

THOUGHTS ON THE MARKET

20th April 2020

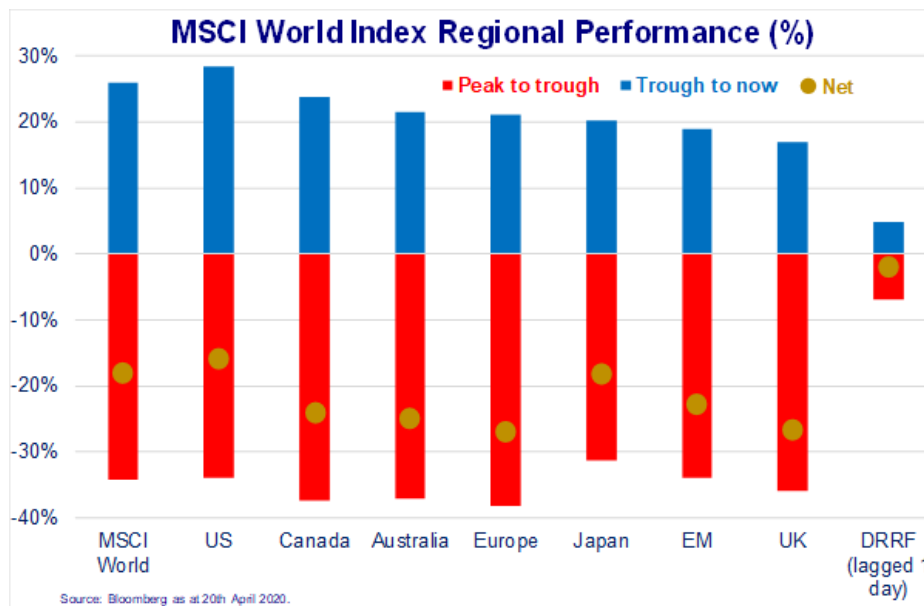


SUMMARY

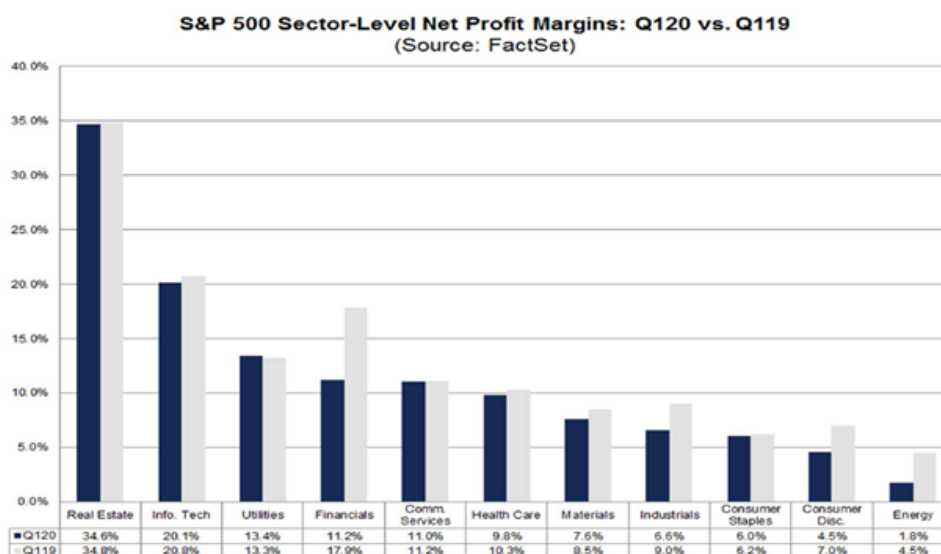
- Although a lot remains unclear, the last two weeks have given some insights into the 2020 global recession. China Q1 GDP growth came in at -37.2% q/qa but there were some signs that industrial production and retail sales have bottomed and lifted notably as the Government flicked the economic light switch back on. In terms of moving forward, there are three caveats to a pre-COVID-19 economic normalisation – firstly whilst better, China industrial and consumer activity are still considerably below end-2019 levels, secondly the weak global economy is likely to weigh on the shape of China's industrial rebound, and lastly it remains uncertain to what extent the China re-opening template can be transferred into large democratic economies like the US and Europe.
- US retail sales (-8.7% m/m) and industrial production (-6.0%) data for March made for bad reading, but survey data for April were completely horrendous and suggest activity this month is set to be much worse than March. Government efforts to contain the virus and central bank action to limit the financial fallout, so far are proving successful which is laying the foundation for an activity rebound later this year when closures are unwound.
- The COVID-19 supply shock will create long-term structural damage to global growth given its impact on corporations and households behaviour. The sheer size of the global activity descent is set to weigh heavily on corporate earnings (-50% in 2020 and +60% in 2021, meaning that corporate bottom lines are down a net -20% over both years), thereby weighing on capex and labour rehiring. Also, the initial large output gap will see global inflation decline sharply (reinforced by oil which declined -8.1% on Friday to USD18.27 per barrel) which will mean little pricing power, lower wages growth and lower inflation expectation. All of these factors will weigh on the recovery and create large issues for central banks which have no reflation policy space left.

