Perpetual Investments

THOUGHTS ON THE MARKET

27th April 2020

SUMMARY

- Economic data has begun to detail the rate of economic deterioration underway from the policies which are successfully stemming the growth in COVID-19 cases and the expected GDP declines are much worse than we saw in the 2008/09 GFC. Economic contractions have already been reported by China (-8.7% q/q) and South Korea (-1.4% q/q) and this is expected to be joined by weakness in the US (-1.8% q/q) and Europe (-3.5% q/q) when preliminary March quarter growth numbers are released this week.

  More worryingly, the flash readings of the April G4 PMI surveys suggested that while the manufacturing sector has declined sharply, services have had the floor taken out from under it. This is a complete change from the recession 'normal' when the impact of the manufacturing contraction is diversified by service sector resilience, and it suggests the growth collapse has worsened in the early stages of the June quarter. The June downturn is expected to be worse in Europe (-11.5% q/q) than the US (-10.0% q/q), Australia (-9.5% q/q) and Japan (-9.0% q/q). These declines will be offset by an expansion in China (+5.5%) which will see the world economy drop -6.5% q/q (which is the largest in recorded history). Overall, we think central banks have done a good job at restoring market functioning, but in the US we question how much things can open up and also whether enough support has been given to boost weak links such as small and medium business survival and labour market dislocation. In the next three months we will see if a strong enough bridge has been built when the economic lights go back on, and whether second round effects emerge.
- The panic-led indiscriminate selling of assets based on COVID-19 data is most likely now behind us and global investors are currently judging both the cumulative earnings and dividends losses, as well as the potential time to recoup the fallout. Citigroup has current bottom-up estimates of EPS down around -14% for 2020 (and up +22% for 2021) but this is materially too high and needs to decline otherwise the market will be subjected to negative earnings surprises, leaving valuations highly vulnerable. The last four global recessions may have had vastly different lengths (8 to 18 months), but all culminated in a two-year corporate recession, so expectations about a strong EPS recovery, without major side-effects from COVID-19 containment strategies and despite the massive uncertainty, has risk market recoveries looking highly fragile.

  Our primary concern is the economic scarring and its impact on household and corporate behaviour leading to an underwhelming GDP and EPS recovery underpinned by higher savings rates, protracted labour market slack, lower wages growth, prolonged deleveraging, low investment growth and low inflation. Another problem is that several countries are preparing to exit from closures in the presence of solid growth in cases number and the absence of mass-testing, which culminates in a high risk of virus resurgence and a potential second round of shut-downs.
- In COVID-19 news, the number of global cases stands at 2.96 million with another +68.3k cases overnight with daily US confirmed cases (+24.1k) coming down from yesterday's record high (+48.5k). The overnight increase means 7 countries have more than 100k cases, 19 over 20k cases and 35 over 10k. It took 73 days to record 1 million cases, 13 days for the next million and in the past 11 days it has grown another +919k. That said, the growth rate of daily confirmed cases continues to decline (+3.0% since Friday). Meanwhile, deaths rose +3.2k overnight (4-week low) to 206.3k, with the US passing 50k and the UK 20k over the weekend, and the death rate sits at 6.88% (although final numbers are not yet in).

FINANCIAL MARKETS

- **EQUITIES**
  - The MSCI World Index rose +0.7% on Friday but this was not enough to prevent the index closing -1.5% lower over the past week. In the last trading session however, gains were led by IT stocks (+1.7% d/d) and

