

# THOUGHTS ON THE MARKET

30<sup>th</sup> April 2020

## SUMMARY

- There is a great scene in Apollo 13 when Ed Harris's character is being so bombarded with bad news about the state of the three astronauts that out of the blue he asks his controllers at Cape Canaveral "what do we have on the spacecraft that's good?". This has been global markets in the past few weeks. Global sharemarkets rallied strongly overnight and decided to ignore everything that is going wrong and focus on what could go right. This pushed the US market to a 7-week high as investors shrugged off a weaker-than-expected March quarter growth result (with a poor composition), an Italian downgrade by Fitch, a somewhat sombre US Fed Chair and data which confirmed more Cov-19 cases and a higher death rate, and instead focused on rising oil prices, a better trial result from Gilead's Remdesvir and some better-than-feared US earnings results. To us, the drug result does not confirm anything as the same drug was reported by the company last week as failing in trials in China.
- The overnight rally in regional equity markets did not flow through to credit markets which again marked time and seemingly don't wish to factor in lower risk premiums until the fog clears on both the global economy and also the impact on central banks rescue programs. In other markets, Treasuries were mixed with the 10-year up two points to 0.63% with modest curve steepening, the US Dollar extended recent softness on the major European crosses, gold was -0.5% lower and WTI crude rose +22% to USD15.06 per barrel.
- Preliminary March quarter US GDP was -4.8% q/qa with broad plunges in consumption, business equipment and structures, exports and inventories, with the economy posting its fourth worst quarter in the past 50 years. However, there is much worse to come with June quarter growth likely to be around -38% q/qa as the consumption and investment decline only began in late March, and there is likely to be a huge detraction from energy structures (which were down only -3% q/qa in Q1) as energy investment has been falling sharply.
- In COVID-19 news, the number of global cases rose +71.2k to 3.19 million with 3 countries having over 200k cases, 7 with more than 100k cases, 23 with over 20k cases and 37 with over 10k. It took 73 days to record 1 million cases, 13 days for the next million and 11 days for the last million. That said, the growth rate of daily confirmed cases continues to decline (+2.4% since Sunday), but total deaths rose +10k overnight (second highest daily increase) to 227.2k and the death rate currently sits at 7.1% (although final numbers are not yet in).

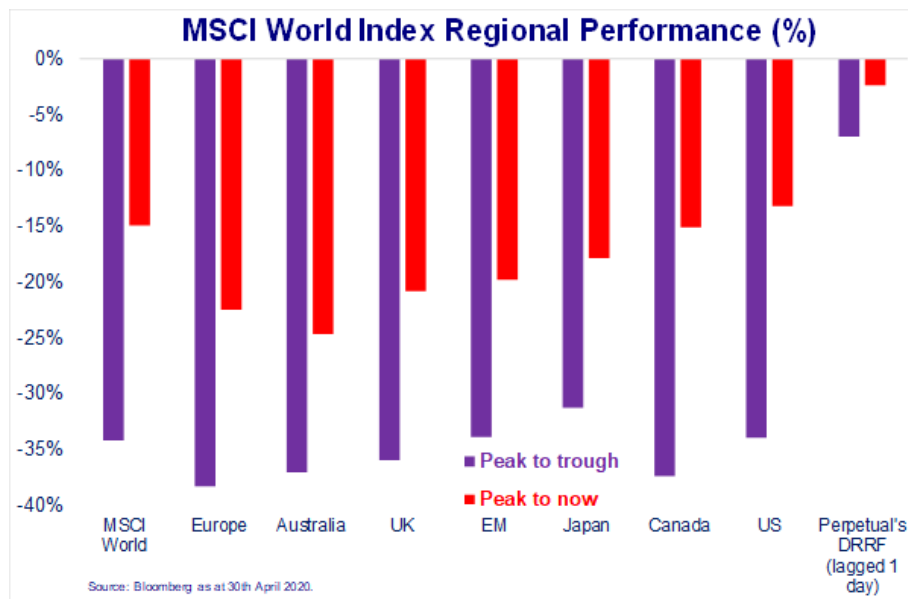
## FINANCIAL MARKETS

### • EQUITIES

- The MSCI World Index closed +2.3% higher with large gains in all regions and most sectors, with the price surge pulling the index's recovery rate up to 56%. The market shrugged off negativity around March quarter US GDP, an Italian debt downgrade by Fitch and also a bearish US Fed Chair, and instead focused on rising oil prices and a positive update on Remdesvir from Gilead (+5.7%) which noted positive test results in US trials. Gains across sectors were broad-based led by energy (+6.2% which pulled the recovery rate up to 41%), telcos (+4.2%, 57%) and IT (+3.8%, 65%), but other defensive sectors were subdued to flat including REITs (+0.8%, 44%), healthcare (+0.1%, 84%), utilities (+0.0%, 48%) and consumer staples (-0.2%, 59%).

