

THOUGHTS ON THE MARKET

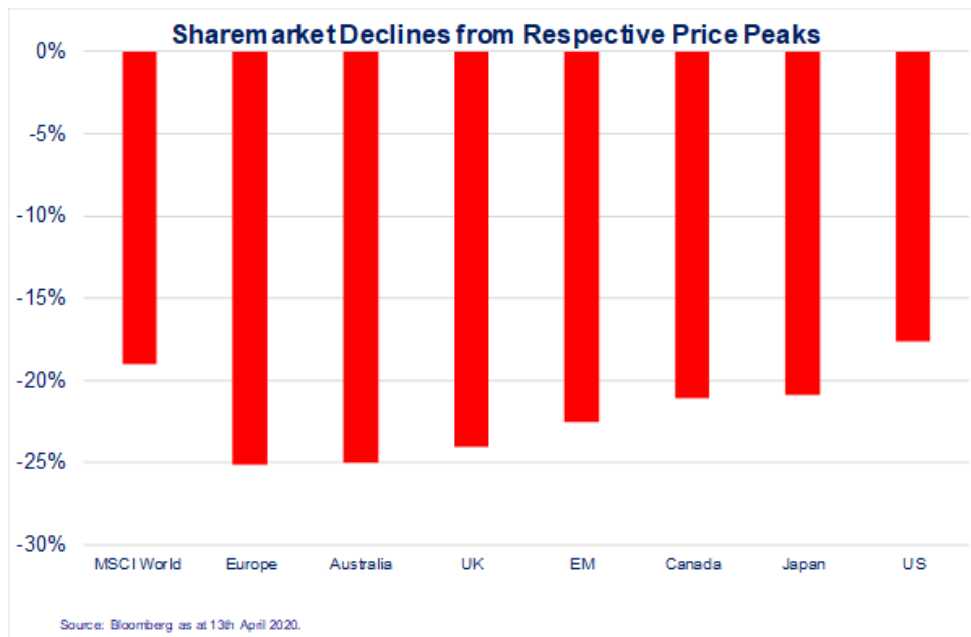
14th April 2020

SUMMARY

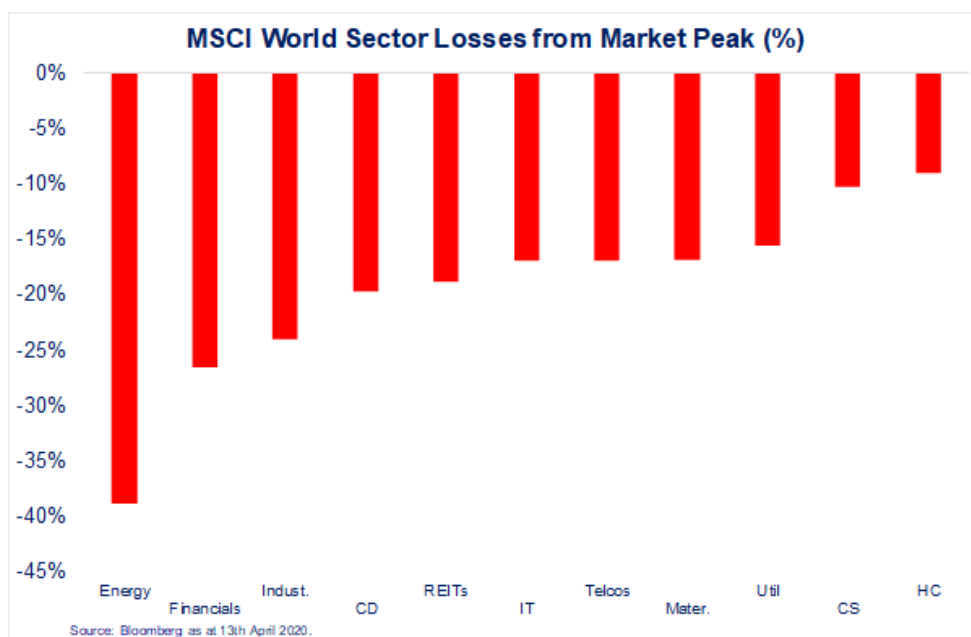
- At this stage, we think a couple of tail risks which threatened a much deeper and prolonged downturn are now starting to dissipate, but several remain. Most importantly, the rate of new cases of COVID-19 appear to be declining across most major regions although some of this may be exaggerated by reduced testing over Easter. While Easter presents a blurred line of sight on trend numbers, we would argue that cases were falling already across numerous European jurisdictions (but the world ex-US and Europe has flattened but is not yet trending down), and given lockdowns are working, the key for markets to hang onto recent gains is when and to what degree economies can re-open. That said there was a massive increase in the US, with cases up +125k overnight which appears to be some reporting error (either previous reports being too low, or today may be being inaccurate).
- Another key tail risk which is lessening, is potential intensification of liquidity and funding stresses in credit markets creating a negative reinforcing feedback loop. The shortage of US dollar is now resolved in response to Fed policy. The Fed had previously announced balance sheet support for highly rated credit markets, which had seen spreads slowly decline, but this was added to last Thursday as part of a USD2.3 trillion expansion in funding support, with new support for some parts of the high-yield market. Overall, given the size and scale of these programs, we suspect they will likely be successful in reducing stresses in credit markets as a whole, but not all market components qualify for support, so defaults are likely to increase notably.
- While a couple of tail risks appear to be moderating, markets are not out of danger as the impending activity and earnings growth hole in the global economy appears to be larger than we first thought and the slope of the recovery is still completely unknown as are the implications for asset valuations, especially given the rebound to date in equities and credit markets. Another huge number of initial jobless claims suggests to us that US unemployment could rise to be near 20% in the June quarter which would be the highest since 1941. A much larger labour market dislocation increases the risk of second round effects and aftershocks, and in the absence of a COVID-19 vaccine we seriously question how much of the economy can re-open without threatening flare-ups in virus case numbers. As such, a V-shaped recovery is not a realistic possibility and with half of US businesses not even having a bank account, we wonder how much support they will receive. In the end, the nature of a supply shock is that recoveries are much slower and considerable economic damage lasts.
- Although OPEC+ stuck a deal to reduce global oil production, we argue that the credit risks from an oversupply of oil remain abundant. The agreed oil production cuts of around 15 million barrels per day is not enough to see prices rise above key breakeven levels given the level of demand destruction currently visible and market prices fell overnight confirms investor disappointment. We think another 10-15 million barrels may be needed to be cut for prices to rise above break even levels.

