Perpetual Investments

THOUGHTS ON THE MARKET

22nd April 2020

SUMMARY

- It was risk-off overnight as regional markets added to Monday's decline and finished near their worst levels in most regions. For a second day running oil was at the epicentre of the market volatility as the US June futures price dropped -35% to USD13.12 per barrel, and this spilt over into Brent prices in London which dropped -23% and dropped below USD20 per barrel for the first time in 18 years.
- This suggests that yesterday's negative oil price action was more than a blip as global energy demand has fallen by as much as a third, which indicates that OPEC+ 14 million barrels supply cuts would have to more than double to bring the market back into balance. As we highlighted in our recent webinar, the dislocation in energy markets is the most under-rated risk in markets and many investors who went long energy on a lower price have lost a lot of money, and there is no relief in sight as oil is a deeply dislocated market and it may not have hit its bottom yet. This will require demand to increase, production to be cut or storage to be expanded – all of which seem very hard to accomplish in the near-term.
- The oil price plunge is signalling the hit to the global economy from the COVID-19 is far worse than markets believe and this is set to drag earnings down and begin a chain reaction of heightened defaults, balance sheet restructuring, low investment, higher savings, high unemployment, weak wages growth and much lower inflationary expectations which suggests the recovery path is a long and slow one.
- Stocks overnight (-3.1%) recorded their largest losses in three weeks as investors shrugged off the deal reached by the While House and Congressional leaders which provides an extra USD484 billion for small business relief, hospitals and more tests. In some ways this deal confirms a worsening growth hole which outweighed the hopes that economic re-opening is coming soon. With equities lower and credit spreads wider, safe havens rallied with the US dollar up to a 2-week high, 10-year US treasuries down -4 basis points to 0.56%, but gold weakened -0.6% to USD1685.69 an ounce.

FINANCIAL MARKETS

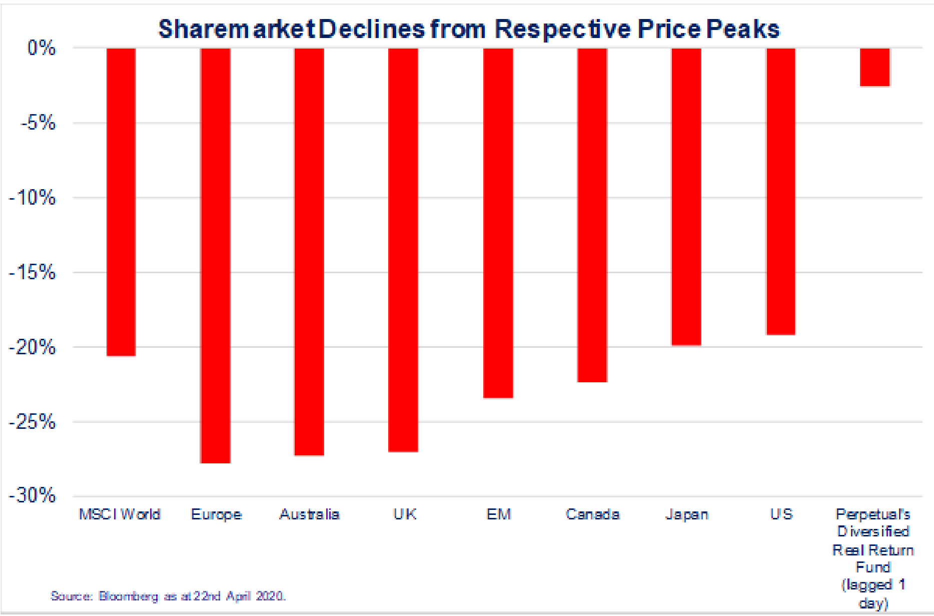
- **EQUITIES**
  - The MSCI World Index declined -3.1% overnight which saw the broad index's recovery rate decline by -7.5 percentage points to 39.6%. There were losses in all sectors led by IT (-4.1%) and financials (-3.1%) whereas energy (-2.5%) and defensives such as REITs (-2.0%) and utilities (-1.8%) fared better. These overnight declines saw energy's peak-to-now decline rise to -43.1%) with financials (-32.3%) also challenged by an likely extended period of deleveraging and bad loans, with industrials (-27.1%) and REITs (-24.3%) also in bear market territory (see chart).