FINANCIAL MARKETS

- **EQUITIES**
 - The MSCI World Index rose +2.7% on Friday night meaning that the market barometer has recovery half of its post-February losses. Among the regions, the gains were led by the US market (+2.7% which saw the recovery rate rise to 55%) which enjoyed a surge in the last hour of trade (which lifted the index +2% and saw it end the day at its session high). Despite limited newsflow and a falling crude price, with sector advances were led by energy (+4.5%), with financials (+3.1%) also gaining despite constant profit warnings and provision boosts from its constituents. The rise in the US has meant that it remains the best performing market in 2020 (see chart) with Europe (-25.3% peak to now) and the UK struggling the most, but Australia is not far behind (-23.6%).

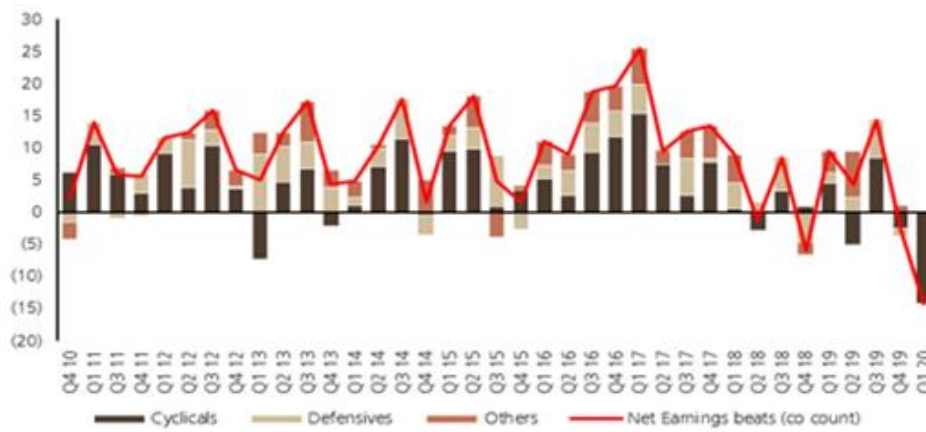


So far 9% of US companies have reported earnings, with six reporting results ahead of expectations, but banks are weighing heavily on the market result which declined to -14.5% q/q which if sustained, will represent the worst result since Q3 2009 (-15.7%), the blended revenue growth is just +0.6% q/q suggesting that there has been enough sales growth in January and February to offset the March decline, but it still culminates in the worst revenue performance since March 2016, although there are over 400 more companies to report. The lack of revenue growth has, or is expected to, weigh fairly heavily on margins which has declined sharply in both energy (-2.7% to 1.8%) and financials (-8.7% to 11.2%) which are the worst two performing US sectors in 2020.

