Perpetual Investments

THOUGHTS ON THE MARKET

23rd March 2020

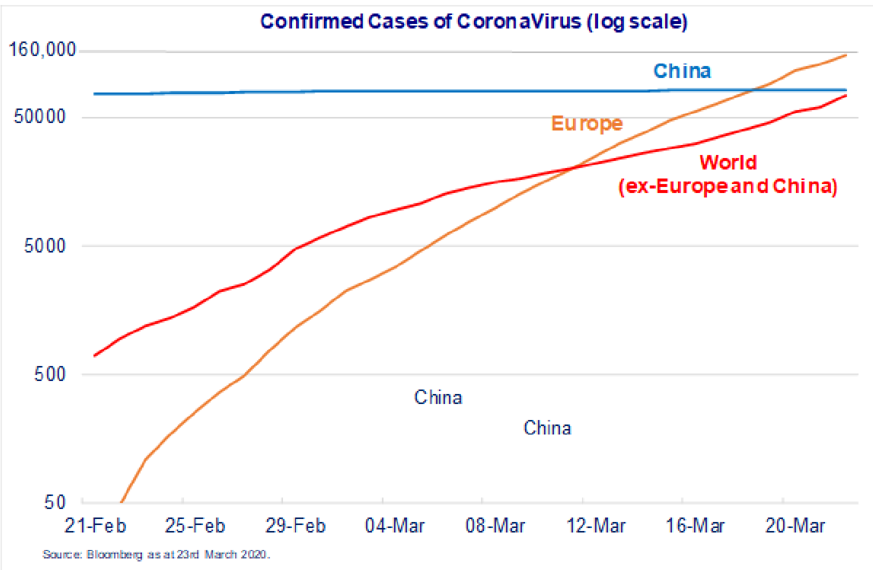
SUMMARY

1. News on the Coronavirus continues to deteriorate with case numbers increasing quickly and spreading across numerous regions. The Government responses has seen social distancing rules and industry closures in advanced economies become more draconian in an attempt to prevent a Hubei-like spike in infection rates, but this is amplifying the initial supply side shock (which always evolves into a demand side shock through labour market contraction and falling income) and this has pushed the global economy into a deep recession.

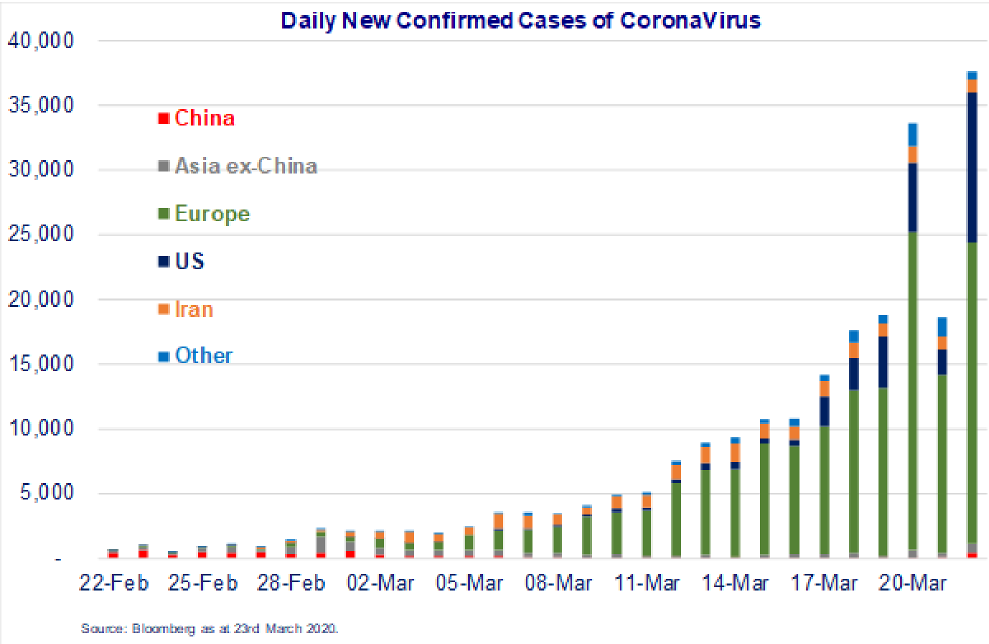
- The key outlook issue is gauging the depth and duration of the downturn and I believe investors, markets, policy makers and economists will be genuinely shocked with the growth and unemployment deterioration that is ahead. The expected June quarter 2020 US GDP result (around -20% q/qa) would represent the greatest contraction in US economic history (the largest have been -15.5% q/qa in December 1932 and -14.7% q/qa in December 1946), but the duration of this should be considerably shorter than in the 1930s (two and three quarter years) which should hopefully prevent 2020 being labelled a 'depression'.
- There is a very large global growth hole ahead with double digit q/qa March quarter contractions in China and Europe, followed by a greater than -20% q/qa plunges in June quarter activity in the US and Europe, and stimulus can do little during this down-leg as businesses in large advanced economies are mostly closed and workers have raised their precautionary savings and are only purchasing the essentials. Policy is not aimed to prevent recession, but rather to lower the likelihood of dangerous negative reinforcing feedback loops forming, which would spark a deeper and longer 'depression'-like environment and also to keep businesses solvent while the health crisis is resolved.
- The Australian government announced its second round of stimulus yesterday and it is unlikely to be the last. This brought the total support from monetary and fiscal policy to AUD189 billion or 10% of GDP and it is likely to rise from there. We remain highly sceptical this will have a major short-term impact as businesses are closed and households have shutdown non-essential spending, so Australian policy is similar to our peers in that its primarily aimed at keeping corporates and economies solvent to be in a position to participate in any recovery

