Perpetual Investments

THOUGHTS ON THE MARKET

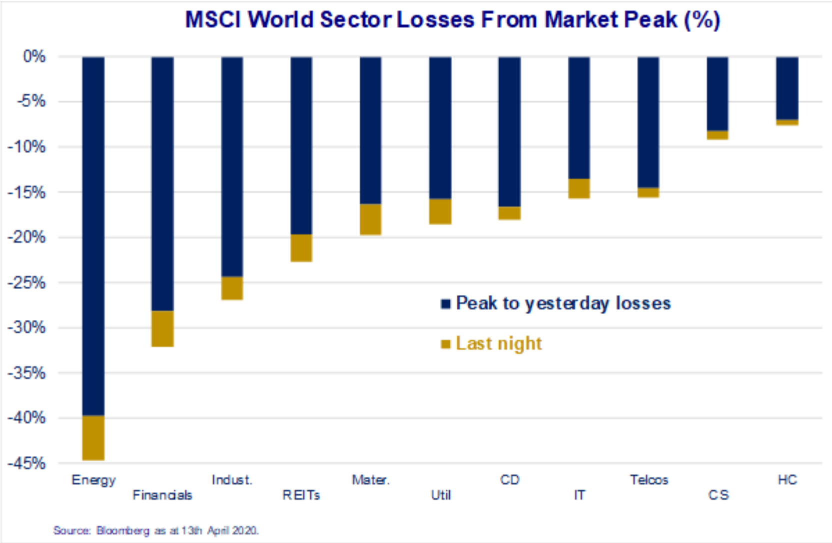
16th April 2020

SUMMARY

- Global equity and credit markets slumped overnight as both earnings and economic data confirmed the brutal impact that economic closures have had on activity. Indeed, overnight data confirmed that US retail sales and industrial production recorded historic declines in March, and surveys suggested that the worse is yet to come in the June quarter. The decline overnight followed on from the largest 15-day rally in the S&P 500 in nearly 90 years, but all market sectors declined as earnings results from Citigroup, Goldman Sachs and Bank of America confirmed they were setting aside billions for loan losses. In contrast, safe havens performed well with Treasuries recording solid gains with the curve flattening, the US Dollar was firmer on the major crosses, but gold was down -1.6% after hitting eight-year high yesterday.
- It appears that the market's mood, which had been upbeat for several weeks as the COVID-19 crisis began to stabilise and then then declined in major economies, has now soured as investors changed their focus from falling case numbers to falling earnings and waning dividend prospects, and we have been highlighting for several weeks the growth hole is considerably larger than current expectations.
- While it is increasingly acknowledged by market analysts that the US, Europe, Australia and the UK will record their largest quarterly contraction in GDP growth in history in the June quarter, the key for markets is the shape of the recovery and in some ways September is more important than June. However, there is a highly uncertain and wobbly path of how to go from lockdowns to exit strategies, and risks around the adjustment to the new 'normal' may have been mispriced.
- Another key development overnight was that oil fell to a fresh 18-year intra-day low of USD19.28 per barrel on data which confirmed a record decline in US fuel demand and this negativity was added to by the International Energy Agency forecasting that 2020 will erase 20 years of demand growth in energy. After the initial selldown, the price lifted off its low and closed pretty much unchanged. However, the decline was enough to see credit spreads widen for the first time in eight trading days.

FINANCIAL MARKETS

- **EQUITIES**
    - Regional sharemarkets recorded large losses overnight. The declines were led by the stressed sectors in these crises namely energy (-5.0%), financials (-4.0%) and materials (-3.4% - see chart below), with the decline in REITs (-3.0%) pushing the sector back into bear market territory.

