

# THOUGHTS ON THE MARKET

26<sup>th</sup> May 2020 - The US default cycle has started



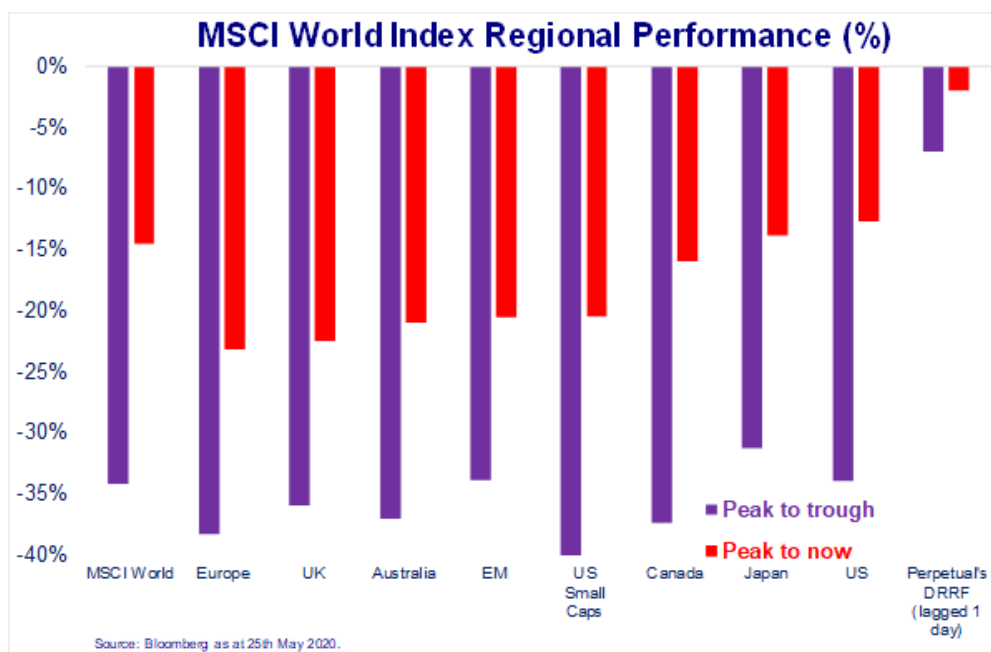
## SUMMARY

- It was quiet on markets overnight with US markets were closed for Memorial Day holidays and nothing of note on the economic calendar. Although trading volumes were light with national holidays also in the UK, Singapore and Brazil, markets in Asia, Europe and US futures all moved higher as investors remained more optimistic about stimulus and re-opening, than they were concerned about geopolitical tensions and elevated valuations. Just as macro stimulus doesn't create growth, it just borrows it from the futures, so asset purchases just borrow returns from the future and current US sharemarket valuations are now at levels which have historically culminated in real total returns of around 2% per annum for the next five years.
- In other markets it was also fairly quiet, with US Treasury not trading, the US Dollar depreciated against the Yen (-0.1%) and Sterling (-0.1%), and was steady against the Euro and AUD, gold dropped -0.4% to USD1,728 per troy ounce and oil rose +1.2% to USD33.65 per barrel.
- Although final numbers are not in for another 3.5 hours, the number of global cases of COVID-19 stands at 5.47 million with another +64.7k cases overnight (which means that Monday is likely to be the 56th occasion in the past 57 days where daily increases have topped 70k). This means 3 countries have more than 350k cases, 6 countries have more than 200k cases, 12 countries have more than 100k cases, 36 over 20k cases and 49 over 10k. It took 73 days to record 1 million cases, 13 days for the next million, 11 days for the third million, 12 days for the fourth and fifth million, and in the past 6 days another 472k cases have been confirmed. That said, the growth rate of daily confirmed cases is trending lower (+1.6% since Friday). Meanwhile, deaths stand at 344.7k and the death rate dropped for a nineteenth straight day to 6.26%.