VIRUS UPDATE

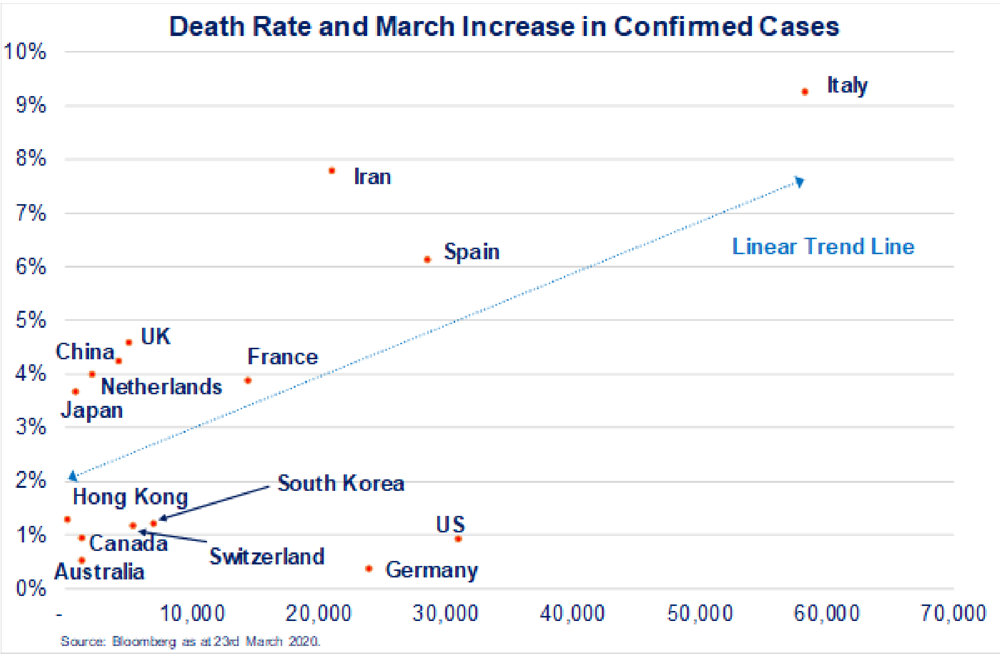
- Corona cases rose +36.4k overnight to 329,299, deaths rose 3,079 to 14,366 and the death rate rose to 4.4% (8th rise in the past 12 days despite surging case numbers);



