Perpetual Investments

THOUGHTS ON THE MARKET

9th June 2020 - Steeper yield curves set to continue the rotation to 'value'

SUMMARY

- **The May US non-farm payrolls** report was a blockbuster and detailed a shock rebound in US hiring with +2.3 million jobs filled instead of a street estimate of -7.6 million lost. That is a remarkable turn-around considering large portions of the US economy remained under restriction, so a key question is what to make of it. The labour market stat certainly defied other signs in the economy in May including continuing jobless claims, the employment gauges in both PMIs, housing construction, consumer confidence and so on, and employment is normally a lagging indicator of growth, not one of the first sectors to turn.

  We were expecting a large bounce in labour hiring in June which was part of our "shock, bounce and incomplete recovery" thesis, so the recovery has started a month early mostly likely reflecting a combination of earlier re-opening and also the US Treasury's USD669 billion Paycheck Protection Program within the CARES Act which saw small business bring some displaced US workers back into employment early to enable their PPP loan to be 'forgiven'.

  While our 'incomplete recovery' thesis remains intact, the payrolls report suggests that the June quarter US contraction is likely to be a bit smaller than initially thought (-36% q/qa) and the large consumer savings rate suggests this may not completely be at the expense of September quarter growth (+23% q/qa). That said, the recovery will remain incomplete underpinned by lingering distancing requirements, continued private sector caution and government stimulus becoming a drag in 2021 (although this may not be visible until late 2020). That said, the most important and sustained change from the US labour market recovery will be the back-up in long bond yields, which should provide a further tailwind to the recent 'value' rotation.

- While better than April, investors should be mindful that the US unemployment rate and global composite PMI for May both remain below where they were at the bottom of the GFC. Clearly re-opening suggest a strong growth bounce in Q3, but reopening comes with large risks especially as EM and US COVID-19 curves have not being flattened – the US cannot get much below +20k new cases per day, whereas numbers in in Brazil, India and Russia are surging. Central bank tapering and Cov-19 case spikes are the key risks facing the market in the next quarter.

- **In markets overnight**, risks sectors rallied with the US sharemarket entered positive territory for 2020 as easing lockdowns boosted earnings optimism and performance in the tech sector saw the NASDAQ 100 index post all-time highs. In other markets, the US dollar declined for an eighth straight day given appreciations in the Yen (+1.1% to 108.43)., Australian Dollar (+0.7% to 70.19) and Sterling (+0.4%), whereas the Euro was steady. Elsewhere, 10-year Treasury yield came down a few points (-0.02% to 0.88%) with the curve flattening to 0.75%, gold rallied +0.8% to USD1,698 per troy ounce and oil declined -3.3% after Saudi Arabia said it wouldn't continue its additional deeper output its after June.

- Although final numbers are not in for another 4.5 hours, the number of global cases of COVID-19 stands at 7.1 million with another +72.6k cases so far overnight (Brazil, Mexico and many US states have not reported their numbers yet) which means that Sunday was the 70th occasion in the past 71 days where daily increases have topped 70k). This means 3 countries have more than 400k cases, 7 countries have more than 200k cases, 16 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, 10 for the fifth million, 11 for the six million and 8 days for the seventh million, and in the past 30 hours another 86k cases have been confirmed. More importantly, the growth rate of daily confirmed cases (+1.9% since Friday) has ceased declining having been close to 1.8% for the past 20 days. Meanwhile, deaths stand at 405.2k and the death rate dropped for a thirty third straight day to 5.72%.