## FINANCIAL MARKETS

### • EQUITIES

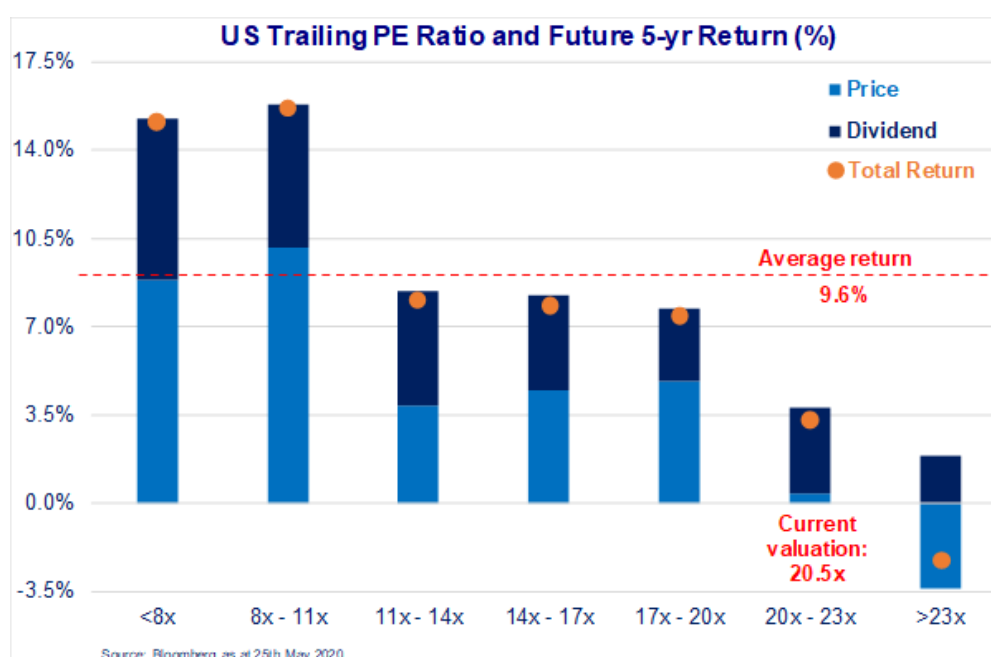
- The MSCI World Index closed +0.5% higher with advances in all sectors led by industrials (+1.1%), financials (+0.6%) and materials (+0.6%). It was a quiet session with the US market closed, but the European gauge was led (+2.3%) higher by Germany (+2.9%) in response to some positive macro data, the conclusion of a rescue agreement between the government and airline Lufthansa, and closure on several cancer lawsuits involving industrial stock Bayer and its Round-up weedkiller. This set to scene for large gains in other bourses including Spain (+2.4%), France (+2.2%), Sweden (+2.1%) and Italy (+1.6%). Earlier, the MSCI Asia Pacific index closed +0.9% higher with gains in China (+0.1%), Hong Kong (+0.1%), Korea (+1.2%), Japan (+1.7%) and Australia (+2.2%), with regional geopolitical risks festering in the background.



Futures markets suggest another strong opening at the bell with gains in Australia (+0.9%) and Japan (+0.7%).