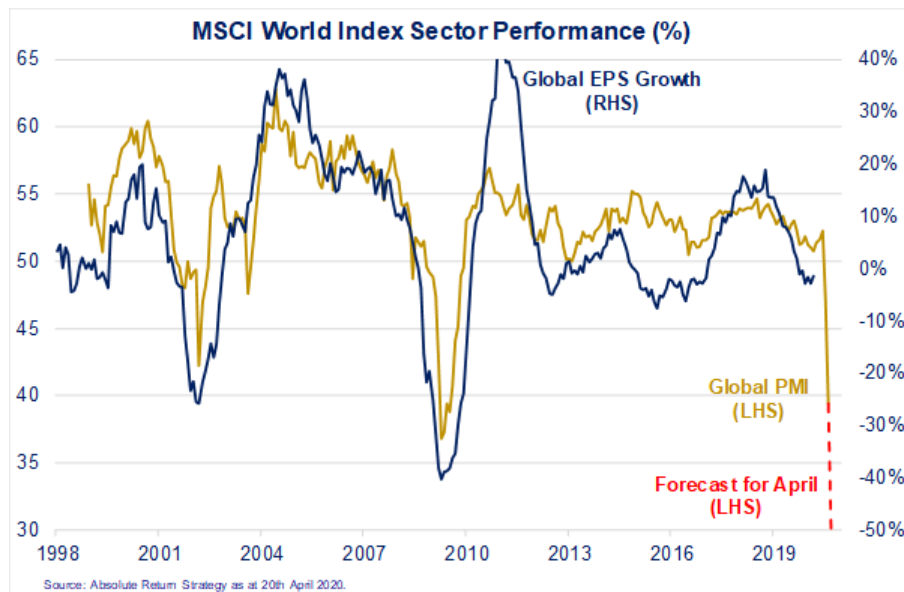


- European markets (+2.7%) also performed strongly on Friday night with advances in France (+3.4%), Germany (+3.2%) and the UK (+2.8%) outweighing performance in periphery markets such as Spain and Italy (both +1.7%) and Greece (-0.1%). The European reporting season began last week with 7 reports (of 389) with the very early net result showing that the low expectations are likely to be challenged (see chart), although in the next three weeks as clearer picture will emerge.

Net Earnings beats (Company count) and its contribution by sectors



- Earlier in Asian trade, there were across the region gains led by Japan (+3.2%), Hong Kong (+1.6%) and Australia (+1.3%). Futures markets suggest a loss in Tokyo (-0.5%) on the opening bell, and a flat start in Australia.
- This week we get April PMIs for the G4 economies, which are a good guide for the global PMI in the following week and we expect the latter to be around 30, which will be a level below the 2009 low, suggesting that global EPS growth in 2020 will be around -50%. At present, the market is expecting global EPS growth to be around -5%, which suggests that a large downgrade cycle is most likely ahead.

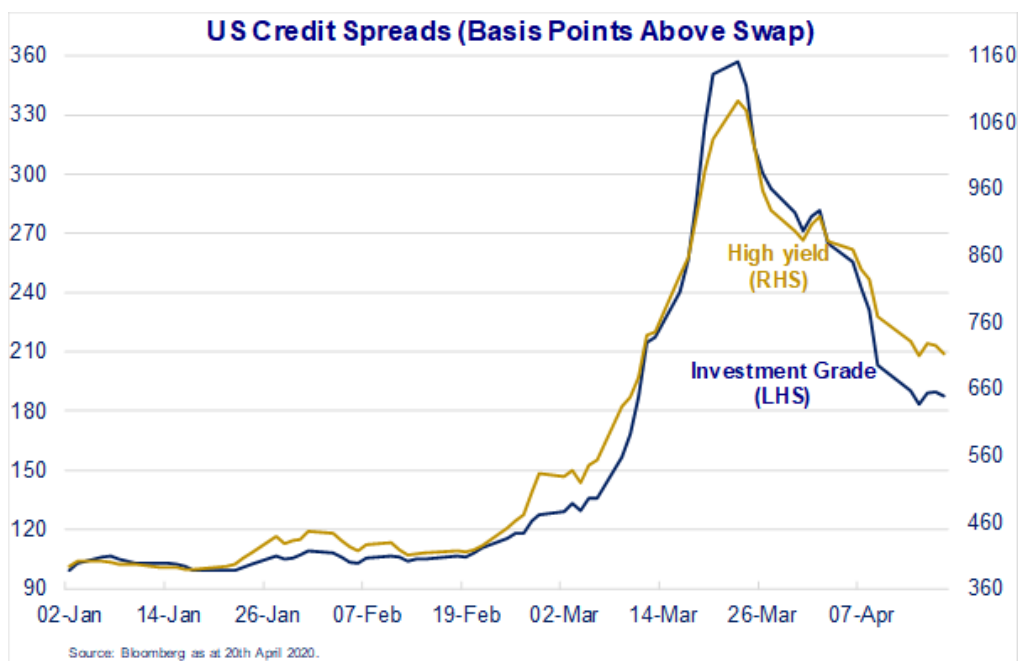


- Perpetual Multi Asset's proprietary EPS model, which typically gives a reliable indication of changes in trend earnings, recorded its largest monthly decline ever (-18.6% in March - see chart). While the abrupt halt to economic and EPS growth in March has not provided its usual 8-months in advance signal, futures 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.