Among the regions, advances were led by the US (+2.7%, 61%) with energy (+7.4%), telcos (+5.1%) and IT (+4.2%) all surging as investors decided today that the glass was half full which led to some rotation out of defensives and into cyclicals which saw the NASDAQ (+3.6%) outperform. Europe also recorded a strong bounce (+2.2%) which means so far this week the regional index has lifted +6.5% which has seen the recovery rate rise to 41% as Austria (+4.2%), Spain (+3.2%), Ireland (+2.8%), Germany (+2.9%) and the UK (+2.6%) outperformed.

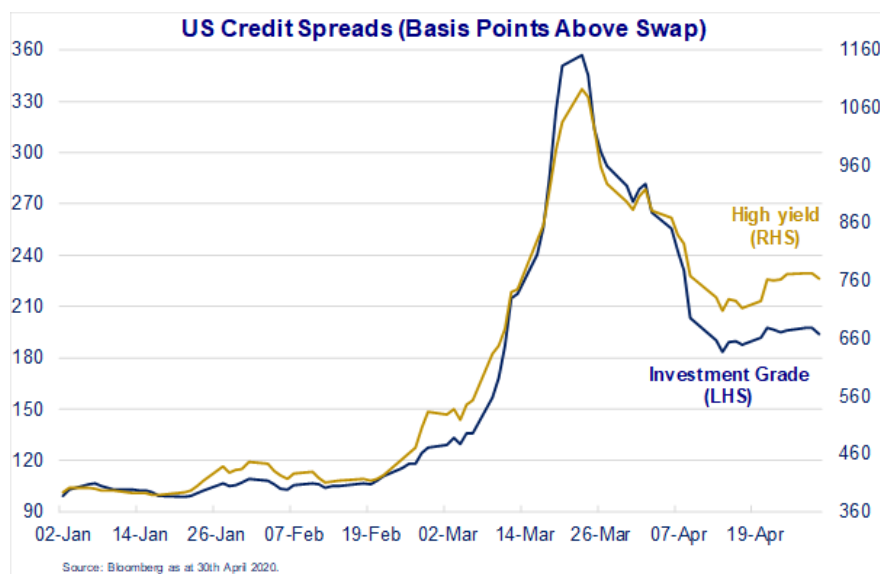
The gains the northern hemisphere markets followed a positive session in Asia where Australia (+1.5%), South Korea (+0.7%), China (+0.5%) and Hong Kong (+0.3%) all closed higher, with Japan closed for Showa Day public holiday. Despite yesterday's rise, Australia is lagging notably with the index still -25% below its February peak (see chart) but futures markets are priced for a strong opening both here (+2.0%) and in Tokyo (+0.8%).