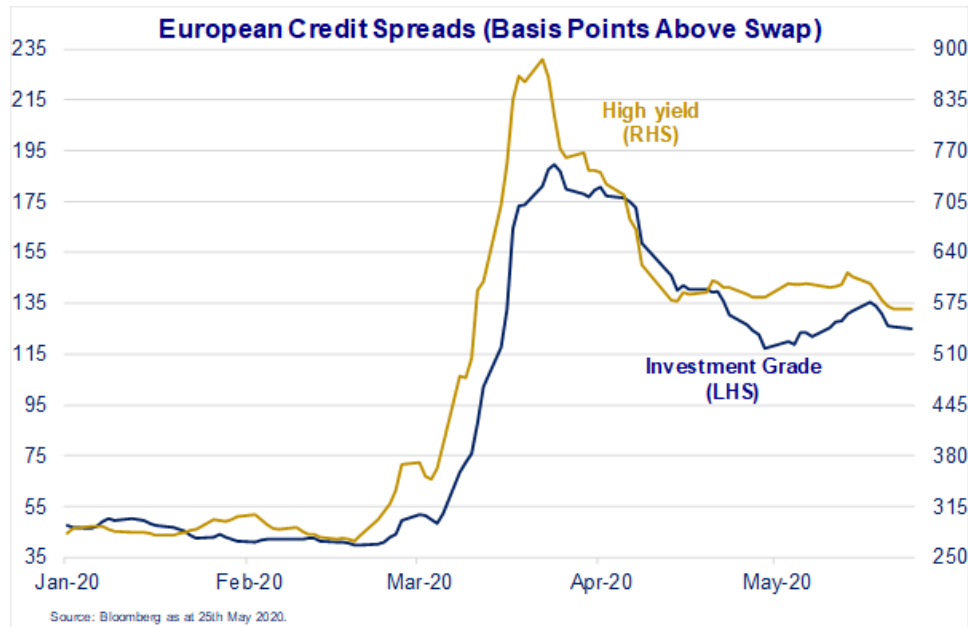
- **The global sharemarket rise since the March lows has been valuation-driven.** However, that has simply pulled returns forward which means future returns are likely to be lower in the absence of a major re-rating of the corporate outlook. In the long run the price investors pay for any asset has an inverse relationship with the return those investors receive. Below is a chart examining the US S&P 500 Index's valuation and its subsequent total return for the next five years.

The sweet spot for investors is a PE ratio of 8x-11x earnings as this generates a 5-year compound return of +15.8% per annum. However, as the US sharemarket's starting valuation increases (i.e. we move across from left to right on the chart), the average 5-year return declines. The current PE ratio for the S&P 500 is 20.5x trailing earnings which is a valuation level which has delivered an average 5-year return of just +3.8% per annum over the past 120 years – this is just over one-third of the US sharemarket's average return since 1900 (+9.6% per annum).



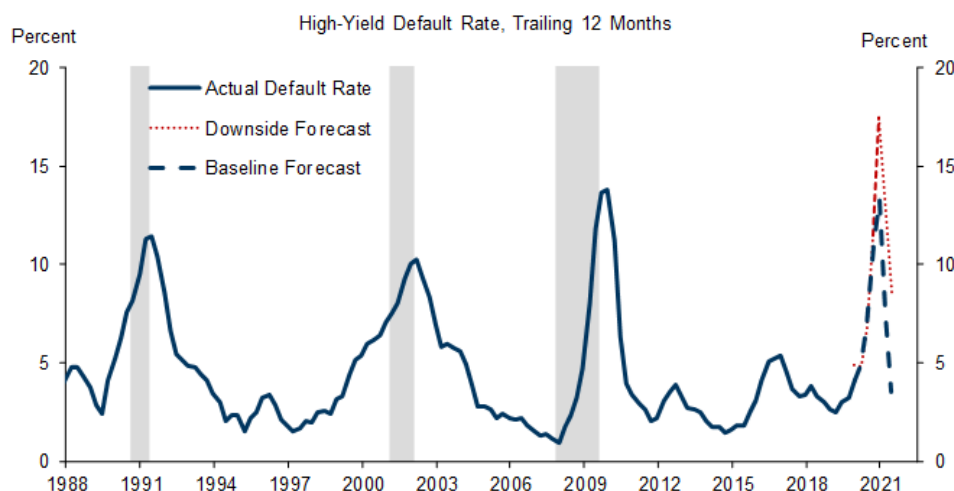
## • CREDIT MARKETS

- US credit markets were closed for national holidays. Meanwhile, **European credit markets** were little moved with spreads in the investment grade universe contracting -1 basis point to +125bpts, which kept the recovery rate to 43%. All 11 sectors recorded lower risk premium led by energy (-1.2 points, +123 bpts, 31%) in response to a higher crude price, but there was nothing aside from that in market action. In the high yield sector, spreads also came in -1 point to +567 bpts (a fresh post-February low) with the recovery rate idle at 52%. Energy also recorded the largest movement in the junk section (-6 points, +672 bpts, 59%), but spreads in healthcare (+2 points, +361 bpts, 63%), materials (+2 points, +524 bpts, 52%) and industrials (+3 points, +672 bpts, 53%) all expanded amid some potential portfolio switching.