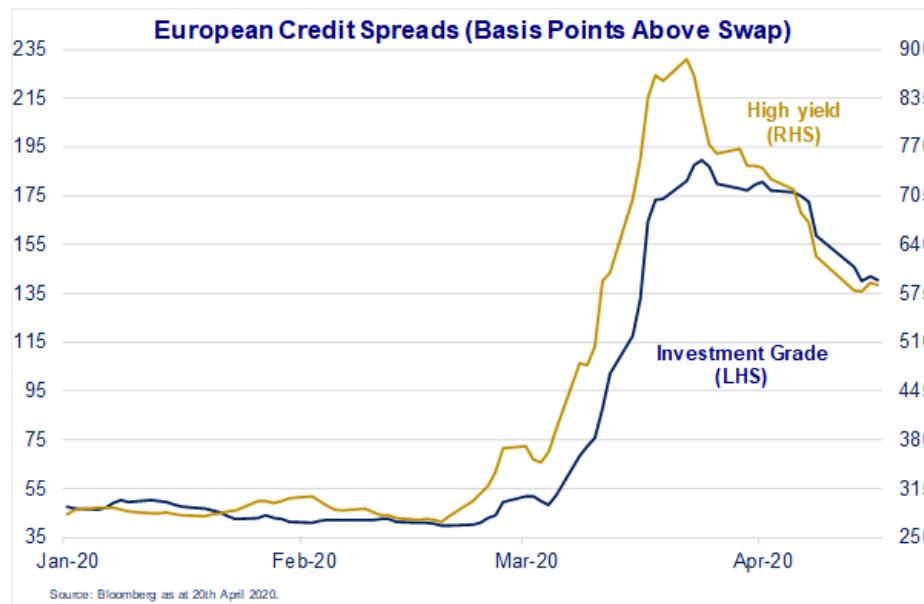
• CREDIT

- Regional credit markets were reasonably quiet on Friday with little movement in spreads. US investment grade spreads came in another 2 points to +188 bpts which lifted the sector's recovery rate to 67% from the March peak (see chart). While all sub-sector spreads declined, major moves were limited to energy (-7 points to +324 bpts) despite another plunge in crude prices (-8.1% to USD18.27 per barrel) and materials (-5 to +242 bpts) despite a -1.5% decline in the CRB index (which is very close to its 2009 low), with all other sector spreads contracting but less than the sector average. In the US high yield space spreads came in 12 points to +713 bpts which brought the sector recovery rate to 56%. Among the subsectors, energy (+1 to +1417 bpts, recovery rate of 58%) and subordinated financials (+2 to +482 bpts, 46%) saw spreads widen, but all other sectors contracted led by telcos (-17 to +559 bpts, 70%) and consumer discretionary (-15 to +703 bpts, 48%).



- European spreads recorded more modest movements than their US counterparts. IG spreads came in 1.7 points to +140 bpts which brought the regional sector recovery rate up to 33%, with spreads lower in all sectors, albeit not by much. Similarly, European High Yield spreads declined -2 points to +587 bpts (see

chart) which brought the sector recovery rate up to 49%. The largest spread decline was in industrials (-5 points to +716 bpts) with little movements elsewhere.



THE GLOBAL ECONOMY

• CHINESE GDP

- Chinese activity recorded acute weakness in Q1 (-6.8% y/y) which is its only contraction since records began in 1992. By breakdown, the most significant decline was in secondary industry (which comprise the industrial and construction sectors which contracted -9.6% y/y from +5.8% in 4Q19), followed by tertiary sector (namely services (-5.2% y/y, +6.6% y/y)) and the primary sectors (agriculture and forestry, -3.2% y/y, +3.4%).

The sequential numbers mean that March 2020 recorded a quarterly contraction of -9.8% q/q (or -38% q/q annualised which is close to the forecast used in the April Webinar - see chart) but the month of March saw economic activities improve almost across the board. Interestingly, industrial production fell only -1.1% in the year to March after recording -15.5% y/y decline in January and February (due to the clearing of earlier order backlogs), exports did likewise (-6.6% y/y versus -17.2% in January/February) but retail sales dropped -15.8% y/y in March versus -20.5% in January-February.



So the China Syndrome is that the supply side of the economy is slowly getting back up, but this process has been disappointingly slow and the return rate only inched up to around 90% at the end of March. This is why economy wide capacity utilisation dropped -10.2% to 67.3% in Q1 with industries with a simple production process such as oil and gas extraction (higher at 89.9%) having higher utilisation rates than complicated industrial sectors such as autos (56.9%).

While production has improved, the spread of COVID-19 around the world threatens to add fresh downward pressure on China's industrial production and exports in the June quarter. In addition, consumption will lag as the economy enters the transition period between lockdown and vaccine, and the key unknown is the extent to which consumers can regain confidence and employment as lockdowns are lifted, given weaker wages growth. Accordingly, China has unveiled a range of stimulus (although not on the scale of other nations) including a RMB3.5 trillion (USD502 billion) low-cost funding for financial institutions, RMB1.3 trillion (USD186 billion) in pre-approved local government special bonds and RMB1.6 trillion in cuts to fee taxes. I'd expect more policy support to come, including circa 1%-2% of GDP in additional spending (probably infrastructure) and more monetary easing to help TSF credit growth to rise to +12.5% y/y.