FINANCIAL MARKETS

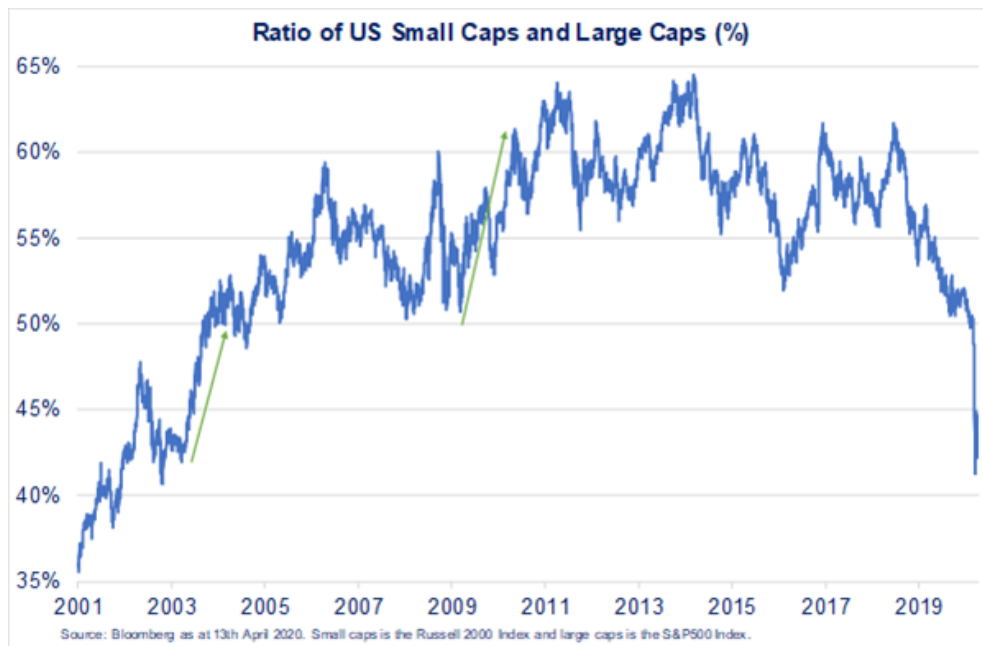
- **EQUITIES**
 - Regional equity markets recorded strong gains last week led by the US (+12.1% w/w) with Japan (+9.4%) outperforming, whereas EM (+6.8% w/w) and Australia (+6.5% w/w) lagged (see chart). This meant that Europe (-25.2%) Australia (-25.0%) and the UK (-24.2%) now have the largest peak-to-now declines. The very strong weekly advance by the US (which moderated overnight) saw their market now having recovered 48% of its market decline since the February peak with investors buoyed by both the OPEC deal and also the US Fed's large-scale policy announcement on Thursday. Recovery rates are much lower in other countries with Canada (43.8%) the only other country with a 4-handle, whereas Europe (34.3%), EM (33.4%), Japan (33.1%), UK (33.0%) and Australia (32.5%) all quite bunched.



- There is more dispersion among sector performance with REITs recording a stellar +18% w/w advanced by last Thursday, with materials, utilities and consumer discretionary (all +13% w/w) finding favour with investors despite recent weakness. Despite the advance, the energy sector (-38.9%) has recorded by far the largest decline but financials (-26.6%) and industrials (-24.1%) are the only sectors with losses greater than -20%. The advance by REITs has meant that the sector (51.1%) and utilities (53.1%), consumer staples (53.8%) and healthcare (65.5%) are the only sub-sectors to recovery half of their respective peak-to trough losses.