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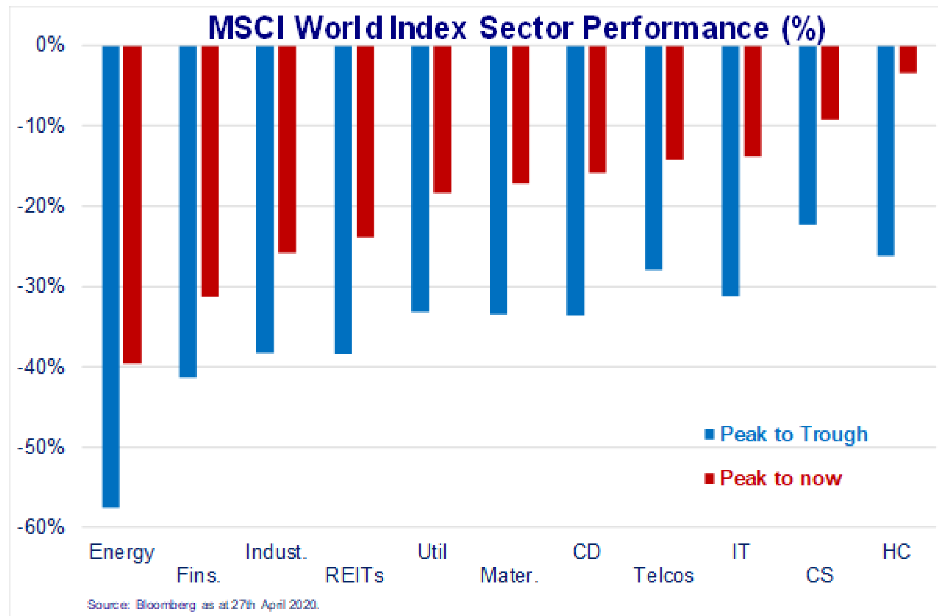
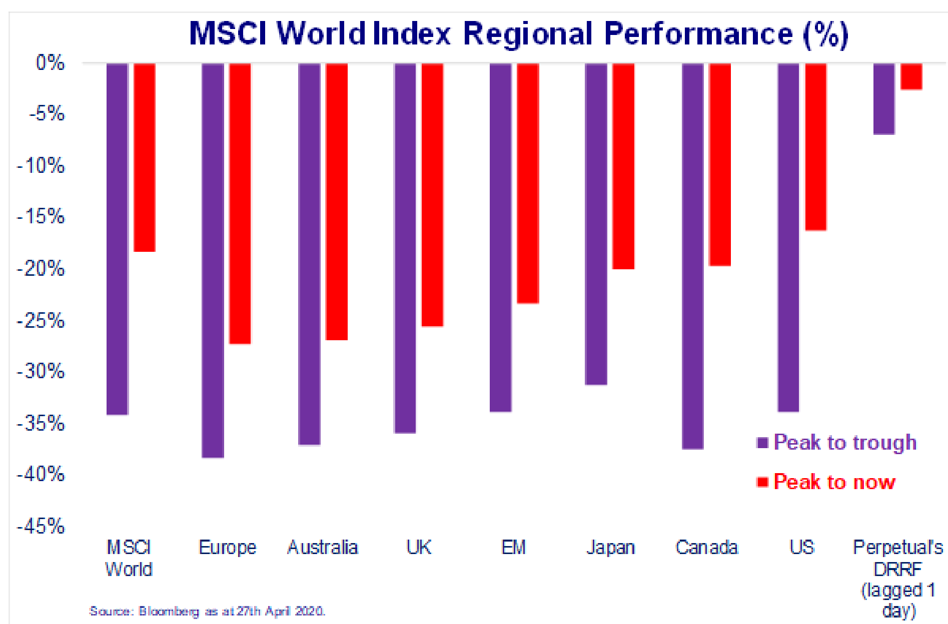
healthcare (+1.1% d/d) with the latter being one of only two sectors (energy +1.5% w/w and healthcare +0.4% w/w) which close higher for the week. The performance of healthcare continues a three-week trend where the sector has now recovered 87% of its initial -26% decline (see chart) which is well above any other sector - consumer staples is next at 58% with IT at 56% suggesting that investors are looking for either non-cyclical earnings or sectors which are likely to benefit from the ensuing low interest rate environment.



- Among countries, the US performed strongly on Friday and closed close to its intraday high, meaning that the region has recovered 52% of its losses. Among its constituents, gains were led by IT (+1.4% d/d, after Google announced cuts to its cost structures and Intel beat street estimates for Q1 earnings), with materials (+1.3% d/d) outperforming despite a -0.2% d/d decline in the CRB raw industrial metals index. In Europe, markets did not so well (-1.5% d/d) as a lack of policy thrust concerned investors and this pulled Europe's recovery rate down to only 28.6%. Among regional bourses Spain (-2.0% d/d) and Germany (-1.7% d/d) underperformed and the UK (-1.3% d/d) also scored a bowler's century.

  Earlier in Asian trade, losses were widespread led by Korea (-1.3%), China and Japan (both -0.9%), with Australia (+0.5%) the only market to close higher although it was hard to pinpoint why that was the case. Despite the increase, Australia has the lowest recovery rate of all major international markets in the chart below, with the peak-to-now decline (-26.9%) only bettered by Europe (-27.3%).