- Among the regions, losses were largest in Europe (-4.1%) as tech (-4.5%), energy (-4.2%) and telcos (-4.0%) all came under heavy selling pressure, but defensive sectors such as utilities (-2.3%), REITs (-1.9%) and health care (-0.8%) fared better. US markets followed the negative European lead and the S&P500 closed -3.1% in the red with losses all sectors led by tech (-4.1% which large declines in large-cap names) and financials (-3.2%), whereas defensives including REITs and utilities (both -1.6%), again, did better.

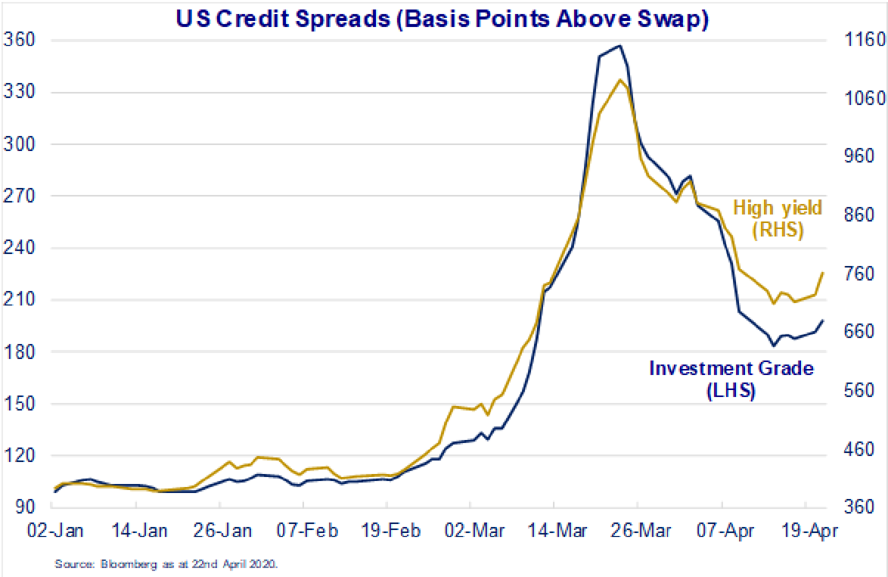
  In the US, there was a large pick up in earnings activity with many companies highlighting solid trends through the first couple of months of 2020 (as picked up by our earnings model) before social distancing and lockdown measures really took hold in March. In terms of themes, banks continue to announce bigger provisions, consumer staple names continue to highlight stock-up demand, although this has faded to varying degrees in April and software sales were adversely impacted late in the quarter. It is no surprise that more firms continue to pull full-year guidance given uncertainty over magnitude and duration of the outbreak, which may explain why analyst 2020 EPS forecasts continue to remain well above that of strategists.

- In Asian trade losses were large yesterday and across the board led by Australia (-2.5%), Hong Kong (-2.2%), Japan (-2.0%) and China (-1.2%). This took Australia to a peak to now loss of -27.2%, but Europe (-27.8% - see chart) is now the largest with Canada back into bear market territory with a losses of -3.1% overnight (see chart).

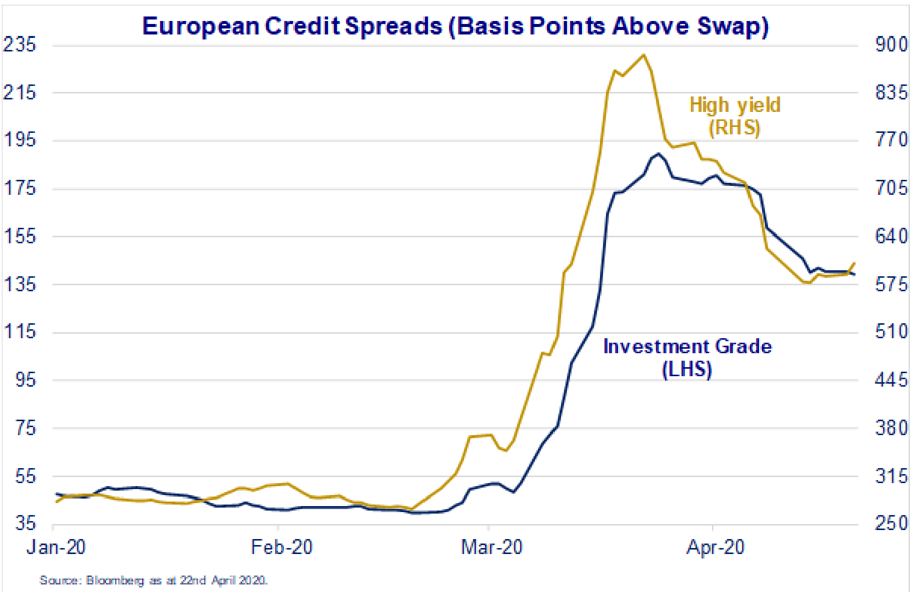
  Futures markets are indicating a -2.0% loss at the opening bell in Sydney and -1.5% in Tokyo.



