Perpetual Investments

THOUGHTS ON THE MARKET

2nd April 2020

SUMMARY

- It was a bad night on global markets with gains in US treasuries and the Yen overshadowed by large losses in equities markets and the first widening of credit spreads in seven trading sessions. In particular, US stocks fell (-4.4%) for the third time in four days, and by the most in two weeks, with major indices now having lost around one-third of its rally from last week. Meanwhile, investors are now bracing for a longer economic shutdown which will weigh more heavily on US corporate earnings and dividends with financials being among the largest declines on most bourses overnight after the large UK banks cancelled dividends and buybacks for 2020 to preserve cashflow in a sign of what may be a broader trend in coming weeks and months. More importantly, the longer industries are closed the more downside risks for growth and the larger the risk of economic 'aftershocks'.
- The 'growth hole' ahead is certain to stress the most vulnerable parts of regional supply chains, the global economy and global financial markets and the epicentre of the latter's stress will be (but not limited to) highly leveraged balance sheets and loss making zombie firms which been kept on artificial respirators this cycle via by Fed's ultra-low interest rates. In these times, the economy and markets are only as strong as their weakest link and markets have lost two key supports in recent days in that quarter-end rebalancing is now complete, and is getting much harder for policy makers to get ahead of the curve with policy easing and to shock the markets upwards.
- Data overnight was centred on regional PMIs and these were better than feared, but COVID-19 has revealed a design flaw in PMI gauges in that delivery delays (which boost the headline numbers) have been assumed to reflect excess demand, not supply delays. Hence investors need to delve deeper into these diffusion indices to better understand what's happening at the industry level.
- Sentiment seems to be souring fairly quickly with the ultra-optimistic US President who four days ago wanted everything opened by Easter, now warning of a 'painful upcoming period for the US' and New York Governor Cuomo discussed new modelling which shows the peak in state cases may not occur for another four weeks, which is an eternity in these markets, but longer estimates mean bigger hits to GDP, earnings and dividends.

FINANCIAL MARKETS

- **EQUITIES**
  - It was a bad night for equities with every market and every sector in the Northern Hemisphere closing in the red. The US led the move lower with the S&P 500, Dow Jones and Nasdaq all losing -4.4% d/d in across-the-board selling. Among the sectors, there was no uniform trend, but several key defensive sectors were at the left tail of performance led by utilities (-6.1% d/d), REITs (-6.1% d/d) and financials (-6.0% d/d), whereas consumer staples did better (-1.8% d/d).
  - European market (-3.8% d/d) recorded similar declines as last week's winners turned into this week's loser led by industrials (-8.5% d/d) with financials (-4.1% d/d) also in the thick of it, but energy recorded the smallest fall (-0.5% d/d) as crude prices rallied +3.6% to USD21.22 per barrel.
  - Large European and UK lenders including HSBC, Royal Bank of Scotland, Barclays, Lloyds and Standard Chartered all axed their outstanding 2019 dividends, said there will be no payments in 2020 and suspended all buybacks, as regulators pushed the sector to contain payouts to shareholders. This came in the shadows of a number of Eurozone lenders announcing similar suspensions and delays, as regulators undertake actions to prevent a health crisis evolving quickly into a financial crisis.
  - In Asian markets yesterday, performance was mixed with Australia (+3.6%) posting a large gain after a sharp fall on Friday, but other markets closed in the red including China (-0.3%), Hong Kong (-2.2%) and Japan (-4.5%) which did like the sound of a rising Yen.