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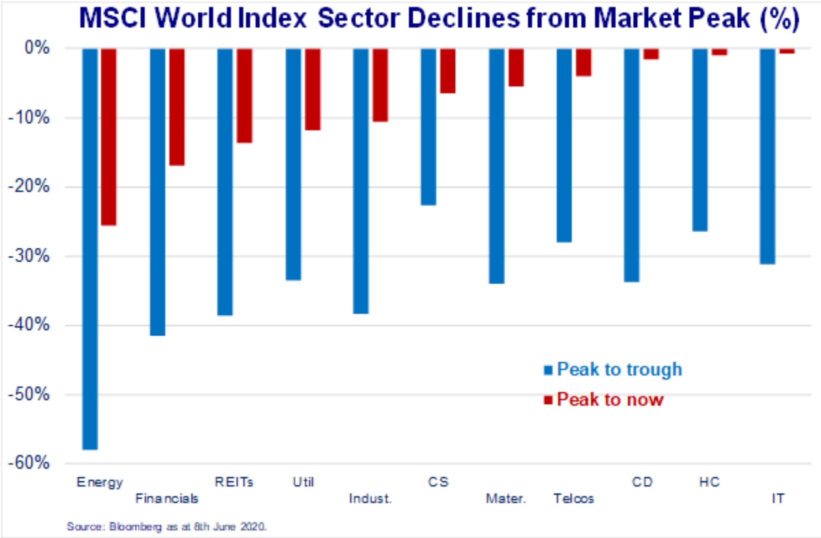
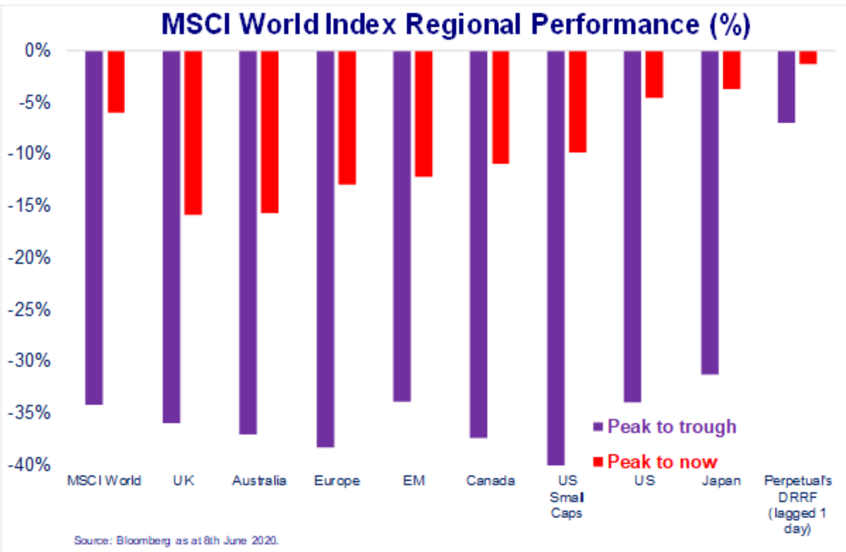
FINANCIAL MARKETS

- **EQUITIES**
  - The MSCI World Index rallied +0.9% overnight with investors optimistic despite a lack of news to underpin it. Cyclicals led the advance overnight as investors continued to plough into cheaper sectors. Energy (+2.8%) led the pace of gains supported by financials (+1.5%) and consumer discretionary (+1.0%). These gains have seen financials (-16.9%) exit bear market territory with only energy (-25.7%) remaining (see chart). In contrast, healthcare (-1.0%) and IT (-0.7%) have nearly recovered all their losses.



