

# THOUGHTS ON THE MARKET

24<sup>th</sup> April 2020

## SUMMARY

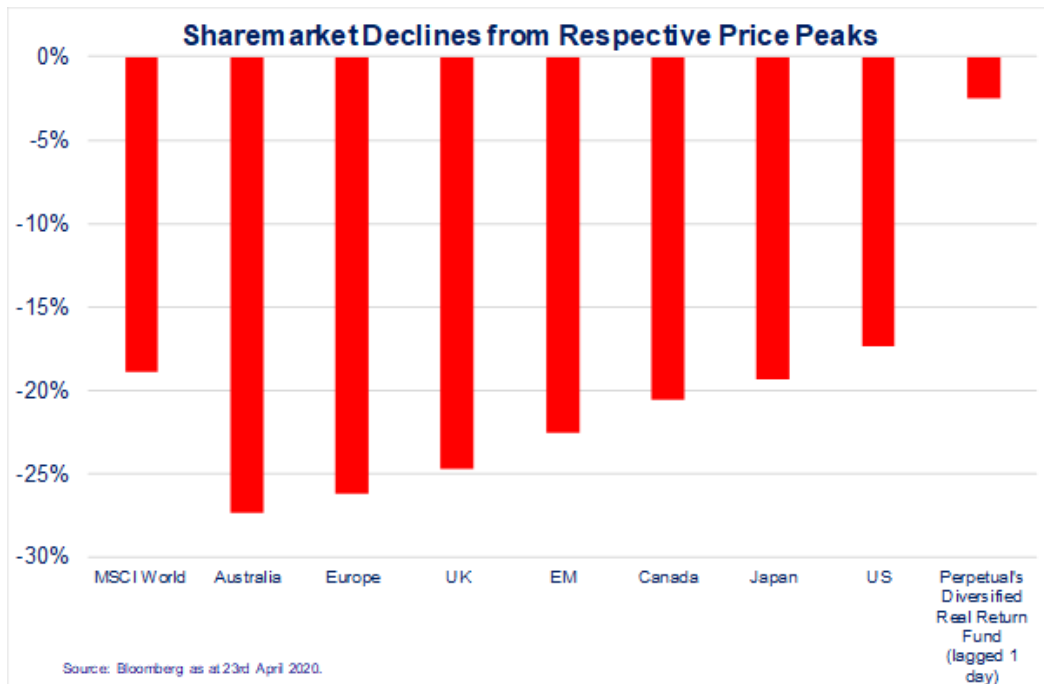
- Risk markets were mixed overnight as the positive impact of another increase in global oil prices (+22% overnight to USD16.37 per barrel) was offset by some really grim economic data out of Europe and the US and a report said that a leading experimental COVID-19 drug performed poorly in a test. Over the past four weeks investors have pinned their hopes around curve flattening, stimulus and an eventual vaccine – the first and last of which were helping them overlook weak economic prints, but overnight reaction suggests investors remain quite concerned about the depth and longevity of this crisis. Elsewhere, the US dollar was little changed against its major peers, gold (+0.1% to USD1729 per ounce) produced a second day of gains for the first time in a week as investors weighed up more stimulus, and US 10-year treasuries rallied with yields down to 0.60% with curve flattening.
- Economic data overnight was dominated by another weak round of initial US jobless claims as 4.4 million registrations last week which brought the five-week total to 26.5 million, which if the US participation rate remained unchanged, would see US unemployment at 20% by May. This followed the worst ever result for the European composite PMI at just 13.5 (relative to 39 at the GFC trough) in a sign that activity in the world's largest economic region is in free-fall. Bad economic data is a given with closures, but PMIs this low suggest a regional EPS decline in excess of -50%, with likely lasting damage on business operating models from expected changes in household behaviour.
- In COVID-19 news, the number of global cases rose +76.7k overnight to 2.71 million, with 7 countries now having more than 100k cases, 18 over 20k cases and 32 over 10k. It took 73 days to record 1 million cases, 12 days for the next million and in the past 9 days it has grown another 709k. That said, the growth rate of daily confirmed cases continues to decline (+3.0% since Tuesday). Meanwhile, deaths rose +6.9k to 190.3k and the death rate rose to 6.96% (although final numbers are not yet in).