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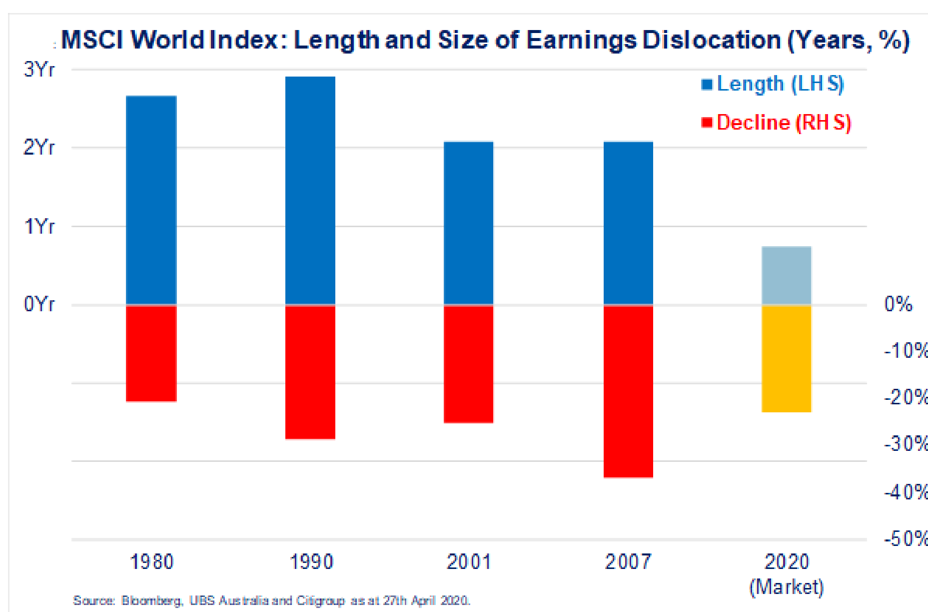
- The US earnings season continued with 24% of companies having now reported with 60% of them beating downbeat street estimates, with the blended earnings decline at -15.8% y/y, which if sustained, would represent the largest annual year-over-year decline since June Q2 2009 (which was -26.9%) and well beyond the March 31st estimate of -6.8% y/y. The sectors with the largest positive EPS surprises have been healthcare (+9.5%), IT (+9.0%) and consumer staples (+8.0% - see chart) which are leading the pace of the recovery, whereas the most negative results have been in energy (-8.1%) and financials (-30.1%) which have the lowest loss recovery. Of the 122 companies which have reported, only 10 have provided guidance for 2020, with 30 withdrawing previous estimates.

	Comm. Services	Utilities	Consumer Staples	Health Care	Real Estate	Info. Technology	S&P 500	Materials	Industrials	Financials	Consumer Disc.	Energy
Today	5.5%	4.0%	3.6%	2.6%	2.3%	0.8%	-15.8%	-24.9%	-31.0%	-41.9%	-42.1%	-66.6%
31-Mar	9.4%	4.8%	-1.5%	2.1%	3.1%	1.5%	-6.8%	-21.3%	-27.3%	-8.8%	-29.0%	-40.3%

- It is abundantly clear that the global corporate sector is in a world of pain with economic closure and its impact of dividend and earnings growth. Nevertheless, it is possible for the market to discount the rate of earnings contraction that the global PMI index suggests if one of two conditions are fulfilled - either the first year of earnings contraction is not so severe that losses can't be recouped, or the second year has some form of material bounce-back. The worry we have is that over the past 40 years, economic recession regardless of its length, has always culminated in a two-year earnings recession.

  Over the past four decades, the two shortest US and global recessions were 8 months in 1990 and 2001 (in fact in the latter US GDP only contracted for 1 quarter), but this did not prevent a much longer corporate recession (all over 2 years – see chart).



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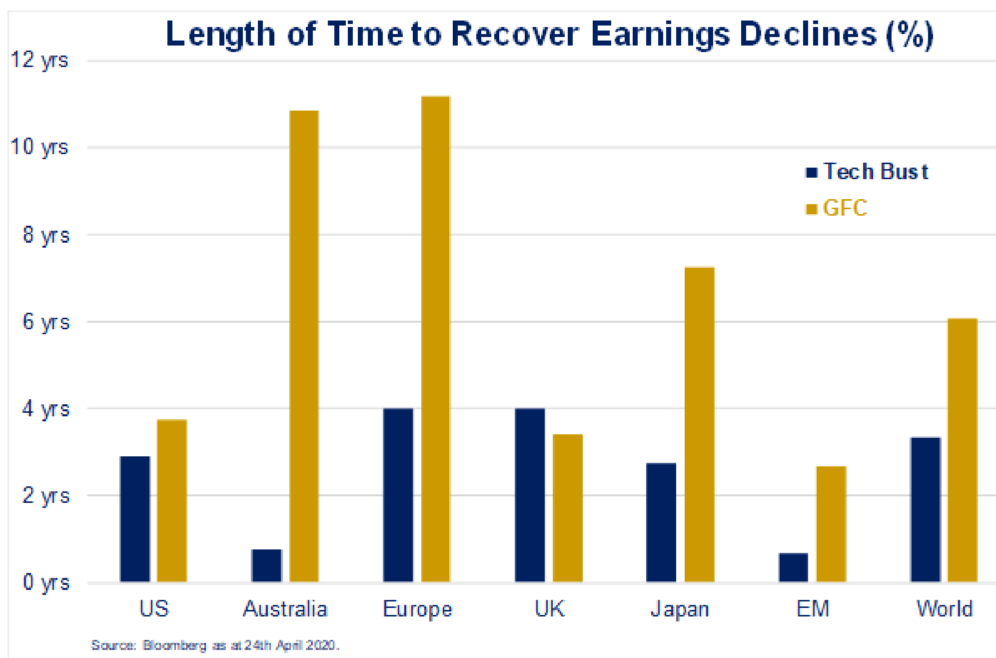
The extent of the corporate retracement is one thing, but the recovery time is another, depending if recession occurs at all (see chart below especially Australia and EM in 2001), or there are long-term structural damages from the recession such as occurred in Australia and Europe after the GFC where it took the market over 10 years to recover the earnings demise from an 18 month recession – in fact Europe never quite recovered its earnings loss (we just felt like being generous).