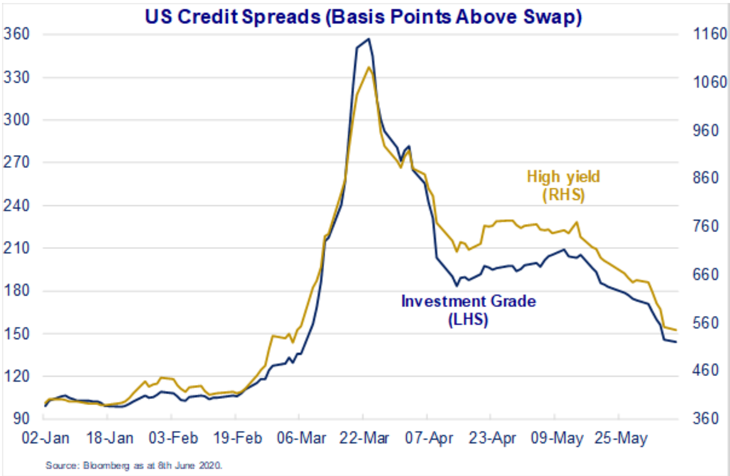
  - Among the regions, the US market (+1.2%) led the pace of gains with the S&P 500 erasing all 2020 losses and re-entering positive territory as the investor equation of stimulus plus reopening plus good data equals better earnings prospects. Meanwhile, the Russell 2000 outperformed (+2.0%) as oversold sectors found renewed investor optimism on valuation ground. Although the NASDAQ 100 index (+0.8%) underperformed the index rose to a fresh all-time high overnight as Amazon rose another +1.7%, with a strong performance from Boeing (%) leading gains in the Dow Jones Industrial Average (+457 points, +1.6% to 27,529).

    In European markets, the Stoxx 600 index declined -0.3% with markets taking a pause after Friday's +3.8% price surge. Among the region, the periphery markets were more resilient with gains in Greece (+2.0%), Spain (+0.3%) and Italy (+90.2%), whereas investors in the UK (-0.2%), Germany (-0.2%), France (-0.04%) and Sweden (-0.7%) took some profits. Earlier in Asia, stocks rallied hard with the MSCI Asia Pacific index up +0.9%) with gains in Hong Kong (+0.03%), Korea (+0.1%), China (+0.5%) and Japan (+61.4%) with Australia closed for national holidays. The movements in markets on Monday saw the UK (-15.9%) and Australia (-15.7%) as the two most oversold markets whereas Japan (-3.8%) is the best performer and is close to recovery all of its March quarter losses.

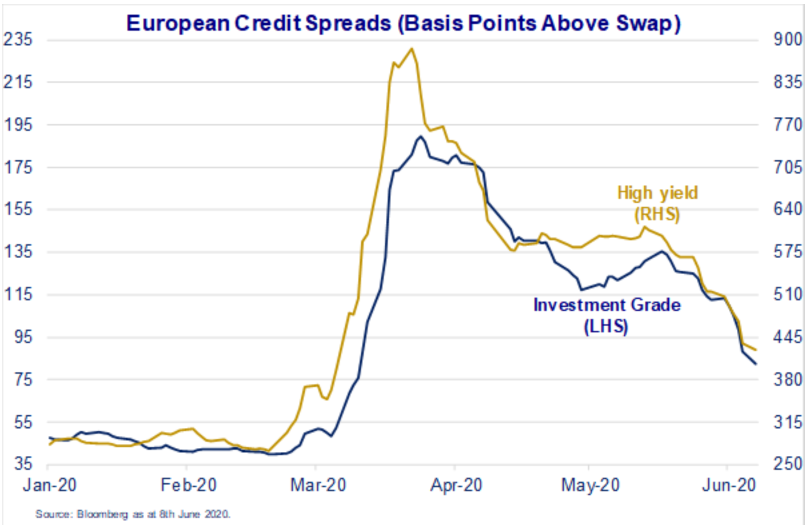


Futures markets suggest a positive opening at the bell in Japan (+0.1%), China (+0.5%), Hong Kong (+0.5%) and Australia (+0.7%).

- **CREDIT MARKETS**
  - Regional credit indices rallied overnight with spreads in the US investment grade space coming in a further -2 points to +144 bpts, which increased he recovery rate to 84%. There were declines in all 11 sub-sectors in what was a quiet night for news, with cyclicals continuing their march to the holy grail or recovering all their February-early March losses. Subordinated financials (-4 points, to +176 bpts, 83%) led the spreads contraction as investors continued to rotate in cyclicals, with consumer discretionary (-4 points, +176 bps, 82%) and senior financials (-3 points, +127 bpts, 81%) also among the leaders. In the high yield space, spreads contracted another -5 points to +546 bpts (see chart), which increased the recovery rate to 80%. The lowering of risk premiums was energy (-20 points +868 bpts, 94%) which defied a lower crude price as investors focused on economic re-opening for optimism about balancing the market, with spreads in consumer discretionary (+529 bps, , 71%) and subordinated financials (-9 points, +602 bpts, 61%) also declining.



