Perpetual Investments

THOUGHTS ON THE MARKET

28th April 2020

SUMMARY

- There wasn't much newsflow overnight with the macro calendar fairly empty, but for a third consecutive session regional equity markets rallied while credit markets declined. The catalyst yesterday was the April Bank of Japan policy meeting which voted to remove any cap on asset purchases, increased its cap on purchasing corporate paper and loosened its collateral criteria to facilitate more liquidity flow. This, combined with continued talk of economic re-openings, saw the higher beta parts of the markets outperform, whereas credit markets still have to contend with expectations of rising default rates as 27% of high securities are trading stressed and only 39% of these will qualify for central bank assistance.
- Continued central bank policy announcements has tranquilised markets from reacting to bad news with investors not worried about a -25% plunge in global oil prices overnight which took prices down to USD12.78 per barrel. The decline was underpinned by the largest US oil ETF announcing it would dump all its June contract holdings in the next four trading days given the supply overhang which is set to see global storage capacity exhausted within a few weeks. When this occurs nearly 20% of global production will have to close and Korea yesterday (which has the fourth largest storage capacity in Asia) was said to have run out of onshore storage space. In other markets US 10-year bonds declined with yields rising to 0.66% with curve steepening, gold was off -0.7% and the US dollar was up against the Yen but flat against the Euro.
- Markets seem to be addicted to central bank stimulus and are ignoring major risks, but this is nothing new. Over the past four decades the global economy has become increasingly more leveraged and nominal income growth for both corporations and households has progressively declined which is why every economic recession has the potential to turn into a financial crisis. This means central banks are seeing their role as having to contain market fallouts through increasingly unconventional policy decisions and over the past month they have done a very good job at stabilising markets through large scale liquidity operations, but this will not prevent a major spike in defaults especially in the high yield space so a key relationship to remember is that liquidity does not equate to solvency (and it never has).
- We would add that growth in COVID-19 cases is still elevated which, in the absence of wide-spread testing, has the potential to trigger a stop-start-stop cycle. Overnight the number of global cases rose to 3.04 million which 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 12 days for the last million. That said, the growth rate of daily confirmed cases continues to decline (+2.7% since Saturday), but deaths rose +4.1k to 210.6k overnight, and the death rate now sits at 6.86% (although final numbers are not yet in).

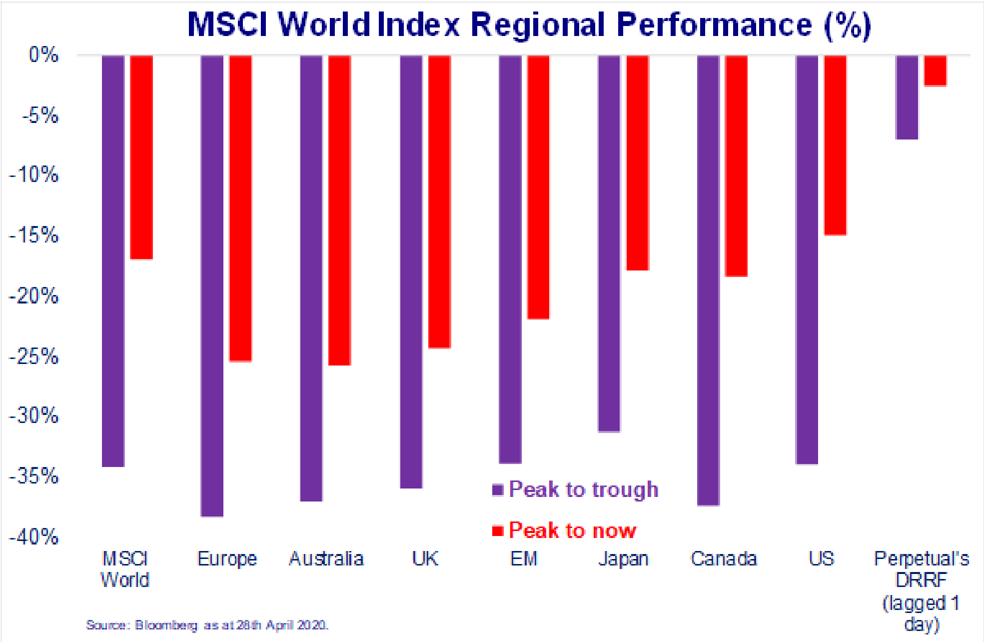
FINANCIAL MARKETS

- **EQUITIES**
  - The MSCI World Index increased +1.8% overnight in response to strong gains in all major regions, bourses and sectors. The rally began yesterday in Asia, in response to strong gains in US markets on Friday night and the positive sentiment continued after the Bank of Japan announced new stimulus measures which moved it in line with other major central banks. This sparked across the board gains led by Japan (+2.7%), Hong Kong (+1.9%), Korea (+1.8%), Australia (+1.5%) and China (+0.7%).