- If our and Citigroup's forecast for the next two years are close to the end result, global earnings will decline -50% this year and bounce 30% next year, but that will leave EPS levels -41% below the end-2018 peak and given EPS globally has averaged +5.4% since 1979 (support by non-repeatable globalisation, EM industrialisation and DM leverage booms), it could take upwards of a decade to recoup corporate profits which may leave the market subjected to negative earnings surprises and valuations highly vulnerable.

CREDIT

- US credit spreads widened on Friday as the market closed out a poor week where investors demanded higher risk premiums despite the promise of central bank intervention. In the investment grade universe, spreads widened 1 point on Friday to close out a week 9 points higher to +196 bpts, which dropped the recovery rate to 63%. Most sectors recorded modest increases with subordinated financials up +3 points to +245 bpts, (61%) and telcos rose +3 points to 208 bpts (68%), but energy recorded a -1 point contraction (to +342 bpts, 56%) despite crude price rising +2.7% to USD16.94 per barrel. In high-yield universe, spreads widened +8 points to +771 bpts, which reduced the market's recovery rate to 47%. Increased risk premiums were evident in all sector bar energy (-13 points to +1468 bpts, 55%) with increases led by financials (+16 points, to 775 bpts, 36%) with most sector putting on around 10 points which continued to trend of spreads slightly widening (see chart).

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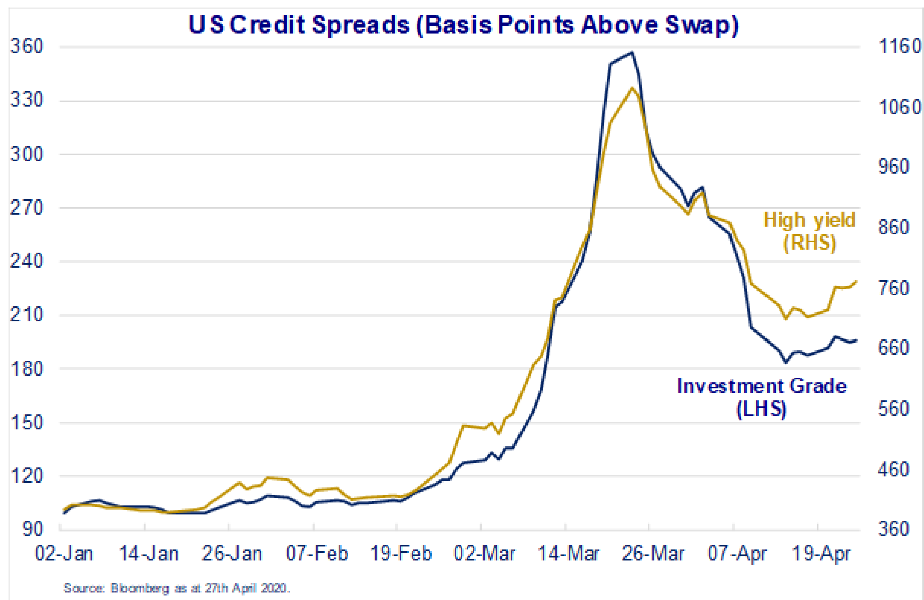
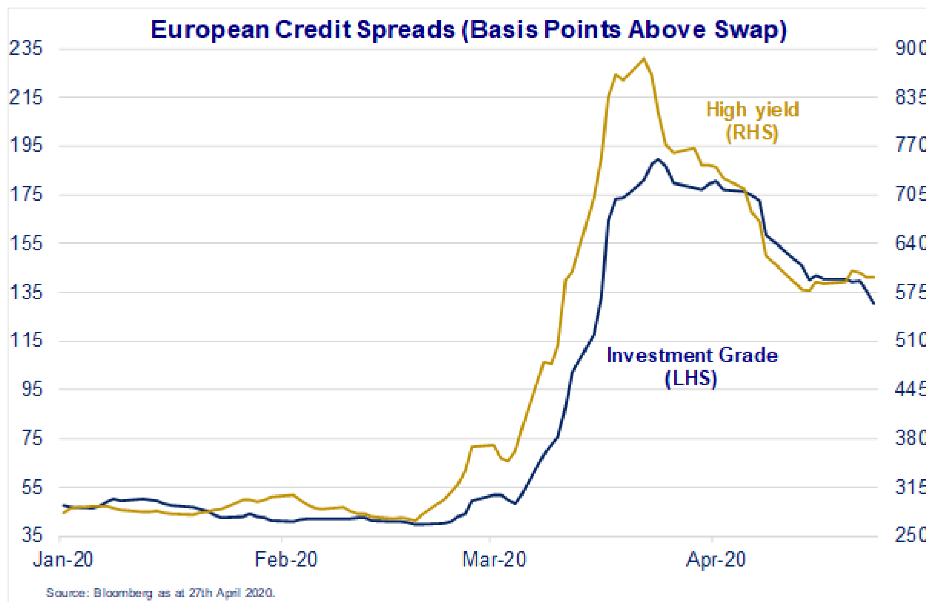