- Europe (+23,349 to 152.6k) continues to lead the world in terms of total cases and daily new cases, and now Italy has surpassed China in total deaths (5,476 vs 3,261).
- Among countries, the most cases are in China (+389 to 81,397), Italy (+12,117 to 59,138), the US (which had its largest daily increase of +3,954 to 31,057), Spain (+3,441 to 26,603), Germany (+974 to 23,974) and Iran (1,028 to 21,638). Australia confirmed cases has increased (+605) to 1,314. While Europe has been at the epicentre of new confirmed cases for March, numbers in the US are really starting to surge, suggesting that a third front has begun to open up – that is, it started in China, then spread aggressively through Europe and now has engulfed the United States and these three regions are the three largest economies which contribute nearly two-thirds of global economic activity.



- You can see below the stress than rising case numbers will eventually put on a health system. The chart below shows the positive relationship between the increase in confirmed case numbers so far in March on the horizontal axis and the country death rate (i.e. deaths/cases) on the vertical axis. The trend line in the chart shows that for every 10k increase in case numbers culminates in an average 1% rise in the death rate.



THE AUSTRALIAN POLICY RESPONSE

- Ten days ago the Australian Prime Minister announced a AUD17.6 billion (+1.2% of GDP, which added to prior announced support) fiscal stimulus program, the RBA provided AUD105 billion worth of measures last Friday and on Sunday the Morrison Government provided a round of 'solvency measures costing a further AUD66 billion (+3.3% of GDP, taking the entire fiscal support to AUD92.7 billion or +4.6% of GDP). This takes the entire support package to AUD189 billion (+-10% of GDP) and the measures will be taken to Parliament likely Monday for legislation and we expect no delays from the Opposition.

- Key new measures on Sunday included:

    1. **A further one-off cash payment to income support recipients.**
       The Government will make a second AUD750 cash payment (after the first on 31 March) on 13th July to all eligible income support recipients (pensioners, the unemployed, war disability folks and alike, who total around 5 million people).
    2. **A 6-month coronavirus income supplement**
       A temporarily income supplement of AUD550 per fortnight for the next 6 months to new and existing recipients of the JobSeeker Payment, Youth Allowance jobseeker, Parenting Payment, Farm Household Allowance and Special Benefit.
    3. **Early release of superannuation**
       The Government will allow individuals in financial stress as a result of the Coronavirus to access up to AUD10,000 of their superannuation in 2019-20 and a further AUD10,000 in 2020-21.
    4. **Cashflow boost to SMEs to pay bills**
       Eligible small and medium sized businesses (and charities and non-for-profits) with turnover of less than AUD50 million will be able to access up to AUD100,000, with a minimum payment of AUD20,000 to be paid from April 20 onwards.
    5. **SME loan guarantees**
       The Government will establish the Coronavirus SME Guarantee Scheme which will support small and medium enterprises to provide working capital to overcome the disruption from the Coronavirus. Under the Scheme, the Government will guarantee 50% of new loans issued by eligible lenders to SMEs up to a total of AUD20 billion.

VIEW OF THE STIMULUS

The Australian (and global) economy(ies) are being hit by simultaneous health and economic crises with sector closures and economic distancing at the forefront of the potential solution. Given the size of the Australian economic contraction to September (-0.5% q/q, -6.0% q/q, -3.9% q/q, respectively), my genuine feeling is that the vast bulk of the cash payments will flow into precautionary savings given plunging consumer confidence and the expected massive rise in unemployment from the Government lockdown. The handouts to business will help but need to be added to (and will be), but the rise in unemployment to double digit territory will take considerable time to unwind, so the recovery is likely to be more subdued than current expectations.

