

THOUGHTS ON THE MARKET

30th March 2020



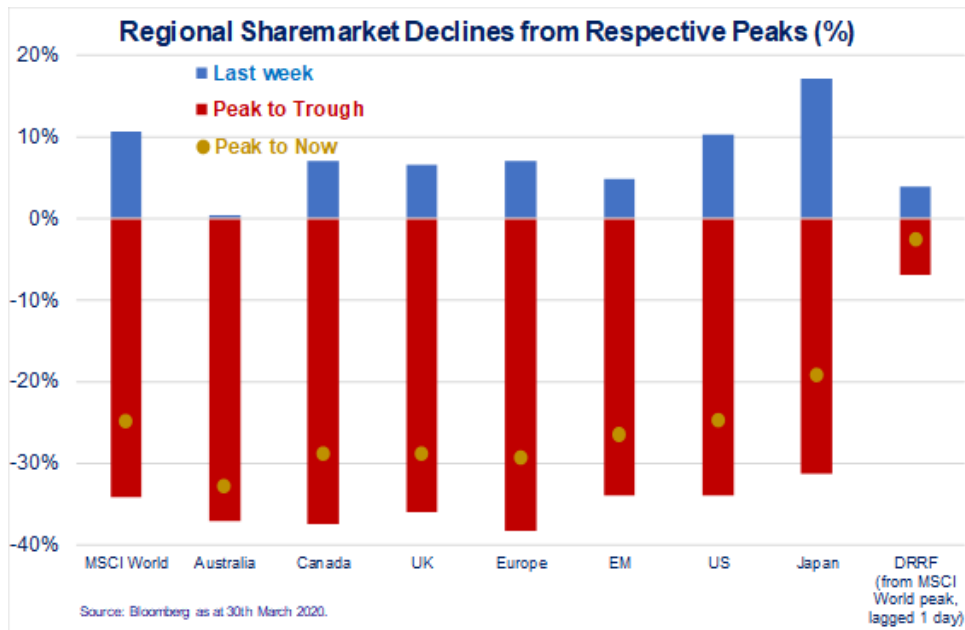
SUMMARY

1. The outlook remains highly challenging for investors and everything seems surreal with markets are all over the place at present. There is certainly no central narrative for investors to cling to - the fear is palpable yet markets rallied strongly last week, the days are long but the weeks feel short, some are saying we are getting on top of the spread, yet we saw 5 record daily increases in the past 7 days. It seems the only two things which persist are uncertainty and volatility.
2. Market returns last week were upbeat as investors focused on the policy delta out of the US which combined with cheaper-than-early 2020 valuations, saw double digit gains in risk markets and an unwinding of the credit spread blow outs. However, the price rise was led by defensive sectors, not cyclicals and bear market rallies are common in every recession and are usually born out of policy expectations, but price gains typically reverse abruptly when the policy is delivered.
3. One major problem at present is that we don't have any data outside China which shows to impact of industry and regional closures on economic activity, but last week we saw some of the lead indicators plunge and it's hard to imagine that these will be far from the reality. There was a record rise in initial US jobless claims (four times the previous record) and preliminary March composite PMIs in Europe and Japan have already plunged below their GFC trough as the normally resilient service sector activity gaped lower. The US will see this in April, not March.
4. We believe investors, markets, policy makers and economists will be genuinely shocked with the growth and unemployment deterioration that is ahead. The expected June quarter 2020 US GDP result (around -30% q/qa) would represent the greatest contraction in US economic history (the largest have been -15.5% q/qa in December 1932 and -14.7% q/qa in December 1946), but the duration of this should be considerably shorter than in the 1930s (two and three quarter years) which should hopefully prevent 2020 being labelled a 'depression'.
5. The shape of the recovery is important for markets to have a sustainable footing, and consensus seem to be hoping for a rerun of the Wuhan template – two months of crunching the economy, followed by a month of rebuild of capacity and then growth returns. The risks to that view is that it is harder to successfully engineer a shutdown in the US and Europe which means health systems potentially collapse which sees risk aversion and precautionary savings sky-rocket to the detriment of the labour market and the duration of the downturn.
6. Policy can do little in the near-term as the economy is closing down, instead it's aimed to prevent dangerous negative reinforcing feedback loops forming, which would spark a deeper and longer 'depression'-like environment. We also suspect there is unlikely to be a sustained surge when the lights go back on, as fiscal policy is replacing lost wages any providing loan guarantees, and monetary policy was close to zero anyway. Consumers are likely to be more risk-averse when COVID-19 passes with a structurally higher savings rate and lower desire for leverage (thereby weighing on the impact of policy when growth returns) and business investment could stay low for another year as cashflows are rebuilt and are earnings are restored.
7. The number of COVID-19 cases continues to rise, but there are very tentative signs of a slowdown in Europe as social distancing rules partially moderate the virus's spread. These Draconian rules are amplifying the initial supply side shock (which always evolves into a demand side shock through labour market contraction and falling income) and this has pushed the global economy into a deliberate deep recession. While fiscal stimulus programs of 10% sound impressive a vast bulk of that is loan guarantees and the circa +2% of global GDP which is outside these measures is around 2008 levels, but unlike then, we believe most of this will go to precautionary savings and won't be spent as businesses are closed.