- **CREDIT**
  - US credit markets recorded wider spreads for a second consecutive day as the dislocation in energy markets sparked a widening in risk premiums, but again, the increase in spreads was not overly large. In the investment grade market, spreads widened +6 points to +198 bpts (see chart) which drove the market's recovery rate down -2 percentage points to 63%. Needless to add that the spread increase was led by energy (+12 points to +349 bpts, 54%) with subordinated financials (+7 points to +246 bpts, 61%) the only other noteworthy increase. The high-yield market saw more price action with spreads up +37 points to +763 bpts, with the recovery rate now down -6 percentage points to 48%. Energy (+83 to +1534 bpts, 51%) led the spread expansion, supported by financials (+37 points to +751 bpts, 39%), healthcare (+39 points to +572 bpts, 39%) and tech (+40 points to +629 bpts, 45%).



  - European credit was a bit more mixed as investors seemingly pulled money out of high yield and invested it in the investment grade space. As such spreads in the IG universe declined -1 point to +139 bpts (see chart) which fractionally increased the recovery rate from the March peak to 34%. All sectors reported minor spread declines other than subordinated financials (+6 to 227 bpts, 47%). The high yield market did not fare so well with spreads out by +15 points, which brought the recovery rate down -2 percentage points to 46%. Among the sub-sectors, spreads in energy (+19 to +787 bpts, 47%) saw the largest increase, it was challenged by wider risk premiums in sectors including financials (+18 points to +688 bpts, 38%), materials (+18 points to +537 bpts, 50%) and consumer discretionary (+17 points to +795 bpts, 44%).



THE GLOBAL ECONOMY

- US existing home sales fell -8.5% m/m in March to 5.3 million units (see chart). This and the pending home sales which suggest that sales didn't change much in February, indicate that sales had not gone through to completion, but we do not know yet, whether the sales were delayed or cancelled. The labour market dislocation, and its increased uncertainty will be at the heart of this development and April existing home sales are likely to decline further to around 4 million units, as the lockdowns are enforced for the full month.

- Australia's 'experimental' weekly payrolls series showed a -6% decline in employment over the three weeks to 4th April 2020 which suggests that to that date -780k Australian have lost work, which if the labour market remained the same size would see the unemployment rate at around 11%, which would be in line with the peak of the early 1990s recession, and the equal highest since the Great Depression in the 1930s. However, the number of adult workers actually seeking employment is a key swing factor here and how the ABS treats the impact of COVID-19 could impact the participation rate, as well as whether the survey captures the impact on self-employed persons. As such, the under-utilisation rate and hours worked will be a better indication of the labour market dislocation. Nevertheless, we continue to think that Australian unemployment will peak around 12% and while the re-opening of the economy will see that rate drop quickly, the time to get the rate back to its pre-COVID-19 rate of 5% will take many, many, many years.

  The data also showed a larger -6.7% drop in wages to April 4th (-5.1% decline in the last week) which UBS estimates -3½% household income hit to June quarter GDP (before handouts) and if the small business income decline is around the same, the total income decline becomes -4% of quarterly GDP.