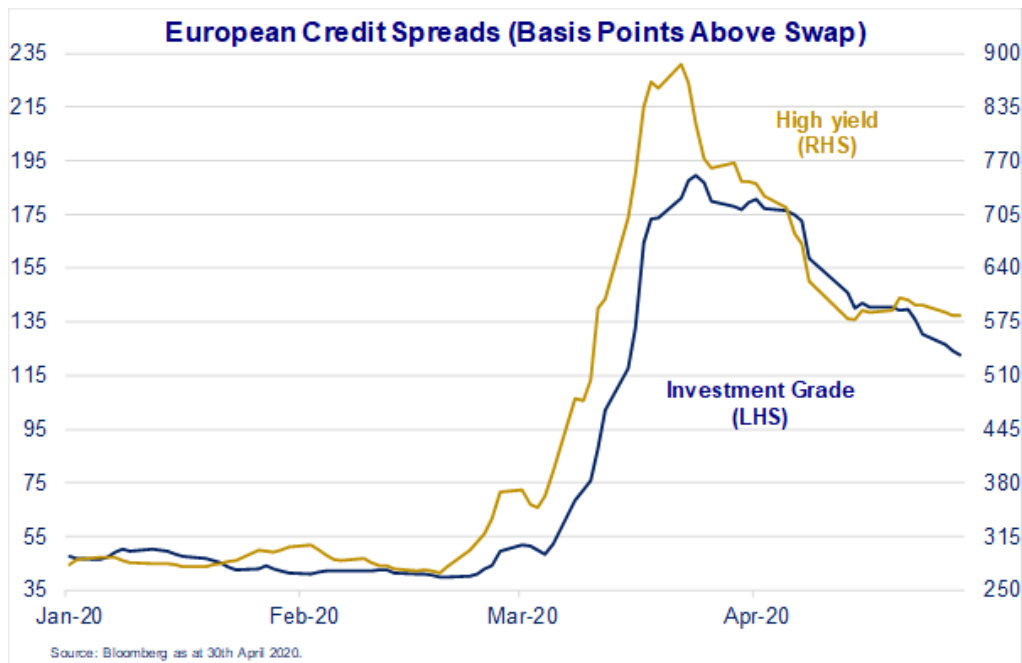
## • CREDIT

- The positive equity market sentiment was not evident in credit markets which closed flat. US credit spreads came in a touch, but nothing to suggest that the market is recalibrating its risk-reward dynamics. In the investment grade universe US spreads came in -3 points to +194 bpts which lifted the recovery rate from the March peak to 64.2%. There were gains in all sectors led by energy (-7 points to +336 bpts, 57%) which responded well to both higher crude prices and also the opening up of some economies as investors believe that will help soak up excess energy production and ease stress on storage systems. This also saw spreads on subordinated financials come in (-5 points to +240 bpts, 63%).

In the high yield universe, spreads came in -9 points to +764 bpts (see chart) which lifted to recovery rate one notch to 48%, but there were not universal declines across all sectors with materials (+1 to +646 bpts, 46%) and financials (+6 to +798 bpts, 33%) demanding higher risk premiums. In contrast, energy came in -34 points to +1417 bpts, which lifted its recovery rate to 58%, but there wasn't much else.



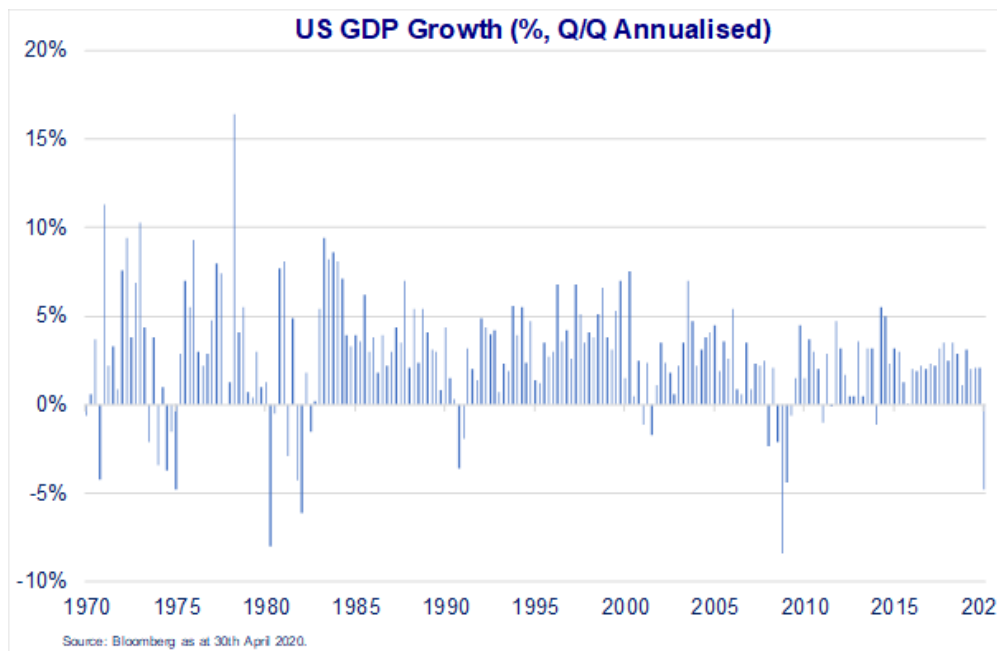
- European credit markets were quite flat overnight with the investment grade universe coming in -1 point to +123 bpts, which lifted to recovery rate to 45%. Although every sector recorded lower risk premiums, the moves were all less than -2.5 bpts, so the action here is best described as minor, but uniform. Things were equally quiet in the high yield universe where spreads increased +0.1 point to 582 bpts (see chart), which kept the recovery rate at 49%, but there was a wider dispersion of movements. Indeed, energy increased (+4 points to 746 bpts, 52%) which flowed through to senior financials (+8 points, +711 bpts, 35%) which have had time to dissect the ECB announcements with investors not wanting to pull spreads in anymore. In contrast, spreads in healthcare contracted (-5 points to +381 bpts, 59%), but in the other sectors there was nothing of note.