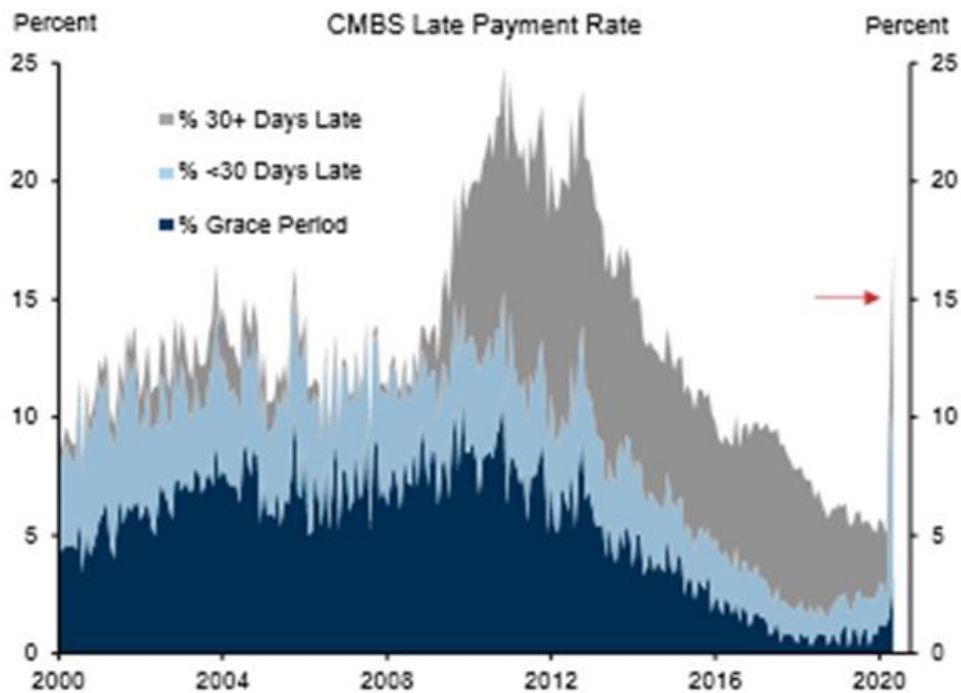


- **The Fed's latest Financial Stability Report** indicated heightened concern about rising credit risk and financial stability, underpinned by high corporate debt, elevated commercial real estate prices, the collapse in oil prices and varying virus exposure among sectors. US non-financial corporate debt has increased by +60% since 2011 and is at a record high as a share of GDP (circa 46%). The sharp decline in revenues since February across many industries has culminated in a large share of companies with negative cash flow and this has already sparked a rise in firms filing for bankruptcy which indicates that the corporate default cycle has started.

Goldman Sachs estimates that roughly half of the high-yield corporate bonds are in the energy or virus-impacted industries (tourism, airlines, hotels and so on). Overall, GS estimate that the 12-month trailing high-yield default rate will increase to 13% by the end of 2020, similar to the peak rate reached during the Global Financial Crisis (see chart).



A key area of concern is US commercial real estate, given signs of overheating and overstretched valuations prior to COVID-19, as well as large vacancy rates in industries such as hotels, healthcare, and retail. Interestingly, commercial real estate prices have outpaced single family house prices since the 2009 downturn with capitalisation rates falling to historically low levels, but late payments on these assets have picked up sharply in recent months, suggesting mounting pressures (see chart).



## THE GLOBAL ECONOMY

- Economic data was focused on Germany where the final estimate for March quarter GDP came in at -2.2% q/q which was in line with the preliminary estimate and consensus. Meanwhile, the Ifo business confidence survey rebounded +1.3 points to 79.5 in May, with the expectations index lifting (+5.1 points to 80.1) more than the current index declined (-0.5 to 78.9).