  - European credit markets were also in a good mood with spreads in the investment grade universe contracting a further -6 points to +83 bpts, which increased the recovery rate to 71%. There were lower risk premiums in all sectors led by materials (-7 points, +79 bpts, 68%) as commodity prices have lifted in the past few weeks, consumer discretionary (-7 points, +100 bpts, 78%) and industrials (-6 points, +91 bpts, 56%). In the high yield universe, spreads came in another -10 bpts (which marked the fifth consecutive double-digit decline in risk premiums) to +426 bpts (see chart), which increased the recovery rate two notches to 75%. Among the sub-sectors, cyclicals continued to benefit as investors embraced the recovery led by consumer discretionary (-17 bpts, +517 bpts, +76%), subordinated financials (-14 points, +447 bpts, 73%) and industrials (-13 points, +534 bpts, 73%).

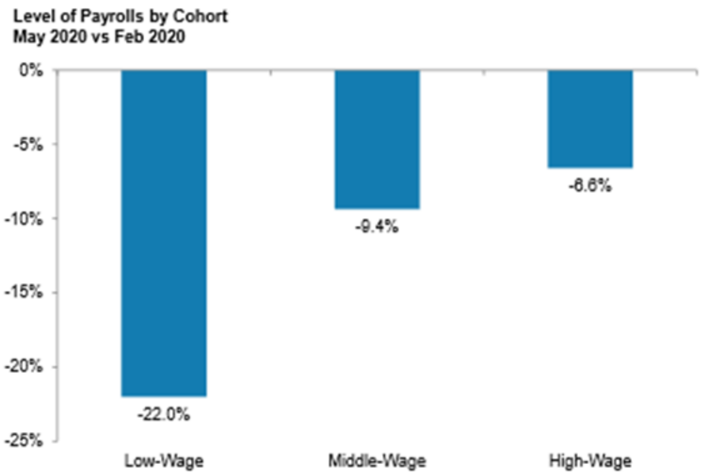


THE GLOBAL ECONOMY

- **The May US non-farm payrolls** report detailed a shock +2.3 million jobs filled in the month which beat street estimates (-7.6 million) by a record amount, and the U-3 unemployment rate declined to 13.3%. While this was a shock to all market participants, it could be a result of a combination of earlier re-opening and also the US Treasury's USD669 billion Paycheck Protection Program within the CARES Act which saw small business bring some displaced US workers back into employment early to enable their PPP loan to be 'forgiven'.

  These two factors being at play were evident with the sector analysis in that payrolls in manufacturing (+225k) and construction (+464k, reversing 44% of job losses in March and April) which were early re-openers, bounced strongly. Moreover, payrolls in the leisure & hospitality sector surged +1.2 million (14% of the declines in March and April which totalled -5.4 million) and retail bounced +368k (16%) strongly. Overall, private sector payrolls rose +3.1 million (reversing 15% of the lost payrolls in March and April), whereas government dropped a further -585k, and 13.1 million US workers were hired, whereas 9.3 million were displaced (in line with initial jobless claims).

  Because the CARES Act provides states with flexibility in enforcing work search requirements, many previously employed people are simply moving from being employed to being out of the labour force without first transitioning through to 'unemployment'. Other's continued to fill their DoL forms out incorrectly stating they were 'employed' but not at work either due to illness or for "other reasons" (6.2 million which is five times the average since 2005). Accordingly, there is a major undercounting of unemployment and when accounting for these issues, a truer the unemployment rate is 20% (still better than the equivalent 23% in April) and most of these are concentrated in low paid jobs (see chart). This explains why average hourly earnings dropped -1.0% m/m in May, but average hours rose +4.3% m/m, so incomes rose for the month, which is constructive for consumption.