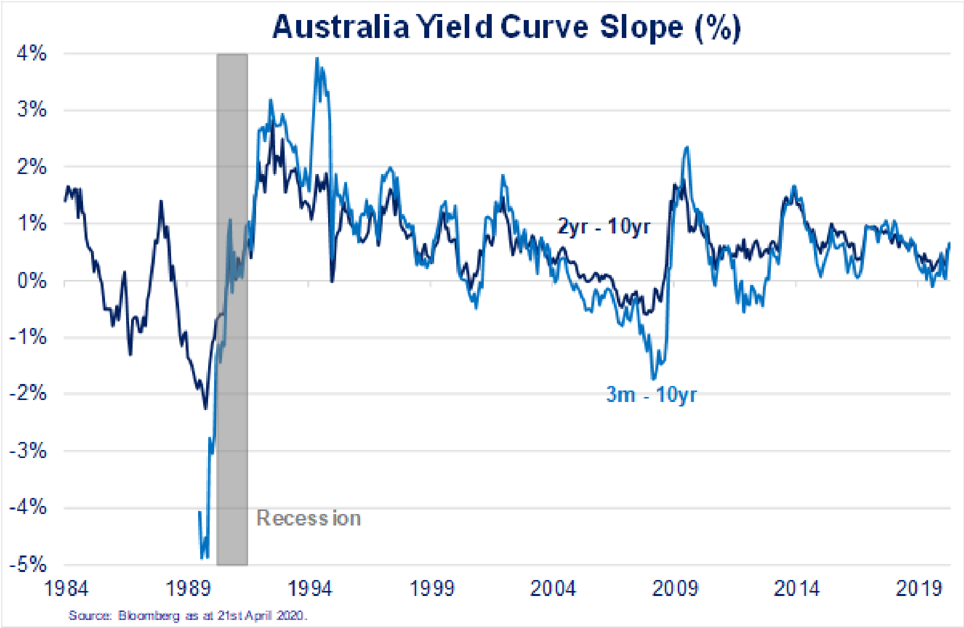
Change in jobs → / Labour force	+100k	+50k	0	-100k	-200k	-300k	-400k	-500k	-600k	-700k	-800k	-900k	-1000k	-1100k	-1200k	-1300k
550	4.6%	4.9%	5.3%	6.1%	6.8%	7.6%	8.3%	9.1%	9.9%	10.6%	11.4%	12.1%	12.9%	13.7%	14.4%	15.2%
500	4.5%	4.9%	5.3%	6.0%	6.8%	7.6%	8.3%	9.1%	9.8%	10.6%	11.3%	12.1%	12.9%	13.6%	14.4%	15.1%
450	4.5%	4.9%	5.3%	6.0%	6.8%	7.5%	8.3%	9.0%	9.8%	10.5%	11.3%	12.1%	12.8%	13.6%	14.3%	15.1%
400	4.5%	4.9%	5.3%	6.0%	6.8%	7.5%	8.3%	9.0%	9.8%	10.5%	11.3%	12.0%	12.8%	13.5%	14.3%	15.0%
350	4.5%	4.9%	5.2%	6.0%	6.7%	7.5%	8.2%	9.0%	9.7%	10.5%	11.2%	12.0%	12.7%	13.5%	14.2%	15.0%
300	4.5%	4.8%	5.2%	6.0%	6.7%	7.4%	8.2%	8.9%	9.7%	10.4%	11.2%	11.9%	12.7%	13.4%	14.2%	14.9%
250	4.4%	4.8%	5.2%	5.9%	6.7%	7.4%	8.2%	8.9%	9.6%	10.4%	11.1%	11.9%	12.6%	13.4%	14.1%	14.8%
200	4.4%	4.8%	5.2%	5.9%	6.7%	7.4%	8.1%	8.9%	9.6%	10.4%	11.1%	11.8%	12.6%	13.3%	14.1%	14.8%
150	4.4%	4.8%	5.2%	5.9%	6.6%	7.4%	8.1%	8.8%	9.6%	10.3%	11.1%	11.8%	12.5%	13.3%	14.0%	14.7%
100	4.4%	4.8%	5.1%	5.9%	6.6%	7.3%	8.1%	8.8%	9.5%	10.3%	11.0%	11.7%	12.5%	13.2%	13.9%	14.7%
50	4.4%	4.8%	5.1%	5.8%	6.6%	7.3%	8.0%	8.8%	9.5%	10.2%	11.0%	11.7%	12.4%	13.2%	13.9%	14.6%
0	4.4%	4.7%	5.1%	5.8%	6.6%	7.3%	8.0%	8.7%	9.5%	10.2%	10.9%	11.7%	12.4%	13.1%	13.8%	14.6%
-50	4.4%	4.7%	5.1%	5.8%	6.5%	7.3%	8.0%	8.7%	9.4%	10.2%	10.9%	11.6%	12.3%	13.1%	13.8%	14.5%
-100	4.3%	4.7%	5.1%	5.8%	6.5%	7.2%	8.0%	8.7%	9.4%	10.1%	10.9%	11.6%	12.3%	13.0%	13.7%	14.5%
-150	4.3%	4.7%	5.0%	5.8%	6.5%	7.2%	7.9%	8.6%	9.4%	10.1%	10.8%	11.5%	12.3%	13.0%	13.7%	14.4%
-200	4.3%	4.7%	5.0%	5.7%	6.5%	7.2%	7.9%	8.6%	9.3%	10.1%	10.8%	11.5%	12.2%	12.9%	13.6%	14.4%
-250	4.3%	4.6%	5.0%	5.7%	6.4%	7.2%	7.9%	8.6%	9.3%	10.0%	10.7%	11.5%	12.2%	12.9%	13.6%	14.3%
-300	4.3%	4.6%	5.0%	5.7%	6.4%	7.1%	7.8%	8.6%	9.3%	10.0%	10.7%	11.4%	12.1%	12.8%	13.6%	14.3%
-350	4.3%	4.6%	5.0%	5.7%	6.4%	7.1%	7.8%	8.5%	9.2%	9.9%	10.7%	11.4%	12.1%	12.8%	13.5%	14.2%