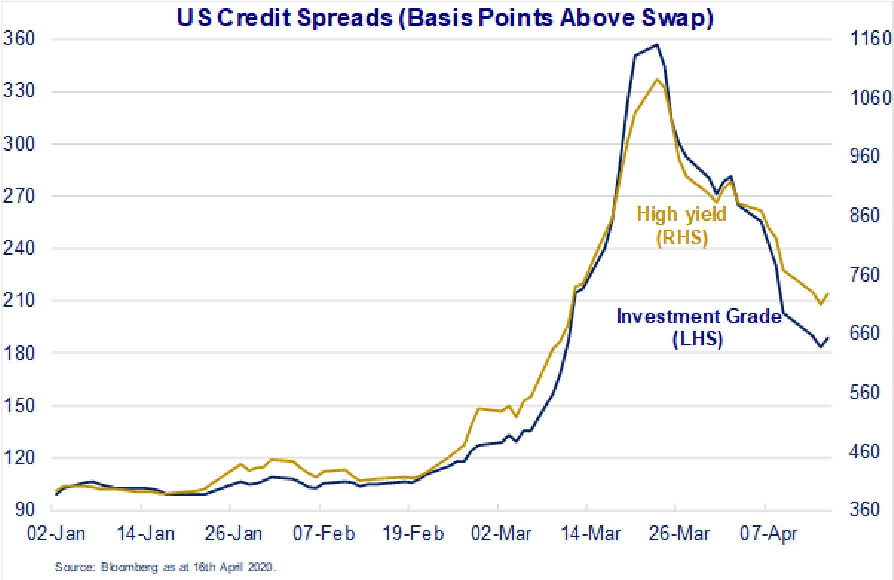


- In the regions, the decline began in Asian markets yesterday where all major bourses closed lower led by Hong Kong (-1.2% d/d), China (-0.7% d/d), Japan (-0.5% d/d) and Australia (-0.4% d/d). This sparked a poor session in Europe (-3.8% d/d) where losses were led by industrials (-8.7% d/d), financials (-4.6% d/d) and IT (-3.9% d/d). The negative vibe from the world's largest economic region flowed through to the world's largest sharemarket with the S&P 500 declining -2.2% d/d having yesterday finished its largest 15-day rally since 1930. That said, there were losses in all US sectors led by energy (-4.7% d/d), materials (-4.5% d/d) financials (-4.4% d/d) and REITs (-3.8% d/d), but these declines were cushioned by defensives such as consumer staples (-1.6% d/d), telcos (-1.1% d/d) and healthcare (-0.5% d/d).

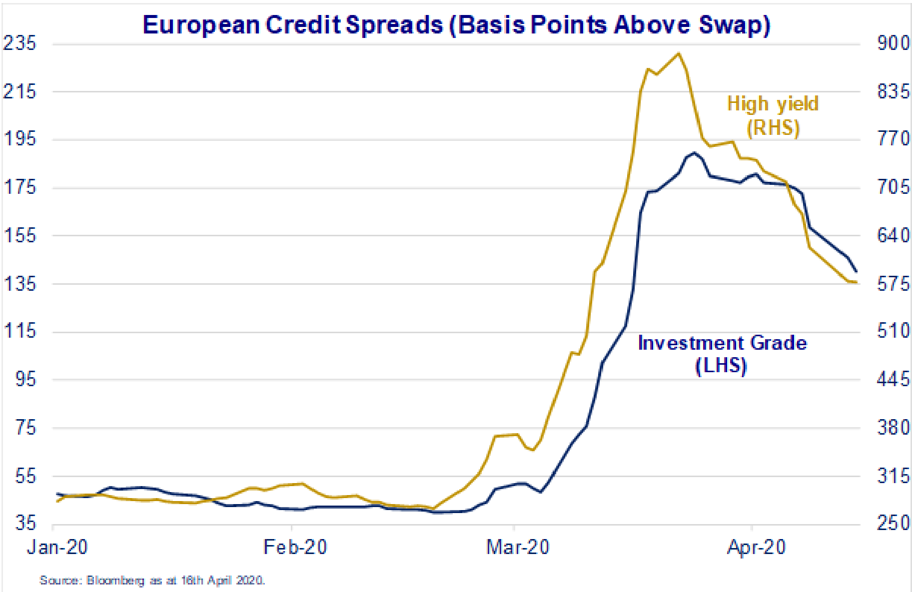
- Futures markets suggest a loss in Australia of -2.4% d/d on the opening bell.

- **CREDIT**
  - US credit spreads widened for the first time in eight sessions as an intra-day decline in oil prices to a fresh 18-year low of USD19.28 per barrel reminded investors that not enough supply is being taken out to equilibrate it with falling demand. IG spreads widened in all sector led by energy (+12 to 336 bpts) and there were rises of between 3 and 7 points in other sectors, which culminated in the sector's recovery rate from the March spread peak declining marginally to 66%. In US HY the movements were slightly larger

with a spread increase of +20 to 729 bpts, with the recovery rate slipping to 53%. Among the sectors HY energy recorded the largest increase (+37 to 1419 bpts – see chart), with senior financials (+26 to 717 bpts) also recording a larger-than-average spread increase with all other sectors increasing by around 15 to 20 bpts.