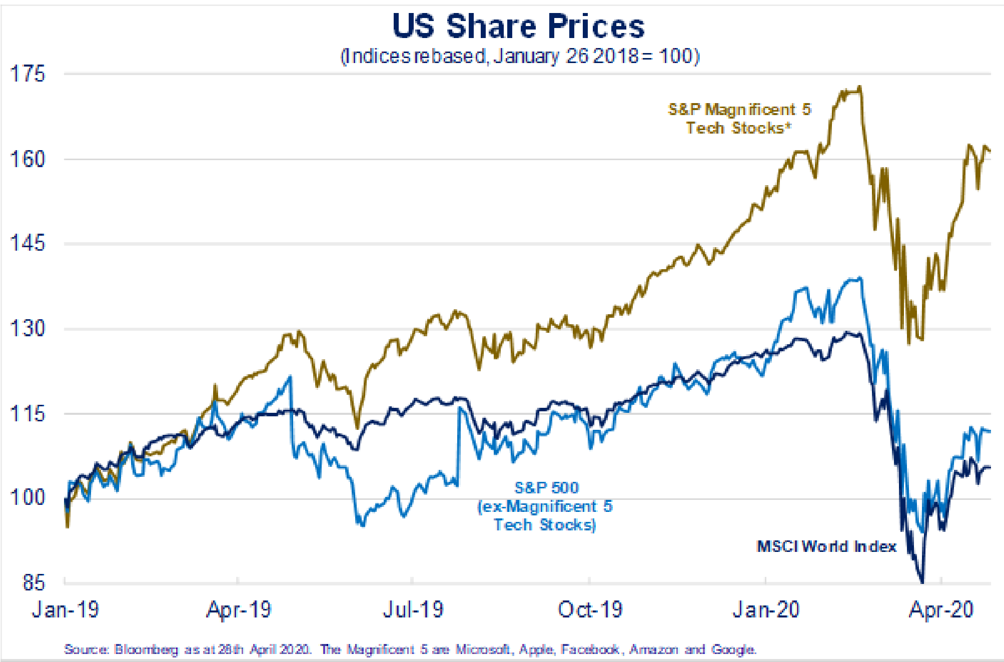
    Europe opened next and led the pace of gains for the day (+2.6%) as an Italian government announcement centred on providing more loan support for SMEs sparked increased optimism around avoiding a credit crunch, which sent risk prices higher led by Italy and Germany (both +3.1%) and France (+2.6%) and the impact here flowed through to the US (+1.5%) at opening with the market closing near its intra-day high.

Among the global sectors, financials (+3.1%) led the advances and sentiment was so positive that even energy rose +1.6% even thought the price of crude plunged -25% to USD12.78 per barrel.