THE GLOBAL ECONOMY

- The coronavirus is a severe blow to the global economy and the ensuing contraction is expectedly to be worse than the global financial crisis and the two 1970s oil shocks. Accordingly, a record contraction in global GDP is now a serious risk in Q2 2020 as businesses close and the labour market is likely to take a massive hit in terms of surging unemployment and reduced income. We would argue that only essential sectors (food, pharmaceuticals, IT, telecommunications, medical and energy) are likely to remain operating which is set to open up an epic growth hole.
- Overall, there have been three broad shocks:
    a. **Supply** – by disrupting supply chains through product availability which has been foster through globalisation and specialisation (which is along the lines of a butterfly flapping its wings in Brazil causing an earthquake in China) and this will be amplified by the limitations of working from home;
    b. **Demand** – all supply shocks delve into demand shocks via the labour market in terms of both higher unemployment, plunging consumer confidence, surging precautionary savings and

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depressed disposable income. These factors negatively impact consumption and investment which is 75% of activity in most advanced economies; and

c. **The financial system** – as the contracting household and business sectors struggle to meet debt obligations.

Importantly, these three shocks can continue to feed off each other and we continue too believe that the destruction of consumer confidence will take considerable time to rebuild – which tells me there is unlikely to be any fast recovery as unemployment is likely to rise to double digit levels in most advanced economies.

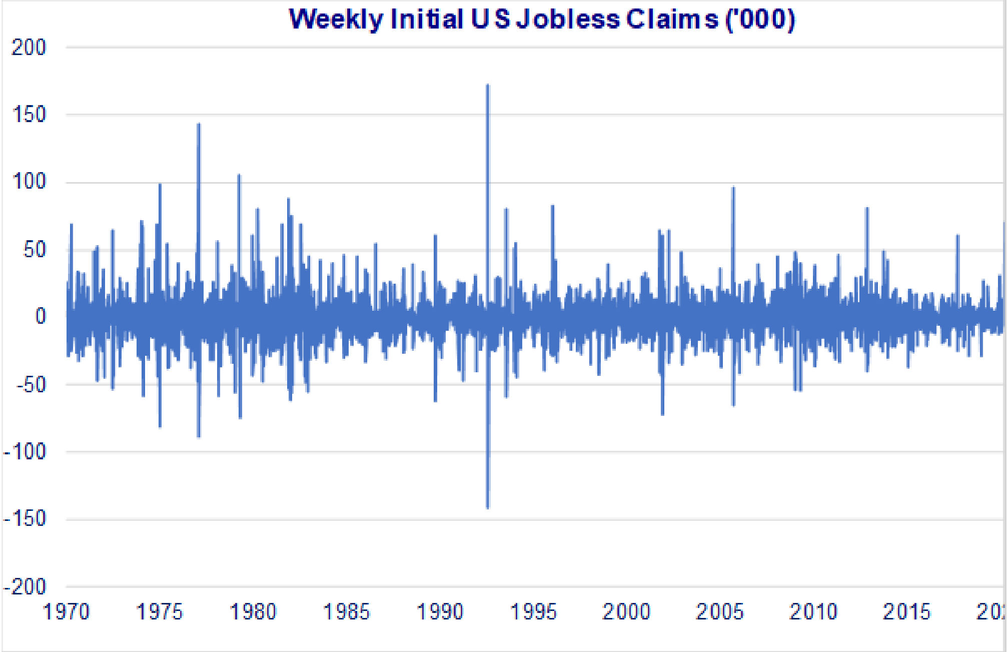
- While the Australian labour market has added an average +26k per month over the past 3 years, that net figure masks large movements of people moving from being employed to unemployed and vice versa. It is quite clear that other than a small group of hiring increases (such as at food retailers), hiring is likely to completely dry up and if an average -120k move from employed to unemployed (only one-third of the monthly average since February 2017), the Australian unemployment rate would rise to double digit territory by August (see gold box in table below). If the move to unemployed to employed was again at zero, and the amount of people moving from employment to non-employment was 40% below the three-year average (i.e. 'only' 230k per month), unemployment would increase to 15%. This does not seem too much of a stretch in an environment where businesses are being told to close and the PM has said this will last for at least six months.

