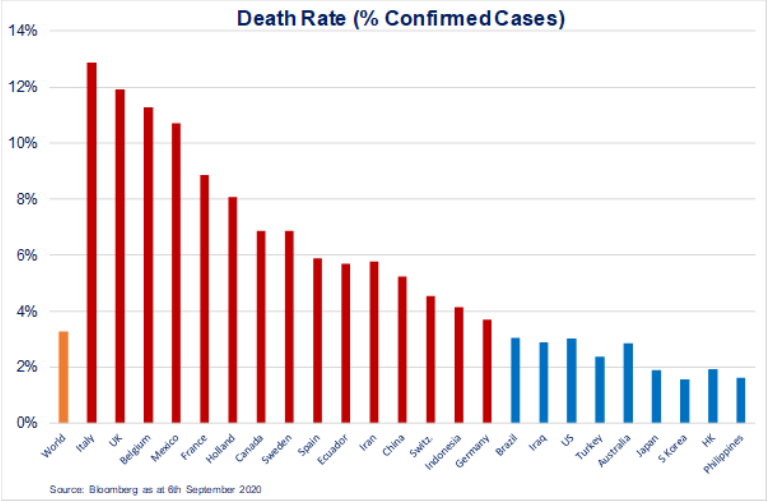


- Although final numbers are not in until 1pm AEST, the global death rate declined to 3.27% with the global total to 881.3k after another +3.0k deaths overnight, so far, which indicates the daily average deaths is stabilising again (see chart). The US (+0.4k so far) has the most deaths at +188.9k, with Brazil (not reported, 126.2k), India (+0.8k to 70.6k), Mexico (not reported, +67.3k), the UK (0 to 41.6k), Italy (+7 to 35.5k) and France (0 to 30.7k) all over +30k. The death rate is highest in European countries where the health systems had collapsed led by Italy (-0.2% to 12.9%), the UK (steady at 11.9%), Belgium (-0.1% to 11.3%), France (-0.2% to 8.9%), the Netherlands (-0.1% to 8.1%), Sweden (steady at 6.9%) and Spain (steady at 5.9%). However, several emerging markets are now on the leader board including Mexico (-0.1% to 10.7%), Ecuador (-0.1% to 5.7%), Indonesia (steady at 4.1%) and Brazil (steady at 3.1%).





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Yours sincerely,

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