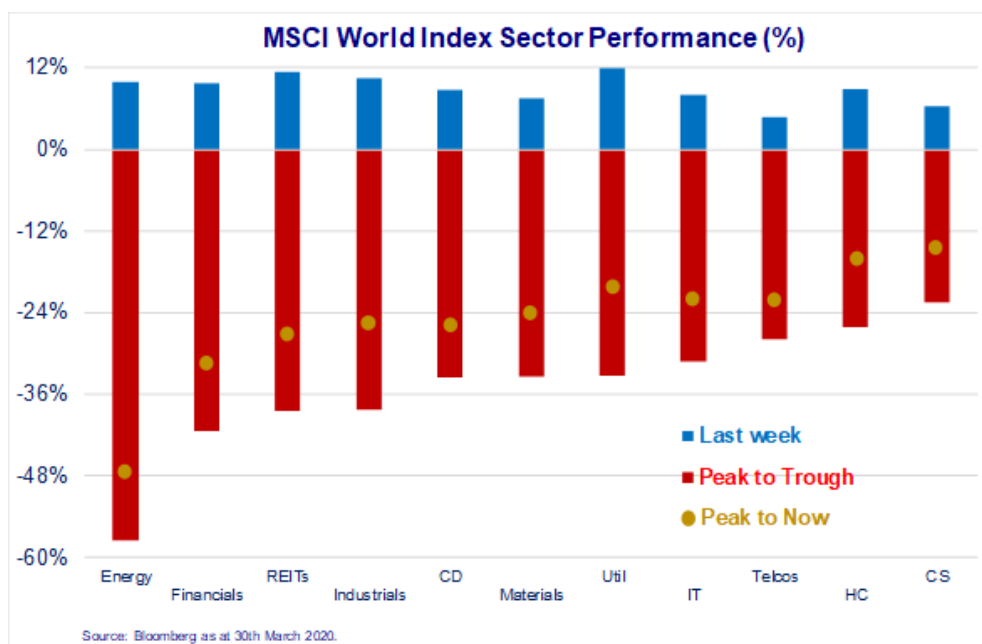
FINANCIAL MARKETS

• EQUITIES

- Regional sharemarkets recorded strong gains over the past week as investors focused on the policy delta out of the US which combined with cheaper-than-early 2020 valuations to drive strong returns in risk markets. Equity gains were led by Japan which also responded strongly to a weaker Yen and the US was another market to record a double-digit rally. There was solid gains in other markets which softened the recent price drop, but at the end of last week, Australia had recorded the largest peak-to-now price decline at -32% (see chart below). While investors could get excited about rising risk prices, they should temper this, as risk rallies of more than +10% have always occurred during bear markets associated with recession, but these normally precede policy responses but have not signalled an end to the price depreciation.