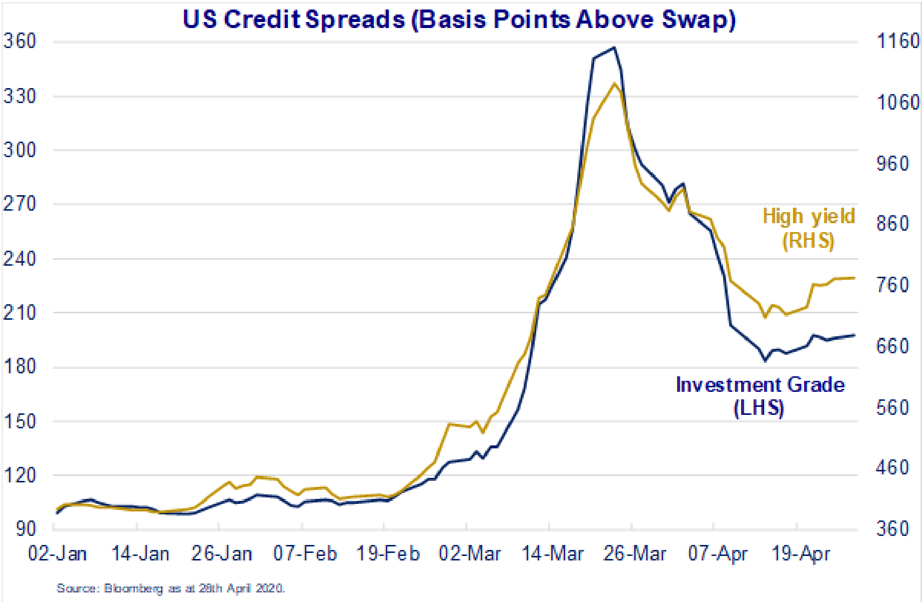
- The gains enabled the MSCI World Index's recovery rate to rise to 50%, with the US recording the highest recovery (56%) despite having the highest COVID-19 cases, and Australia (at 31%) is at the tail end of the field on this metric despite a great Government effort to limit the spread of the virus.



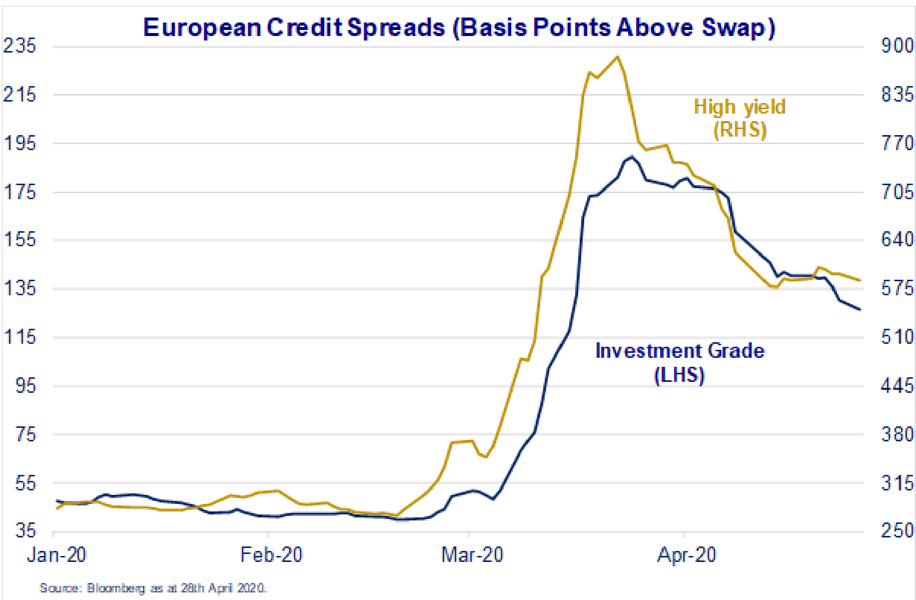
- Much has been made of the recovery of the US market relative to others despite the US economy likely having one of the highest unemployment rates in 2020. In the end, the recovery rate of the US sharemarket owes much to the Magnificent 5 tech stocks (Microsoft, Apple, Facebook, Amazon and Google) which despite an amazingly strong performance between 2009 and 2019 recorded a smaller price decline in the COVID-19 crisis, relative to the remainder of the US market and the broader MSCI World Index (-26.3%, -32.3% and -34.2%, respectively) and the five stocks have collectively recovered much more of this decline (recovery rates of 74.7%, 39.6% and 46.3%, respectively). So, outside the 5 tech giants, the US market has recovered less than other markets such as Japan (42.9%) and Canada (50.8%) but it continues to outperform the laggards including Australia.



- **CREDIT**
  - Credit markets were mixed overnight. US credit spreads widened +1 point for a second consecutive session in the investment grade space to +197 bpts which pulled the recovery rate down to 62.9%. There weren't many news other than another plunge in oil prices which dropped -25.0% to USD12.78 a barrel which saw energy widen +3 points to +344 bpts (56%) which was the same spread increase in industrials (to +187 bpts, 58%). In the high-yield universe spreads increased for a third consecutive session by +3 points to +774 bpts which pulled the recovery rate down to 47% (see chart). While energy rose +6 points (0+1474 bpts, 55%) the main action was in subordinated financials (-20 points to +512 bpts, 41%), but interestingly, its senior financial counterpart has widened 81 points in the last five sessions which has pulled down its recovery rate -12%.