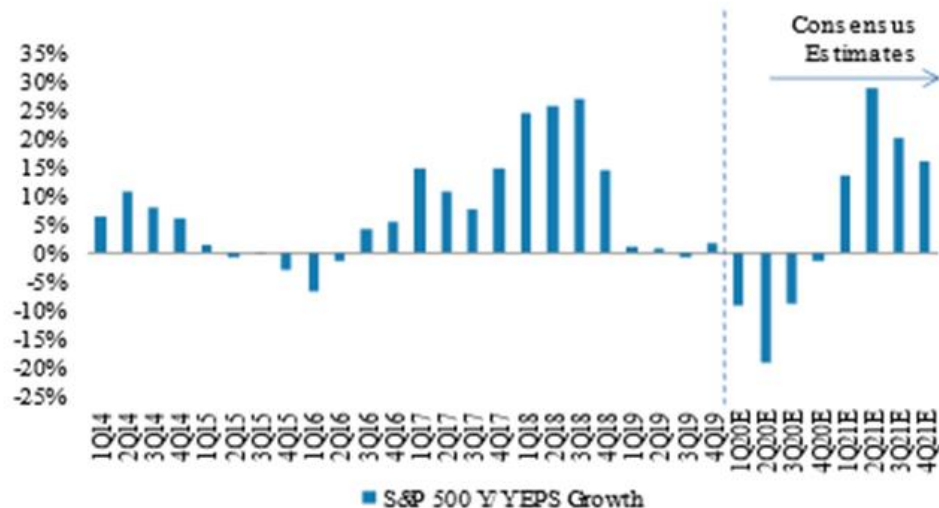
- Another interesting sign last week was the stellar +18.5% performance of the US small caps. Since June 2018, small caps (-26%) have significantly underperformed large caps (+1.1%) which is what normally happens as the cycle ends (albeit the trend here was amplified by the US China trade war). However, when the economy bottoms, small caps significantly outperform in the first year (+64% for the Russell 2000 in the year to March 2004 relative to +38% for the S&P500, and +95% and 69%, respectively in the year to March 2010 – see arrows in chart below).



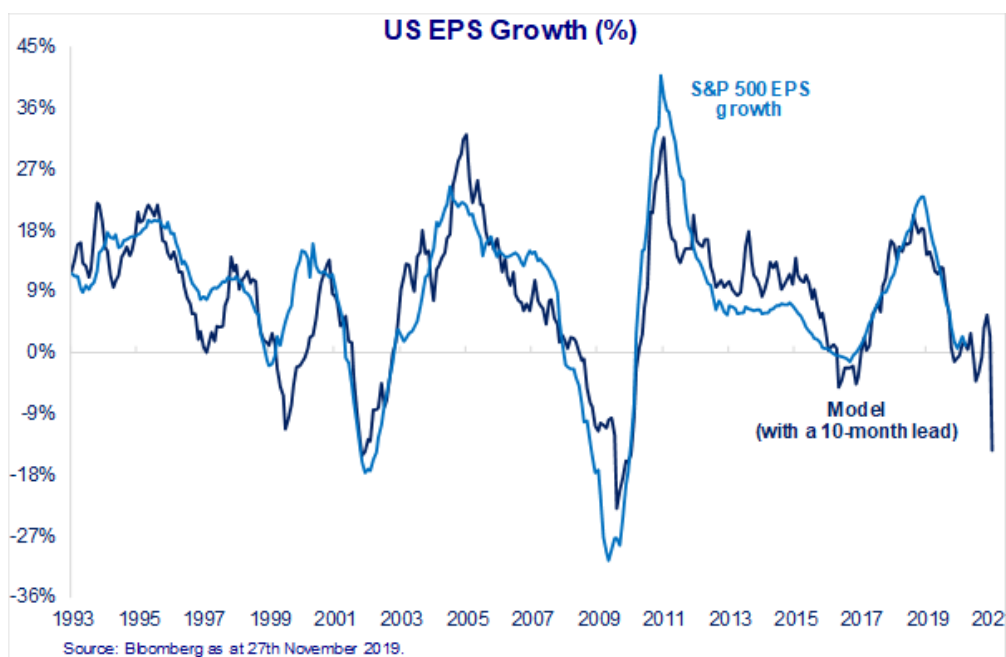
- The US reporting season starts tomorrow night with a handful of reports from the banking sector (Wells Fargo and JPMorgan on Tuesday, then Bank of America, Goldman Sachs and Citigroup on Wednesday) as well as stalwarts like Johnson & Johnson. As stated before, analysts are a long way behind the changing landscape with bottom-up consensus currently forecasting +5.9% US EPS performance in the next 12 months. Nevertheless, the earnings revision breadth is already at its second lowest level over the past two decades and there is every chance the gauge could match its 2009 low as downgrades continue.



- The market is currently expecting US EPS growth to be -7% q/qa in the March quarter and this will decline to -18% q/qa in June which will be the cyclical trough with further modest EPS contractions in September and December (see chart below) with a strong recovery in 2021.



- Perpetual Multi Asset’s proprietary EPS model, which typically gives a reliable indication of changes in trend earnings, has begun to decline sharply (see chart below). Much like 2008/09 given the abrupt decline in US economic activity from economic closures in March 2020, the model may not provide its signal ten months in advance, but the signs of an earnings recovery should still be reliable even if the economic recovery is patchy and below-average as supply side recession usually are given their typical lower and more prolonged recovery.