POLICY

- The US Senate passed a USD484 billion relief package that included additional aid for a small-business relief loan program (which was USD349 billion, but ran out of funds after two weeks), as well as more funding for hospitals and virus testing. The package now goes to the House of Reps for a vote planned on Thursday.
- **Fitch downgrades Hong Kong to 'AA-' from 'AA'; outlook stable**: Fitch said that after prolonged social unrest in 2019, Hong Kong's economy is facing a second major shock from the emergence of the COVID-19 pandemic in January. Government and society-wide social distancing efforts to contain the virus' spread have led to a contraction in economic activity and rise in unemployment, prompting policymakers to announce the most expansionary budget in the territory's history. These challenges have amplified the negative rating trends already in place from the anti-government protests were inflicting on international perceptions of Hong Kong's political stability and business environment.
- The Minutes of the RBA's April Board Meeting reaffirmed its comprehensive policy package and reiterated that the yield curve control "would be maintained until progress was made towards the Bank's goals of full employment and the inflation target”. They added that “it would be appropriate to remove the yield target before the cash rate itself was raised". On the macro outlook, the RBA noted that the "broadening shutdown of non-essential activities and the restrictions placed on household activities" would weigh on spending in the near term, despite the support policies. The Bank also noted that banks had reported that around 5% of households have enquired about deferring mortgage repayments and they said that risks in commercial property market warranted close monitoring.
- After this, the RBA Governor provided an update on policy tools and the RBA outlook. Unsurprisingly, the outlook was bearish, but he announced that the RBA purchases of Australian Government bonds will decline to a maximum of three times per week, but will return to daily bond purchases, if required. He strongly reiterated that the Bank is not financing the deficit but rather lowering the cost of funding for both, the public and private sectors.
- He also provided some broad parameters for the bank’s expectations for the economy including:
    1. Output is likely to fall by circa -10% over 1H20;
    2. The unemployment rate could reach 10% by June and is unlikely to decline below 6% over the next few years;
    3. Total hours worked are likely to decline by 20% over 1H20;
    4. Annual headline inflation is likely to be negative in the June quarter given falling energy prices and the introduction of free childcare and limited or deferred price increases elsewhere; and
    5. A negative output gap is likely to remain “for some time to come”, implying that core inflation will be sub 2% for the next couple of years.