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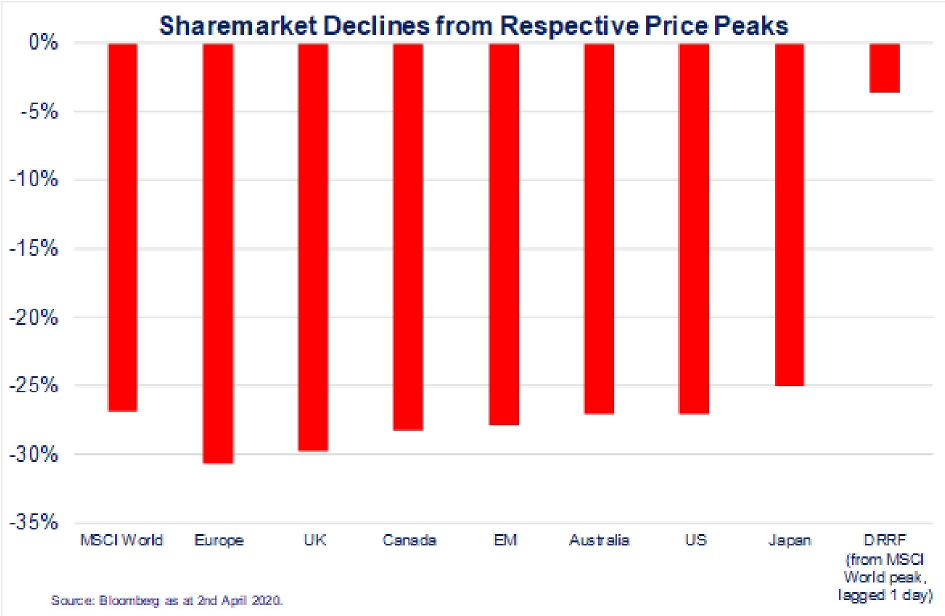
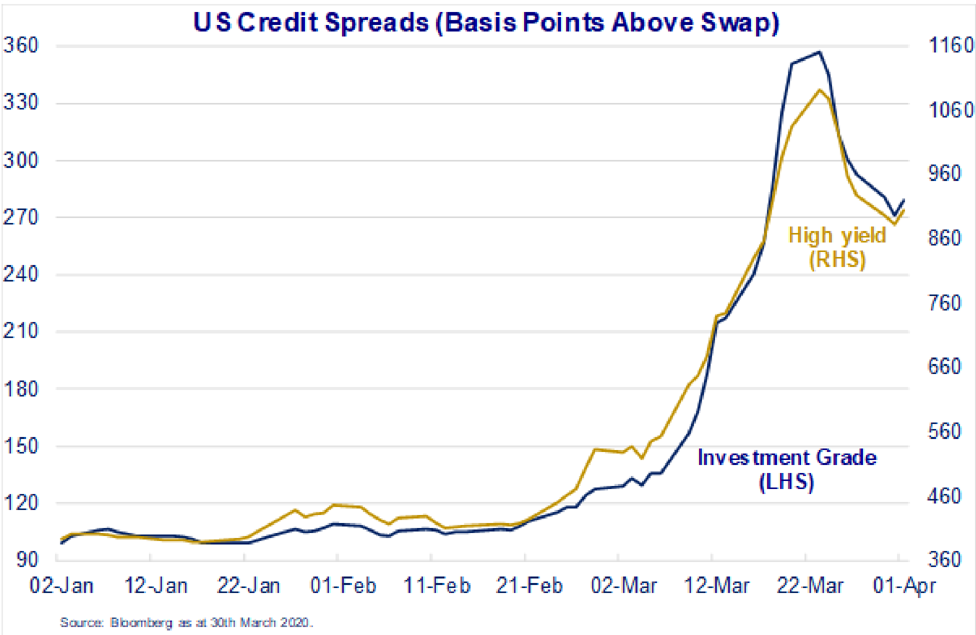
- The declines in recent sessions has obviously halted the bear market rally on most bourses with Europe now recording a peak to now decline of -30.7%, followed by the UK (-29.8%) with most other markets between -25% and -30% (see chart).



CREDIT

- Credit spreads widened overnight for the first time in the past seven trading sessions, but the losses were minor relative to equities, which only removed the spread tightening recorded yesterday morning (see chart). There were spread increases relative to option adjusted swap rates in every US sub-sector, but the increases were fairly uniform with the largest increase being in financial sub debt (+12 to 311 bpts) and the least in utilities (+4 to 254 bpts). In the HY space, the losses were also modest led by healthcare (+30 to 773 bpts) and the smallest being energy (+14 to 2071 bpts).