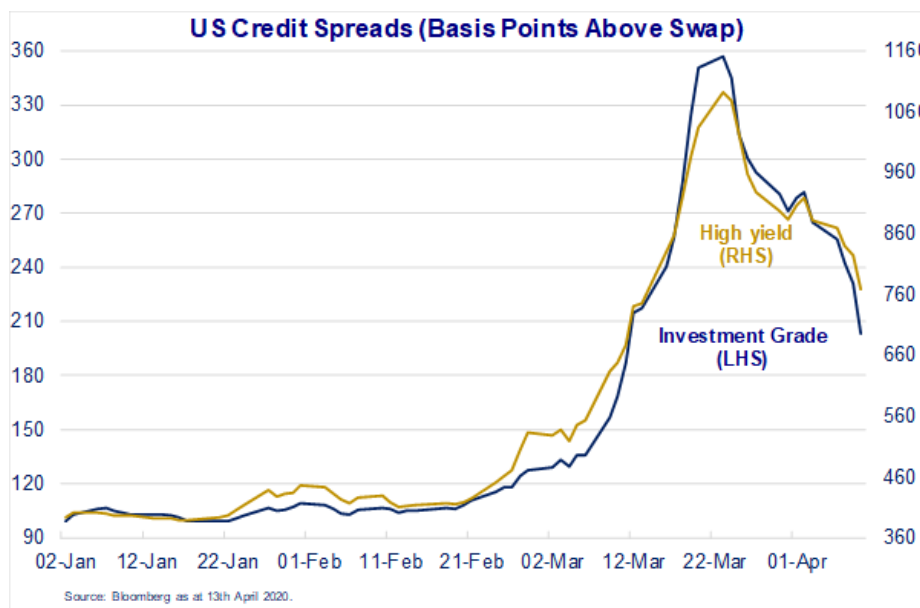


• CREDIT

- Regional credit markets continued to recover COVID-19 losses last week across all regions. The US Fed’s announcement of purchasing more credit ETFs as well as additional funds to help fallen angels was an adrenaline shot for the US market which flowed through to other regional indices. Over the past week, US IG spreads came in 74 to 190 bpts which is a three-week low, signalling that the market has now recovered 60% of its COVID-19 losses, but energy (recovering 55%) and materials (53%) are the laggards, and healthcare (78%) and Tech (72%) are the best improvers.

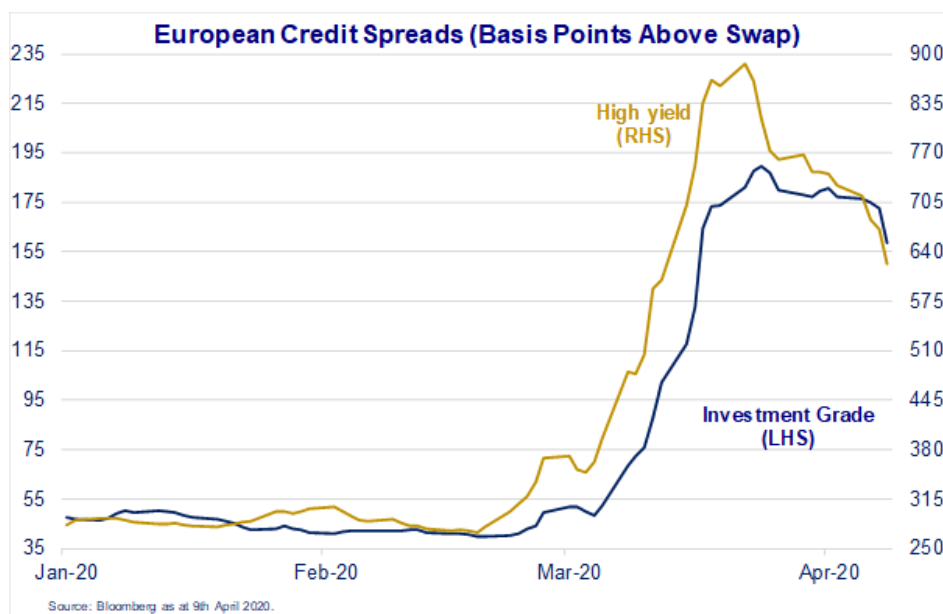
In the US HY space, gains were larger after the Fed announcement, but overall to sector recovered -149 to 732 bpts which is a 19-day low (see chart). Overall, the index has recovered 53% of the spread blow out from mid-February but there is little doubt that the HY market liked the sound of the proposed oil

production cut with energy now recovering 58% of its spread blow out. With consumer staples (82%) leading the recovery rate, whereas materials (48%), consumer discretionary (41%), subordinated financials (46%) and industrials (35%) at the other end of the sector distribution.



- European credit also had a positive week with IG spreads contracting -19 to 159 bpts which is a 17-day low with the sector now having recovered 21% of its COVID-19 spread blow out. However, gains here have been concentrated in that subordinated financials (45% recovery rate) and senior financials (31%) are the only sub-sectors above the sector average.