Table 1: Australian employment declines, participation rates and unemployment rates

Change in jobs	+100k	+50k	0	-100k	-200k	-300k	-400k	-500k	-600k	-700k	-800k	-900k	-1000k	-1100k	-1200k	-1300k	-1400k	-1500k	-1600k
-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%	15.9%	16.7%	17.5%
-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%	15.9%	16.6%	17.4%
-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%	15.8%	16.6%	17.3%
-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%	15.8%	16.5%	17.3%
-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%	15.7%	16.5%	17.2%
-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%	15.6%	16.4%	17.1%
-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%	15.6%	16.3%	17.1%
-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%	15.5%	16.3%	17.0%
-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%	15.5%	16.2%	16.9%
-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%	15.4%	16.2%	16.9%
-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%	15.4%	16.1%	16.8%
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%	15.3%	16.0%	16.8%
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%	15.3%	16.0%	16.7%
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%	15.2%	15.9%	16.6%
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%	15.1%	15.9%	16.6%
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%	15.1%	15.8%	16.5%
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%	15.0%	15.7%	16.5%
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%	15.0%	15.7%	16.4%
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%	14.9%	15.6%	16.3%
Labour force																			

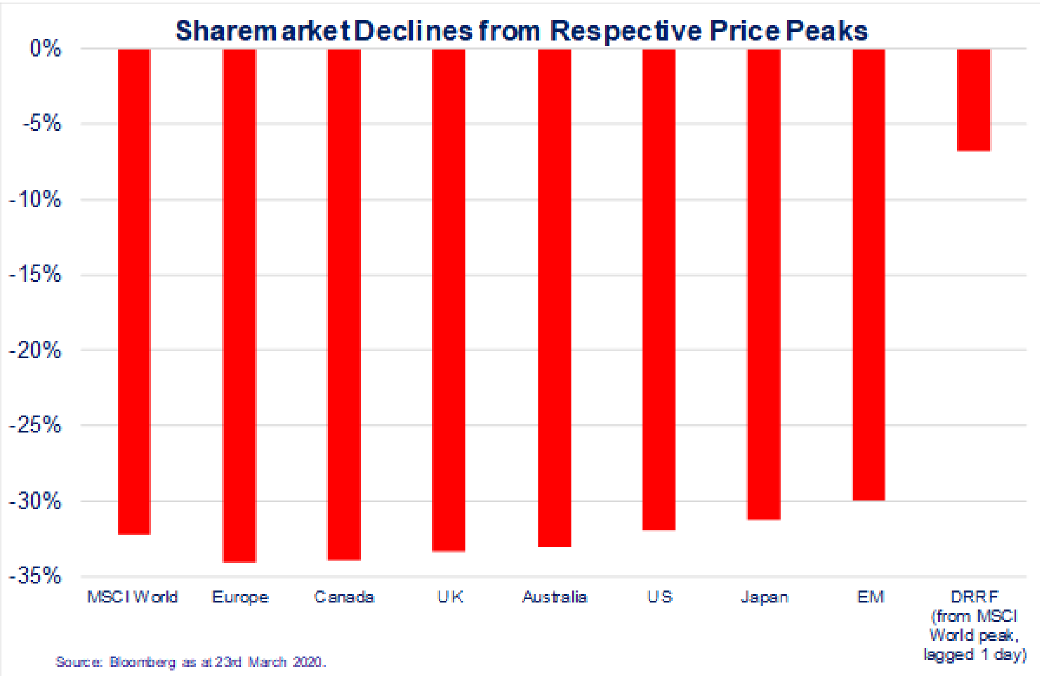
- Recessions occur when shocks hit vulnerabilities and unlike the 2018 market decline, corporations have clear dual vulnerabilities from both lower margins and record high debt, both of which will be stressed by falling GDP/revenue. In 2019 US firms had fractionally negative EPS growth but the labour market held together because firms offered lower average weekly earnings growth in exchange for continued employment. The difference between that time and 2020 GHC (Global Health Crisis) 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.
- We may have seen the first sign of this last week when initial jobless claims jumped +70k in the week of March 14 to +281k. This measure is a much timelier indicator of an economic inflexion point than lagging indicators such as industrial production, payrolls or retail sales, and it will provide an early glance of the economic damage being caused by Covid-19.