- European credit markets recorded slightly larger spread contractions but nothing that would rewrite the history books. Investment grade spreads contracted -4 points to +136 bpts, which boosted the market's recovery rate to 36%. There were spread contractions in all sectors led by subordinated financials (-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%).



Clearly US (and European) investors and corporations have responded positively to central bank sector support announcements in a period of tightening financial conditions, with US investment grade corporate issuance totalling USD380 billion in the past two months which is equivalent to the prior five months (see chart). However, we sense that Fed liquidity conditions will lessen, but not eliminate, solvency risks. Defaults will clearly rise more in the high yield market where primary market issuance has been in the past two months (USD11 billion) has been much less than the prior five months (USD144 billion). Citigroup reports that 'fallen angels' (i.e. companies which are downgraded from investment grade to high yield and therefore have to be sold by large pension funds) totalled nearly USD100 billion In March which is a record month and matched the total during 2002, and that was before the April oil price

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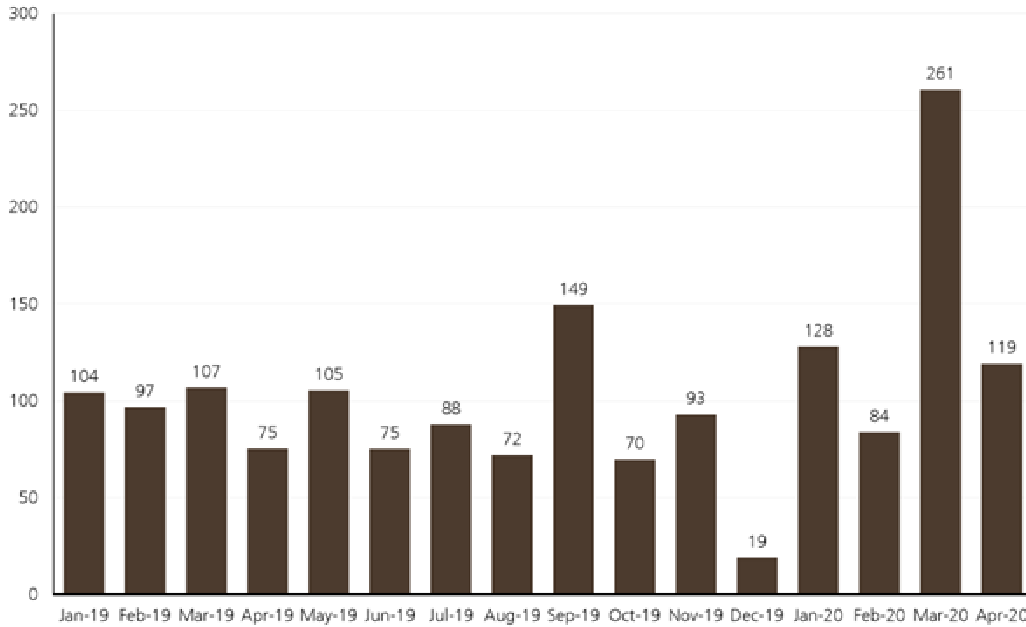
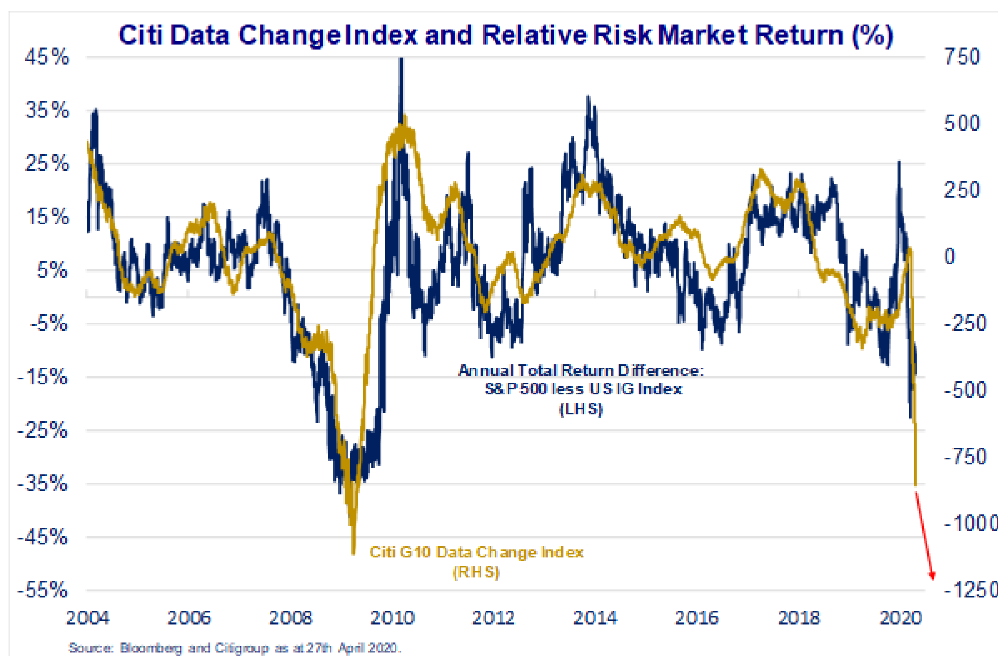
plunge which is set to see the number of energy companies either filing for bankruptcy or missing coupons payments increase sharply.