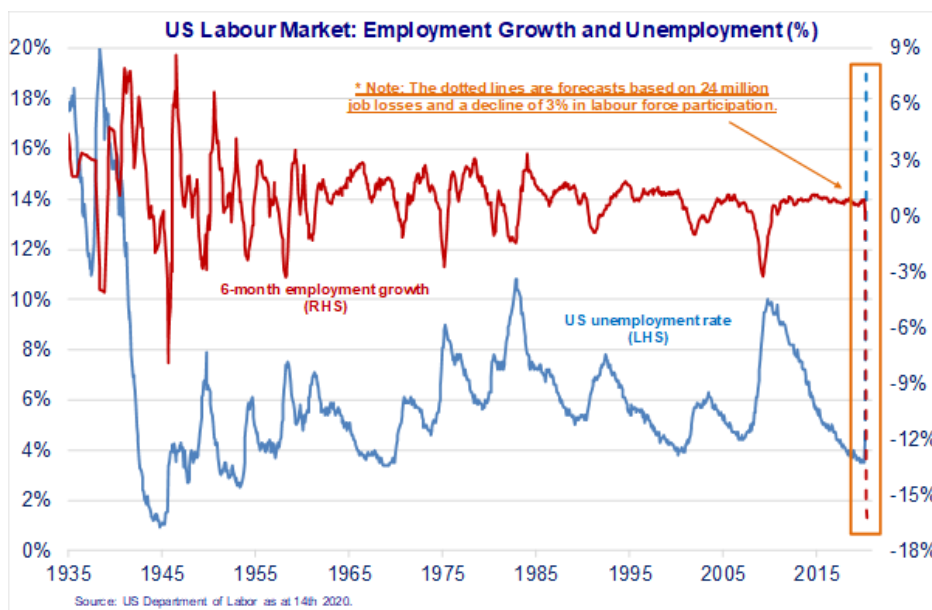
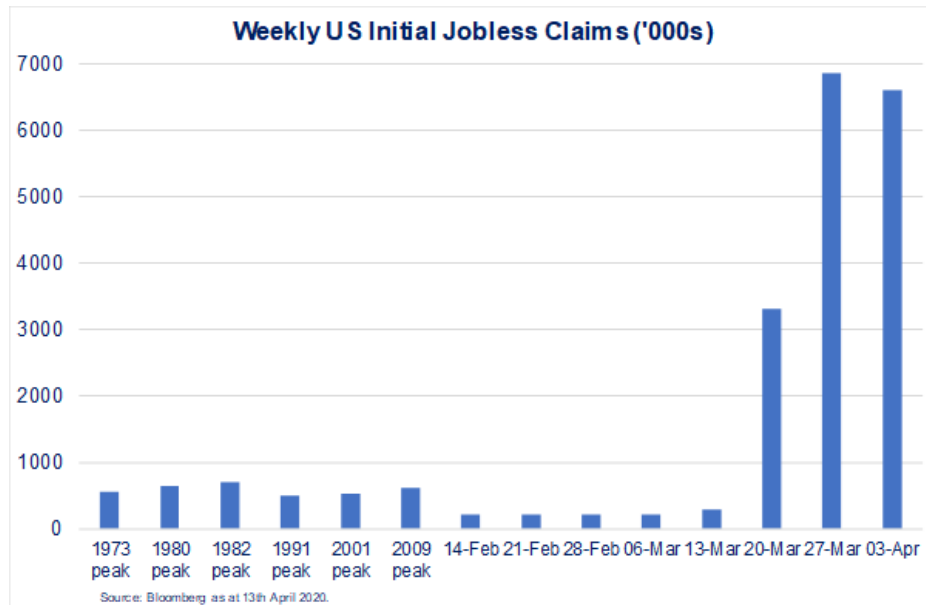
In contrast, the recovery rate in the European HY sector was -102 to +625 bpts (which is a 19-day low – see chart) with the sector now having recovered 43% of its COVID-19 spread blowout. HY energy (-218 to +783 bpts having a strong week and taking its recovery rate (48%) above the sector average for the first time in the past month, but all sectors saw spread contraction over the past week.



THE GLOBAL ECONOMY

• US LABOUR FORCE DATA

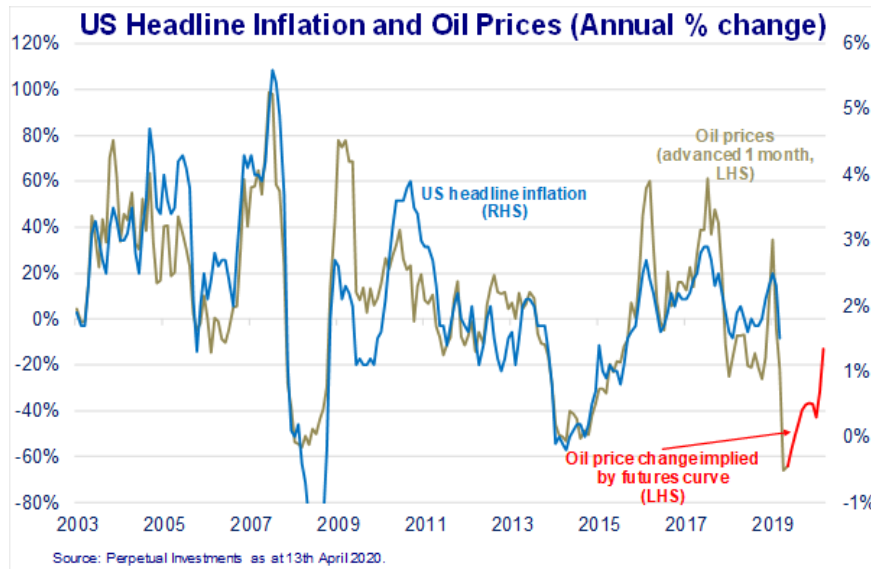
- An additional 6.6 million US workers filed for jobless claims in the week ending 4th April (see chart – which is ten times the record rise in the GFC). This result combined with the previous two week's +3.3 million and +6.9 million has meant that in the past three weeks about 17 million US workers have registered as unemployed (see chart), which is around 10.2% of the 165 million US labour force, and if the participation rate was unchanged, it is already enough to see unemployment rise to 14% by end-April. This would be the highest rate since 1941 which may rise even further (see following chart).