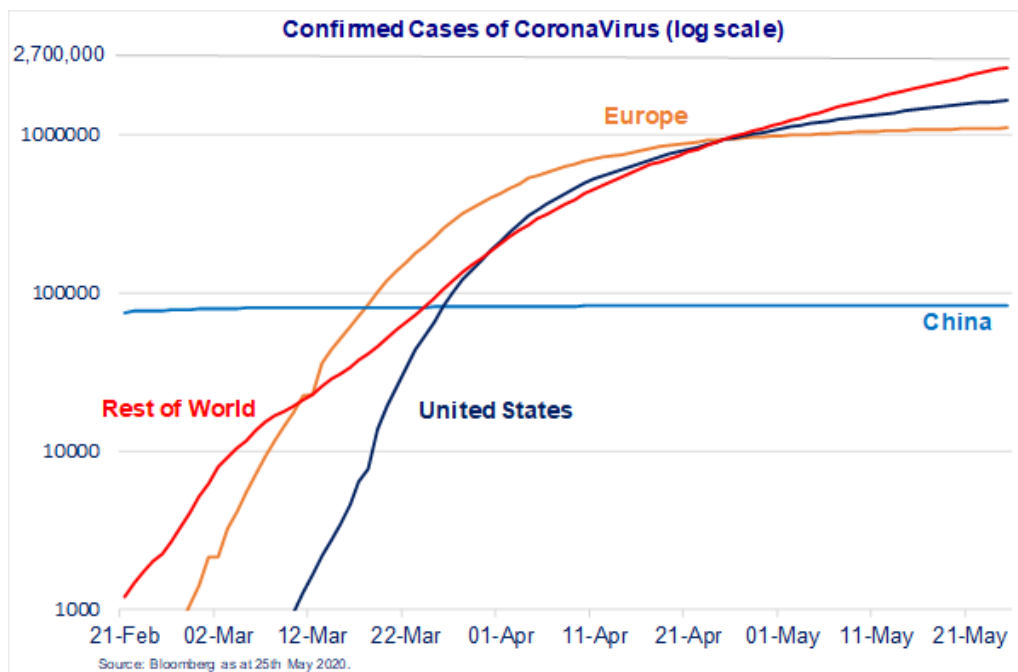


## POLICY

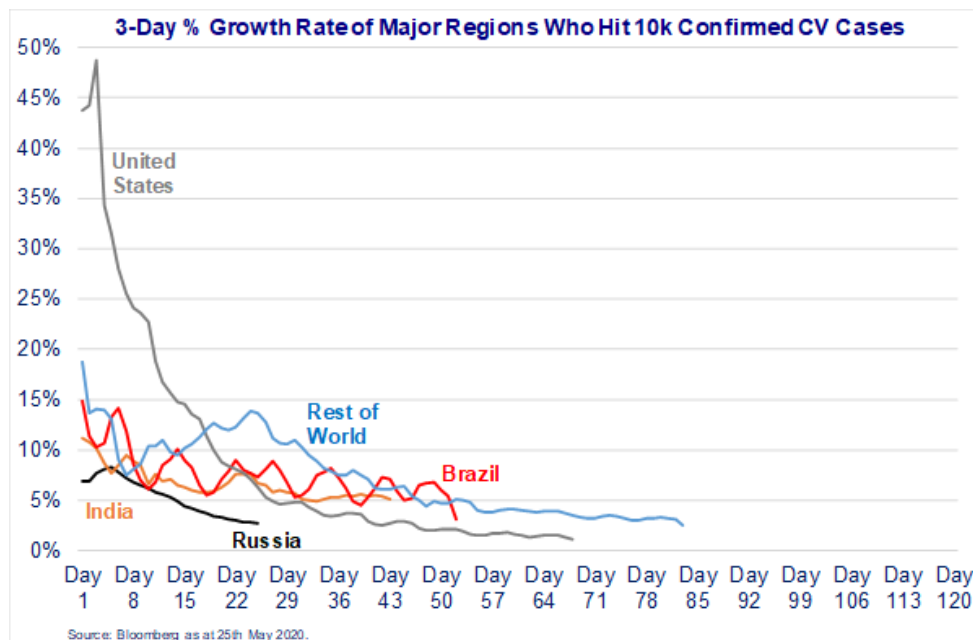
- There were several policy announcements/leaks overnight:
  - Japan is set to lift its coronavirus alert in Tokyo and other areas in three-stage plan which will end the nationwide state of emergency;
  - A leaked German government document stated that the Economy Ministry wants to support medium-sized firms with less than 250 employees whose sales have declined by -60% or more in April and May by paying them €50k per month for six months to December, with the total cost being €25 billion with on-going costs depending on virus developments in country.
  - China Foreign Minister Wang Yi warned that some in America were pushing relations to a "new Cold War" and cautioned the US "not to challenge China's red line" on Taiwan after Secretary of State Michael Pompeo broke with tradition last week, and he warned the US that China's stance on Hong Kong was an internal matter and that the principle of non-interference must be upheld by all countries.