Markets may find themselves disappointed in the ability of the Fed to prevent defaults. Importantly, 27% of the high-yield universe is currently trading distressed (i.e. spreads over 1000 above swap), but only 39% of these companies qualify for the Fed programs and UBS expects a 10% US HY default rate which may be only partially priced in.

This also suggests downside risks for equities which are a higher beta asset class than IG and HY credit. Interestingly, end-cycle dynamics (namely deteriorating economic data) have previously culminated in US IG outperformance relative to US equities as the hit to payout ratios is larger in equities than the widening in credit spreads as companies deleveraging their balance sheet. 2020 is unlikely to prove different especially given the extent of economic deterioration from regional PMIs suggests a much large economic dislocation than that witnessed in 2008/09. More importantly, the underperformance of equities relative to credit continues until the Citi G10 Economic Data Change Index increases (see chart below).



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THE GLOBAL ECONOMY

- In contrast to plunging PMI reports, the US durables report for March showed remarkably little slowing in underlying activity with total orders fell -14.4%m/m but this decline was almost entirely driven by lower transport orders (-40% m/m) and motor vehicles (-18% m/m), with orders ex-transport down just -0.2% m/m which seems almost implausible with core capital goods up +0.1% m/m. Interestingly, shipments showed a similar pattern, with total durable shipments down -4.5% m/m, but ex-transport it was -0.3% m/m (see chart). The implication of this resilience is less contraction in March quarter US GDP to around -5.0% q/qa. That said, durables are completely contrasting with factory surveys and jobless claims both of which have recorded historic activity declines and it's hard to know how all these reports hang together, but the Census Department recognised that the "ability to provide accurate, timely information to Census may be limited" by business closures but that the "quality metrics fell within normal ranges for this survey" we find that very hard to believe.

- The German IFO survey recorded a decline to a new record low in April in the expectations component (-10 to 69.4) and business climate (-10.6 to 74.3) fell below 2009 trough levels, whereas the 'current assessment' gauge recorded its largest decline (-13.4 to 79.5) but remains slightly above its May 2009 trough (77.1 – see chart).

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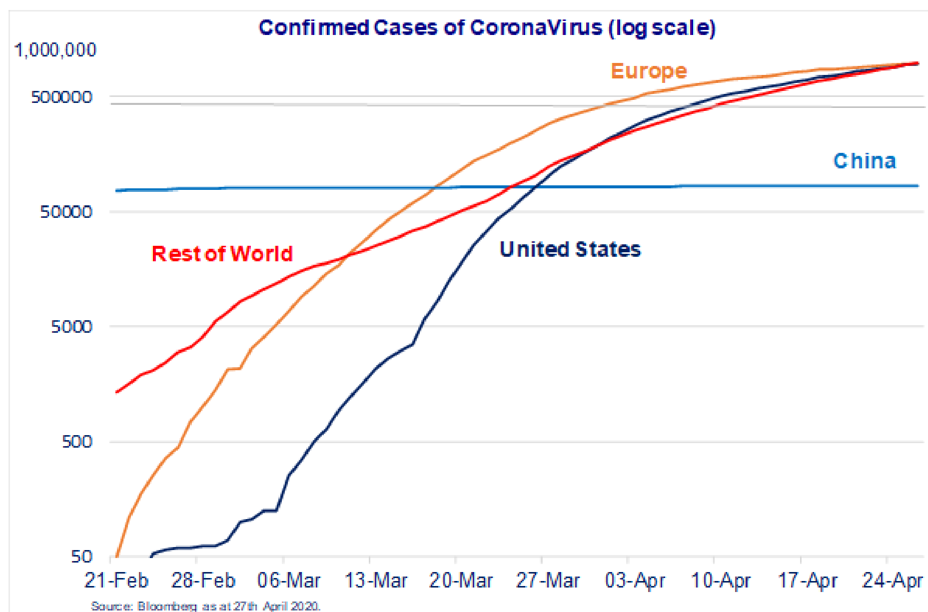
POLICY