Among the states, California reported the highest number of jobless benefits filed at 925k, Georgia 388k, Michigan 385k and New York (which has been the US epicentre for Covid-19) reported 345k claims. Although the claim numbers are massively above other crisis periods, we may not have seen the peak as the recently signed stimulus package included people self-employed workers and the number of weeks Americans can file for claims was extended. In addition, states also face a massive backlog in unemployment insurance claims as their websites and phone lines are over-loaded.

- US headline inflation fell -0.4% m/m which dragged the annual rate to +1.5% y/y. Among key components, food prices rose +0.3% m/m but energy goods slipped -10% m/m and when these measures were excluded, the remaining core inflation gauge declined -0.1% m/m in March, which reduced the annual rate -0.3% to 2.1% y/y. This was the lowest monthly core inflation reading since mid-2009. Interestingly, oil prices declined to a trough of USD20 per barrel in early April, which combined with the lags in transmission from spot market prices to retail prices, should culminate in an even larger fall in gasoline prices in April which could see US headline inflation decline below zero in May, but this is likely to be temporary unless oil structurally declines from here.

Using March's CPI and PPI results, we'd estimate that the core PCE prices declined -0.15% in March which would see the annual rate decline to about 1.6% y/y and it is likely to bottom about 1.25% in the next two months.



POLICY

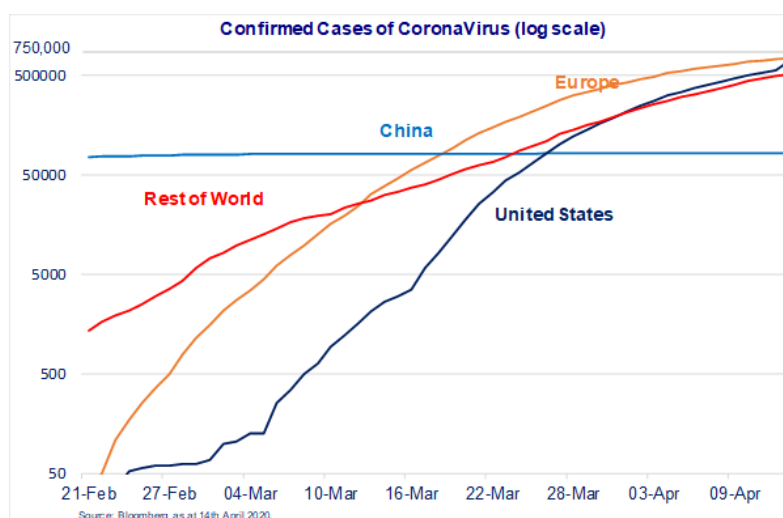
- The world's top oil producers agreed to cut global crude output. OPEC will cut 9.7 million barrels a day for two months (with Saudi Arabia cutting to about 8.5 million which is a 9 year low), and the US, Brazil and Canada and other G-20 countries who are not a member of OPEC will contribute another 4.5 million barrels of cuts with some reduction also in other G20 producers, although this will not amount to much. The OPEC+ cuts are four times larger than the previous record production reduction in 2008 and they become effective on 1 May 2020 and are effective for two years, but the cuts taper off after June 30th. OPEC+ said in a draft statement that it expected total global oil production to be more than 20 million barrels per day, but this seems an over-reach, and the market impact has been quite muted since the announcement amid concerns the cuts still won't match the collapse in total oil demand (seen to be in the order of 25 – 30 million barrels per day).



