

# THOUGHTS ON THE MARKET

14<sup>th</sup> May 2020 – If the bear market rally is over, where are the stress points?

## SUMMARY

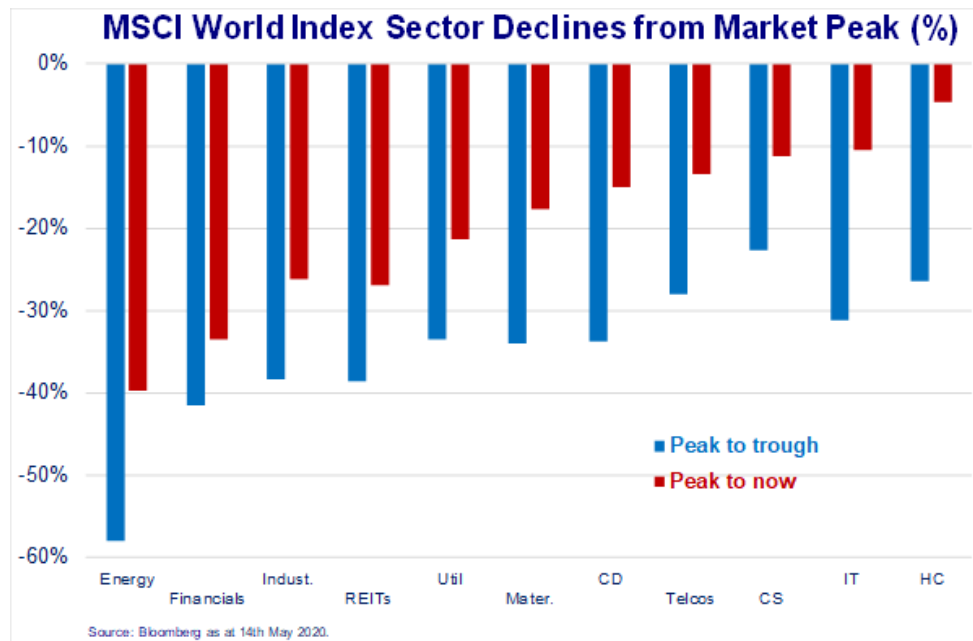
- Global risk markets slumped for a second consecutive day after US Fed Chair Powell warned of the large economic risks from the COVID-19 virus. The Fed chair noted in his remarks that the Fed is not looking to negative rates, and that the threat of a lasting downturn can increase without additional fiscal spending, and the Republicans overnight rejected out of hand Democrat plans of another USD3 trillion of fiscal support. The overnight message continued the theme from yesterday of a weaker and slower recovery and provide comfort for two key views we have is that global growth will decline -5% in 2020 and US unemployment will peak at a Depression-like 25%. These are more than double the respective numbers for 2008/09, yet markets believe that the global and US earnings decline will only be down -20% and -22% respectively relative to -37% and -36%, respectively in 2008/09 – these seem too optimistic given the growth backdrop and will need to be downgraded and investors will need to consider how to diversify their equity and credit risks considering bonds and gold have already rallied strongly and therefore will provide less portfolio ballast than in previous crises.
- Although tomorrow is a new day, views are beginning to firm that the 2020 bear market rally may have run its course and many people are asking what price would make markets attractive. That is the wrong question to ask because in the end price targets don't work in periods of stress – in rolling bear markets, indices move abruptly lower when new stresses emerge and these make previous price targets out of date. What are the likely new stress points? Given the COVID-19, growth and debt metrics around the world, new stresses can emerge in any number of place, but the two most obvious are:
  - Firstly, emerging markets which have built up considerable debt (now totalling USD71 trillion) over the past decade and it has to be remembered that some in these regions are suffering considerable capital flight, the economic shock is huge as they on the whole are dependent on globalisation for growth, and they have limited central bank firepower, and time, to be given a financial bailout. Indeed, in recent weeks Argentina, Lebanon, Zambia, Ecuador and Rwanda have all announced they are struggling to repay their debts and these may be the tip of the iceberg if the economic downturn persists and stresses become amplified.
  - Another potential stress point is the US collateralised loan obligations market which package up risky corporate loans to fund payments on a group of new securities that have cascading exposure to default by any underlying borrowers. These are similar to CDS securities which became famous in the build up to the 2007 sub-prime crisis, and in 2020 these loans could be ground zero in terms of vulnerabilities to the COVID-19 crisis. The growth in this area has resulted from the rapid expansion of private equity firms post-2008 and the willingness of yield-hungry investors to fund their activities.
- Economic news was scant overnight with US producer prices coming in well below street estimate and when the result is combined with yesterday's CPI, it suggests that the April core PCE will drop around -0.65% to +1.1% y/y. Meanwhile, March European industrial production declined a record -11.3% m/m with Italy down an incredible -28% m/m with worse to come in April.
- Although final numbers are not in, in COVID-19 news the number of global cases stands at 4.34 million with another +73.5k cases overnight (which is the 43rd day in the past 44 where daily increases have topped 70k). The increase means 5 countries have more than 200k cases, 10 countries have more than 100k cases, 29 over 20k cases and 48 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 million, and in the past 5 days another 337k cases have been confirmed. That said, the growth rate of daily confirmed cases is declining (+1.9% since last Sunday). Meanwhile, deaths rose +4.2k overnight to 296.7k and the death rate dropped for a seventh day to 6.78%.