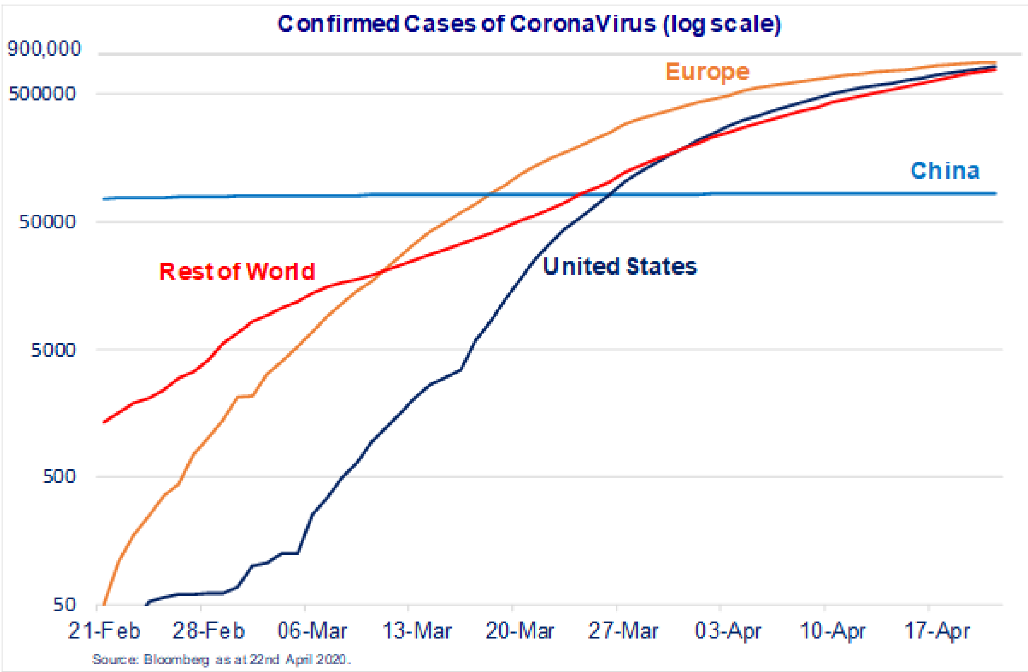
The 2020 forecast seems reasonable (ours is -6.2%), but we suspect the labour market dislocation will be much larger than that suggested by a 10% unemployment rate (our’s is 12%) and under the Bank’s ‘central’ scenario, economic growth recovers in the September quarter and accelerates to 6%-7% in 2021. To us, that assumes too much recovery in the labour market and reduction of slack. We think 4% to 5% is the best case scenario as sustained behavioural change by households in the form of a higher savings rate and prolonged deleveraging, combined with increased corporate failures (all of which were acknowledged by the Governor as being likely) and weak wages growth will weigh heavily on consumption and investment and hence on GDP growth.

Consequently, the only way to get growth of 6%-7% is for the world economy to recover more quickly in FY21, or for the Government to continue to run large deficits and for the funds to be spent. The former has little chance as COVID-19 is a global problem, which will lead to supply chain realignment, and while the latter has a higher probability, we can’t see Prime Minister Morrison turning into Prime Minister Whitlam mark 2. Conclusion: the recovery is likely to be much weaker and take much longer for the RBA to achieve its objectives, and this has serious implications for Australian EPS growth which is why the domestic yield curve remains flat (see chart below)



VIRUS UPDATE

- The percentage of daily confirmed COVID-19 cases continues to decline (+3.1% since Sunday) with the number of daily increasing by +76.3k overnight (3-day high) with smaller rises in both the US (+28k) and Europe (+11.4k), suggesting moderation in large advanced economies, but EMs such as Turkey, Brazil and Mexico are still rising notably. Therefore, while the percentage increase is declining, the daily number of new confirmed cases is not coming down as the base number is high. The number of global cases is now at 2.6 million, deaths rose +5,845 to 176.9k but the death rate rose to 6.82% (although final numbers are not yet in).