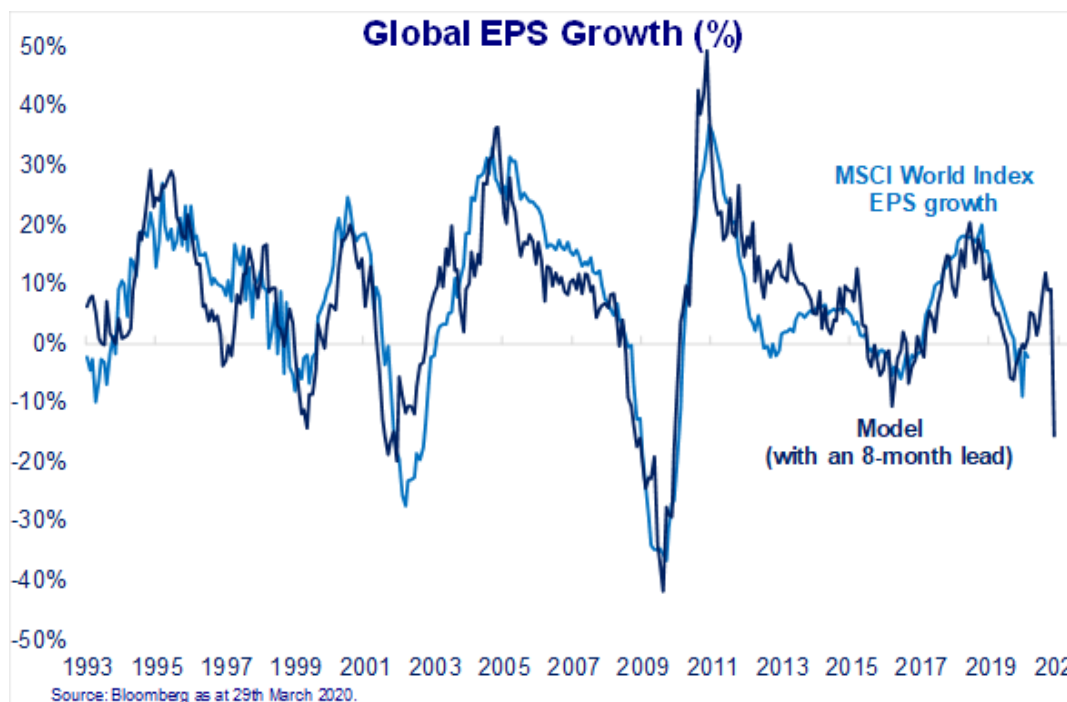


- Global sector performance presents an interesting picture of last week's rally as it was led by defensive sectors (those that have low correlation with economic activity) such as utilities (+12.0%) and REITs (+11.5%), which outperformed the strongest cyclicals including industrials (+10.5%) and financials (+9.7%) (see chart below).

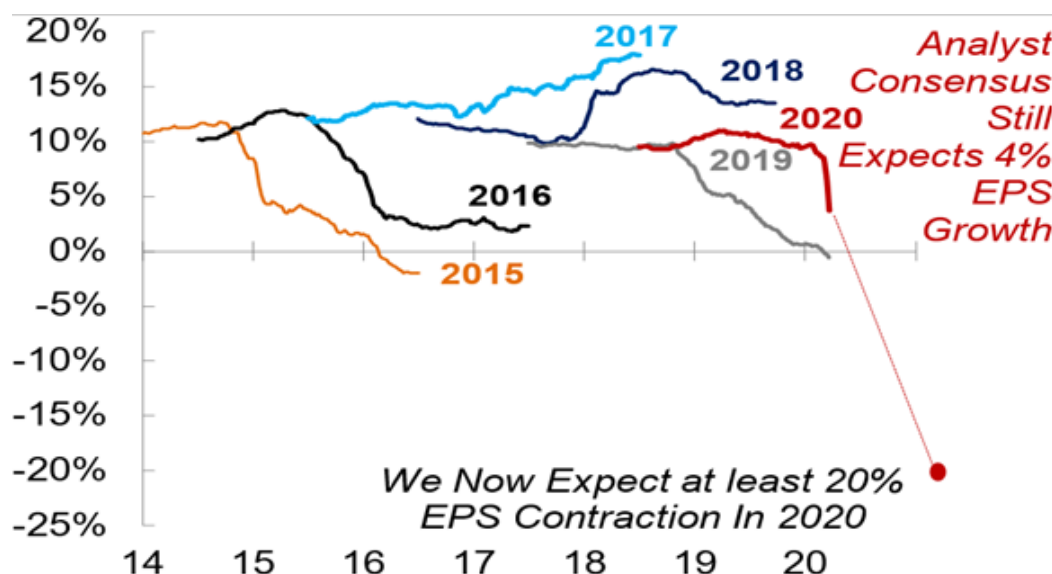


- A key question is what will be the impact of the recession on global earnings growth. It has to be remembered the corporates came into 2020 in a weak state with global EPS growth declining -9% in 2019 despite positive revenue growth, as margins were hammered by rising costs. In 2020 revenue growth is likely to take a large hit and Perpetual's proprietary global earnings model has recorded its sharpest ever one month decline since 1993 (see chart below).

The model's estimate for global EPS growth fell 25 percentage points in March to currently be -15.7% but this may fall further when final G3 March composite PMI indices, US consumer confidence and US new housing stats are released this week. The largest previous decline was -15% m/m in June 2009 and the model has given good leads on turnarounds in corporate performance in the 2001 and 2007/09 recessions.