## FINANCIAL MARKETS

### • EQUITIES

- The MSCI World Index fell (-1.7%) for a third consecutive session which pulled the global bellwether index to a 3-week low. There were losses in all sectors led by energy (-3.9%) which suffered after US Fed chair Powell talked about the growth risks surrounding COVID-19 and that a more prolonged downturn could occur if more fiscal firepower was not unleashed. As usual, what was evident in the energy space was also apparent in financials (-2.8%) with some very heavy losses in Europe where the economy looks incredibly weak and bank dividends have been cut to zero to bolster balance sheets.

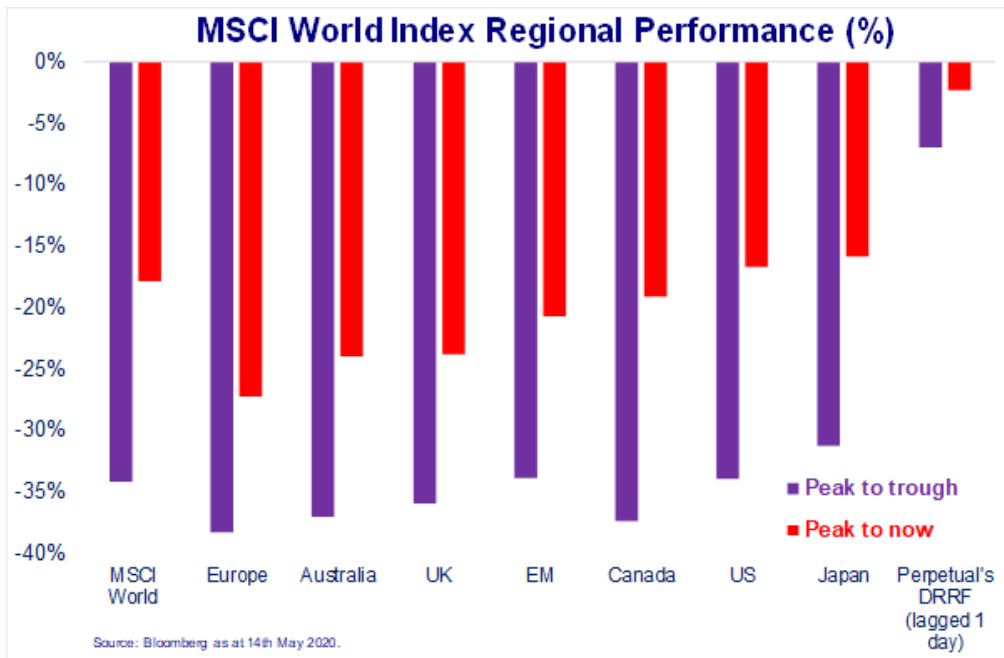
Other cyclical sectors were in the firing line including industrials (-1.9%) and tech (-1.6%), but healthcare (-0.7%) proved itself resilient yet again as the non-cyclical nature of the earnings and dividends bolstered the attractiveness of the sector, not to mention the additional support being given to find a vaccine for COVID-19. The overnight decline lowered recovery rates in all sectors but only 5 at this stage remain in bear market territory (see chart).



- Among the regions losses were largest in Europe (-2.6%) whose larger share of the FIRE sectors weighed on performance with very sharp losses in banks including ABN Amro (-9.1%), Commerzbank (-7.1%) and ING (-5.4%). This poor sentiment flowed through to US markets at opening and markets kept heading south for most of the day and closed -1.7% lower which combined with Monday wiped out last week's gains with the index now at a 3-week low. The Magnificent 5 stocks (-1.1%) outperformed the broader index whereas financials (-3.0%) and energy (-4.4%) led the pace of declines.