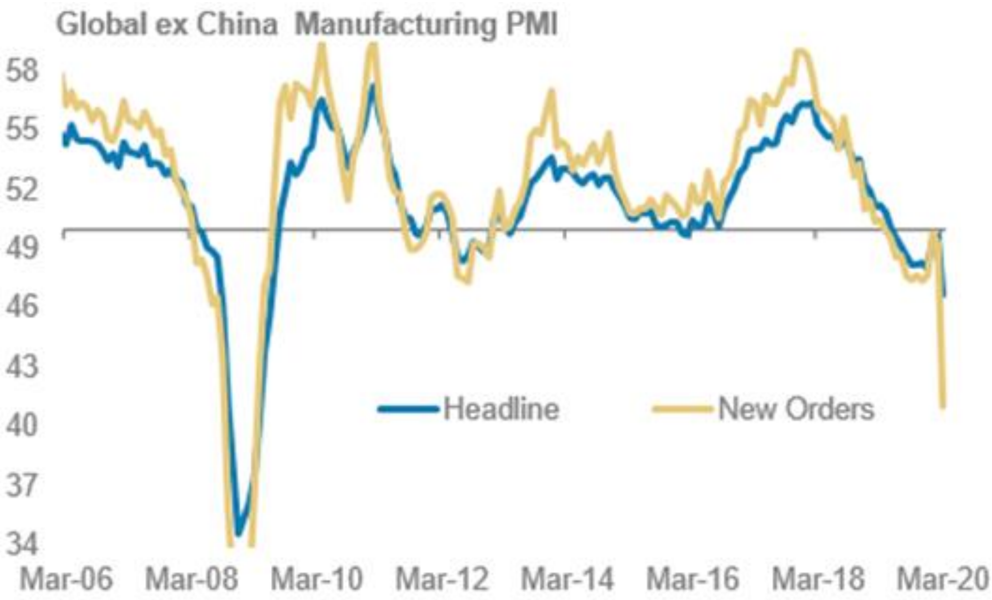


- In European markets, the widening in spreads was only 2 to 180 bpts in the IG space, which suggests that ECB buying is providing a backstop. The largest rise was in bank subordinated debt (+5 bpts to 322 bpts) but bank senior debt tightened (-1 to 186 bpts) as investors sought to climb up the credit risk spectrum. In the European HY space, spreads were mostly unchanged (+0.2 to 745 bpts) with little movements in between sectors.

- There is no doubt that Government debt markets are likely to be swamped with new issuance and that the Fed will be busy soaking up the supply. The recently passed support mechanisms by the US government, combined with automatic stabilises will see the US Treasury issue USD3 trillion over the next nine months.

THE GLOBAL ECONOMY

- The March Global Manufacturing PMI rose +3 points to 48.2, underpinned by a sharp rebound in China, but the rest of the world fell -3 to 46.7 points with only 20% of countries reporting an improvement (50% last month). Among the components, new orders ex-China index fell -8.2 to 41.1 (15% of countries recorded a rise, relative to 55% last month), reflecting a pronounced deterioration in global demand and this certainly won't represent the trough.



- The China Caixin (non-official) manufacturing PMI came in at 50.1 in March (+9.8 from February's record low), which was lower than the official gauge, but the underlying message was the same. While production expanded, aggregate new orders and export orders remained in contraction territory and the associated commentary was highly cautious, stating the output increase reflects manufacturers only gradually getting back to work, so like the government gauge, the rise above 50 simply represents a sequential improvement rather than things getting back to normal.
- The final European PMI were revised slightly lower to 44.5 (-0.3 from preliminary estimate), but the reading for Italy is revealing the extent of the economic contraction (-8.4 to 40.3) with Spain (-4.7 to 45.7) also sharply lower. The survey compiler, IHS Markit, flagged big fall in new orders and purchasing, sharp fall in jobs and supply side constraints intensifying at record pace. Additionally, confidence about the outlook also fell to historical low.
- The March US ISM manufacturing index decreased by only 1 point to 49.1, but the underlying composition was weak, as the key production (-2.6pt to 47.7), new orders (-7.6pt to 42.2) and employment (-3.1pt to 43.8) components all dropping deeper into contraction territory (see table below), with the overall score boosted significantly to a rise in supplier deliveries (+7.7pt to 65.0). This is a complete rerun of what happened in China in February as slower deliveries is considered to be a net positive for the index as it assumes a longer delivery time is driven by excess demand, rather than COVID-19-related supply problems. This is confirmed by firms carrying extra inventories (i.e. parts they cannot move) (+0.4 to 46.9 points).