This suggests that China's recovery is going to be a long haul as consumption and investment both remain weak and with the rest of the world in lockdown in June, industrial production growth is likely to be close to zero and this will weigh on exports. Needless to add, it is fairly clear that China is not remotely on track to meet its US import targets – Phase 1 targets would have hit USD23 billion in January and February, but they were only US9 billion (see chart).



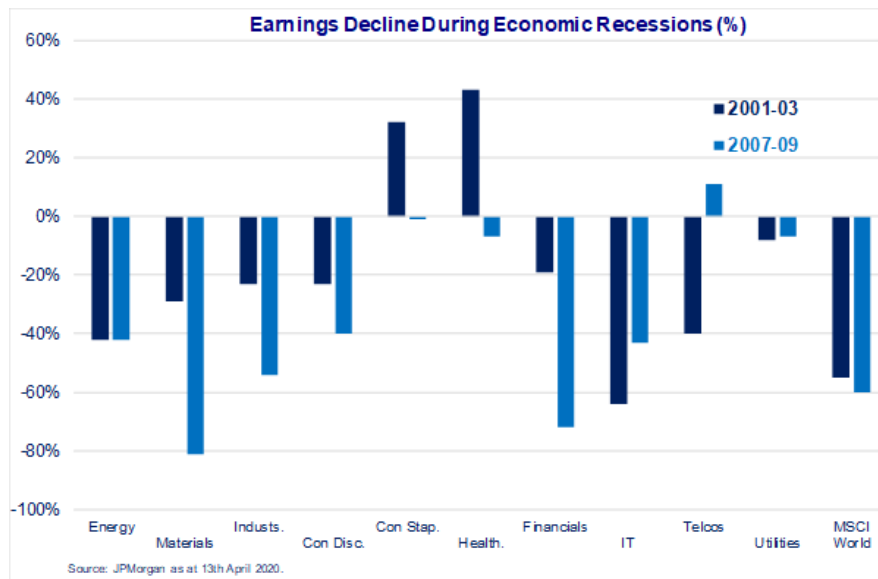
• THE UPCOMING PROFIT HIT

- We expect global EPS growth to be -50% in 2020, but the largest decline will be recorded in the June quarter. Unlike the GFC, which initially was a US financial market shock, the COVID-19 pandemic has spread globally so each country has experienced both a loss of external demand (normal for a global recession) and weaker domestic demand from economic closure policies.

Although profits dropped 50-60% in each of the past two global recessions (see chart below), the composition considerably varied. The 2001 recession reflected the bursting of the tech bubble in which tech and telcos recorded the largest declines (-64% and -40%, respectively), but both did better in the GFC, whereas financials (-72%) were mortally wounded in 2008 given the GFC was a financial crisis, but materials (-80%) fared worse as the 2001 downturn culminated in a housing bubble which burst in 2008.

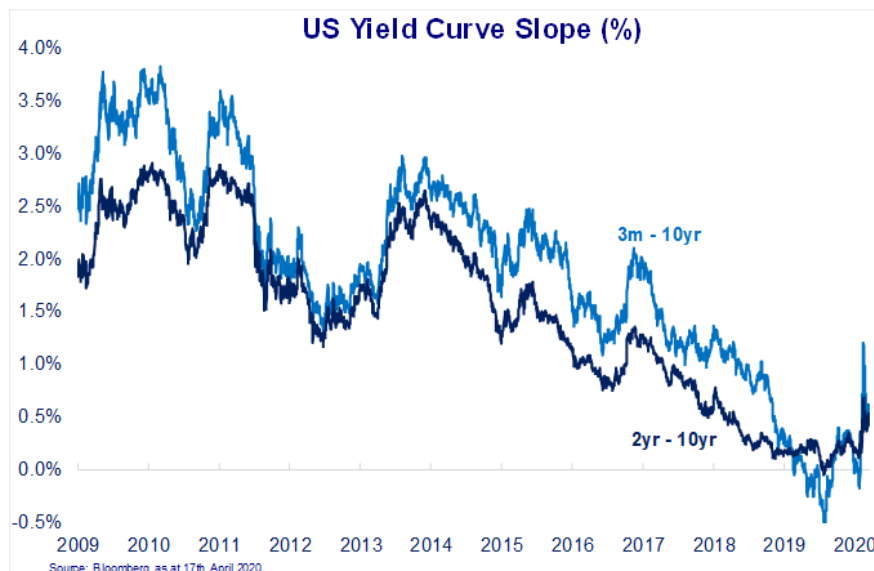
In contrast to 2001 and 2008, there are unlikely to be many sectors that escape the 2020 downturn unscathed, but tech should do relatively well as social distancing is constructive for numerous sub-sectors through the increased use of streaming, remote working and video conferencing. In contrast, consumer