## FINANCIAL MARKETS

### • EQUITIES

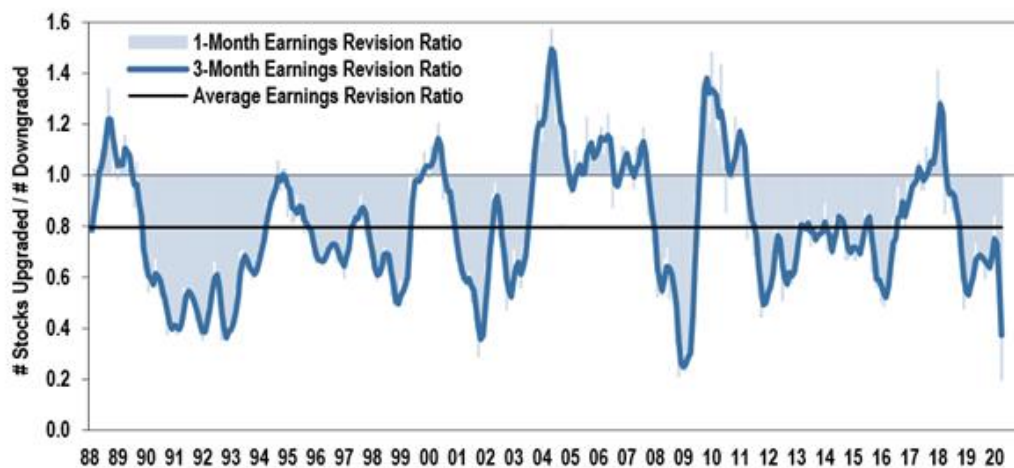
- The MSCI World Index rose +0.3%. Among the regions, gains were led by Europe (+0.9%) where energy stocks (+2.9%) led the advance supported by financials (+1.4%), whereas consumer staples (-0.5%) went the other way. In country performance gains were led by Italy (+1.5%), the UK and Germany (both +1.0%) and that positive performance flowed through to the US market which opened in the black but the announcement that Gilead's experimental COVID-19 drug had failed in tests saw investors ducking for cover in a trend amplified by another poor set of initial jobless claims and regional PMIs. This saw the US market hug the breakeven line in the last hour of trade but the market closed -0.1% lower as advances in energy (+3.0%) and industrials (+0.8%) were outweighed by losses in defensive sectors including consumer staples (-1.0%), REITs (-1.2%) and utilities (-1.8%).

In Asian trade yesterday, markets were mixed with losses in China (-0.3%) and Australia (-0.1%), whereas Hong Kong (+0.4%) and Japan (+1.5%) both advanced. The overnight rally in Europe has seen Australia record the largest regional peak-to-now decline (at -27.5%) despite our generally perceived defensive market structure, closely followed by Europe (-26.2%) and the UK (-24.7%). Meanwhile, Canada's overnight decline (-0.3% to -20.2%) has seen its index re-enter bear market territory.



Futures markets are pricing in a bounce in Australia (+0.2%) at the opening bell, but a decline in Tokyo (-0.3%).

The economic closures implemented to slow the impact of COVID-19 continue to have a devastating impact on earnings with the April Global Earnings Revision Ratio (the ratio of upgrades to downgrades) falling to an all-time low of 0.20, which surpassed the previous low of 0.21 in November 2008. Across the region the ratio has reached all-time lows in the US (0.07), Europe (0.09) and Australia (0.07), and six global sectors including insurance (0.07), banks (0.08), consumer discretionary (0.10), REITs (0.19), utilities (0.26) and healthcare (0.28). Bank of America notes that “*despite earnings downgrades outnumbering upgrades 5-to-1, it's not all bad news. In the past when the one-month Global Ratio was near these levels, the MSCI All Country World Index averaged 40% in the next 12 months*”.