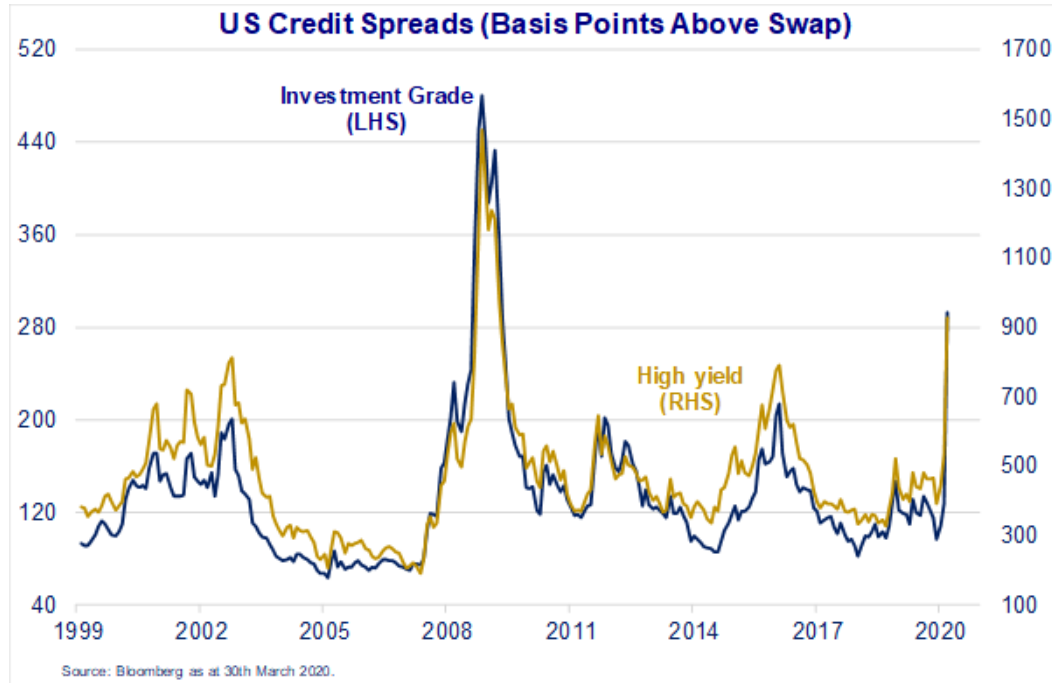


- Negative GDP growth in 2020 has implications for global EPS growth where street estimates still have +4% pencilled in for 2020. There is no doubt that it takes time for analyst consensus to cut EPS forecasts in the wake of a shock and they have downgraded the 2020 outlook -5% in one month, which is unusually large relative to recent year (see chart). Top down, we expect around -35% given a forecast -10% hit to GDP growth in Q2 alone. Citigroup expect -20% for 2020.