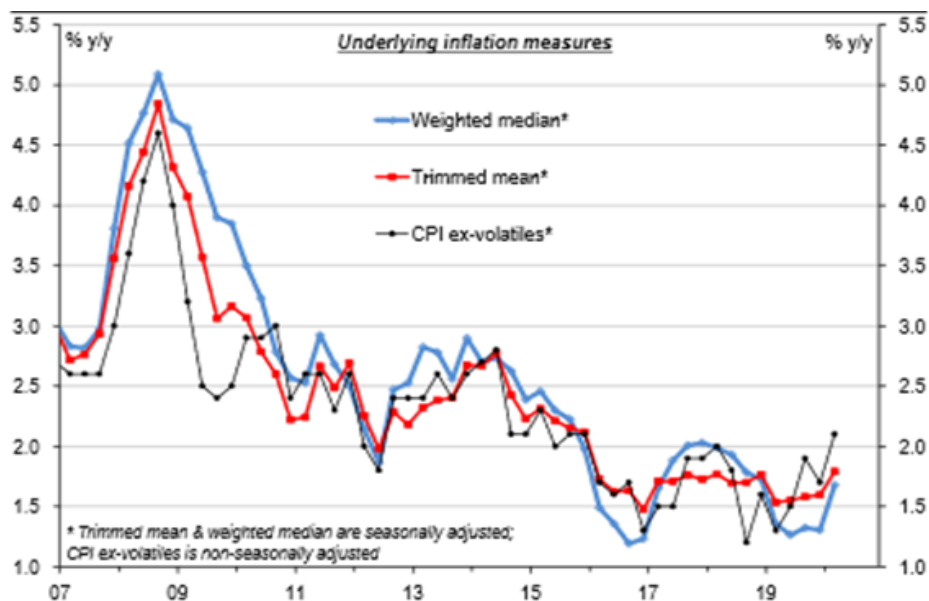
## THE GLOBAL ECONOMY

- Preliminary March quarter US GDP** was -4.8% q/qa with broad plunges in consumption, business equipment and structures, exports, and inventories. While the depth of any number is possible in this crisis, the consumption number is based on just retail sales data and is subjected to wide revisions at this stage, and model assumptions underpin the residential investment and intellectual property estimates, instead of data. Among the components:
  - consumer spending fell -7.6% q/qa which was much larger than expected led by services (-10.2% q/qa);
  - business investment dropped -8.6% q/qa, despite a positive contribution from intellectual property investment which boosted GDP by around +0.3%;
  - residential investment was reported up at a +21%q/q annual rate (single family homes were up +33% q/qa) which seems out of line with everything else and is not remotely aligned with recent homebuilder surveys;
  - net trade recorded huge swings in activity with exports off -8.7% q/qa as foreign demand began to dry up, and imports dropped a larger -15.3% q/qa but the latter is unusually large as the import orders which have to have been processed in February before lockdowns occurred; and
  - inventories dragged -0.5% from growth given ceased production.

So overall, the numbers seem indicative of a weaker than expected US economy in March, with the quarterly result being the fourth worst in the past 50 years (see chart) beaten only by the depths of the recessions in 1980 (-8.0% q/qa, from the second oil shock), 1982 (-6.1% q/qa) and 2008 (-8.4% q/qa after the collapse of Lehman Brothers). However, there is much worse to come with June quarter growth likely to be around -38% q/qa as the consumption and investment decline only began in late March, and there is likely to be a huge detraction from energy structures (which were down only -3% q/qa in Q1 and energy investment has been falling much faster since then), but things should be lifting in the month of June as the US reopens.



- Australia's March quarter headline inflation** rose +0.3% q/q which pulled the annual rate up to +2.2% which is a 6-year high. The key quarterly drivers came from both supply shortages (after the January bushfires) and temporary demand increases (panic buying in relation to COVID-19 in March) with key increases being food (1.9% q/q which added +0.3% to the result) and alcohol & tobacco (+1.6% q/q, +0.1%pts), whereas automotive fuel (-6.0% q/q, -0.2%pts) and holiday travel & accommodation (-3.2%, -0.2%pts) both detracted. Meanwhile, the 'statistical core average' of the trimmed mean and weighted median ticked up to +0.5% q/q to +1.7% y/y and the RBA's preferred trim mean measure rose +0.5% q/q to +1.8%, after Q4 was revised up +0.1% to +1.8% y/y, the equal highest since 2015.