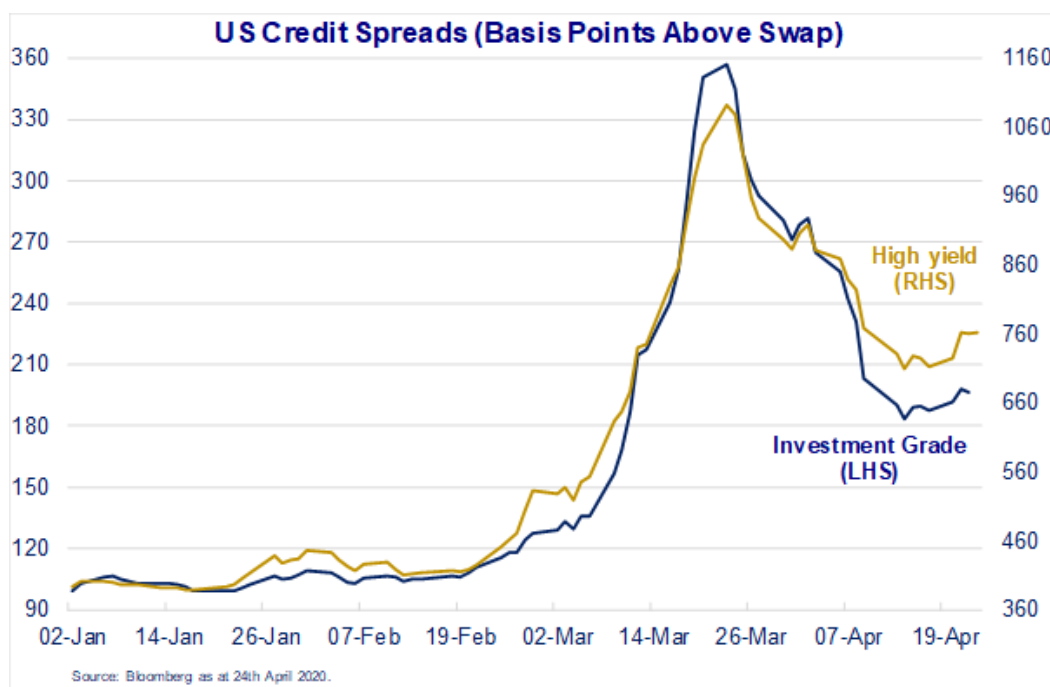


Source: BofA Global Quantitative Strategy, MSCI, IBES

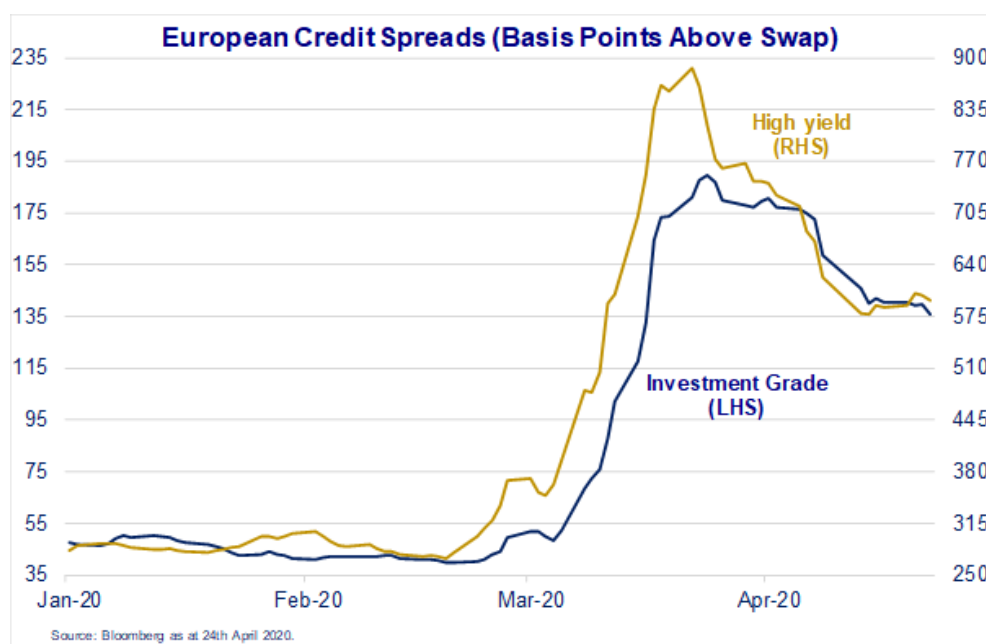
## • CREDIT

- US credit spreads were mixed overnight. Spreads in the investment grade universe declined -2 points to +195 bpts which drove the recovery rate up to 64%. Among the sectors energy (-6 points, +343 bpts, 56%) outperformed in line with another rise in the crude price (+22% to USD16.87 per barrel) and this sentiment

lift also supported prices in the subordinated financials (-3 points, +242 bpts, 62%), but there wasn't much elsewhere. In contrast, spreads in the high-yield universe widened +2 points to +763 bpts which pulled the recovery rate down to 48%. That came despite a large contraction in energy spreads in the past week (-35 points to 1480.5 bpts, 54%), but outside this spreads widened in every sector led by financials (+16 points, +760 bpts, 38%) and industrials (+11 points, +816 bpts, 31%).

