Perpetual Investments, Multi Assets

MARKET INSIGHTS

16 March 2020

EXECUTIVE SUMMARY

- COVID-19 - general update
- The world's policy responses to the COVID-19
- The global economy - are we foreseeing a global recession?
- Financial markets update

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VIRUS UPDATE

- The number of Corona virus cases continues to grow aggressively (+57k to 165k over the past week). All the growth is coming from the World ex-China (+56.3k to 85k) where the number of cases has doubled in the past 96 hours and is now surpassed the number of China cases. The number of deaths has increased +2,629 to 6,438 and the death rate has risen to +3.9%.

- Among countries, the increase has been centred in Europe and Iran. In Italy data is 'clumpy' most likely due to the difficulty in collating numbers in a health system so stressed. More worryingly, Europe is now reporting daily confirmed case increases at a faster rate than China did at its peak.

- There are now 11 countries with over 1,000 cases – China (a total of +80,977 but this has seemingly peaked), Italy (21,158), Iran (13,938), South Korea (8,162 where cases seem to be flattening out), Spain (+158% in 72 hours to 7,753), France (+98% in 72 hours to 5,400), Germany (having tripled in 72 hours to 4,838), UK (doubled in 48 hours to 1,372), the US (doubled in 72 hours to 3,037) and Switzerland (2,200), Holland (1,135) and Norway (1,077). Australia has +197 cases.

- The next countries to record sharp case rises in coming weeks are the UK and Switzerland who are not undertaking policies to combat the virus's spread.

THE POLICY RESPONSE

- The slowdown in new cases in China (+282 to 80,977 in the past week) and lack of fatalities in Singapore (0 from 226 confirmed cases) indicate that draconian measures to contain the virus can work. In contrast, the rapid number of deaths in Italy (1,809 for a death rate of 8.5%) raises the question over whether Western healthcare systems can cope, even though Italy's health system was ranked third best in the world in 2018. This was reinforced by New York (with 729 cases) Mayor Andrew Cuomo's warning that his health system was about to be overwhelmed

- In contrast to China and Singapore measures, no policy response in the developed world has addressed what is at the epicentre of the recent market malaise – it is a health crisis which is spreading fast. Accordingly, fiscal packages, emergency interest-rate cuts, more central bank asset purchases and liquidity injections have not put a solid floor under the worst rout since the GFC, notwithstanding Friday's market bounce.

- Governments have begun to close industries (travel, tourism, restaurants, bars, night clubs, sporting facilities) where the virus can easily spread and have legalised (in some places) self-isolation for returning citizens. While schools and universities remain open, they will likely be closed very soon. It is hoped these measures can reduce the growth of the virus, but it will come late and at a large cost to all economies.

- Policy responses to deal with the 'containment shock' need to be large, targeted, immediate and credible.

AUSTRALIA

Last week, Prime Minister Morrison announced a AUD17.6 billion (+1.2% of GDP, which added to prior announced support) fiscal stimulus package with 60% (AUD11 billion) to be spend before June 30, which means the spending is heavily front loaded.

There are four key parts to the plan:

1. Keep households spending through cash handouts: A cash injection worth AUD4.8 billion (+0.25% of annual GDP in one quarter) will be paid to 6.5 million Australians which each eligible person receiving $750 from 31 March 2020. More than 5 million Australians on Newstart, pensions and family tax benefits will be eligible for the emergency cash payments.

2. Improving health outcomes: There is a AAUD2.4 billion package to deal with the health impacts of CV and its based around bulk-billed phone consultations with doctors, and 100 pop-up fever clinics (capacity for 75 patients per day).

3. Keep small business open: There is a AUD1.3 billion package for small- and medium-sized businesses who will receive $2000 to $25,000 to help pay wages or hire extra staff. This is augmented with an extension of instant asset write-off to support investment with the cap lifted to companies with turnovers of $500 million (AUD50 million currently) with the maximum investments of $150,000 ($30,000).

4. **Supply side effects**. There is a AUD1 billion fund to help the tourism sector given travel restrictions and so on.