Earlier in Asian trading the MSCI Asia Pacific index closed +0.1% higher as advances in Korea (+1.0%), Australia (+0.4%) and China (+0.2%) were mostly offset by losses in Hong Kong (-0.3%) and Japan (-0.5%). The overnight declines saw Japan overtake the US as the best performing market since the mid-February peak (-15.8% - see chart) with Europe (-27.3%) now clearly the worst as the region's index composition and lack of policy firepower continue to hinder investment performance.

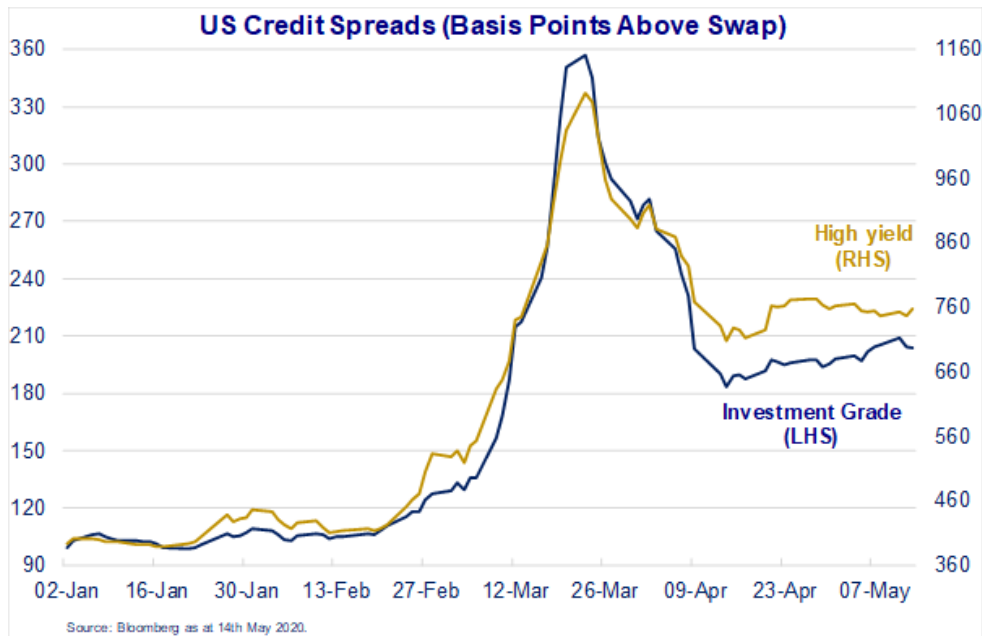
Futures markets suggest markets will open lower in both Australia (-1.1%) and Japan (-1.1%).



## • CREDIT MARKETS

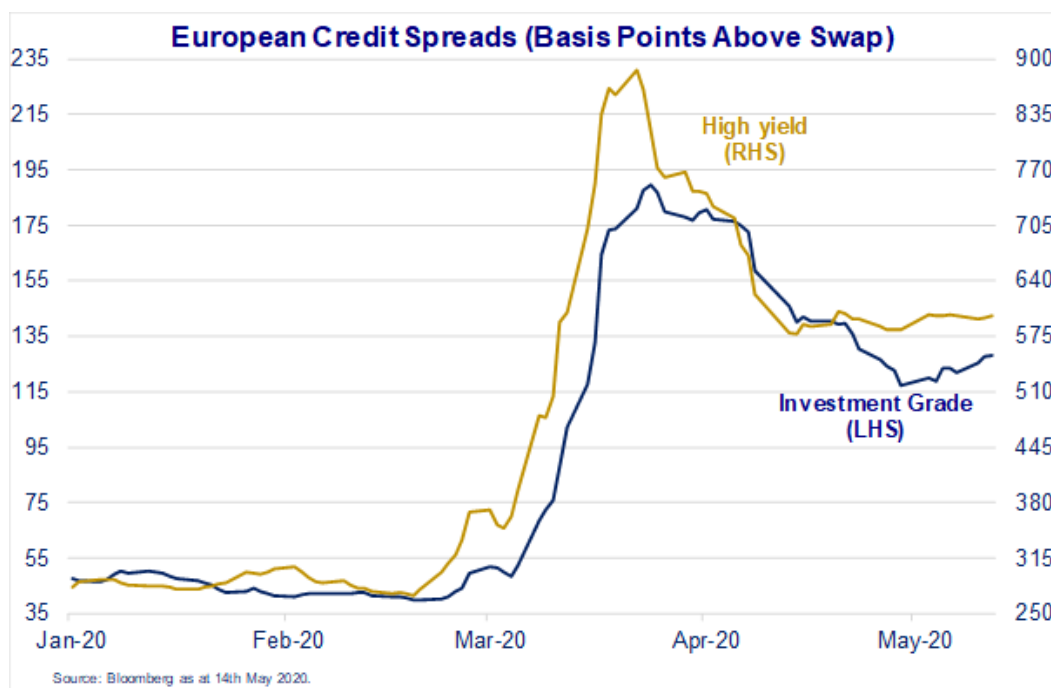
- Regional credit markets were mostly lower. In the US investment grade universe, spreads came in a point to +204 bpts (see chart), but the recovery rate was unchanged at 60%. There were declines in most sectors, but these were minor, and investors marked time and may have moved money out of the higher-risk high yield markets and placed it in the sectors which are more likely to receive Fed support. The largest credit spread contraction was in consumer discretionary (-1.7 points to +250 bpts, 62%) and energy also came in (-0.9 points, +317 bpts, 62%) despite a -1.9% decline in the global crude price to USD25.29 per barrel.