  The magnitude of last week's rise has been evident before every recession in the past 50 years, but not every rise of this size has been followed by a recession that is, sharp rises in jobless claims are necessary, but not sufficient to signal a recession). Interestingly, in the state of Washington (one of the more infected states as a share of population with 1,793 cases and 94 deaths) claims rose by around 66% to +15.8k and this is likely to foreshadow a broader economy-wide rise in coming weeks to around +500k and then +3-5 million by end April which could have US unemployment in double digit territory in H1 2020.

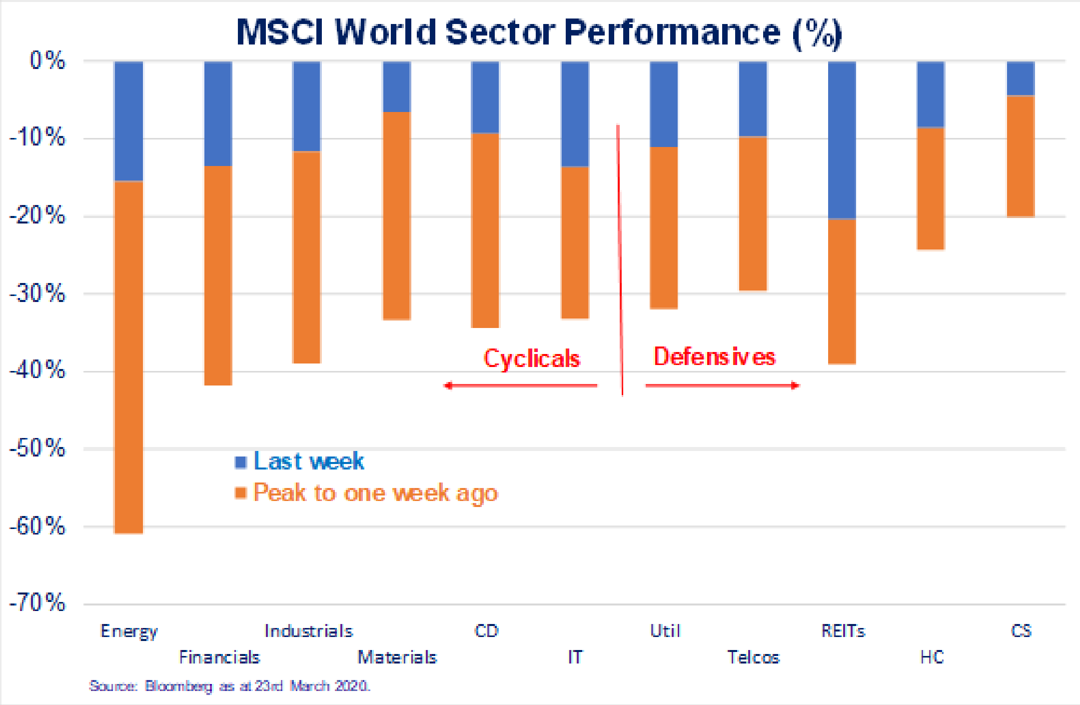


THE FINANCIAL MARKETS

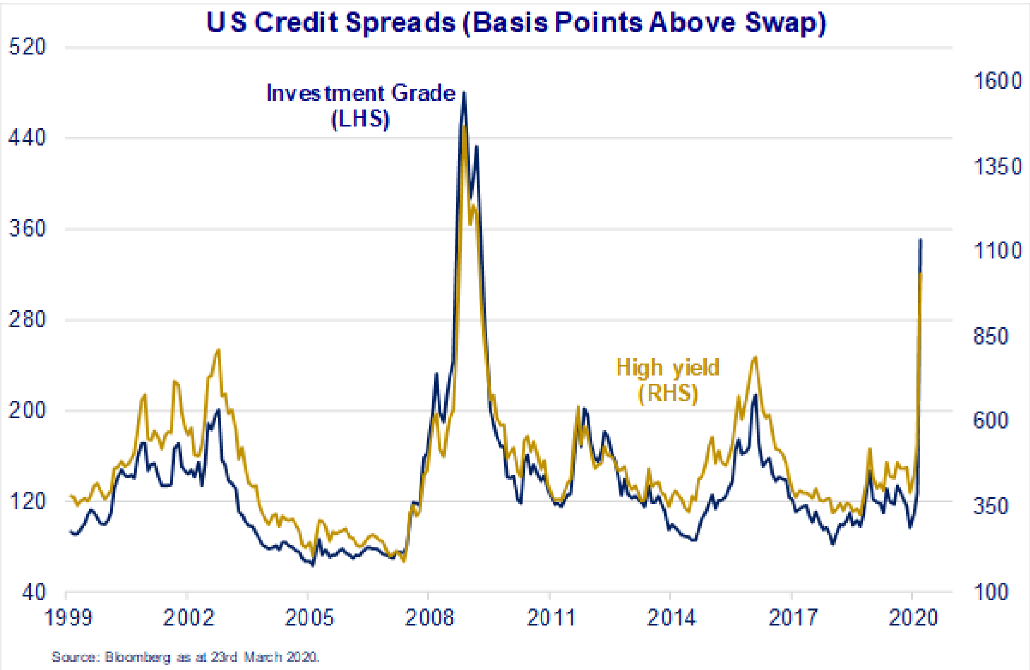
- **EQUITIES**
  - Sharemarket volatility has increased sharply given the economic dislocation caused by Cov-19. Indeed, over the past 10 trading sessions the S&P 500 index has moved more than +4% in nine of them which is something that has never happened before going back 90 years – not even during the Great Depression.
  - While high volatility is one sharemarket trait since mid-February, another is the uniform nature of the price decline with major indices in all regions down between -30% and -35% (see chart below).



  - Global sectors performance has also had little return deviation more recently. Indeed, defensives sectors (those that have low correlation with economic activity) underperformed many of the cyclical peers such as materials and consumer discretionary (See chart below). This may reflect the rise in bond yields more recently as investors and corporations sought to deleverage balance sheets and asset holdings and this sparked a particular sharp decline last week in REITs as numerous retail stores closed.



- **CREDIT**