The Morrison Government's plan is to write off Q1 and to front load the stimulus into Q2 after which measures flow onto business to continue the recovery. The Q1 handouts total around +1.3% to GDP (q/qa) and they are well aimed at groups with the highest propensity to consume (lower income earners and pensioners), but I suspect that the rapidly deteriorating health crisis will see a large portion of the stimulus being saved, unlike 2008 (88% of the Rudd Government's cash handouts were spent and the RBA cut rates by -425 bpts instead of -125% in total this time around).

Fiscal stimulus will be combined with the RBA reaching the effective lower bound (0.25%) on 7th April (if not before). This will likely bring unconventional monetary policy sooner rather than later. There have been reports about the RBA using forward guidance and yield curve controls (instead of asset purchases). To me, this idea has considerable merit as YCC would be easier to implement than QE as the target is a price not a quantity, it maintains better control of the balance sheet's size and it's easier to exit once targets are achieved.

UNITED KINGDOM

The UK policy response has also been well designed with careful coordination between the Johnson Government and Bank of England creating a combination of shared purpose and re-enforced effectiveness. The Bank of England eased rates (-0.5% to 0.25%), provided a 1-year window for banks to access long-term funding (i.e. provided cheap funding for a four year period) and providing a counter cyclical reduction in the capital buffer (from 1% to 0%) and this was combined with a fiscal stimulus of +0.75% of GDP.

EUROPE

The world's largest economic region has had the largest build-up of Corona risk cases in the past month and last week delivered the most underwhelming policy response. Government's appeared to be preparing for helping supply side issues such as targeted lending, short-term work subsidies (for Germany) and the European Commission promised a €37 billion fund to handle the fallout, but it's certainly not co-ordinated and its far too small considering large parts of major economies are now in lock-down. This was combined with poor demand management from the ECB last week when new President Lagarde not only failed to cut rates, but then delivered clumsy messaging for markets when she said it not the ECB's job is protect high-indebted countries or to limit the upside risk for credit spreads. Accordingly, the overall European response is piece meal, not targeted, slow, un-coordinated and no way near enough. This needs to be rectified very quickly.

UNITED STATES

The Federal Reserve completed its policy seep on Monday morning by cutting its benchmark interest rate by -110 bpts to near zero and promising to boost its bond holdings by at least USD700 billion. They also announced other actions including allowing banks to borrow from the discount window for up to 90 days and lowering the reserve requirement ratios to zero. They will also insure than US dollars are available around the world via swap lines.

THE GLOBAL ECONOMY

As much as economists don't want to admit a global recession is possible despite deep negative interest rates already being in place, a global recession has moved from a risk case to a base case and the key for markets is the labour market impact as this will govern the recession's depth and duration (and in many ways these continua will reinforce each other) and subsequent policy adjustment/reinforcement.

The way I see it unfolding initially is that large growth contractions in China, Japan and Italy in Q1 will combine with a sizable contraction in Europe ex-Italy and a modest one in the US (but could be flat) to culminate in a -0.3% q/q (-1.3% q/qa) decline in global activity.

This decline will intensify in June (-0.7% q/q) as the contractions in the US, Europe and Japan deepen, and nearly all other G20 economies are engulfed and outweigh a modest positive score in China.

In the September quarter the recession will either continue or the recovery will start and at the epicentre of this binary world will be the labour market. We have no data to analyse is regard to this and it won't arrive for another month, but can make some key generalisation about the risks:

- Recessions occur when shocks hit vulnerabilities and unlike the 2018 market decline, corporations have clear dual vulnerabilities from both lower margins and record high debt, both of which will be stressed by falling GDP and declining revenue.

- In 2019 US firms had fractionally lower earnings but the labour market held together because firms traded lower average weekly earnings growth for continued employment. The difference between that time and 2020 is that the earnings contraction will be driven by lower revenue, not higher costs, and as such considerable labour resources may be idle and are likely to be retrenched.

- Financial conditions are tight and are likely to remain so until the CV's growth rate slows, and stimulus is enhanced. This may take considerable time as oil prices are implying high stress in credit markets and this stress will not be able to be ring-fenced.

- I suspect it will take considerable time for confidence to be restored and activity to rebound and firms will be forced to hold more stock on hand (softening just in time processing) which will weigh on labour hiring and weigh on free cashflow.