In the high-yield universe, spreads widened +11 points (16-day high) to +758 bpts (two week high) which pulled the recovery rate down two notches to 49%. Larger risk premiums were priced in every sector with the increase led by tech (+29 points, +637 bpts, 44%), subordinated financials (+16 points, +805 bpts, 32%) and materials (+14 points, +652 bpts, 45%).



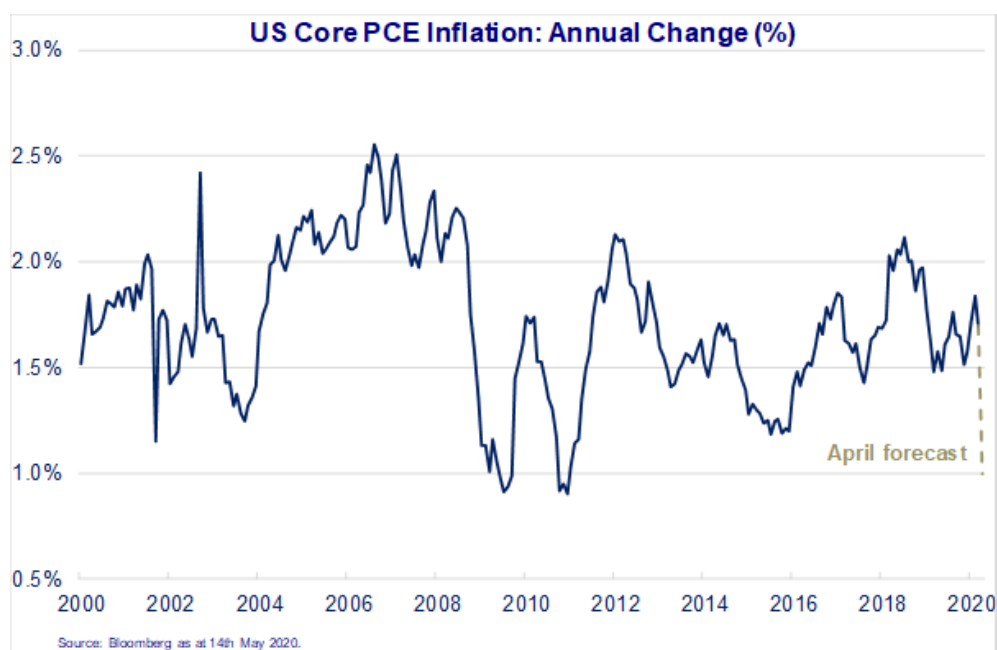
- European credit markets saw wider spreads overnight with the investment grade market to +0.2 points, +128 bpts (see chart), but the recovery rate was unchanged at 41%. This was the third consecutive day of

higher risk premiums and the increases were led by sub-ordinated financials (+7 points, +225 bpts, 48%) and consumer discretionary (+4 points, +199 bpts, 35%), but energy declined -1 point to +131 bpts, 25%) as the daily crude price peaked at the end of the European session and then headed lower during US trading. In the high yield universe, spreads increased +4 points to +600 bpts, which lowered the recovery rate to 47%. Among the sectors, higher risk premiums were recorded in both consumer discretionary (+12 points, +795 bpts, 44%) and materials (+10 points, +553 bpts, 47%) given overnight declines in global raw materials prices including copper (-1.2%).