  - In contrast European credit markets rallied for a third consecutive day as markets responded positively to an Italian Government announcement that they will 'back up' intermediated loans to corporate and SMEs and will soak up losses that banks can't bear which culminated in a considerable tightening in the spreads for subordinated financials in the high yield universe (-18 points to 526 bpts, 43%) and there was also flow-through to consumer discretionary (-17 points to +764 bpts, 47%), but not much elsewhere. In the investment grade space spreads came in -4 points (to 127 bpts, 42% - see chart) as financials performed strongly after a solid earnings announenement from Deutsche Bank (saw spreads come in -3 points to 143 bpts, 38%).



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THE GLOBAL ECONOMY

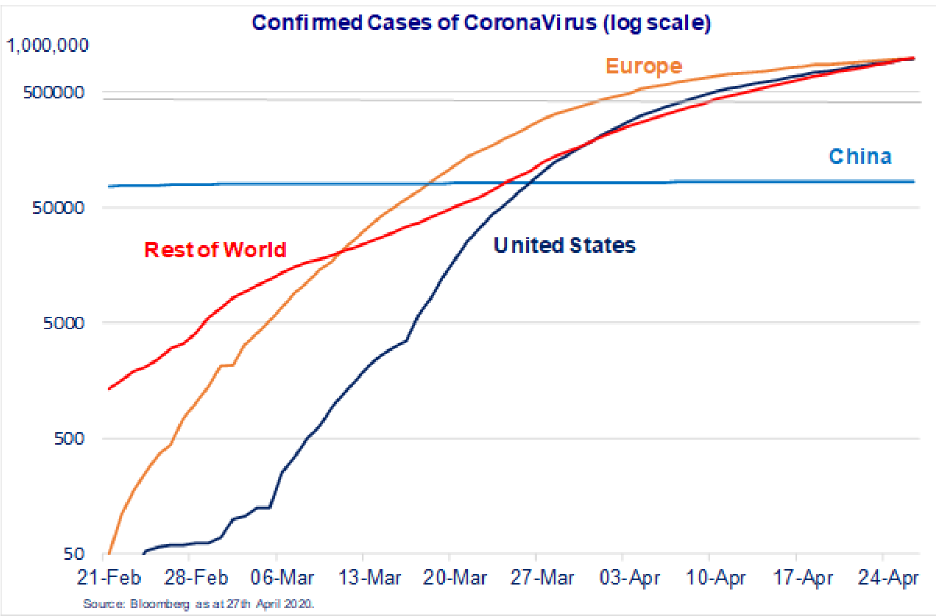
- There was no material economic data overnight.