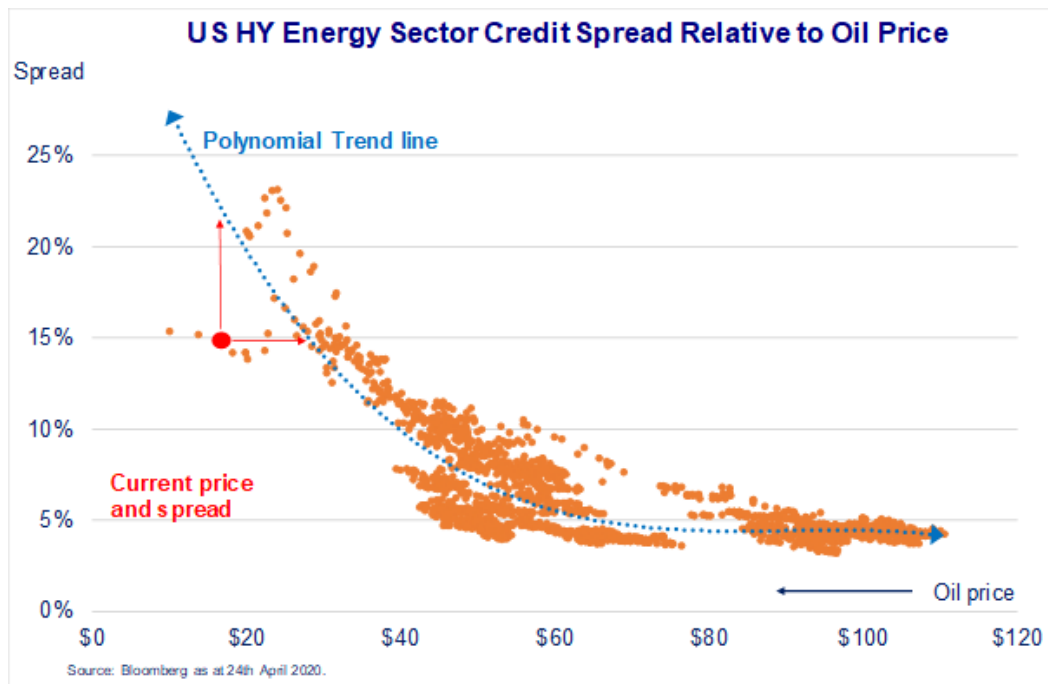


- European credit markets recorded slightly larger spread contractions but nothing that would rewrite the history books. Investment grade spreads contracted -4 points to +136 bpts, which boosted the market's recovery rate to 36%. There were spread contractions in all sectors led by subordinated financials (-8 points to +217 bpts, 51%) and consumer discretionary (-8 points to +198 bpts, 35%). In the high-yield universe, spreads came in a further -6 points to +595 bpts, which saw the recovery rate increase to 47%. The news was dominated by blow out in spreads for subordinated financials (+25 bpts to 572 bpts, 35%) which responded poorly to the ECB's policy announcement which left high yield markets vulnerable to dislocation which no central bank backstop. In contrast, European HY energy spreads came in solidly (-15 points, +758 bpts, 50%).



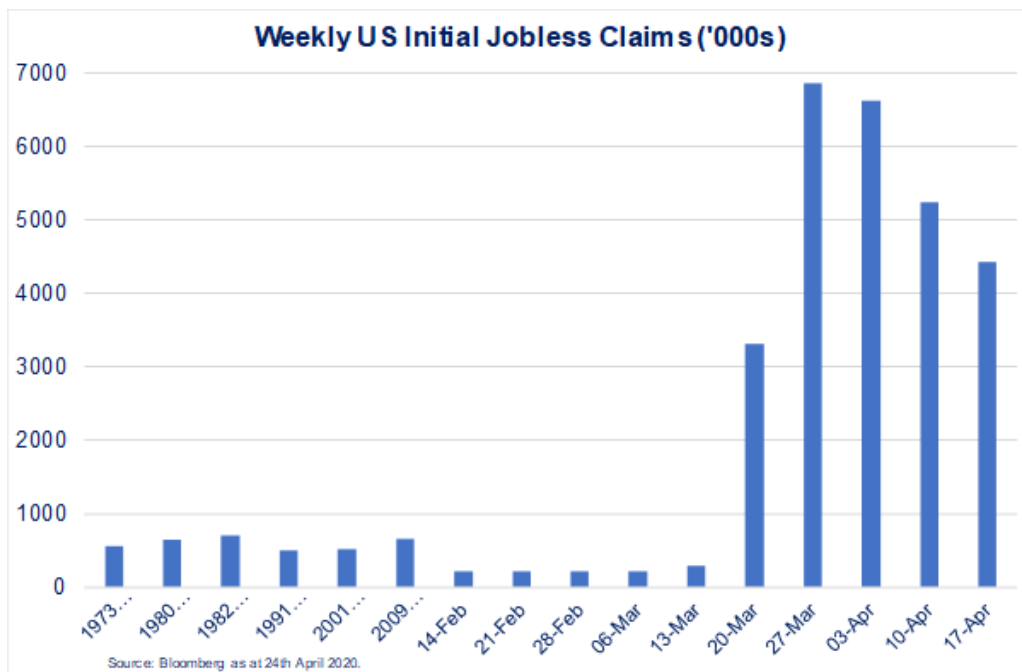
- Many people are asking us how much of an effect has the US Fed's two credit market support purchase programs have had on yields. The two programs have a limit of USD500 billion (for primary market purchases) and USD250 billion (secondary market purchases) in potential size, respectively, and there is no doubt the programs have quashed yield premiums –the chart below shows the relationship between the oil price (here the rolling 1-month futures contract) and the HY spread of the energy sector (to the option adjusted swap rate).