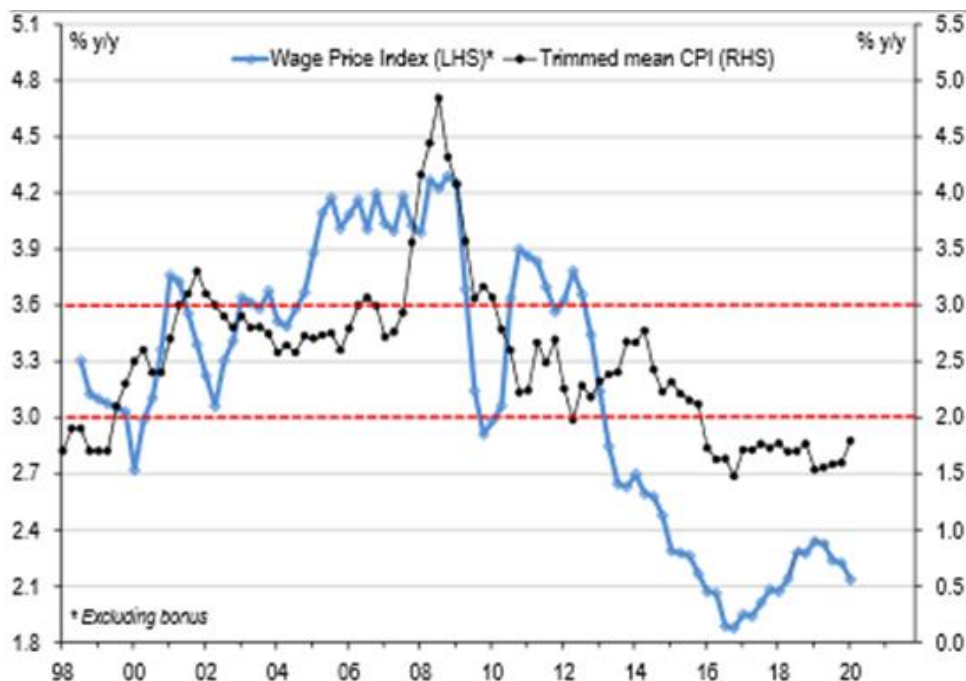


## THE GLOBAL ECONOMY

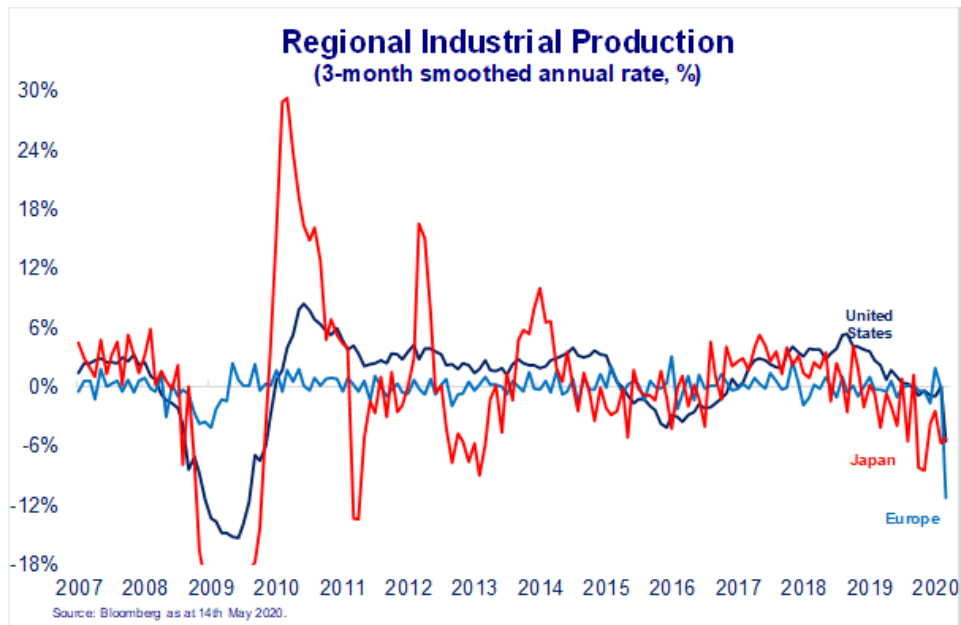
- **The April US producer price index** decreased by -1.3% m/m which was more than double street estimates. The decline reflected a decrease in energy prices (-19.0% m/m), lower food prices (-0.5% m/m) and a large decline in core producer prices (-0.9%) with the latter suggesting firms have lost pricing power. When combining the components from the April PPI and CPI releases, the core PCE price index is likely to decline by -0.35% m/m in April, which will lower the annual rate to +1.08% y/y which is the lowest since January 2011 (see chart).