  - Credit market liquidity has dried up worse than in 2008 as financial conditions are tight and are likely to remain so until the Coronavirus's growth rate slows, and stimulus so far is likely to have little flow through to the real economy as the issue is not monetary in its nature. The tightening in financial conditions may take considerable time to resolve itself as the US is about to record its largest ever contraction in economic activity, and oil prices are implying high default rates in HY and this stress will not be able to be ring-fenced. Rising defaults is likely to see spreads remain wide in coming months.
  - Global oil prices fell -29.3% last week and credit spreads continued to widen as global crude prices still remain well below the industry breakeven price of USD40 per barrel. Investment grade spreads widened +32 bpts on Friday (its 12th consecutive daily rise and 21st in the past 22 sessions) to fresh post-GFC highs of +351 bpts (see Chart below) and US HY followed suit (+ 48 to 1,034 bpts) also hitting yet another post-GFC high. Interestingly, the spread of high-yield energy to underlying swap rates declined for the first time in 10 trading sessions during which spreads had increased +950 bpts.



- The latest round of asset purchases by the ECB saw some stabilisation of credit spreads on Friday with declines of a handful of basis points, but spreads so far have decline for 24 hours on stimulus surprises, but after this the selloff continues. Nonetheless, over the past week IG spreads widened +72 bpts to 174 which (which is equal to its 2011/12 peak and the highest since early 2009, and HY spread rose +256 to 858 bpts which is also (yet another) post-GFC high.

Yours sincerely,

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MORE INFORMATION

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