There is a clear negative correlation in that when oil prices decline, spreads blow out. Using a 3-order polynomial trend line we can ascertain that historically the current oil price should see spreads around 2200 basis points, but the current spread is around -700 bpts below this, suggesting that Fed policy is reducing the spread blow out in high yield energy substantially, or put another way the current compensation HY energy investors are receiving is equivalent to an oil price of USD28.50 per barrel (69% above the current 1 month futures price) – that is a lot of distortion.

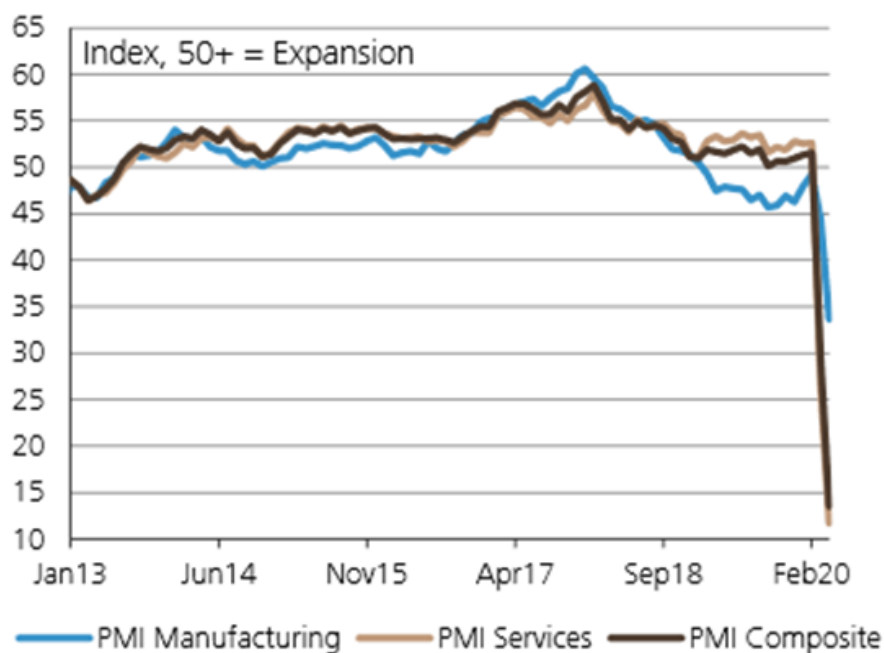


## THE GLOBAL ECONOMY

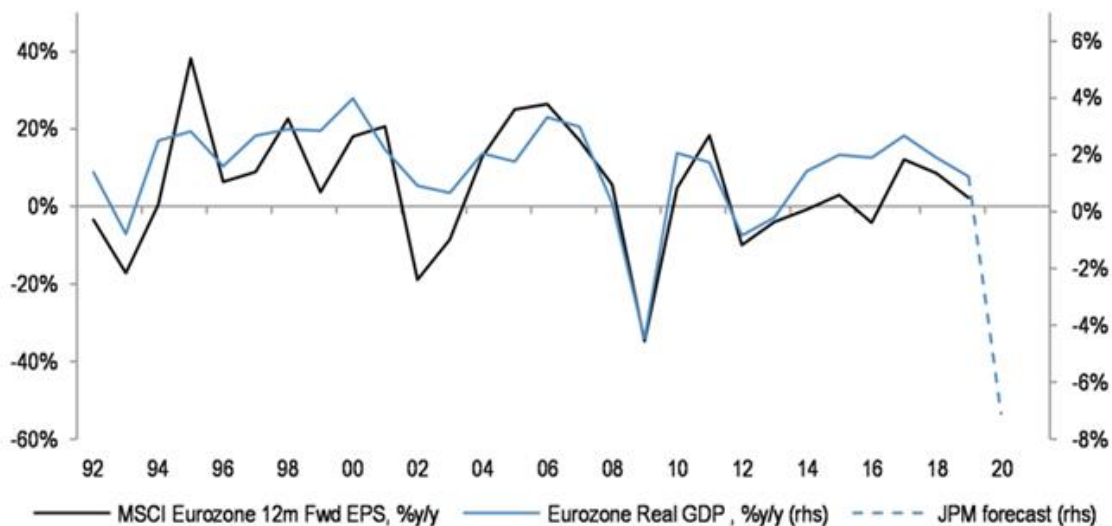
- US jobless claims came in at +4.43 million in the week of April 18th which is a bit below consensus and brought the five-week tally to 26.5 million (17% of the labour force) which is as number greater than the total employment growth in the last cycle (22 million). On the negative side, the increase is already enough to have US unemployment rise to 12% - 15% in April and 20% in May assuming no change in the participation rate and the Bureau of Labor survey correctly captures the dislocation, but on a more positive front 40 states have recorded falling claims including large states such as New York (196k) and California (508k). One exception to that is Florida, where claims tripled (to 563k), where the leisure and hospitality industries is continuing to contract rapidly.