- **The Australian March quarter wage price index** (excluding bonuses) held steady at 0.5% q/q, which is the equal second lowest quarter on record which pulled the annual rate down to +2.1% y/y (equal lowest since 2017). The survey was undertaken before economic lockdowns, so this is not a signal of household income resiliency. Interestingly, the WPI including bonuses moderated to only +0.3% q/q and 2.0% y/y. Wages were already slowing before COVID-19 hit the economy and with unemployment likely to get to double digit territory in the June quarter we believe the excess labour market capacity will see wages growth drop to less than +1% y/y by end 2020 as many companies have implemented wage freezes and government's starved of revenue will try to better control current elevated government wages growth. As such wages growth in 2020 and 2021 will be well below the +3.5% the RBA needs to have domestic inflation at the midpoint of the 2% - 3% target band.



- **Australian consumer sentiment** recorded a record bounce in May (+16.4% to 88.1%), albeit after a record fall in March and April which took the gauge to the lowest level since the 1990 recession. The survey period (4-8 May) covers the release of the Government's plan to reopen the economy in three-stages and the rise was broadly based and results of this magnitude are normally associate with flat real consumer spending growth. Clearly with the economy closed for most the Q2 that won't be the case in 2020.
- **Eurozone industrial production** suffered its worst monthly fall on record (-11.3% m/m and -12.9% y/y) in March. In terms of countries Italy, which went into lockdown first and closed a large part of its production sites, was hardest hit with industrial output down a massive -28.4% m/m. Elsewhere, France slumped -16.4% m/m, Spain -11.9% m/m and German output was -11.2% m/m lower. Among the components, production of durable consumer goods fell -26.3% m/m in the month, capital goods and intermediate goods declined -15.9% m/m and -11.0%, respectively, with energy (-4% m/m) and non-durable consumer goods (-1.6% m/m) preventing a much large regional decline. Overall, numbers this large are no surprise given the plunge in manufacturing PMIs, but worse is set to come in April before a gradual recovery begins as the economic lights are turned by on, but the rebound is likely to be underwhelming as many restrictions will stay in place in coming months and global demand set to remain exceptionally weak.

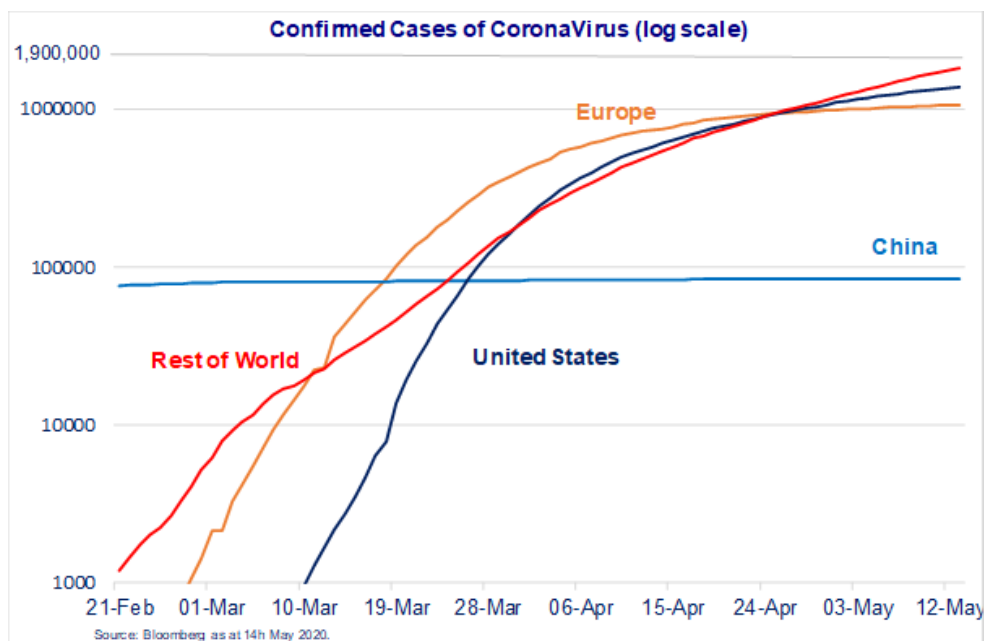


## POLICY

- There were no major policy announcements yesterday.

