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## Does that change everything?

- **Massive surprise on US employment favours risk assets**
- **With waves of powerful policy response still flowing investors will be upbeat**
- **We expect an ongoing rotation into assets that have underperformed**
- **We expect Europe and emerging markets to play catch up**
- **Growth stocks may struggle due to higher long-term interest rates**
- **COVID-19 remains a threat**

The massive surprise in the US unemployment data should not be seen in isolation. The bears can easily dismiss this as just an aberration. However, other data tends to corroborate the belief that the US recovery has started, and has maybe more considerable momentum than previously thought. Indeed, that recovery is not just focused on the United States but better than expected Canadian employment data and signs of improved demand in Europe will all give further impetus to risk assets.

The US jobs report showed that 2.5 million jobs were added in May. This brought the unemployment rate down from 14.7% to 13.3%. The numbers were a massive surprise to the markets. Consensus forecasts were that there would be a further 5 million job losses during May. Economists, after the event, are saying that the employment report squares with, for example, the strong May auto sales figures and credit card spending numbers. In Canada, the 290,000 increase in employment for May was again a huge surprise to the market and relative to expectations.

The better employment data, the ongoing lifting of the lockdown around the world, and announcements of further support for growth through easing monetary conditions and additional fiscal measures will only reinforce the positive mood in the markets. For sure there are risks ahead; a second wave of the virus, defaults rising, social distancing hampering the full recovery of many industries. However, for the moment, the momentum is with risk assets as economists eye a possible 25-35% annualised recovery in global GDP in the third quarter.

In looking for ways to play the current market momentum, we favour rotation into those assets that have been left behind in the rally. European equities are still down 10 percent since the beginning of the year quite a contrast with the United States, which is now just down 4%. Several things favour Europe. In contrast to the United States, as Europe is opened up incidences of coronavirus remains well controlled. Secondly, policymakers are positively surprising – the recent agreement between the French and German governments to support the rest of Europe with direct grants and the ECB's larger than expected (Euro 600bn) expansion of its bond-buying programme are all supportive. Last week the German government announced further spending increases equivalent to 1.6% of GDP. In the United States, while additional phases of government spending are being promoted, the improved employment picture and a large gap in thinking between Republicans and Democrats may delay or moderate any further spending plans. It also easily forgotten that in all the noise about an improvement in US employment data Euro area unemployment remains close to its record lows.

Emerging markets may be due a serious rebound. With investors very much in a 'buy the underperformer mood' emerging markets could be in for a strong run. Such performance could come irrespective of whether some emerging countries are still not on top of their COVID-19 problems. The Emerging markets index is heavily weighted towards Asian economies particularly China, South Korea, and Taiwan all of which are on the front foot again.

Growth stocks, particularly in the tech sector, may suffer a period of underperformance here. Part of the reason why share price of growth stocks went up even when earnings forecasts were dropping was that the discount factor or future growth, i.e. long-term interest rates had fallen so sharply. However, in the past week, long-term interest rates have been rising, thus taking away some of the valuation support for the tech sector. We've also noticed a pause in the performance of all sectors such as utilities and REITs, again two very interest rate-sensitive sectors. There is an argument that REITs could do better here supported by you, but if the economy is getting better, then there is less risk of tenants not paying rents. Improved cash flows for REITs would help the sector, and it's further recovery from the extremes when in the depths of March the sector was down almost 50% from February levels.

Where does this leave the bond market? We would caution investors not to abandon the safety of government bonds during this risk-on phase of the markets. The U.S. 10-year government bond yield was rushing towards the 1% level at the close of last week. That provides something of a headwind to bond market returns even when spreads may be compressing in the high yield and emerging market debt spaces. However, in our view, the Federal Reserve is still not done. We suspect the Fed will be concerned that a recovery could be undermined by a steep rise in government bond yields and hence may try to cap any increase. We may find that the Federal Reserve alludes to such a policy at the meeting this coming week; however, direct action in the market in the very near term is unlikely.

One asset class that has benefited from the improvement in risk sentiment without as much support from the underlying data has been Emerging Market debt. Even so, flows into the debt of even some of the more questionable credits has been sufficient to lift performance from the lows seen in April. The data from Asian economies would broadly suggest that the recovery is underway but quite modestly so. China has given up on providing growth forecasts for the immediate future, as a possible reflection of the fact that much more evidence is required before it can be assumed that things are on an even keel again. Emerging markets are quite dependent on trade; flows to and from China will be an important indicator for EM countries as they battle to get lockdown lifted. Should Europe and the US lead the way in a quick recovery, EM debt has some catch-up to do still.

Let's be clear: a rise in US employment and improved levels of confidence do not solve the COVID-19 virus problem. There are currently 130 potential vaccines in development, and there is much hope. As the [Straits Times points out](#) "this tempo in development is unprecedented, as it could previously take up to 10 years or more to make a vaccine. In fact, the fastest any new vaccine had taken to obtain regulatory approval was five years, this being the Ervebo vaccine to prevent Ebola virus disease." As the article points out, it would be quite unprecedented for the pharmaceutical industry to provide us with a safe solution even within 18 months.

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