- Eurozone business activity has crashed to a record low in April with the IHS Markit composite PMI, which measures both the services industry and manufacturing, dropping to 13.5 (see chart). In March, the same index recorded its biggest ever single monthly drop (-21.9) to 29.7 but the April result built on this and confirmed unprecedented damage to the Eurozone economy amid lockdown measures and slumping global demand. Among the two components, manufacturing (-10.9 to 33.6) fell less than services (-14.7 to 11.7).



The record decline in German activity in March (-15.7 to 35) was surpassed in April (-17.9 to 17.1) and if that wasn't bad enough the index in the UK (-23.1 to 12.9) and France (-17.7 to 11.2) came in even lower. IHS Markit said demand all but dried up, headcount was reduced at a record pace and firms cut prices at one of the steepest rates since the survey began in a bad sign for regional EPS growth. We estimate that the result is indicative of a European quarterly GDP contraction of around -9% q/q, which is enough to have regional EPS growth cut by half (see chart below), but the impact could be even more severe given the higher operating leverage in the region. Indeed, a typical 7x beta is observed between GDP and earnings growth, suggesting a contraction closer to -60%.



- Activity in Japan's economy also took a hammering in April as the impact of COVID-19 and the state of emergency hit demand at home and abroad. This combination saw a gauge of Japan's manufacturing sector fall to 43.7 in April which is the largest contraction since April 2009 and the service gauge fell to an all-time low of 22.8, which was enough to pull the all-industry measure down to 27.8 which is a level never seen before in the gauge's 13-year existence. The combination of the weak world economy and a record low for domestic output suggests that the world's fourth largest economy is set to face three quarters of contracting activity, which will weigh heavily on corporate earnings growth and warrant more fiscal support from Prime Minister Abe.
- In other news:
  - The South China Morning Post reported that China's Hubei province saw GDP collapse -39.2% q/qa in Q1 due to virus-driven shutdown which was by far the largest economic contraction of any of China's 31 provincial-level jurisdictions at the start of the year, and the largest published drop for any province since the founding of the People's Republic of China in 1949. The province is a key base for auto production and parts which is a sector which contracted -60% q/qa, retail sales dropped -45% q/qa and fixed asset investment plunged an unimaginable -82.8% q/qa. While the Chinese supply side of the economy is not far from being back to full capacity, demand has not recovered as the virus' impact on the global economy weighs on exports and the services sector continues to lag.
  - South Korea's economy shrank at fastest pace since 2008 on a steep drop in consumption.