Source: Bureau of Labor Statistics, Morgan Stanley Research

  We think the way to think of it is that the surge in employment we were expecting in June, July and August came a month early. While it is true that May data has been coming is better than feared, this is the first released that signalled a recovery was forming which contrasts with history in that the labour market is normally one of the last sectors to improve in recovery.

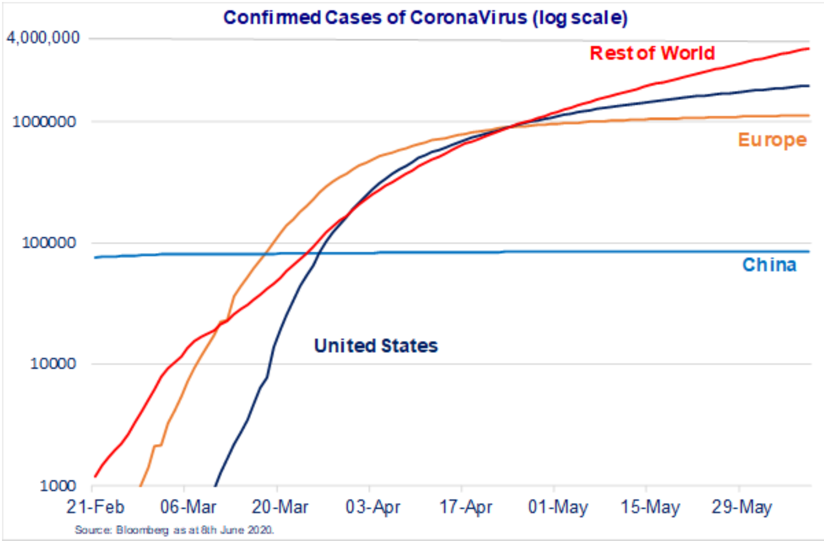
- March quarter Japanese GDP growth was revised to a -2.2% q/q annualized contraction (first print was -3.4% q/qa) which was in line with street estimates. The primary source of revision was non-residential private investment, which was revised higher following the Ministry of Finance corporate survey, which was partially offset by modest downward revision to private inventories. The June quarter is where the growth contraction is its sharpest (circa -30% q/qa) which is the weakest quarterly reading on record going back to 1955.

POLICY

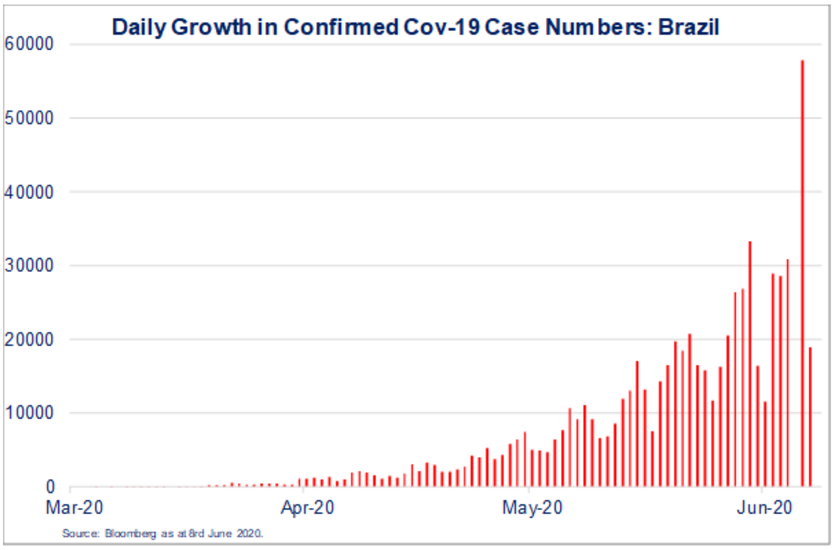
- The US Fed announced it would expand upcoming Main Street Lending Program to allow more small- and mid-sized businesses to receive additional funding. Release notes Fed is lowering the minimum loan has halved to USD250K and increasing the maximum loan size for all and increased the term of each loan option to five years (from four years) and raising the Fed's participation to 95% for all loans. These changes have come as the much-heralded USD600 billion program has been criticised given worries about minimum and maximum loan size, high interest rates' and curbs on buybacks, dividends, and executive pay, not to mention the rollout has been very sluggish, with some companies forced to seek alternatives.