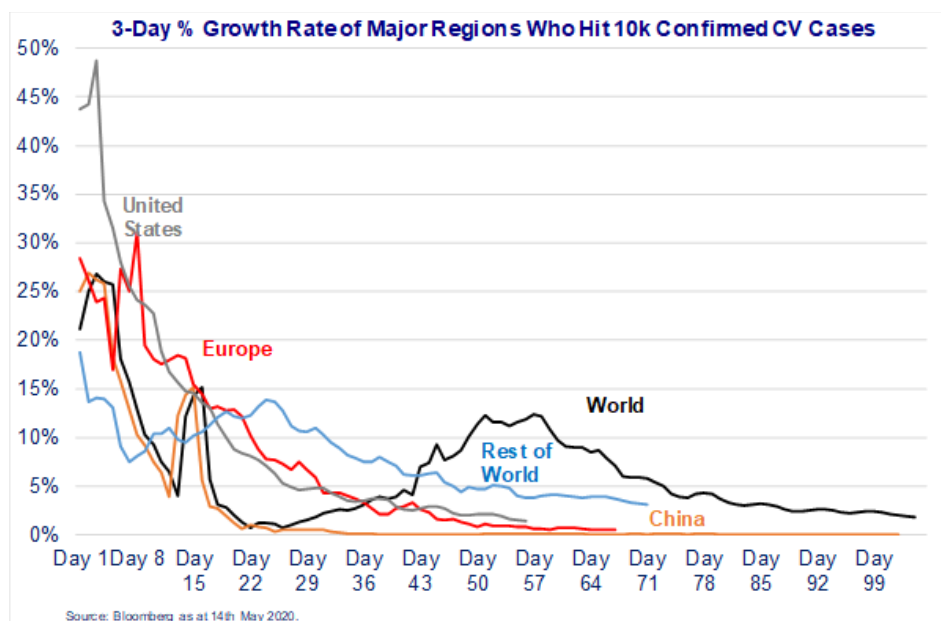
## VIRUS UPDATE

- Although final numbers are not in, the number of global cases of COVID-19 stands at 4.34 million with another +73.5k cases overnight (which is the 43rd day in the past 44 where daily increases have topped 70k). The increase means 5 countries have more than 200k cases, 10 countries have more than 100k cases, 29 over 20k cases and 48 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 million, and in the past 5 days another 337k cases have been confirmed. That said, the growth rate of daily confirmed cases is declining (+1.9% since last Sunday). Meanwhile, deaths rose +4.2k overnight to 296.2k, with the US now over 80k (28.3% 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 seventh day to 6.78%.



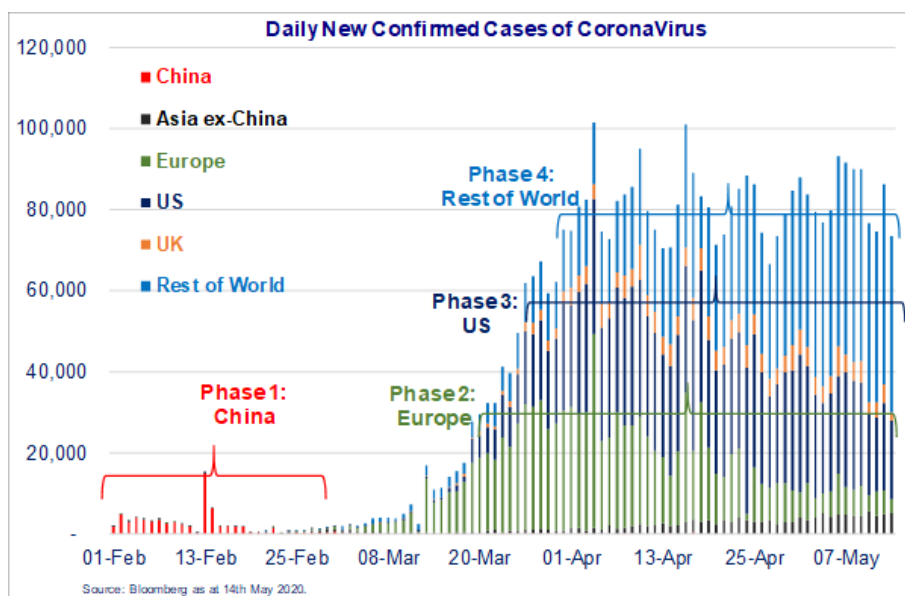


- We break the infections into four groups – the US, Europe, China and ‘others’ and the rest of the world outside the G3 economies now has the most total cases (+43.5k to 1.83 million) and highest daily new cases (and by a considerable margin) followed by the US (+19.4k to 1.39 million) and Europe (+3.6k (9 week low) to 1.07 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 two concerns here are Russia (+10.0k to 242.3k) which has now overtaken Spain to be the second most infected nation after the US) and Brazil (+7.6k to 185.8k).