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	Dec-19	Jan-20	Feb-20	Mar-20
Overall index	47.8	50.9	50.1	49.1
Production	44.8	54.3	50.3	47.7
New orders	47.6	52.0	49.8	42.2
Supplier deliveries	52.2	52.9	57.3	65.0
Inventories	49.2	48.8	46.5	46.9
Employment	45.2	46.6	46.9	43.8
New export orders	47.3	53.3	51.2	46.6
Imports	48.8	51.3	42.6	42.1
Prices paid	51.7	53.3	45.9	37.4
Assessment of customers' inventories				
Net too high/too low (%)	41.1	43.8	41.8	43.4
Too high	8.8	10.1	6.6	11.4
Too low	26.5	22.4	23.0	24.6

Source: ISM, UBS

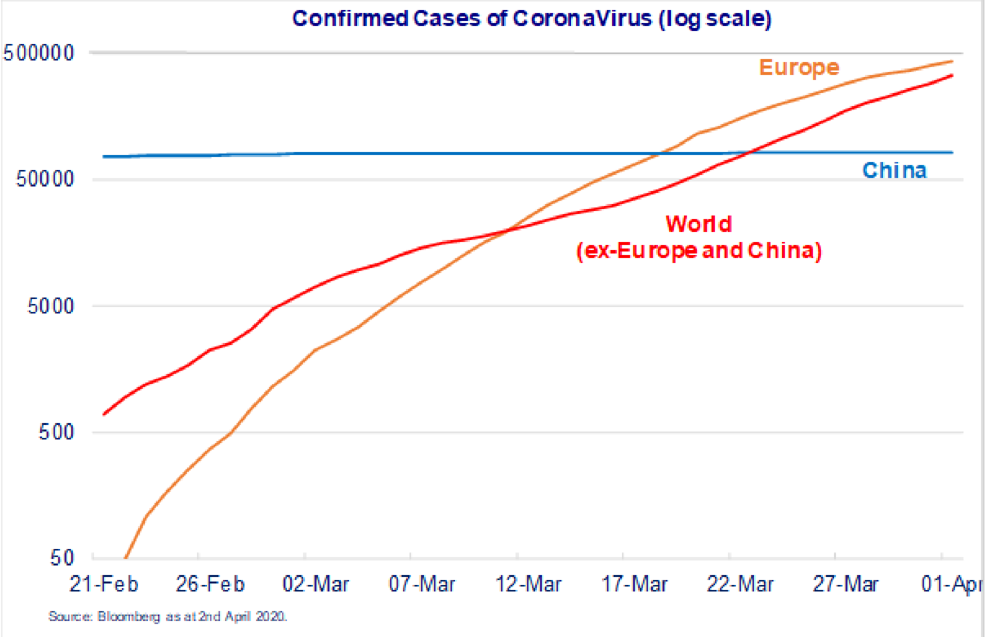
- The March ADP private sector employment report fell by -27k, which was much less than expected most likely due to timing issues and incomplete survey data. Among the sectors employment in the services sector declined by 18k, led by a decrease in the trade, transportation, and utilities (-37k) industry, and employment in goods producing industries declined by 9k, led by a decrease in the construction (-16k). But interestingly, small business employment declined by 90k in a sign of where the stress points are likely to be in the coming two months. While the numbers look innocuous, the ADP model uses the prior month's nonfarm payrolls as its base (and these were strong) and we would argue this prevented a much larger decline.

POLICY

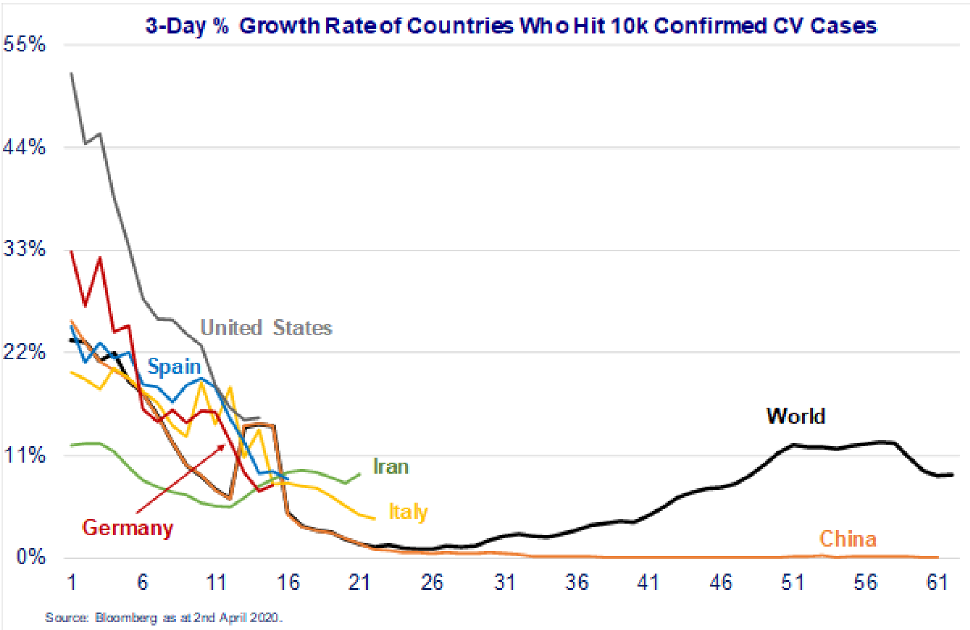
- No surprises in the RBA minutes from its inter-meeting 18th March policy discussion where rates were cut to 0.25%, with the key messages in line with the Governor's recent statements. The minutes reiterated that the cash rate was now at its effective lower bound, members had no appetite for negative rates and that the cash rate would remain at a very low level for an extended period (as it would take time to achieve full employment and have inflation sustainably within the 2-3% range). They also noted that Australia would experience a very material contraction in economic activity, which would spread across the March and June quarters and potentially longer, with likely significant job losses over the months ahead. The minutes stated that lower interest rates were benefiting the community as a whole, although those on interest income suffered uneven and negative consequences.