Although the inflation increase defied trends in other economies the data is 'old news' as inflation is set to plunge -1.5% q/q in the June quarter as fuel prices are tracking ~25% q/q lower, large excess capacity will open up as the economy records its largest quarterly growth decline since the Great Depression and unemployment surges into double-digit territory. Indeed, recent business survey has selling prices in negative territory in March, and this will persist in the near-term. Excess capacity and weaker than normal recovery suggest it will take considerable time to have domestic inflation move back to the RBA's target band, but we will not be along on that front.

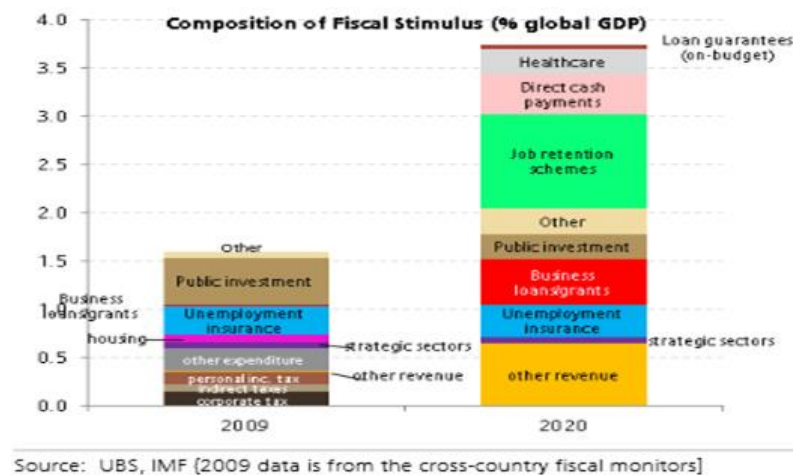
## POLICY

- **FOMC April meeting** - There were no material surprises at the FOMC's April meeting. This was the committee's first scheduled meeting since January and all interest rates were unchanged with the committee noting its intention "... to maintain this target range until it is confident that the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals". Forward guidance was also aligned to that from the March policy statement, but the tone of the statement was somewhat more dire with statements including:
  - *"tremendous human and economic hardship"* caused by COVID-19;
  - *"sharp"* declines in economic activity and *"a surge"* in job losses, that weaker demand and lower oil prices *"holding down"* inflation, and a deterioration in financial conditions and credit access; and
  - the health crisis will weigh *"heavily"* on economic activity, employment, and inflation in the near term, and pose *"considerable"* risk to the medium-term economic outlook.

In the subsequent press conference, the FOMC chair:

- provided more details about the medium-term risks from the crisis in that even after the sharp contraction is done, the recovery could be tepid and it was evident that Powell is not a V-shaped recovery guy. He is also worried about the medium-term risks around inflation as expectations are set to drop sharply and the large output gap will be evident for many years. He would have this view centred around the last cycle where despite huge stimulus the Fed only hit its inflation target in a handful of months over a 10-year expansion;
  - stated asset purchases will continue "as needed" both for market functioning and easier financial conditions. I think this constructive ambiguity is intentional to allow for more information to be accumulated and for the internal debate to firm up before any easing of support in QE;
  - noted that more fiscal support will be needed as the central bank is only able to make loans where they are expected to be paid back, and those loans may not be helpful where incomes and revenues have been dramatically reduced; and
  - said that the two corporate bond programs and the "Main Street" facility will be operational "soon" for the former, but he was elusive on the latter.
- **Italy sovereign credit rating** – Although it was not scheduled to review Italy's rating until July, credit ratings agency Fitch lowered the sovereign debt rating for Europe's third largest economy one notch to BBB-, which is one rating level above 'junk'. If another happened and other agency's followed suit, the country would not receive assistance from existing ECB programs (and the ECB never change the rules to suit the times!) and it would trigger force selling by pension funds. This represented the first downgrade to a major economy after the Cov-19 crisis which has led to a swelling of public debt metrics. For what it's worth, Fitch expects the outbreak to shrink the Italian economy by -8% y/y which would see the country's debt load rise +22% to 156% this year, and that there's a risk of a deeper downturn. Italy's Finance Minister stated overnight that "The fundamentals of Italy's economy and public finances are solid". Ahh, yeah.
  - **Global monetary, fiscal and debt dynamics** - While monetary measures have been smaller in response to this crisis (the real cash rate in 2020 has declined -0.85% relative to -3.5% in 2008/09) and currently sits around +1.7% of GDP, the discretionary fiscal measures enacted to fight the slowing economy are -3.7% of global GDP which is more than double the support seen in the GFC, but it's not 'traditional' stimulus'. Looking at the chart below we can see that the traditional fiscal routes for stimulus, namely infrastructure investment and tax cuts, are largely absent in this crisis as they would be largely ineffective if supply chains are disrupted and/or health issues are unresolved, and the traditional measures are too slow to offset the speed of the downturn.