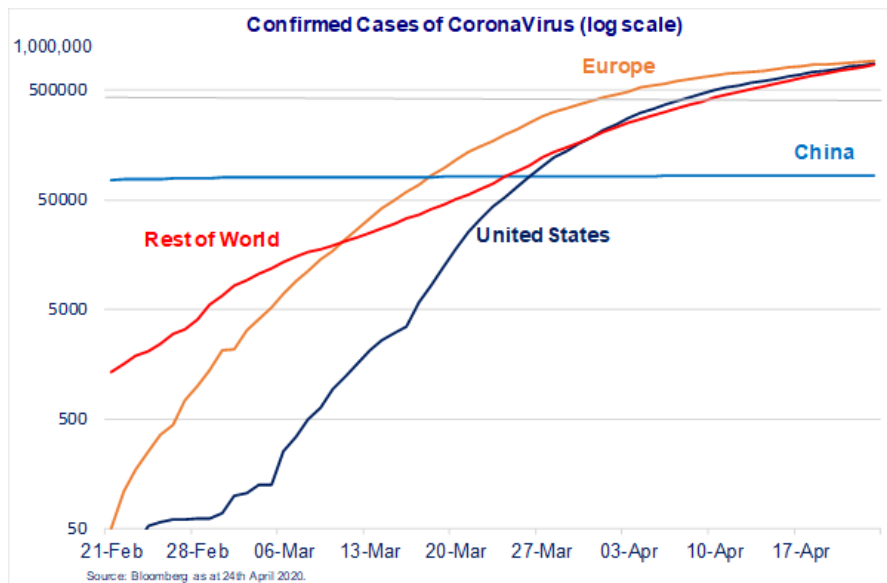
## POLICY

- On Wednesday the ECB stated that they will relax the rules on eligible collateral (i.e. only now need at least one IG rating on 7 April 2020) for funding operations until September 2021 in a move that leaves low-triple-Bs the comparative winners, but existing double-Bs in the cold. There were no changes to the rules governing the asset purchase programs, which implies that IG securities will be eligible for the various programs. As such, the ECB is adopting some of the Fed's policy in that eligibility is related to the COVID-19 crisis (with a longer horizon), but at this stage they aren't undertaking anything to avoid a potential sovereign debt crisis in that any downgrade of a sovereign from a higher debt burden is unlikely to return to IG for many years which could produce liquidity issues from massive bond issuance in 2020.
- EU leaders agreed on the need for a European Recovery Fund to offset the economic fallout from the COVID-19 outbreak and in true European style they asked the European Commission to come up with a proposal. A large-scale fiscal response is needed to take the pressure off the ECB, and while any fund is likely to have €1 trillion in its firepower, is unlikely to start until 2021, which makes it fairly pointless at this stage. Reuters noted that the same usual divisions were evident in that northern countries opposing recovery aid through grants, something sought by the likes of Italy, Spain and France.



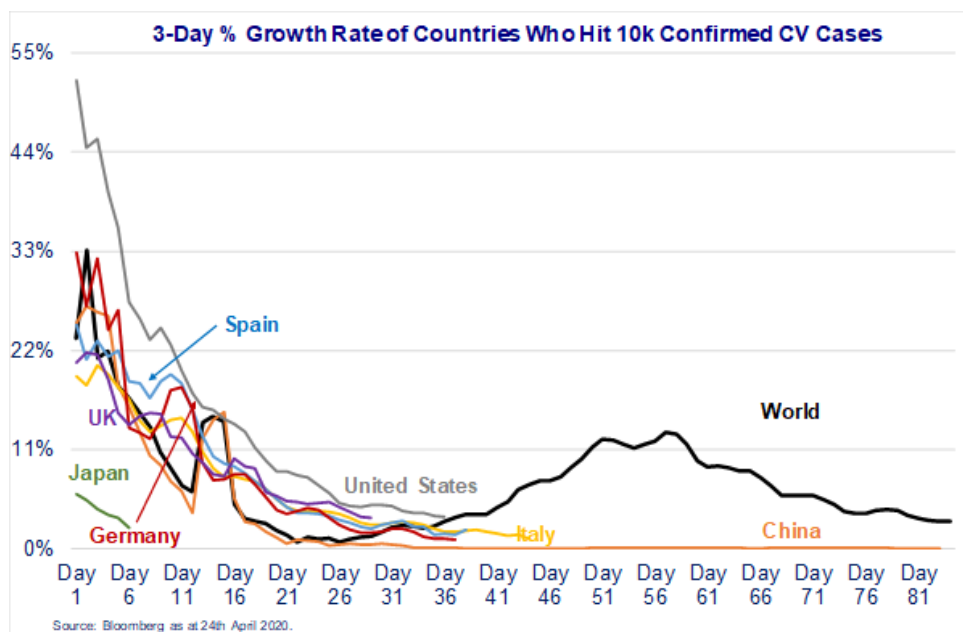
## VIRUS UPDATE

- The number of global cases of COVID-19 stands at 2.71 million with another 76.7k cases overnight with rising daily confirmed cases in both the US (+26.2k) and Europe (+13.0k). The overnight increase means 7 countries now have more than 100k cases, 18 over 20k cases and 32 over 10k. It took 73 days to record 1 million cases, 12 days for the next million and in the past 9 days it has grown another 709k. That said, the growth rate of daily confirmed cases continues to decline (+3.0% since Tuesday). Meanwhile, deaths rose +6.9k (second highest in the past week) to 190.3k and the death rate rose to 6.96% (although final numbers are not yet in).



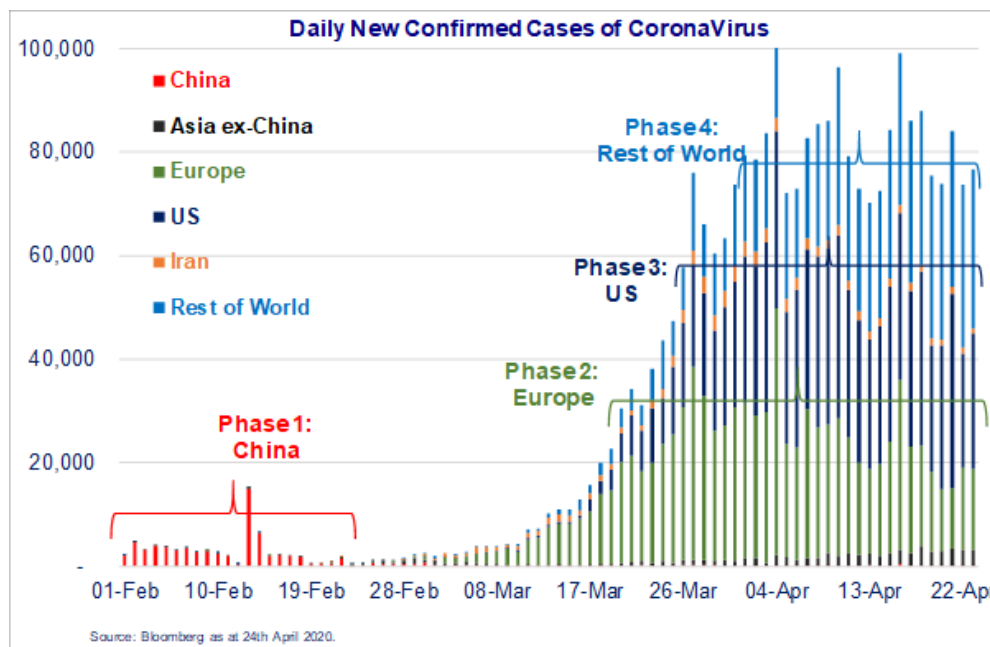
- Europe (+13.0k to 920.8k) continues to lead the world in terms of total cases but its daily increase (number, not percentage) is trending lower (third lowest in the past 37 days) which shows that social isolation works to reduce the spread of the virus, even though it comes at an enormous economic cost.