VIRUS UPDATE

- Confirmed COVID-19 cases continue to rise at a record speed in terms of total new daily case, and despite a falling percentage increase. Yesterday, there were an additional +80.0k cases to 926.1k, deaths rose a record +4,916 to 46.4k and the death rate rose to 5.01% (22nd rise in the past 25 days despite surging case numbers) having doubled of the past 6 weeks.

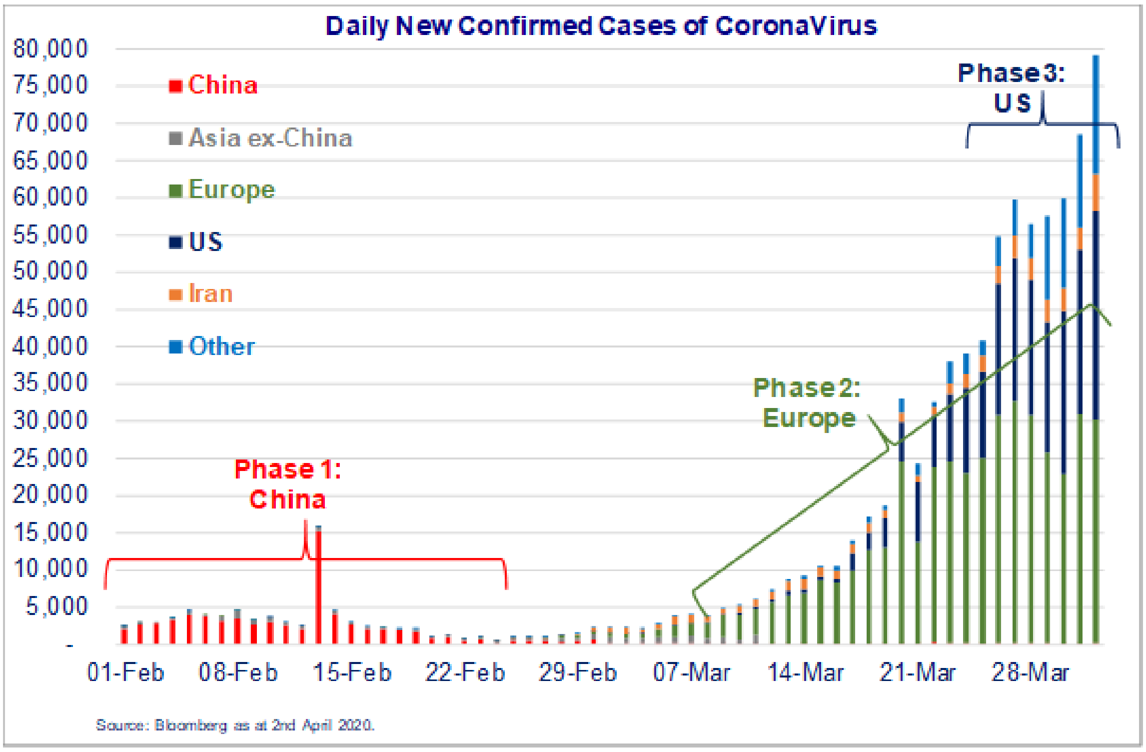


- Europe (+30.1k to +428k) continues to lead the world in terms of total cases but its daily increase (number, not percentage) has clearly flattened out showing that social isolation does work, even though it comes at an enormous economic cost. In contrast, the US had its third consecutive record daily rise (+27.9k to 209.1k) and its the 3-day US compound growth rate is still the highest of any nation listed on the chart below. This has meant that its base grew so quickly that the percentage change may give the wrong interpretation of the pressure on the US health system, especially in New York.