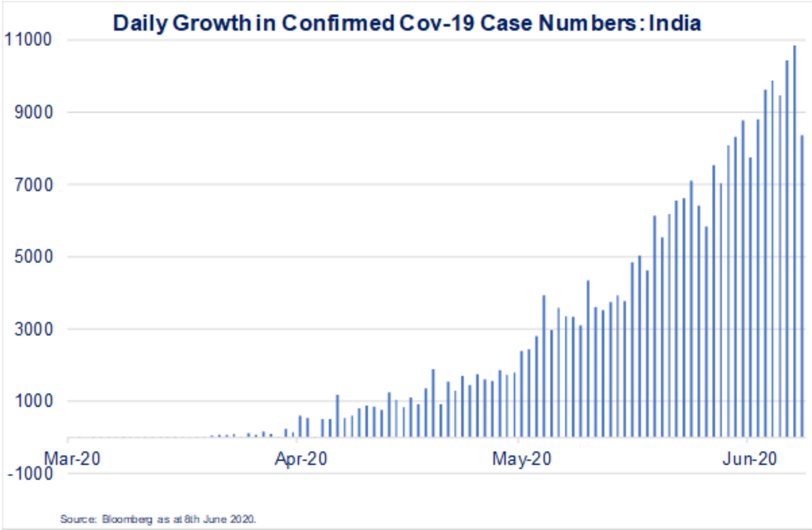
VIRUS UPDATE

- Although final numbers are not in for another 4.5 hours, the number of global cases of COVID-19 stands at 7.1 million with another +76.8k cases so far overnight (before Brazil, Mexico and some US states report their numbers) which means that Sunday was the 70th occasion in the past 71 days where daily increases have topped 70k). This means 3 countries have more than 400k cases, 7 countries have more than 200k cases, 16 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, 11 for the six million and 8 days for the seventh million, and in the past 30 hours another 85k cases have been confirmed. More importantly, the growth rate of daily confirmed cases (+1.9% since Friday) has ceased declining having been close to 1.8% for the past 20 days. Meanwhile, deaths stand at 405.2k, with the US now over 110k (27.4% of global deaths even though they have only 4% of the global population), the UK, Italy and Brazil over 30k, with Spain and France over 25k, and the death rate dropped for a thirty third straight day to 5.72%.



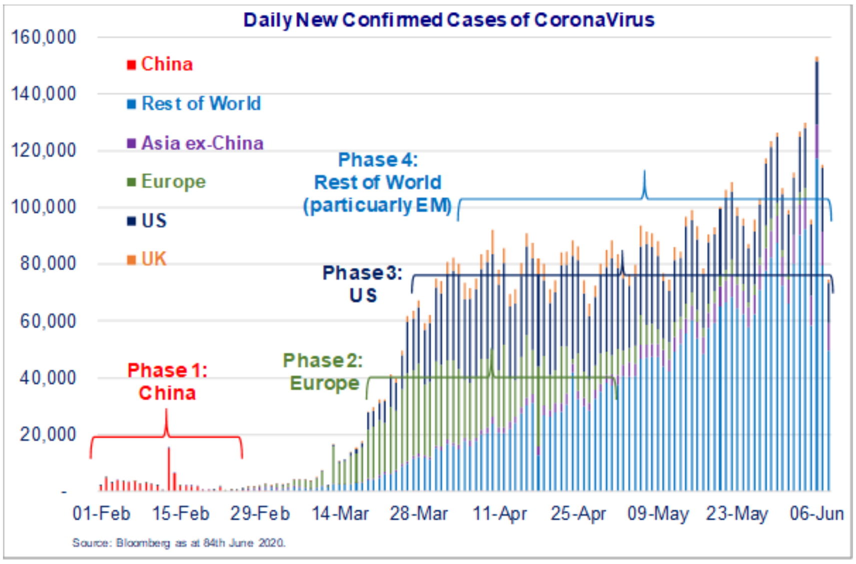
- We break the infections into four groups – the US, Europe, China and 'others' and the rest of the world outside the G3 economies now has the most total cases (+46.3k to 3.92 million) and highest daily new cases (and by a considerable margin) followed by the US (+13.3k to 1.96 million) and Europe (+2.0k to 1.12 million), with the latter'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, +691.6k, which is the second highest in the world), Russia (+9.0k to 476.0k, third highest) and India (+8.3k to 265.9k, fifth highest).