- Last week Japan declared a month-long state of emergency for seven regions which comprise around half of Japan's economic production. On the surface the ¥108 trillion (19.4% of GDP) FY2020 package seems extreme, the direct support through the government's general account supplementary budget represents only ¥16.7 trillion (3% of GDP) which will support growth by around +1% in 2020 and +0.1% for 2021 which was actually underwhelming and nowhere near enough considering the -17% q/qa decline in GDP in March (as the lockdown in Japan is voluntary), but this runs the risk of a more damaging COVID-19 outbreak and the need for a broader and more forceful economic closures and growth deterioration. The expected -4.75% growth deterioration in 2020 is likely to see Japan head back into deflation territory in 2020 for the first time in 7 years.
- The US Federal Reserve radically altered its policy response to COVID-19 and announced it will invest up to USD2.3 trillion in loans to aid small and mid-sized businesses, state and local governments and to purchase of some types of high-yield bonds, collateralized loan obligations and commercial mortgage-backed securities. The announcement is on top of its previously announced USD2.2 trillion QE and rate cuts, and it moves the institution into many types of speculative lending activities which it has shunned in the past which to us is a clear sign that downside risks to the US economy have deteriorated since the Fed last cut rates. The package includes:
 - A USD600 billion Main Street Lending Facility (which will work through banks and which) will deliver funding to companies with up to 10,000 employees or USD2.5 billion in annual revenue with loans ranging from USD1 million to USD150 million, with borrowers subjected to previous restrictions such as employee retention, distribution of dividends and other factors. The program will be backstopped by \$75 billion from the Treasury to absorb losses;
 - The Municipal Liquidity Facility will offer as much as \$500 billion in short-term lending (up to two years duration) to states and municipalities which are at the forefront of the health battles with COVID-19 and whose revenue is likely to collapse given rising unemployment and business closure;
 - The Fed's enhanced Primary and Secondary Market Corporate Credit Facilities (PMCCP, SMCCP) provided an additional USD550 billion (to USD750 billion) to support credit markets. The Fed's Primary Market Facility will purchase new issuance of high yield debt of companies which were investment-grade rated as of March 22 but were later downgraded to no lower than BB-, or three levels into high yield. Similarly, the Secondary Market Corporate Credit Facilities will operate in a similar way to the PMCCP but will also provide market support by purchasing credit ETFs. Both of these are very important as it helps deal with the liquidity issue of corporates being downgraded from investment grade to high yield. However, we believe that the high-yield ETF buying endeavour is a bigger deal than the inclusion of fallen angels as the latter are a narrower set of companies, whereas providing support for high-yield ETFs pretty much puts a floor under the price.

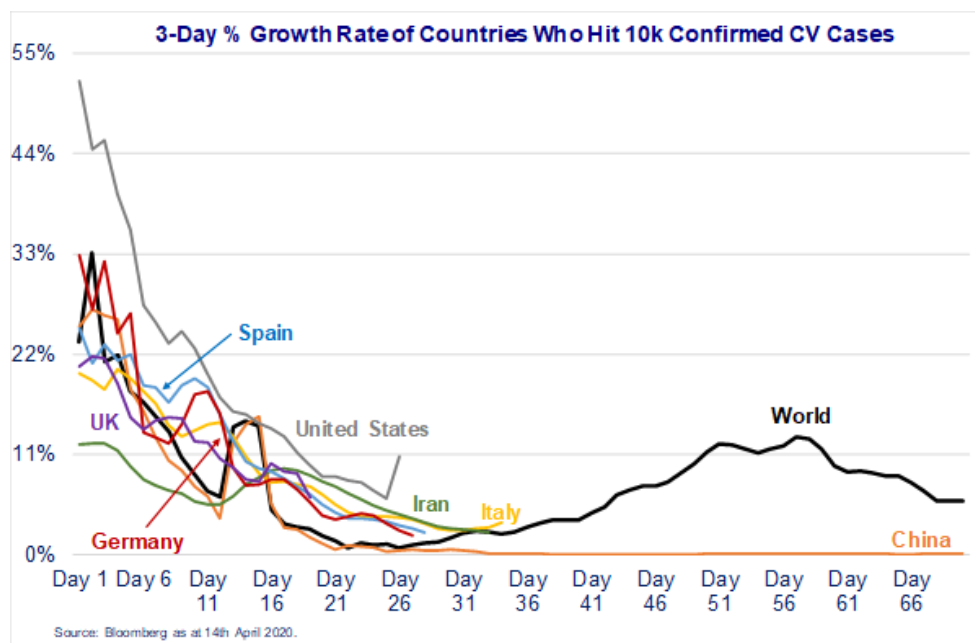
VIRUS UPDATE

- Even though the percentage of daily confirmed Coronavirus cases continues to decline, the number of daily increased by +168k overnight with a major rise in the US. It's hard to know what to make of this as it could be a catch up over Easter, but there is a clear moderation in large advanced economies including Europe, but EMs such as Turkey, Brazil and Mexico are still rising notably. The number of global cases is now at 2.02 million, deaths rose +5,236 (although final numbers are not yet in) to 119.5k but the death rate declined to 5.91% (its first decline in 30 days).