- European credit did relatively better than the US with IG spreads contracting -6 to 140 bpts which is a 19-day low, but HY spreads were steady at 577 bpts (see chart). Among the IG sub-sectors there was a modest 5 to 7-point decline in spreads with energy down 5 points to 138 bpts and there wasn't much of note elsewhere. In HY spreads were unchanged but energy rose a sharp +38 to 768 bpts and a modest increase in senior financials paper +2 to 643 bpts and a whole bunch of moves within five points of the breakeven line.



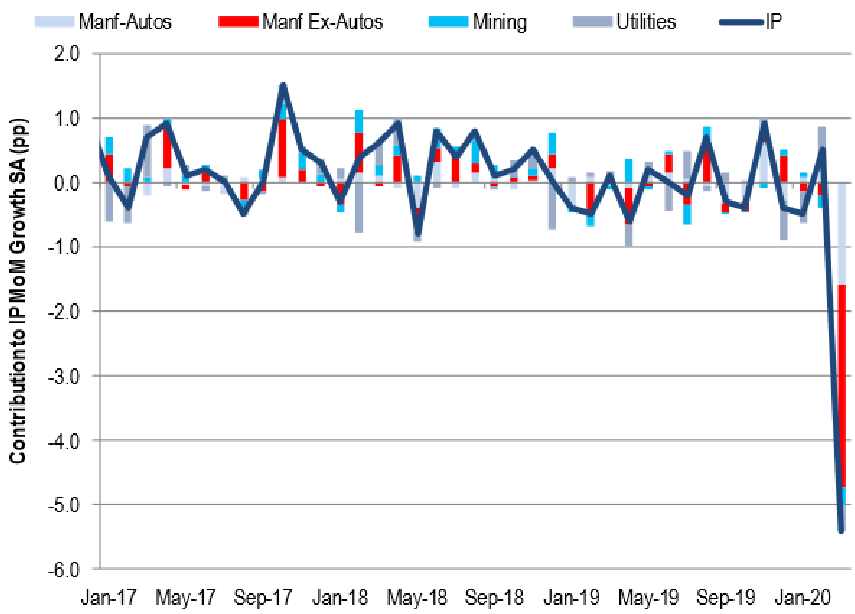
- In other credit news, Fitch Ratings downgraded Mexico's credit rating to BBB-, which is the lowest investment grade rating. The company said in its accompanying statement that the Mexican economy will suffer a "severe recession" which will increase the country's debt burden and that consolidating public finances once the crisis has passed and returning debt metrics to a sustainable path will be challenging.

THE GLOBAL ECONOMY

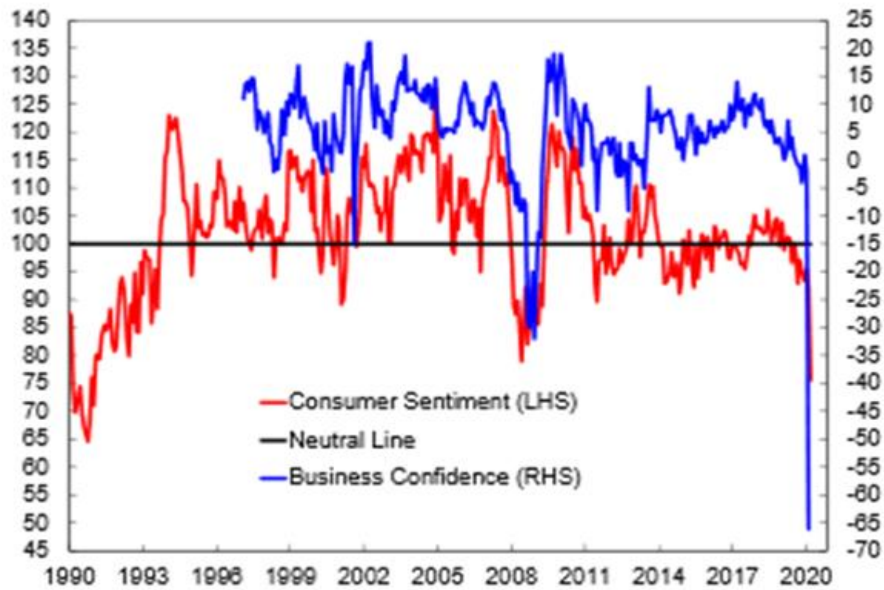
- March US retail sales declined a record -8.7% m/m (see chart) which pulled the annual rate down to -6.2% y/y. Among the key components, clothing (-50.5% m/m), furniture (-26.8% m/m), motor vehicle (-25.6% m/m), sporting goods (-23.3% m/m), gasoline purchases (-17.2% m/m, which is a record low which weighed on oil prices overnight) and electronics (-15.1% m/m) were down bigtime.