## VIRUS UPDATE

- Although final numbers are not in for another 3.5 hours, the number of global cases of COVID-19 stands at 5.47 million with another +64.7k cases overnight (which means that Monday is likely to be the 56th occasion in the past 57 days where daily increases have topped 70k). This means 3 countries have more than 350k cases, 6 countries have more than 200k cases, 12 countries have more than 100k cases, 36 over 20k cases and 49 over 10k. It took 73 days to record 1 million cases, 13 days for the next million, 11 days for the third million, 12 days for the fourth and fifth million, and in the past 6 days another 472k cases have been confirmed. That said, the growth rate of daily confirmed cases is trending lower (+1.6% since Friday). Meanwhile, deaths stand at 344.7k, with the US now over 90k (28.4% of global deaths even though they have only 4% of the global population), the UK and Italy over 30k, with Spain and France over 25k, and the death rate dropped for a nineteenth straight day to 6.26%.

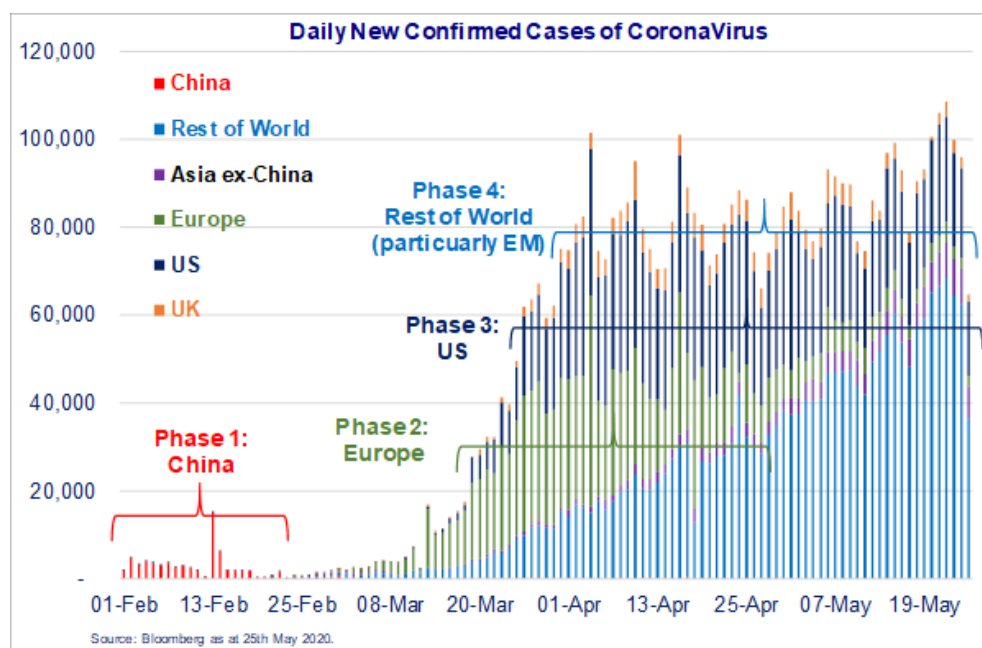


We break the infections into four groups – the US, Europe, China and ‘others’ and the rest of the world outside the G3 economies now has the most total cases (+35.6k to 2.65 million) and highest daily new cases (and by a considerable margin) followed by the US (+16.8k (7-week low) to 1.66 million) and Europe (+2.4k to 1.11 million), with the latter two’s daily increases, in terms of percentages, grinding lower which shows that social isolation works to reduce the spread of the virus, even though it comes at an enormous economic cost. In the rest of the world, the three concerns here are Brazil (who has not reported but have 363.2k cases which is the second highest in the world), +Russia (+8.9k to 353.4k, third highest) and India (+6.4k to 144.9k, tenth highest).