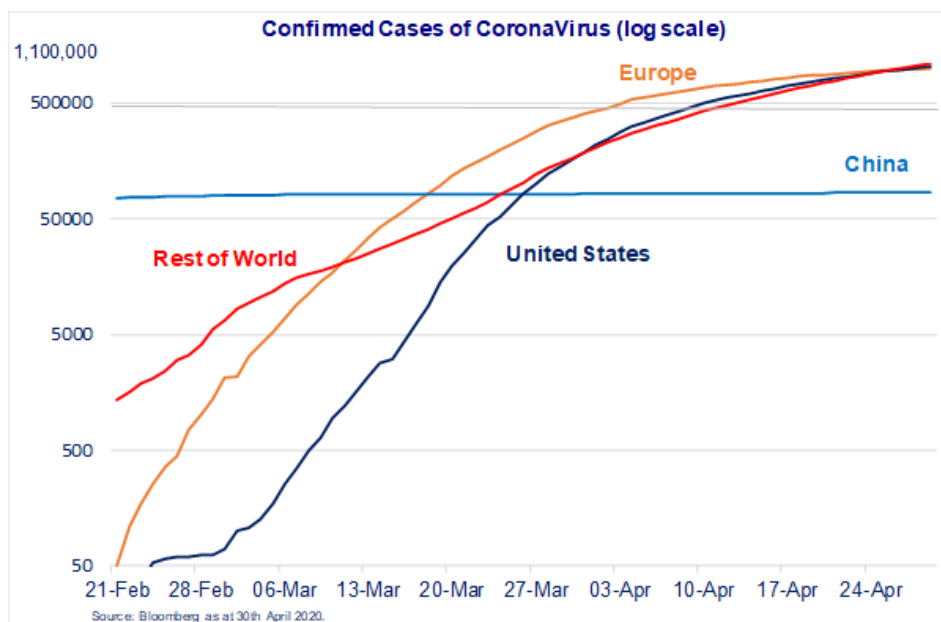




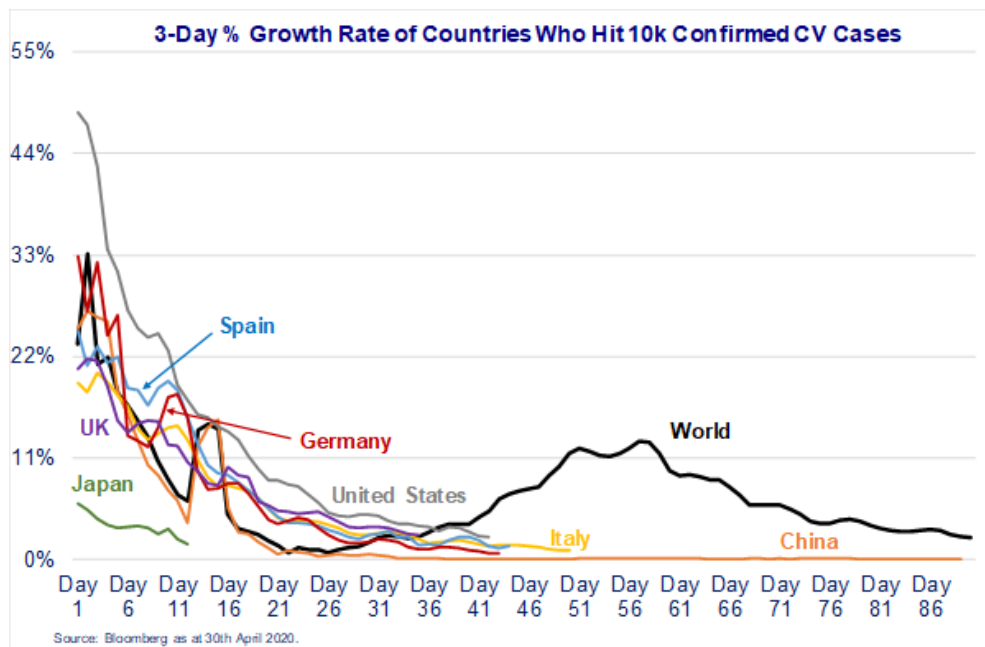
As usual, these are cyclically adjusted numbers, so the headline fiscal deficit is much higher, as both global GDP is expected to decline by -4.5% (-0.1% in 2009) and a large part of the spending programs are loan guarantees rather than 'discretionary GDP stimulus'. This means the global fiscal deficit could be around -14% of 2020 GDP, and whether the stimulus is remotely enough remains to be seen as US firms have laid off workers at a rate 10x faster than any five-week period in 2008/09, but this crisis will likely push public debt in many countries to the highest level since WWII.