  The core control group (used in estimating GDP consumption component) rose +1.7% m/m but this was boosted by a massive one-off increase in sales at food stores (+25.6% m/m) and health stores (+4.3% m/m) as consumers stockpiled essentials before stay-at-home orders went into effect. These increases will not be repeated in April and beyond. While the core control group rose, consumer spending will decline in the March quarter as the bulk of spending is on services which are mostly outside the realm of this report.

- March US industrial production declined -5.4% m/m (see chart). In all honesty, industrial production was expected to decrease an historically large amount in March, but the contraction still managed to surprise to the downside, as manufacturing activity fell -6.3% m/m which is the largest monthly decline since 1946. The production decline appears to have not only come earlier, but also is broader than expected led by durables including motor vehicles, fabricated metal, aerospace and furniture while non-durables fell by less. Utilities (-3.9% m/m) and mining (-2.0% m/m) declined by less, and capacity utilisation dropped to 72.7% in a sign that inflation is heading lower (no surprise there). In the end, manufacturing activity is likely to fall further in April due to both some facilities shutting down and also a lack of demand for certain products (such as airplanes).



- In other US data:
    - April New York Fed Empire manufacturing survey fell to a record low of -78.2 (prior record low was -34.3 during 2008) as business activity, new orders, shipments and employment all declined sharply, but surprisingly expectations six months ahead held up well.
    - April NAHB housing market index of 30 states missed consensus of 52.5 following 72 in March is what was the lowest reading since June 2012 with broad-based declines in all regions, present and future sales and buyer traffic.
- It's hard to think that sentiment data can come out worse than expected, but Australian household sentiment recorded its worst ever monthly decline (-17.7%) in its 47-year history, with the index down to a level (75.6) seen in the 1990/91 recession. Indeed, the only lower level was 71.0 in February 1991.



There were all kinds of horrible metrics within the report, but a couple which caught our eye were that compared to March, 7% of survey respondents reported losing their job while a further 14% reported as being mothballed without pay, which means one-fifth of labour market could be without base income. Despite government support, this is bad for consumption as is the fact that only one quarter of the 53% of respondents who receive income support intend to spend all of it (relative to 62% during the GFC) and a further 20% expect to spend half.

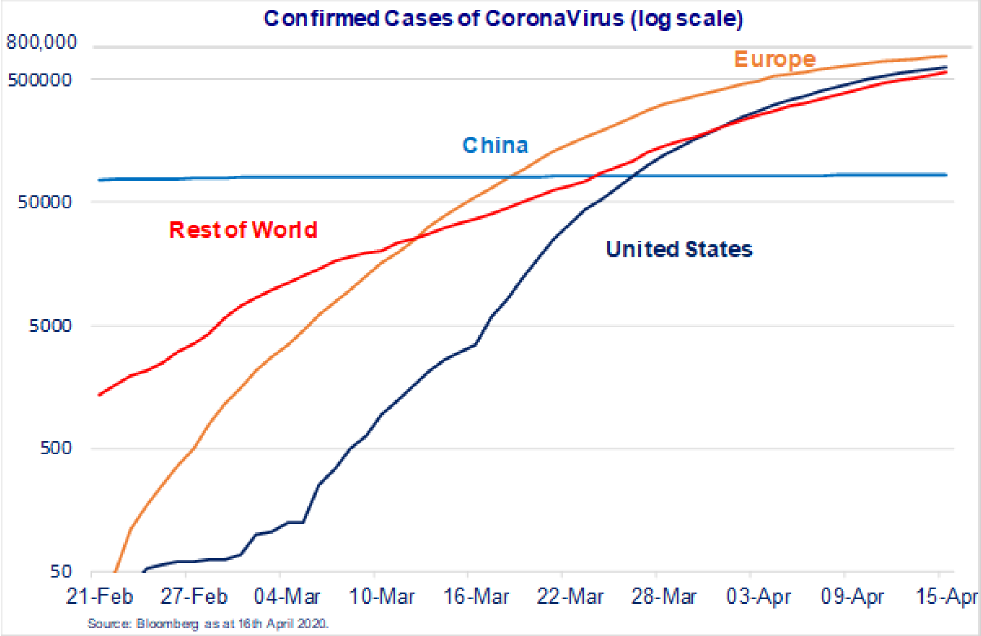
This tells us that household savings are set to structurally rise in the downturn and in the recovery, and is no material monetary policy to support consumption as policy is tapped out.