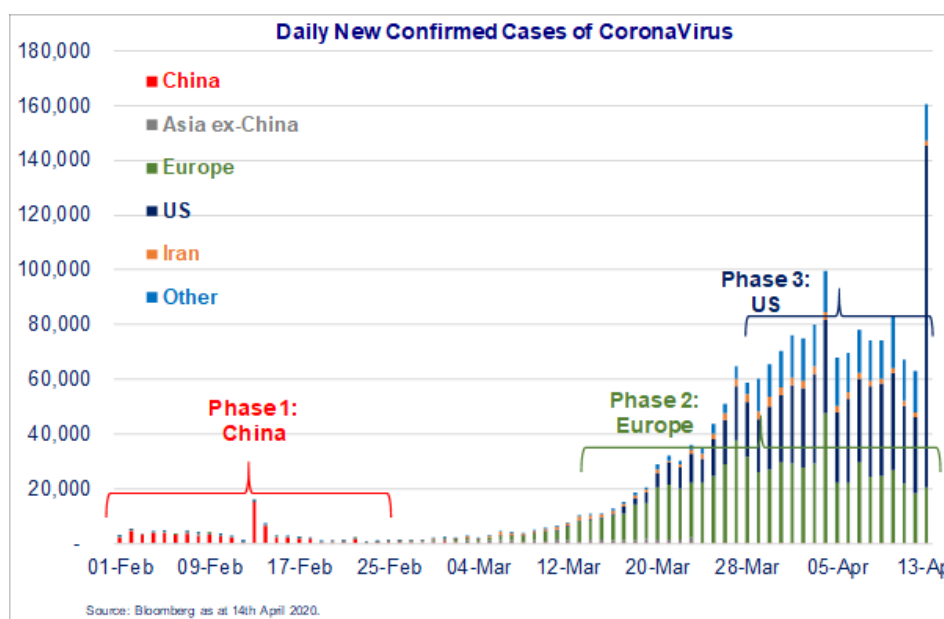


- Europe (+20.3k to 741k) continues to lead the world in terms of total cases but its daily increase (number, not percentage) is trending lower and is now declining (lowest in the past 20 days) which shows that social isolation works to reduce the spread of the virus, even though it comes at an enormous economic cost.

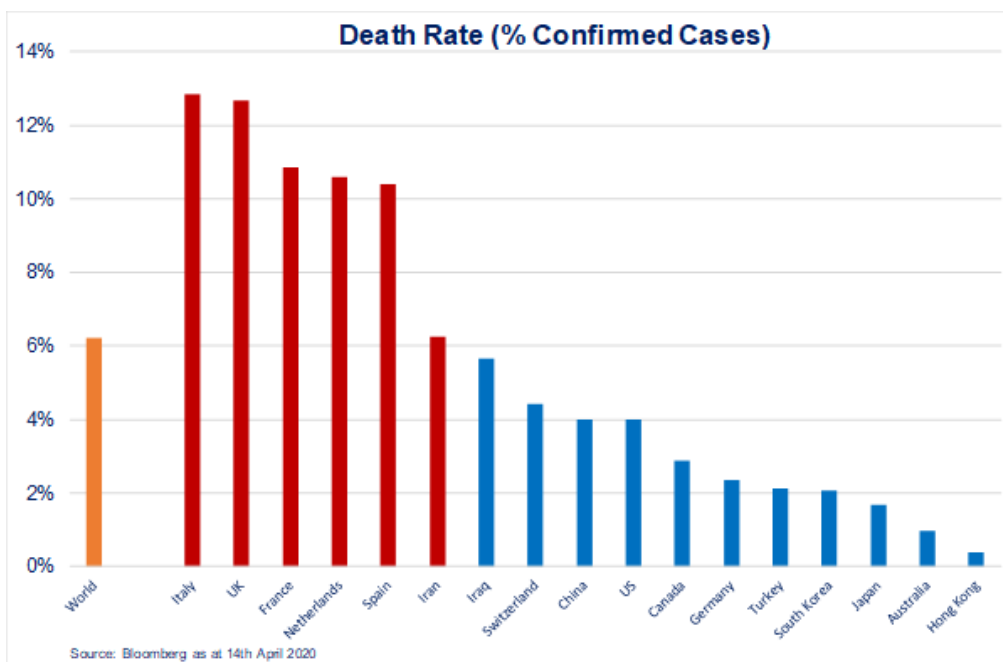
In contrast, the US had its largest daily increase of new confirmed cases (+125.0k to 682.6k) and its 3-day compound growth rate has risen to 10.8% 26 days after they reached 10,000 cases. The slow and piecemeal lockdown of the US meant that its base grew so quickly that the daily percentage change may give the wrong interpretation of the pressure on the US health system. That said, New York cases rose +5.5k and +3.9% overnight which is now below the US average, but deaths in the city that never sleeps rose to 10,060. At this stage, the US surge to me looks like a reporting error, or some kind of data quirk.



- Among countries, the most cases are in the US (+125.0k to 682.6k), Spain (+3.5k which is a 26-day low) to 170.1k), Italy (+7.2k to 160k, which is a record daily increase), France (+4.2k to 137.9k), Germany (+1.4k (27 day low) to 128.2k), China (+78 to 83.2k), Iran (+1.6k to 73.3k) and Turkey (+4.1k to 61.05k). Australia confirmed cases has increased (+36) to 6,351 which placed us 31st in terms of total infections.



- The global death rate has declined to +5.91% (having doubled in the past 7 weeks and risen in each of the prior 29 days) with another +5.2k fatalities overnight bringing the global total to 119.5k. The death rate is highest in European countries where the health systems have collapsed led by Italy (+0.1% to 12.8%), the UK (+0.2% at 12.7%), France (+0.1% to 10.9%), the Netherlands (-0.1% to 10.6%) and Spain (+0.1% to 10.4%).



Yours sincerely,



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