POLICY

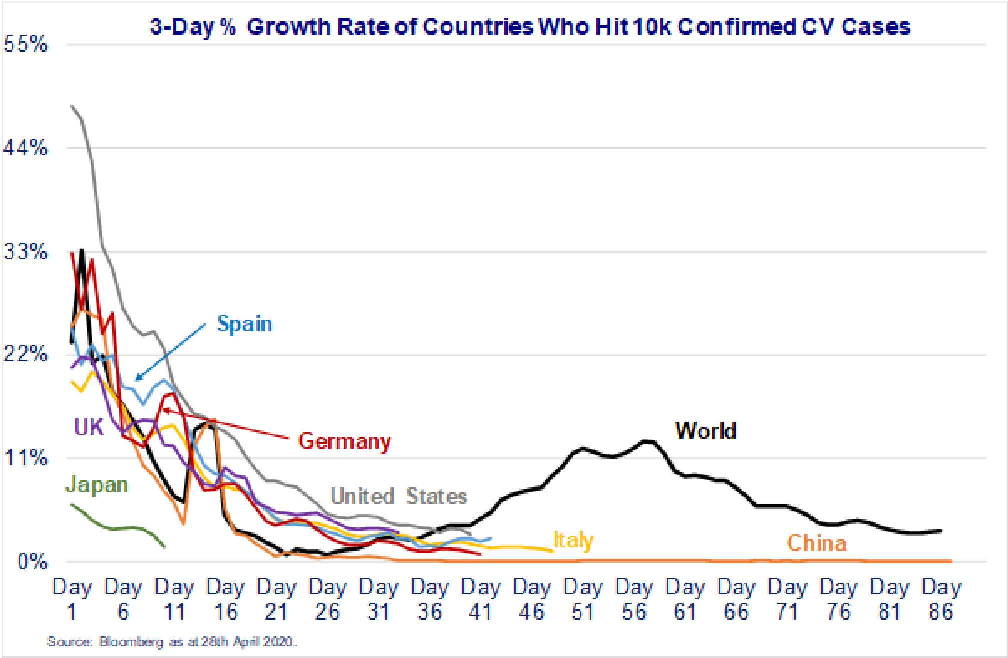
- The Bank of Japan left its policy rate at -0.1% at its April meeting, but it removed its self-imposed ¥80 trillion annual quota for Japanese government bond purchases and announced extra stimulus by increasing its annual limit on corporate bond and commercial paper purchases to around ¥20 trillion (around three times the prior total) and also increased individual issuer limits and duration (to five years). The Bank also strengthened its Special Funds-Supplying Operations to Facilitate Financing in Response to COVID-19 by loosening its collateral criteria which will allow additional liquidity flow. This brings the BoJ in line with other major central banks and there was little surprise in the announcement, but I would view the extra government bond purchases as part of the yield curve control rather than the reported "additional stimulus".
- The Italian government announced a guarantee scheme which would back-up loans to corporates (worth €170 billion) and SMEs (€200 billion) in which the state will take up losses that the banks don't wish to bear anymore thereby averting a credit crunch and financial system instability. In the end, the business of banking is based on the notions of low margins and high leverage and the latter can become problematic in periods of stress as bank's have a low capital-to-asset ratio (that would be unacceptable to any other business) which provides little protection if defaults increase. The government scheme aims to take the worst credit of the books of banks.

VIRUS UPDATE

- The number of global cases of COVID-19 stands at 3.04 million with another +67.2k cases overnight (4-week low) with daily confirmed cases in the US (+19.6k) coming in at a 4-week low. 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 12 days for the last million. That said, the growth rate of daily confirmed cases continues to decline (+2.7% since Saturday). Meanwhile, deaths rose +4.1k overnight to 210.6k, and the death rate sits at 6.86% (although final numbers are not yet in