discretionary should be a clear underperformer it is hard to see leisure and hospitality industries recovering quickly and energy is likely to lag given sustained supply-demand imbalances. We'd add that financials may not take the hit of 2008, but loan defaults are set to be high which suggests they are likely to underperform.



• RECOVERY SHAPE

- Many are asking us if this is a short recession and a quick recovery. As we said last week, although there is considerable uncertainty ahead, lead indicators for the labour market, give an indication of the growth hole ahead is the largest since 1930, however, the yield curve slope, to us, is not indicative of a robust recovery brewing. Some may say that Fed QE is holding long rates lower and while that is true the US central bank was doing QE in early 2009 yet the 3M – 10yr curve slope rose to 380 bpts (see chart). To us, the current 0.5% slope is indicative of a weak economic outlook.

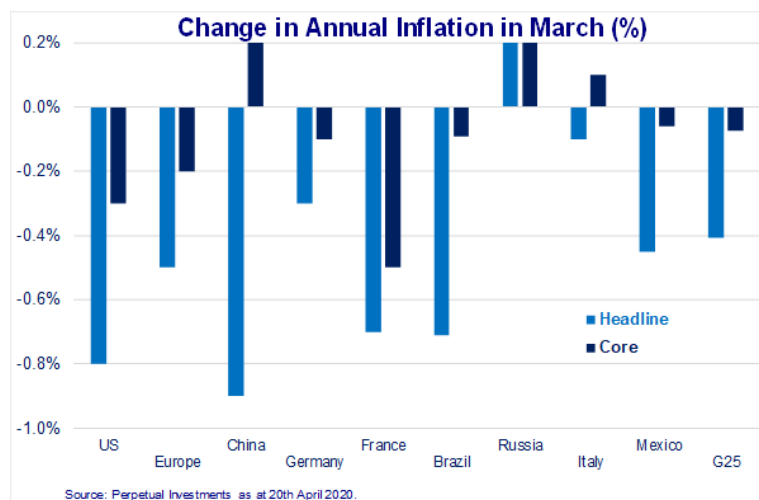


• REGIONAL INFLATION

- The COVID-19 shock is depressing both the demand and production sides of the global economy. However, from a near-term perspective (for the next 12 months) there is little doubt that the dominant forces driving regional inflation will be the weakness in global demand, the existence of large output gaps and record percentage declines in global oil prices. These factors have already begun to impact regional

inflation with the G25 average annual headline rate declining -0.4% and core by -0.1% in March (see chart below).

Overall, it is likely that key economies (including the US, Japan and Europe) will have headline rates temporarily in deflation territory, but worse still the G25 core rate could decline by -0.5% to around +1%, which will see inflation expectations anchored further below targets. Lower core inflation also will see corporations with very weak pricing power, which will negatively impact EPS growth, capex, wages growth and consumption. The challenge for central banks is not only falling core inflation and weak inflationary expectations, but also they face this dilemma with reflation tools completely exhausted.



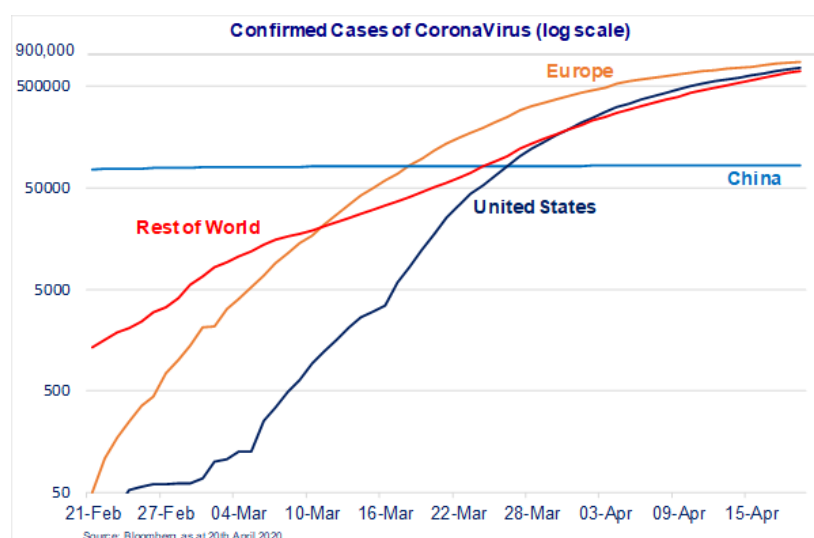
POLICY

- There were no material policy announcements on Friday.