POLICY

- There were no policy announcements overnight.

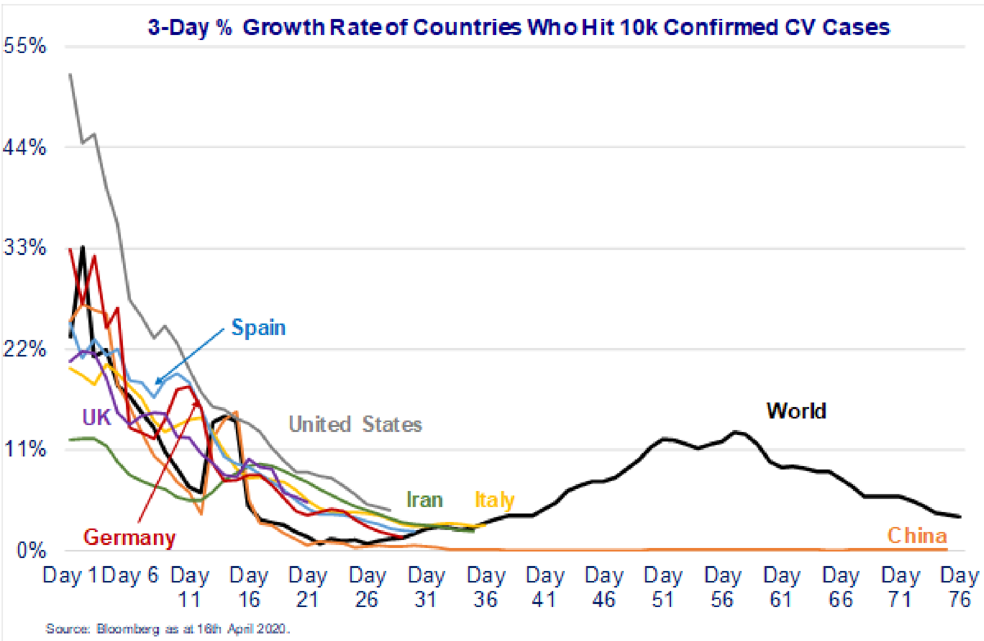
VIRUS UPDATE

- The world recorded another +73.2k confirmed cases of COVID-19 which is a four-day high, but the 3-day global growth rate slowed further to 3.7% which is the lowest in five weeks. The total confirmed cases increased to 2.06 million and deaths rose to 134.2k which brings the global death rate up to 6.46%.



- Europe (+21.5 to 777k) continues to lead the world in terms of total cases and the daily number of cases was a 4-day high but still remained low relative to the past month. The overnight rise does not dissuade us from the view that the region's curve has flattened and that it's heading lower like China's did in March. This confirms that social isolation works to reduce the spread of the virus, even though it comes at an enormous economic cost.

  Similarly, the US (+27.1k to 636k – the final numbers are not in) recorded a solid rise, but it does appear that case growth is peaking, but there is no sign yet that daily increases are declining, and its 3-day compound growth rate declined to 4.5% which is equivalent to those seen in other countries four weeks after they reached 10k cases. New York new confirmed cases (+11.1k to 214.5k) increased to a 5-day high, which took the 3-day growth rate up to 4.1% but this may reflect more testing after Easter, but the number of deaths (+775 to 11.6k) remains elevated.



- Among countries we can see the number of daily cases is really starting to flatten out. The most infected country is the US (+27.1k to 636k), Spain (+3.6k to 177.6k), Italy (+5.6k (17-day high) to 165.2k), France (+4.6k to 147.9k), Germany (+1.2k (26 day low) to 133.5k), United Kingdom (+4.6k to 99.5k), China (+5 to 83.3k), Iran (+1.5k to 76.4k) and Turkey (+4.3k to 69.4k). Australia confirmed cases were unchanged at 6.5k which keeps us at 31st in terms of total infections.