## VIRUS UPDATE

- The number of global cases of COVID-19 stands at 3.19 million with another +73.3k cases overnight which means 3 countries have over 200k cases, 7 countries now have more than 100k cases, 23 over 20k cases and 37 over 10k. It took 73 days to record 1 million cases, 13 days for the next million and 11 days for the last million. That said, the growth rate of daily confirmed cases continues to decline (+2.4% since Saturday). Meanwhile, deaths rose +10k overnight (second highest daily increase on record) to 227.2k, with the US now over 60k and the UK, Spain and Italy all around 25k, and the death rate sits at 7.1% (although final numbers are not yet in).

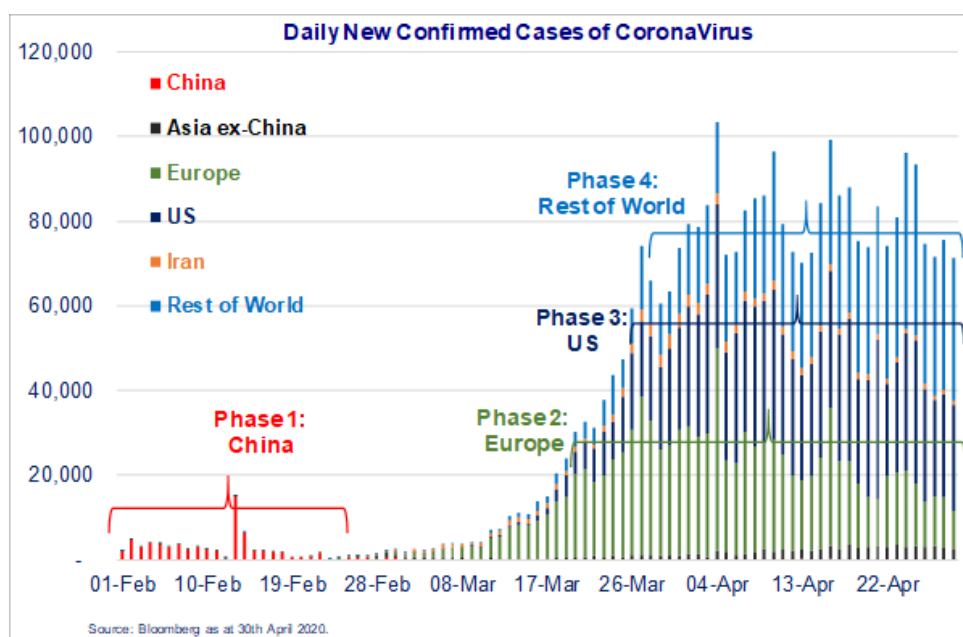


- We break the infections into four groups – the US, Europe, China and 'others' and the rest of the world outside the G3 economies (+35.2k to 1.1 million) now has the most cases followed by the US (+25.3k to 1.04 million) and Europe (+9.0k to 1.01 million) but the latter two daily increases, both number and percentages, are trending lower which shows that social isolation works to reduce the spread of the virus, even though it comes at an enormous economic cost.