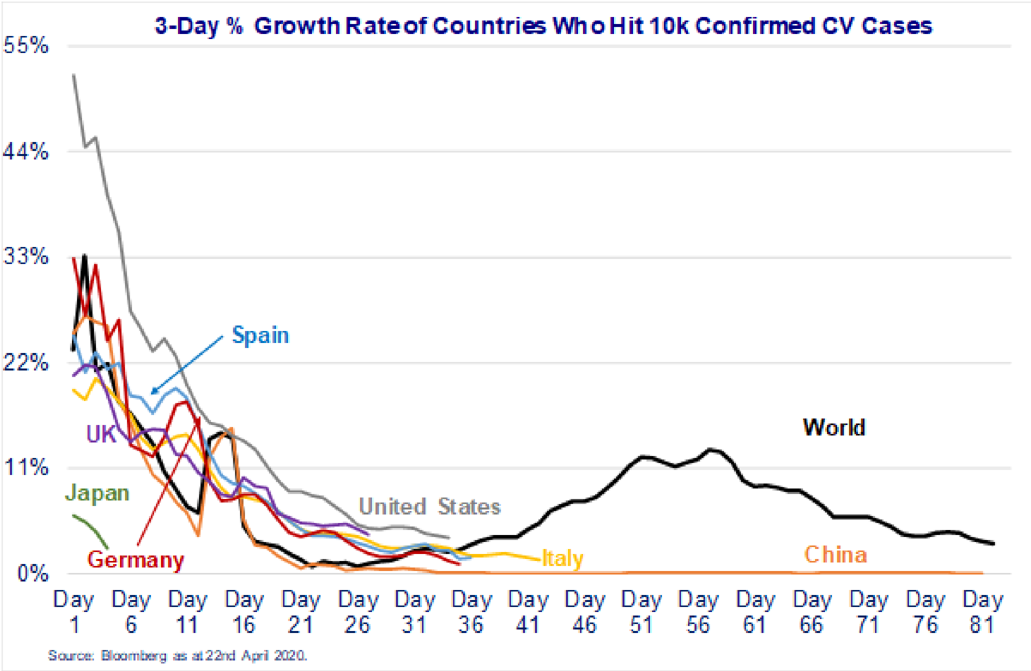


- Europe (+11.4k to 891.6k) continues to lead the world in terms of total cases but its daily increase (number, not percentage) is trending lower (lowest in the past 35 days) which shows that social isolation works to reduce the spread of the virus, even though it comes at an enormous economic cost.

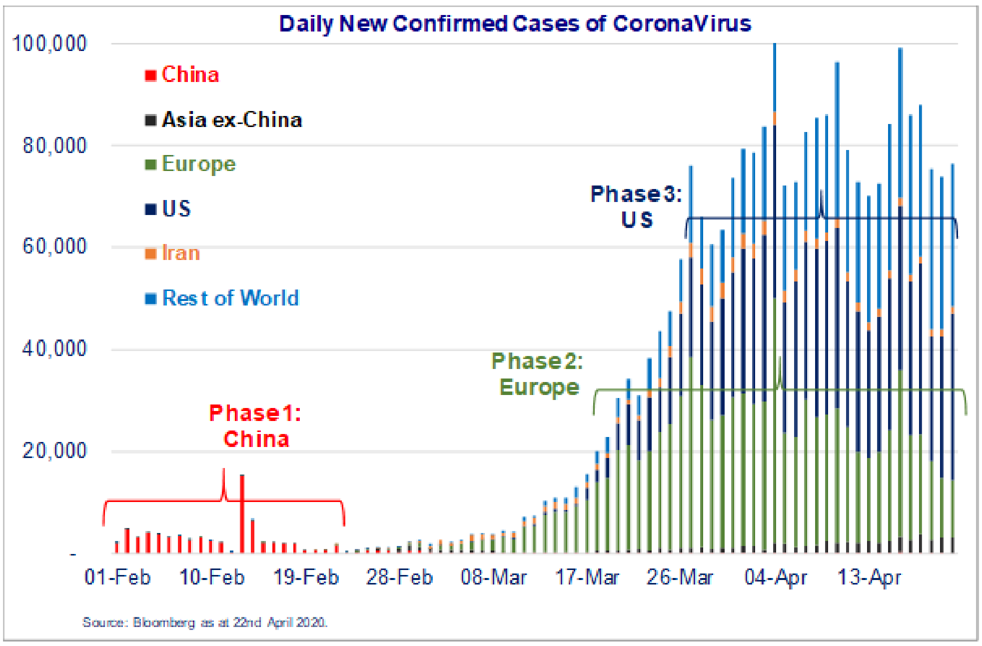
  Similarly, the US had its second highest daily increase of new confirmed cases in the past 11 days (+32.7k to 820.1k) and its 3-day compound growth rate has declined to 3.7%, 34 days after they reached 10,000 cases. That said, New

York cases rose +5.1k and +2.1% overnight which is now below the US average, but deaths in the city that never sleeps rose +168 (23 day low) to 18.8k.