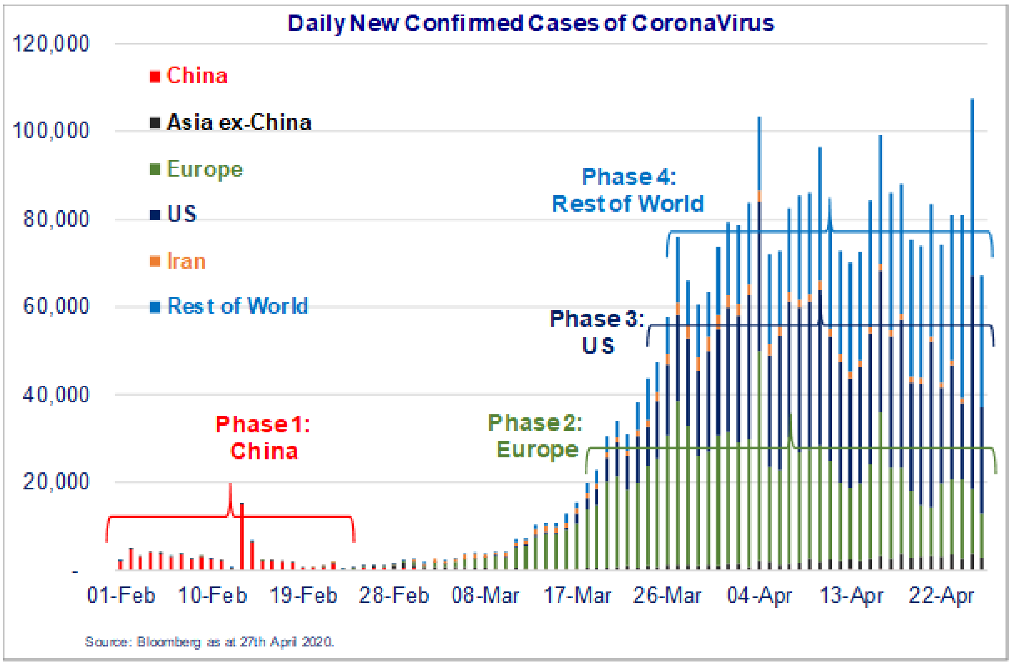


- Europe (+13.8k to 982.0k) continues to lead the world in terms of total cases but its daily increase (number, not percentage) is trending lower which shows that social isolation works to reduce the spread of the virus, even though it comes at an enormous economic cost. The US case load eased overnight (+20k to 985.4k) and its 3-day compound growth rate has declined back to +2.9% 40 days after they reached 10,000 cases.

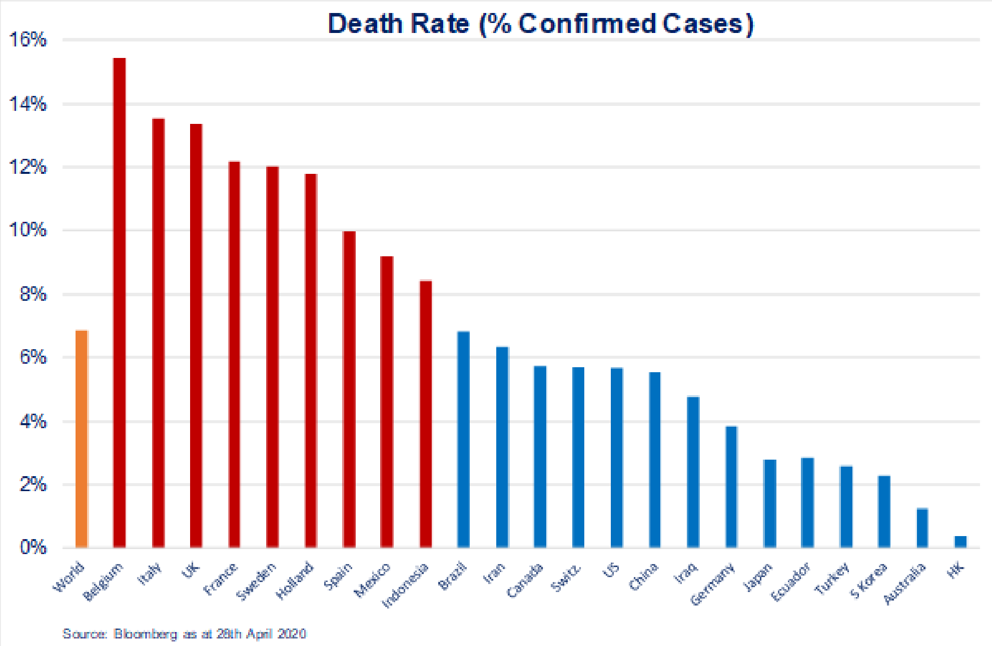


- Among countries, the most cases are in the US (+20k to 985.4k), Spain (+3.2k to 229.4k), Italy (+1.7k to 199.4k), France (+4.3k to 166.0k), Germany (+664 (6-week low) to 158.4k), the United Kingdom (+4.3k to 158.3k), Turkey (+2.1k to 112.3k), Iran (+1.0k to 91.5k) and China (+4 to 83.9k). Australia confirmed cases rose to 6,725 which placed us 42nd in terms of total infections.

  Elsewhere, Singapore recorded +799 new cases (to 14.4k) 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 (+214 to 9.1k) and the Philippines (+198 to 7.8k).



- The global death rate declined to +6.86% (only its fifth daily decline in the past its 51 days) with another +4.2k fatalities overnight bringing the global total to 210.6k. The death rate is highest in European countries where the health systems have collapsed led by Belgium (steady at 15.4%), Italy (steady at 13.5%), the UK (-0.1% to 13.4%), France (+0.3% to 12.2%), Sweden (+0.2% to 12.0%), the Netherlands (steady at 11.8%) and Spain (-0.2% to 10.0%). However, several emerging markets are now on the leader board including Mexico (steady at 9.4%), Indonesia (steady at 8.4%) and Brazil (steady at 6.8%).



Yours sincerely,

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MORE INFORMATION

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