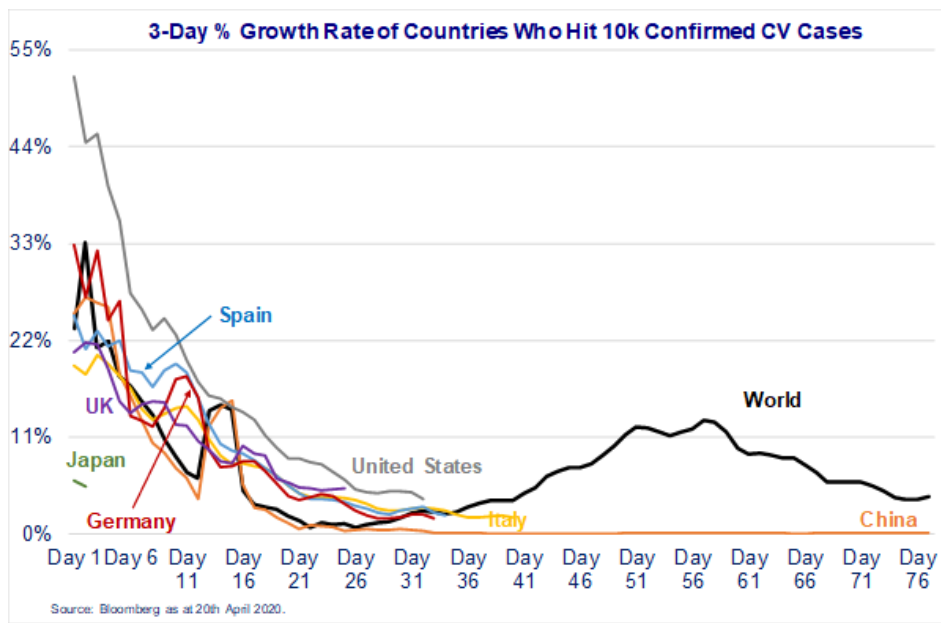
VIRUS UPDATE

- The percentage of daily confirmed COVID-19 cases continues to decline (+3.5% since Friday) with the number of daily increased by +65.6k overnight (25-day low) with smaller rises in both the US and Europe, suggesting moderation in large advanced economies, but EMs such as Turkey, Brazil and Mexico are still rising notably. The number of global cases is now at 2.42 million, deaths rose +5,182 (although final numbers are not yet in) to 164.9k but the death rate declined to 6.87%.

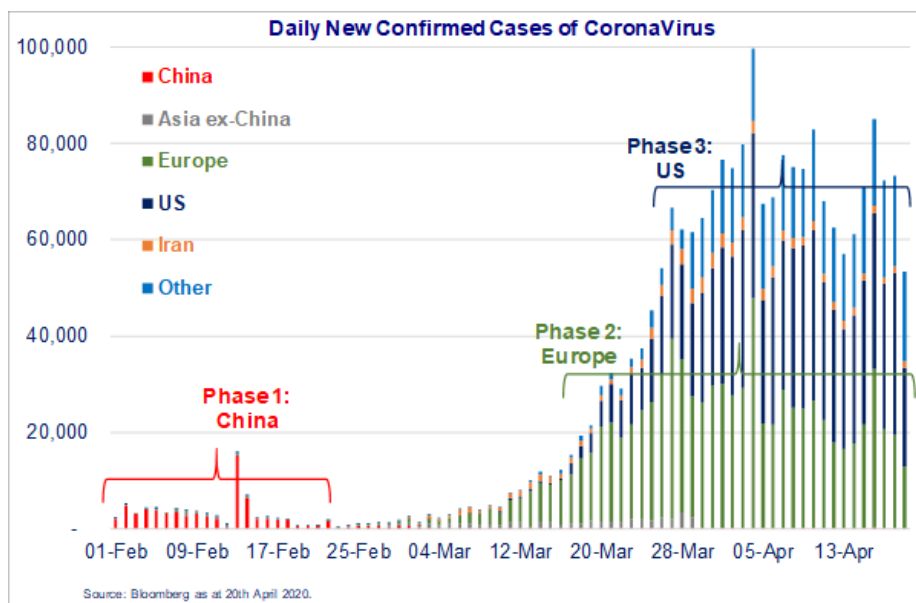
Importantly, the COVID-19 infection curves have flattened enough for some governments to announce schedules for partial re-openings of economies by specified sectors from Apr 13th in Spain, Apr 20th in Germany, Apr 27th in Switzerland and May 11th in France. In contrast, the US is shrouded in uncertainty given federal/state conflict and US federal guidance without a timetable.