- President Trump signed the USD484 billion interim coronavirus relief package. As such, the focus in Washington has now shifted to another large spending bill though the politics are expected to be much more difficult with Senate Majority Leader McConnell pushing back against more state aid. Mnuchin said the White House is exploring options to help energy industry, but is not planning a liquidity facility for mortgage industry.
- There are four key central bank meetings this week – the Fed, ECB, BoJ and Riksbank and given the vast announcements to date (even though the bulk have not been implemented) we are not expecting any material announcement from these meetings. However, in time the ECB is likely to double its current €750 billion QE program to address periphery spread blow outs, the BoJ is likely to follow their peers and ease collateral standards, whereas nothing is likely from the Fed in the near-term. The Riksbank will be interesting as markets are expecting a return to negative rates to be announced – we think it is unlikely and we don't expect any explicit policy move at this meeting, but rather a mention that they can increase QE, if the economic outlook warrants it.

VIRUS UPDATE

- The number of global cases of COVID-19 stands at 2.97 million with another +68.2k cases overnight with rising daily confirmed cases in the US (+24.1k) coming down from yesterday's +48.5k record high. The overnight increase means 7 countries now have more than 100k cases, 19 over 20k cases and 35 over 10k. It took 73 days to record 1 million cases, 13 days for the next million and in the past 11 days it has grown another +919k. That said, the growth rate of daily confirmed cases continues to decline (+3.0% since Friday). Meanwhile, deaths rose +3.2k overnight (4-week low) to 206.3k, with the US now over 50k and the UK 20k, and the death rate sits at 6.88% (although final numbers are not yet in).



- Europe (+10.2k to 967.9k) continues to lead the world in terms of total cases but its daily increase (number, not percentage) is trending lower (41-day low) which shows that social isolation works to reduce the spread of the virus, even though it comes at an enormous economic cost.

  The US case load eased overnight (+24.1k to 963.2k) having come off yesterday's record +48.5k increase and its 3-day compound growth rate has declined back to +3.3% 39 days after they reached 10,000 cases. That said, New York cases rose at a 2-day low with another +5.9k (+2.0% over the past three days) but it continues to underperform the national average death rate (7.8% against 5.7%) with another +367 to 22.4k deaths in the city that never sleeps.

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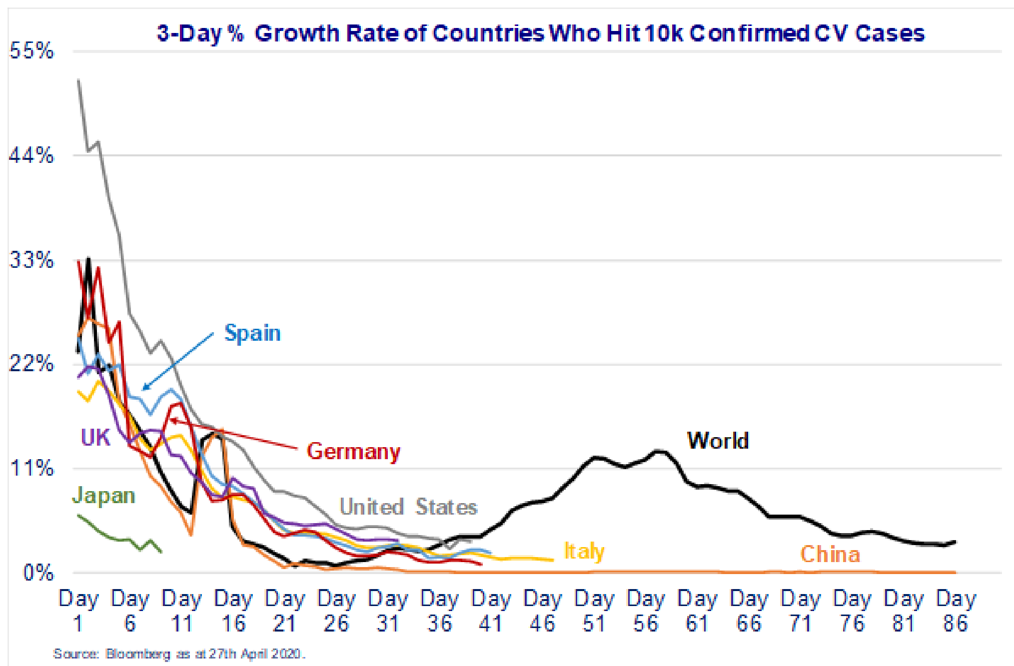
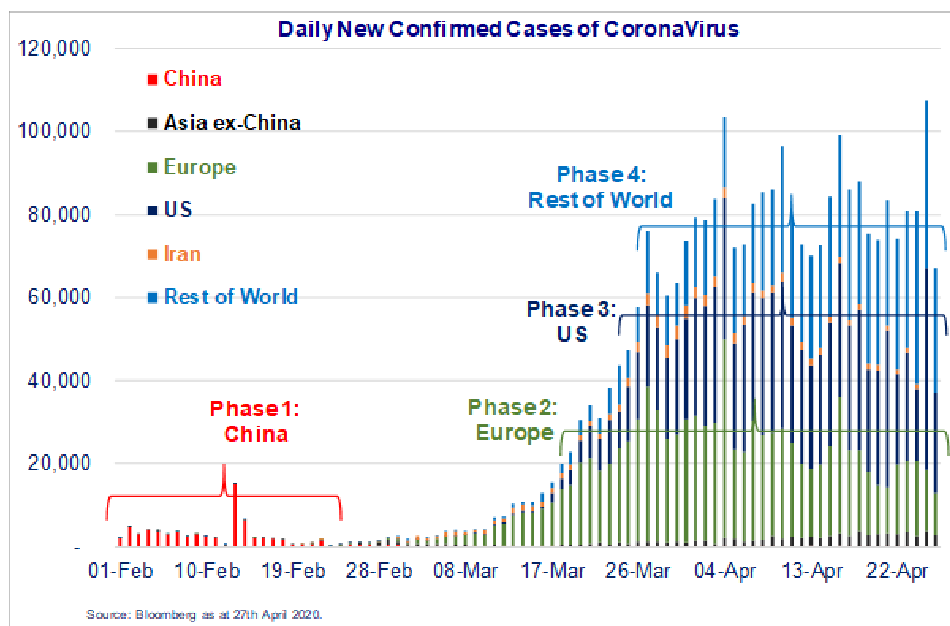