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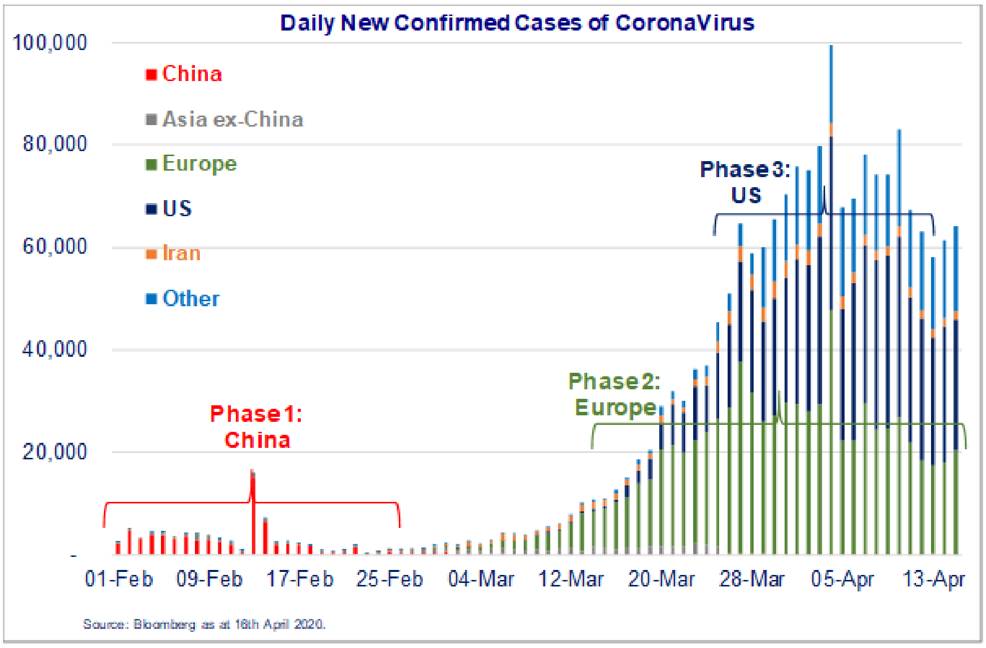
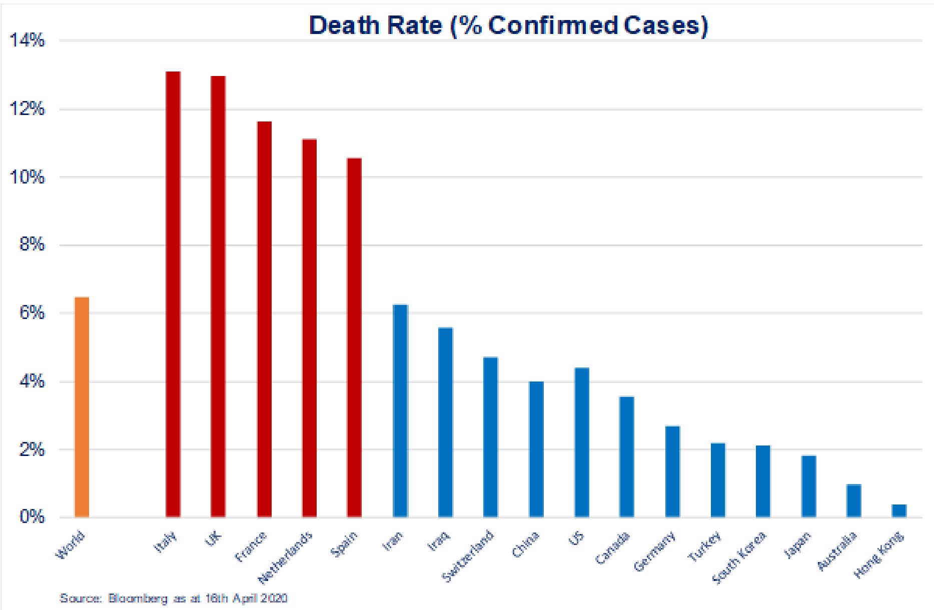


Source: Bloomberg as at 16th April 2020.

- The global death rate has risen to +6.45% (having doubled in the past 7 weeks and risen for 32 consecutive days) with another +6.9k fatalities (fifth highest daily increase) overnight bringing the global total to 134.2k. The US had its second worst day of increases (+1.9k to 27.9k), but the death rate is highest in European countries where the health systems have collapsed led by Italy (-0.1% to 13.1%), the UK (+0.2% to 13.0%), France (+0.6% to 11.6%), the Netherlands (+0.4% to 11.1%) and Spain (steady at 10.5%).



Source: Bloomberg as at 16th April 2020

Yours sincerely,

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MORE INFORMATION

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