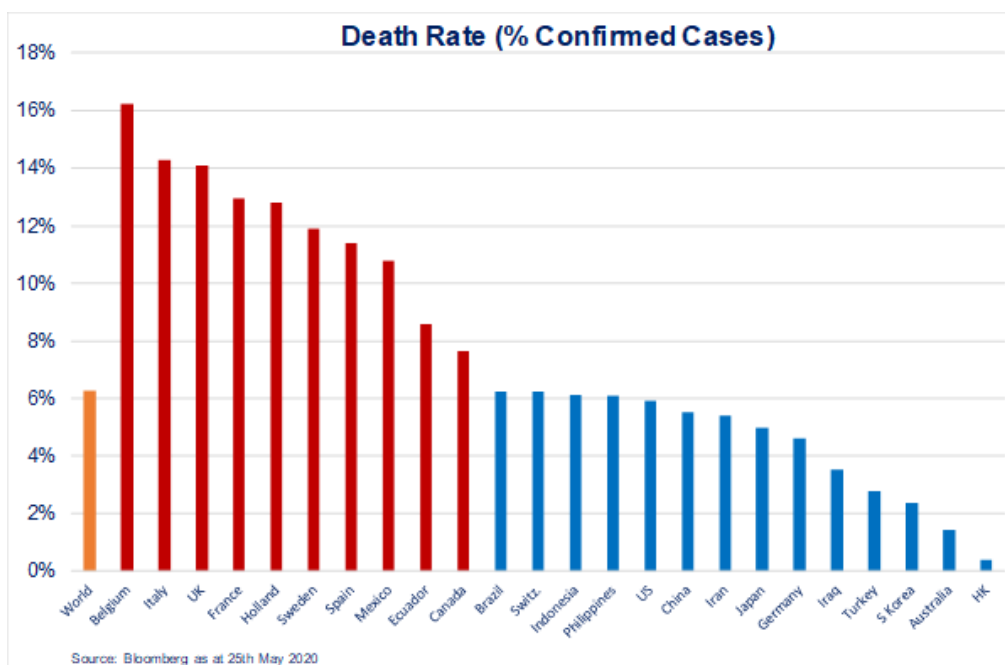
- Among countries, the most cases are in the US (+16.8k to 1.66 million), Brazil (not reported, +363.2), Russia (+8.9k to 353.4k), the United Kingdom (+1.6k to 262.5k), Spain (not reported, 235.4k), Italy (+0.3k to 230.2k), France (+1.1k (16-day high) to 183.1k), Germany (+0.3k to 180.6k), Turkey (+1.0k to 157.8k), India (+6.4k to 144.9k), Iran (+2.0k to 137.7k) and China (+11 to 84.1k). Australia confirmed cases rose +4 to 7,118 yesterday which placed us 60th in terms of total infections.

Elsewhere, Singapore recorded +344 new cases to 32.0k 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 (+479 to 22.8k) and the Philippines (+0.3k to 14.3k). Note final numbers for yesterday at not in yet so these numbers can rise.



- Although final numbers are not in until 11am AEST, the global death rate declined for a nineteenth straight day to 6.26% with the global total to 344.9k. The US (+0.5k) has the most deaths at +98.2k, with the UK (+0.1k to 37.0k), Italy (+0.1k to 32.9k), Spain (not reported, 26.8k) and France (+0.1k to 28.5) all over +25k. The death rate is highest in European countries where the health systems have collapsed led by Belgium (-0.1% to 16.2%), Italy (steady at 14.3%), the UK (-0.1% to 14.1%), France (steady at 12.9%), the Netherlands (-0.1% to 12.8%), Spain (11.4%) and Sweden (-0.1% to 11.9%). However, several emerging markets are now on the leader board including Mexico (-0.1% to 10.8%), Ecuador (+0.1% to 8.6%), Brazil (-0.1% to 6.2%) and Indonesia (-0.1% to 6.1%).





Yours sincerely,



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