- Among countries, the most cases are in the US (+24.1k to 963.2k), Spain (+2.9k to 226.6k), Italy (+2.3k to 197.7k), France (+1.1k to 161.7k), Germany (+982k (5-week low) to 157.5k), the United Kingdom (+4.5k to 154.0k), Turkey (+2.4k to 110.1k), Iran (+1.2k to 90.4k) and China (+1 to 83.9k). Australia confirmed cases rose to 6,694 which placed us 44th in terms of total infections.

  Elsewhere, Singapore recorded +931 new cases (4-day high to 13.6k) 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 (+275 to 8.9k) and the Philippines (+285 to 7.5k).



- The global death rate declined to +6.88% (only its fourth daily decline in the past its 50 days) with another +3.2k fatalities overnight bringing the global total to 206.3k. The death rate is highest in European countries where the health systems have collapsed led by Belgium (+0.1% to 15.4%), Italy (steady at 13.5%), the UK (-0.1% to 13.5%), France (steady at 11.9%), Sweden (-0.3% to 11.8%), the Netherlands (+0.1% to 11.8%), and Spain (steady at 10.2%). However, several emerging markets are now on the leader board including Mexico (+0.2% to 9.4%), Indonesia (steady at 8.4%) and Brazil (steady at 6.8%).

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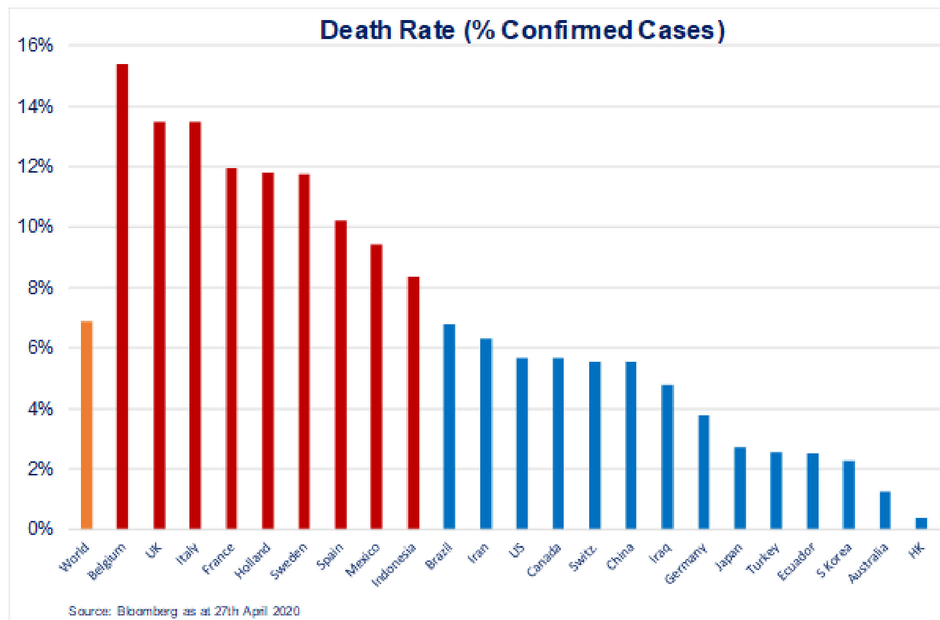

Yours sincerely,

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