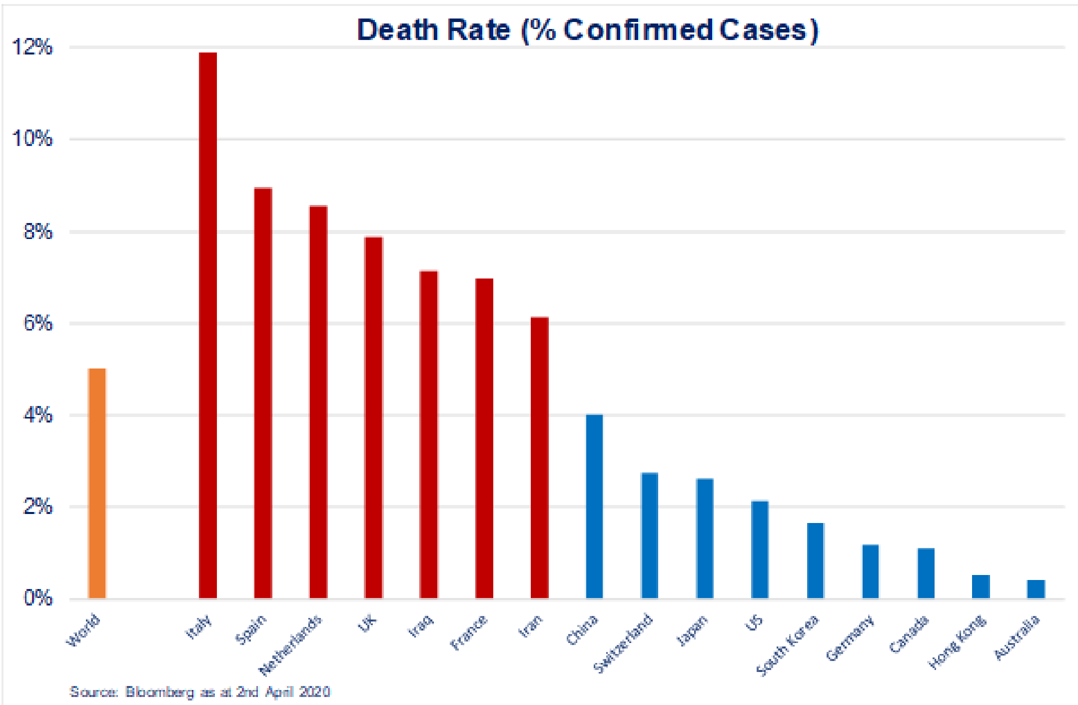


- Among countries, the most cases are in the US (+27.9k to 209.1k), Italy (+very modest at +4.8k to 110.5k), China (+83 to 82.4k), Spain (+7.8k to 102.2k), Germany (which recorded its third highest daily increase of +6.8k to 77.8k), France (which also recorded its third highest daily increase of +5.0k to 57.8k) and Iran (who recorded its tenth record daily increase in the past 13 days +5.0k to 50.0k). Australia confirmed cases has increased (+303) to 4,862 which placed us 19th in terms of total infections.
- Interestingly, China yesterday reported 130 asymptomatic cases of coronavirus in one day, which is a sign that the group of people who can spread the virus without being detected is sizable – this followed another 1,541 asymptomatic people have been put under observation (i.e. they are not in the official stats but can spread the

virus) and this establishes a new benchmark to measure the scope of the outbreak amid a growing chorus of international criticism of China's data.



- The global death rate has risen to +5.01% (having doubled in the past 6 weeks) with another record rise of +4.9k fatalities overnight bringing the global total to 46.5k. The death rate is highest in Italy (+0.1% to 11.9%) and Spain (+0.1% to 8.9%) where the health systems have collapsed, and above the global average levels in the Netherlands (+0.4% to 8.6%), the UK (+0.9% to 7.9%), Iraq (-0.1% to 7.1%), France (+0.3% to 7.0%), and Iran (-0.4% to 6.1%).



Yours sincerely,

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MORE INFORMATION

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