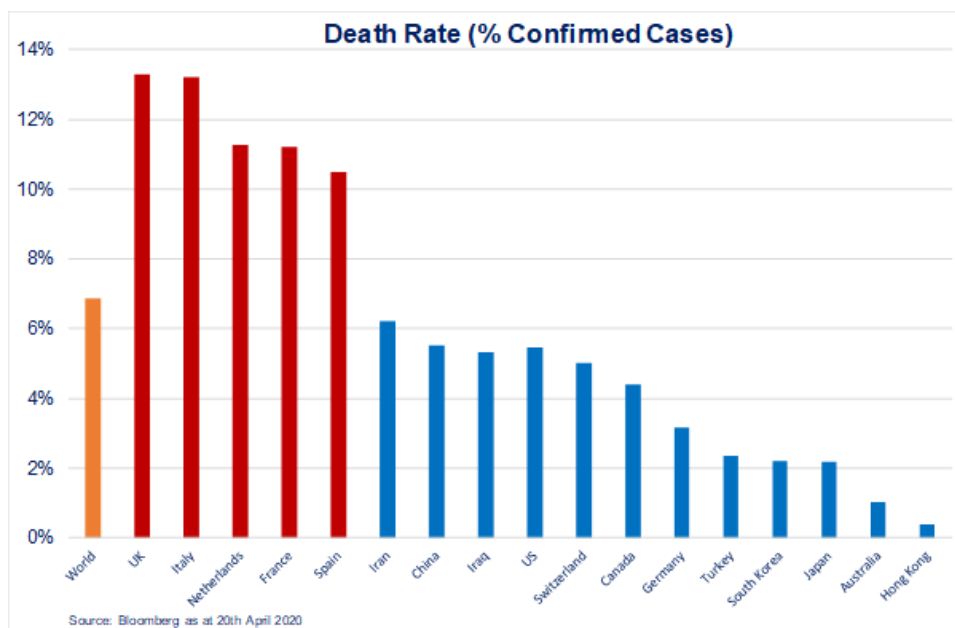
- Europe (+12.9k to 865k) continues to lead the world in terms of total cases but its daily increase (number, not percentage) is trending lower (lowest in the past 33 days) which shows that social isolation works to reduce the spread of the virus, even though it comes at an enormous economic cost. Overnight, Paris shut down part of its water system after discovering trace amounts of the virus in water used to cleaning streets and public gardens. Similarly, the US had its lowest daily increase of new confirmed cases (+20.4k to 755.5k) and its 3-day compound growth rate has declined to 4.0% 32 days after they reached 10,000 cases. That said, New York cases rose +5.1k and +3.5% overnight which is now below the US average, but deaths in the city that never sleeps rose to 19.4k. Elsewhere, Singapore recorded a sharp increase in cases (+596 to 6.6k) all 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 (+327 to 6,575) and the Philippines (+172 to 6,529).. Meanwhile, Japan (+501 to 10.8k) cracked the 10k barrier but its growth rate is the lowest of any nation which has reached that level.



- Among countries, the most cases are in the US (+20.4k to 755.5k), Spain (+2.2k which is a 33-day low) to 196.7), Italy (+3.0k to 179k), France (+1.9k to 154.1k), Germany (+1.5k (31-day low) to 145.2k), China (+1 to 83.8k), Iran (+1.3k to 82.2k) and Turkey (+4.0k to 86.3k). Australia confirmed cases were unchanged yesterday at 6,547 which placed us 38th in terms of total infections.



- The global death rate has declined to +6.87% (having doubled in the past 7 weeks and risen in each of the prior 43 days) with another +5.2k fatalities overnight bringing the global total to 164.9k. The death rate is highest in European countries where the health systems have collapsed led by the UK (-0.1% to 13.3%), Italy (steady at 13.2%), the Netherlands (-0.1% to 11.3%), France (+0.1% to 11.2%) and Spain (-0.1% to 10.5%).



Yours sincerely,



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