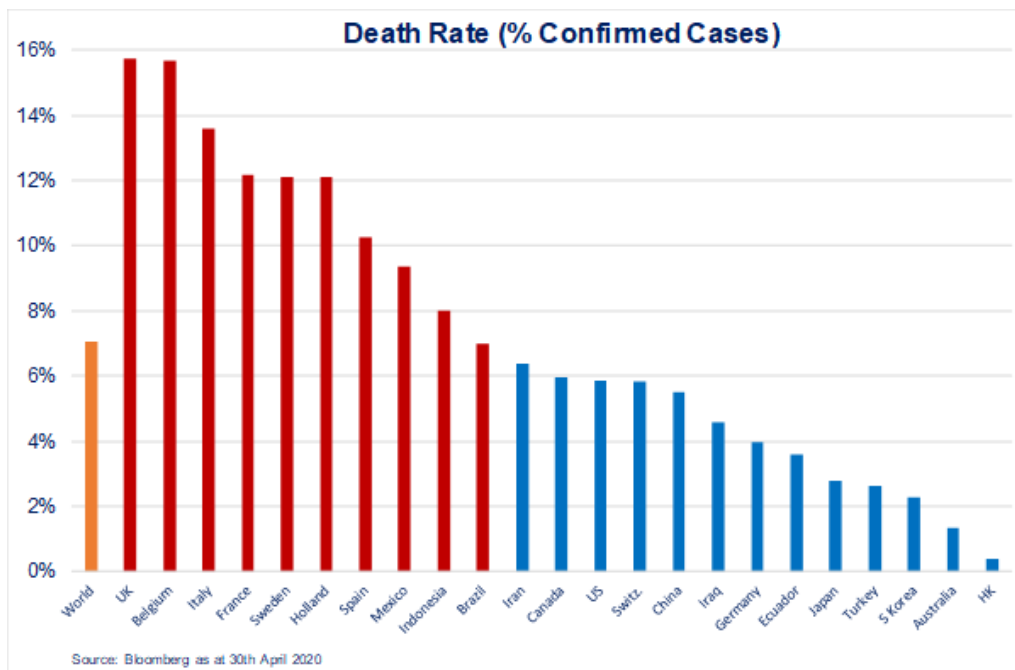


- Among countries, the most cases are in the US (+25.3k to 1.04 million), Spain (+4.8k (5-day high) to 236.9k), Italy (+2.1k to 203.6k), France (+1.5k to 166.5k), the United Kingdom (+4.1k to 166.4k), Germany (+1.3k 4-day high) to 161.2k), Turkey (+2.9k (5-day high) to 117.6k), Russia (+5.8k to 99.4k), Iran (+1.1k to 93.7k) and China (steady at 83.9k). Australia confirmed cases rose to 6,746 yesterday which placed us 45th in terms of total infections.

Elsewhere, Singapore recorded +690 new cases (13-day low to 15.6k) 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 (+260 to 9.8k) and the Philippines (+254 to 8.2k). Note final numbers for yesterday at not in yet so these numbers can rise.



- The global death rate increased by +0.2% (2-week high) to +7.1% (48th rise in the past 52 days) with another +10k fatalities overnight bringing the global total to 227.2k. The US has the most deaths at +60.8k, with the Italy (27.7k), Spain (24.3k) and the UK (26.2k) all over +20k. The death rate is highest in European countries where the health systems have collapsed led by the UK (+2.3% to 15.7%), Belgium (+0.2% to 15.7%), Italy (steady at 13.6%), France (+0.3% to 12.2%), Sweden (+0.1% to 12.1%), the Netherlands (+0.2% to 12.1%), and Spain (steady at 10.2%). However, several emerging markets are now on the leader board including Mexico (+0.2% to 9.4%), Indonesia (-0.1% to 8.0%) and Brazil (+0.1% to 7.0%).



Yours sincerely,



**MATT SHERWOOD**  
Head of Investment  
Strategy, Multi Asset



**MICHAEL O'DEA**  
Head of Multi Asset

This document has been prepared by Perpetual Investment Management Limited (PIML) ABN 18 000 866 535, AFSL 234426. It is general information only and is not intended to provide you with financial advice or take into account your objectives, financial situation or needs. You should consider, with a financial adviser, whether the information is suitable for your circumstances. To the extent permitted by law, no liability is accepted for any loss or damage as a result of any reliance on this information. The PDS for the Perpetual Diversified Real Return Fund, issued by PIML, should be considered before deciding whether to acquire or hold units in the fund.

The PDS can be obtained by calling 1800 022 033 or visiting our website [www.perpetual.com.au](http://www.perpetual.com.au). No company in the Perpetual Group (Perpetual Group means Perpetual Limited ABN 86 000 431 827 and its subsidiaries) guarantees the performance of any fund or the return of an investor's capital. Past performance is not indicative of future performance.

## MORE INFORMATION

**Perpetual Investments** 1800 062 725

**Email** [investments@perpetual.com.au](mailto:investments@perpetual.com.au)

[www.perpetual.com.au/investments](http://www.perpetual.com.au/investments)