Similarly, the US had its fourth lowest daily increase of new confirmed cases in 11 days (+26.2k to 873.1k) and its 3-day compound growth rate has declined to +3.5% 36 days after they reached 10,000 cases. That said, New York cases rose at a 5-day high with another +7.5k (+2.3% over the past three days) but it continues to underperform the national average for new cases, although the death rate is much higher (7.7% against 5.7%) with another +1,532 deaths in the city that never sleeps (1-week high) to 21.0k.

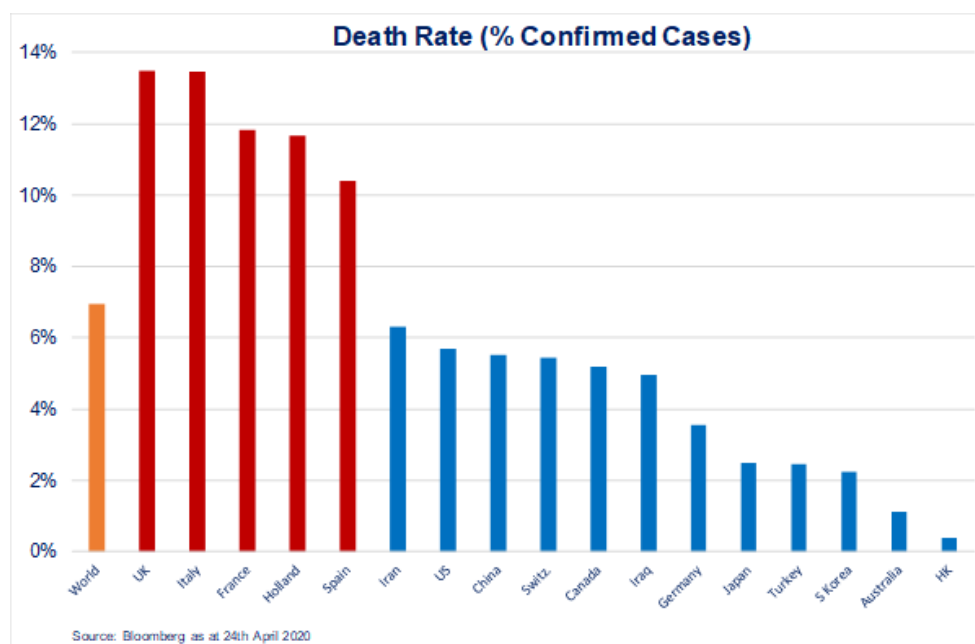


- Among countries, the most cases are in the US (+26.2k to 873.1k), Spain (+4.6k (6-day high) to 213.0k), Italy (+2.6k (4-day high) to 190.0k), France (+3.7k (5-day high) to 159.5k), Germany (+1.1k (5-week low) to 151.7k), the United Kingdom (+4.6k to 139.2k), Turkey (+3.1k to 101.8k), Iran (+1.0k (32-day low) to 87.0k) and China (+2 to 83.9k). Australia confirmed cases rose to 6,661 which placed us 43rd in terms of total infections.

Elsewhere, Singapore recorded a record high in daily cases (+1,037 to 11.2k) 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 (+357 to 7.8k) and the Philippines (+271 to 7.0k).



- The global death rate rose to +6.96% (its 40th rise in the past 41 days) with another +6.9k fatalities overnight bringing the global total to 190.3k. The death rate is highest in European countries where the health systems have collapsed led by the UK (steady at 13.5%), Italy (steady at 13.4%), France (steady at 11.8%), the Netherlands (+0.1% to 11.7%), and Spain (steady at 10.4%).





Yours sincerely,



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