- This is another stress point for globalisation.

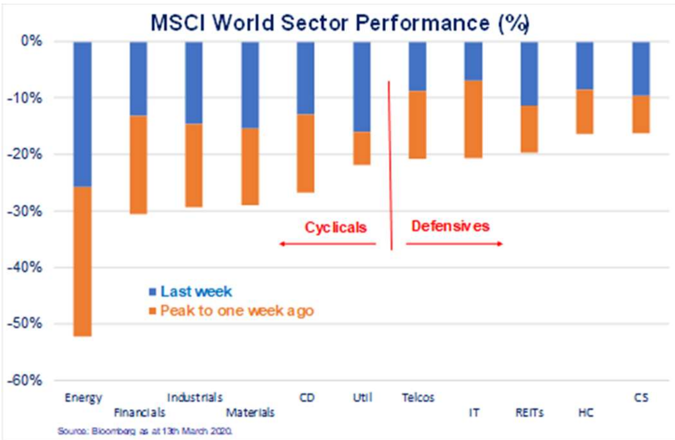
THE FINANCIAL MARKETS

EQUITIES

Equity markets remain volatile with a large recovery in Australia (an (+12% same-day turn around) and large rise in the US (+9.3%).

Little bounce in Europe (+1.2%) and non in Japan given a strong Yen.

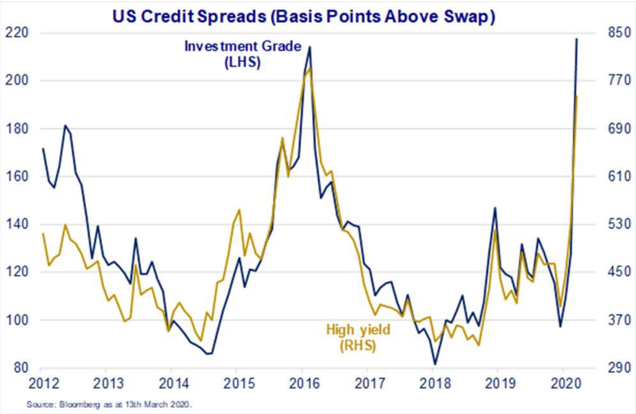
- Defensives continue to have mixed performance with yield plays such as utilities (-16% last week), REITs (-11.3%) recording similar sized losses to cyclicals such as financials (-13.2%) and consumer discretionary (-12.9%) and larger than IT (-7.0%). This suggests that rising yields could cause market problems as defensive sectors provide less diversification than expected.



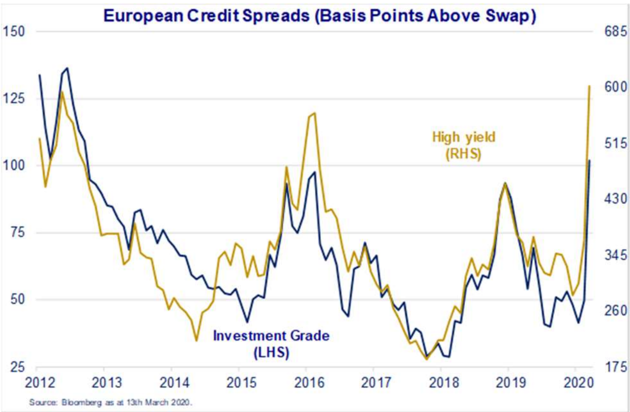
CREDIT

- Despite a strong rally on Friday in US and global equites, US investment grade and High yield credit spreads continued to widen, although the increase was a handful of basis points. However, IG spreads are now wider than in 2016 and HY is only 45 basis points off its 2016 peak suggesting that investors remain on edge.

- There were spread widening for cyclical sectors (but energy remains 50 basis points below the 2016 peak of +430 bpts), but defensives such as consumer staples (-2 bpts), utilities (-3 bpts), healthcare (-3 bpts) and telcos (-9 bpts) provided modest respite, but this is not indicative of calling the peak.



In Europe, IG spreads remain around 2016 peak levels despite ECB support, but HY spreads are now back to their highest level since 2009, which suggests the economic outlook and poor policy response risks creating a negative reinforcing feedback loop.



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