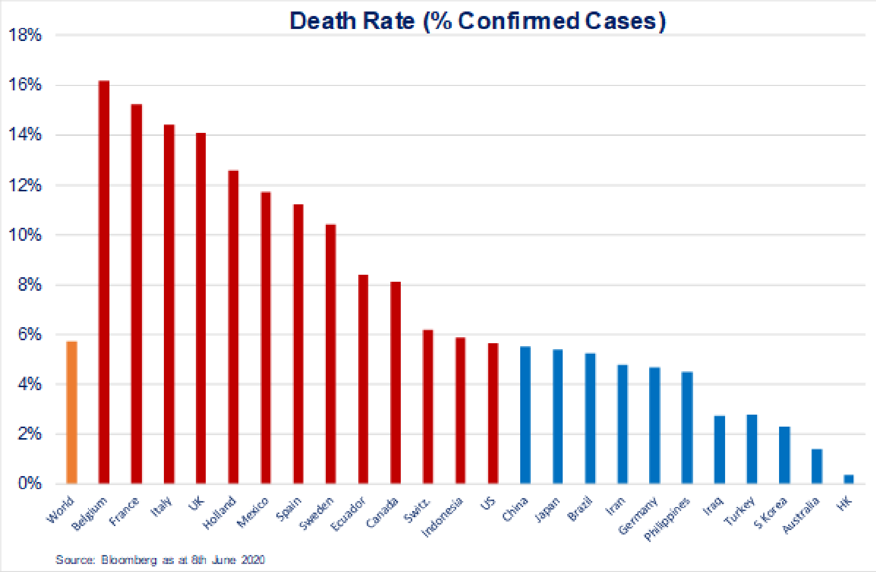


- Among countries, the most cases are in the US (+14.1k (so far) to 1.96 million), Brazil (not reported, 691.8k), Russia (+9.0k to 476.0k), the United Kingdom (+1.2k (19-day low) to 288.8k), India (+8.4k to 265.9k), Spain (+0.2k to 239.5k), Italy (+0.3k to 235.3k), France (+0.2k to 191.3k), Germany (+0.4k to 186.1k), Turkey (+1.0k to 171.1k), Peru (+0.2k to 196.5k) and Iran (+2.5k to 151.5k) and Australia confirmed cases rose +3 to 7,195 yesterday which placed us 63rd in terms of total infections.

  Elsewhere, Singapore recorded +0.4k new cases to 38.3k 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 (+0.8k to 32.0k) and the Philippines (+0.6k to 22.4k). 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 thirty third straight day to 5.72% with the global total to 405.2k. The US (+0.4k) has the most deaths at +110.9k, with the UK (+0.1k to 40.7k), Italy (+0.1k to 34.0k), Spain (steady at 27.1k) and France (+0.1k to 29.2k) 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 15.2%), Italy (steady at 14.4%), the UK (steady at 14.1%), the Netherlands (steady at 12.6%), Sweden (-0.2% to 10.4%) and Spain (-0.1% to 11.3%). However, several emerging markets are now on the leader board including Mexico (-0.2% to 11.7%), Ecuador (steady at 8.4%), Indonesia (-0.2% to 5.9%) and Brazil (steady at 5.3%).



Yours sincerely,

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