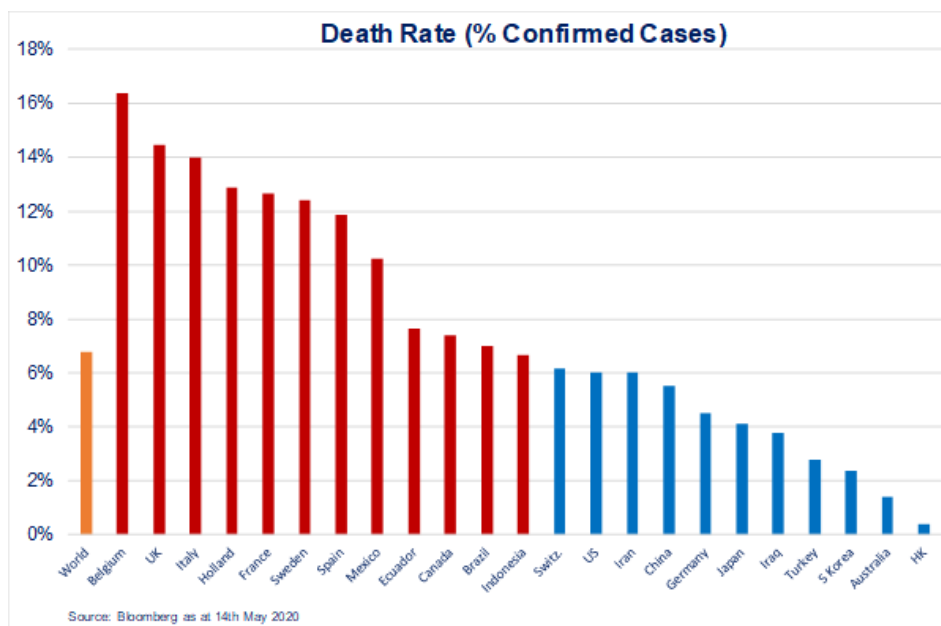


- Among countries, the most cases are in the US (+19.4k to 1.39 million), Russia (+10.0k to 242.3k), the United Kingdom (+2.0k to 231.0k), Spain (+0.7k to 228.7k), Italy (+0.9k to 222.1k), Brazil (+7.6k to 185.8k), France (+0.8k to 178.2k), Germany (+0.9k to 174.1k), Turkey (+1.6k to 143.1k), Iran (+2.0k to 112.7k) and China (+3 to 84.0k). Australia confirmed cases rose +7 to 6,979 yesterday which placed us 50th in terms of total infections.

Elsewhere, Singapore recorded +675 new cases to 25.3k 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 (+689 to 15.4k) and the Philippines (+268 to 11.6). Note final numbers for yesterday at not in yet so these numbers can rise.



- The global death rate declined for a seventh straight day to 6.77% with another +4.1k fatalities overnight bringing the global total to 296.3k. The US (+1.4k) has the most deaths at +83.8k, with the UK (+0.4k to 33.2k), Italy (+0.2k to 31.1k), Spain (+0.2k to 27.1k) and France (+0.04k to 27.0) all over +25k. The death rate is highest in European countries where the health systems have collapsed led by Belgium (+0.1% to 16.4%), the UK (+0.1% to 14.5%), Italy (steady at 14.0%), the Netherlands (+0.1% to 12.9%), France (+0.1% to 12.7%), Sweden (+0.3% to 12.4%), and Spain (steady at 11.8%). However, several emerging markets are now on the leader board including Mexico (+0.4% to 10.2%), Brazil (+0.3% to 7.0%) and Indonesia (-0.1% to 6.7%).



Yours sincerely,



**MATT SHERWOOD**  
Head of Investment  
Strategy, Multi Asset



**MICHAEL O'DEA**  
Head of Multi Asset

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**Perpetual Investments** 1800 062 725

**Email** [investments@perpetual.com.au](mailto:investments@perpetual.com.au)

[www.perpetual.com.au/investments](http://www.perpetual.com.au/investments)