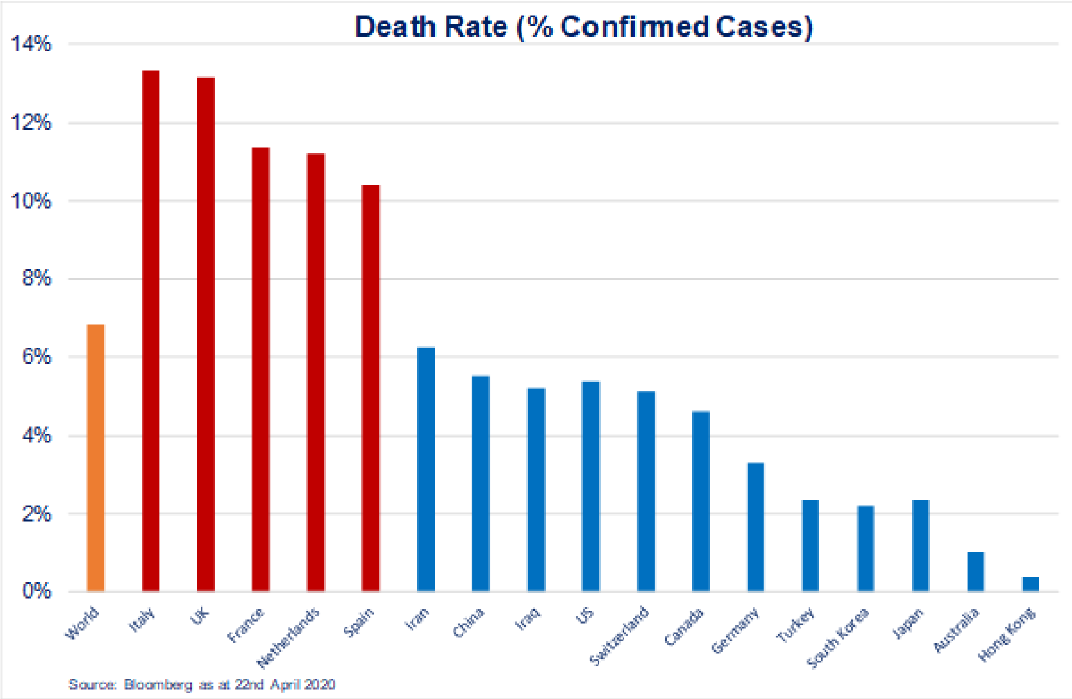
Elsewhere, Singapore recorded a sharp increase in cases (+1,111 to 9.1k) most of which are linked to foreign workers who are forced to live in crowded dormitories, with the countries having the largest case numbers in South East Asia after overtaking Indonesia (+375 to 7.1k) and the Philippines (+140 to 6.6k).



- Among countries, the most cases are in the US (+32.7k to 823.3k), Spain (+4.0k which is a 37-day low) to 204.2k), Italy (+2.7k to 183.9k), France (+1.2k to 159.3k), Germany (+1.2k (33-day low) to 148.3k), the United Kingdom (+4.3k to 130.2k), Turkey (+4.6k (fifth highest daily increase) to 95.6k), China (+5 to 83.9k) and Iran (+1.3k to 84.8k). Australia confirmed cases were unchanged yesterday at 6,547 which placed us 41st in terms of total infections.



- The global death rate has declined to +6.82% (its 38th rise in the past 398 days) with another +5.8k fatalities overnight bringing the global total to 176.9k. The death rate is highest in European countries where the health systems have collapsed led by Italy (steady at 13.3%), the UK (-0.1% to 13.1%), France (+0.2% to 11.4%), the Netherlands (steady at 11.2%), and Spain (steady at 10.4%).



Yours sincerely,

MATT SHERWOOD
Head of Investment Strategy, Multi Asset

MICHAEL O'DEA
Head of Multi Asset

MORE INFORMATION

Perpetual Investments 1800 062 725
Email investments@perpetual.com.au
www.perpetual.com.au/investments

Perpetual