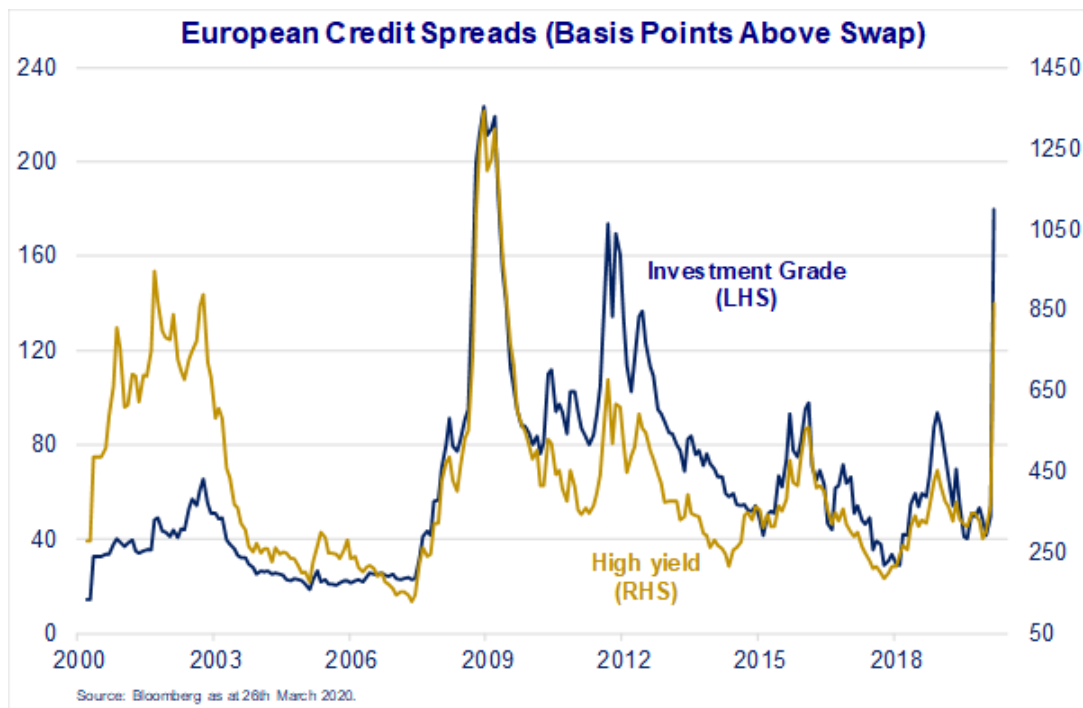


• CREDIT

- Credit spreads responded positively to policy over the past week as the US Fed has essentially backed the investment grade space with its balance sheet (although the package announced will need to be bolstered). On Friday US IG spreads fell for a fourth consecutive day (-8 to +292 bpts, which is 65 points below its peak, representing a recovery of one quarter of its spread blowout since mid-February) and HY also recorded its fourth consecutive spread decline with a (-30 decline on Friday to +928 bpts which sums to a total of 164 bpts recouped since last Monday which is also one quarter of the total losses since mid-February).



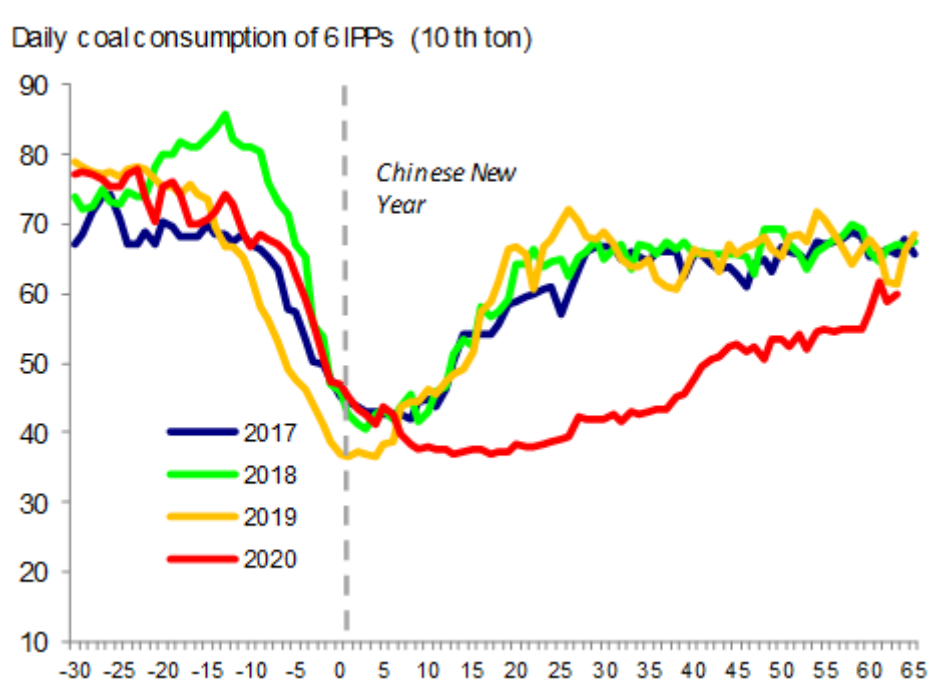
- The decline in spreads came despite a -4.1% decline in global oil prices over the past week, all of which was delivered on Friday. The key for credit markets moving forward is whether markets are correctly priced for the economic downturn ahead and the backdrop here is not favourable as a decade of low interest rates has encouraged companies to gorge on cheap debt up to the point which doesn't see them lose an "investment-grade" ratings. The issue here is not only the debt build up, both the growth deterioration which is likely to see some firms downgraded and a move into 'junk' could create a liquidity crisis as all kinds of institutional investors, including pension funds and insurers, would be forced sellers. A deepening crisis from the spread of COVID-19 and the global oil rout has meant that a vast number of BBB-rated companies (which around half of the investment grade space totalling USD2.5 trillion) will be at risk of downgrades. The risk here is not just investment grade downgrades but also a forced 25% increase in the junk market size which would be very tough for markets to stomach.
- European credit has also recovered some of its spread blow out, but the claw back is far less convincing than the US. European IG spreads decreased by -7 to 180 bpts on Friday bringing a total recovered points to 10 out of +150 basis point spread widening, but their HY counterpart has fared somewhat better following its fourth spread contraction on Friday (-112 points) bringing a total decline to -126 bpts which is one-fifth of the total 612 point blowout.

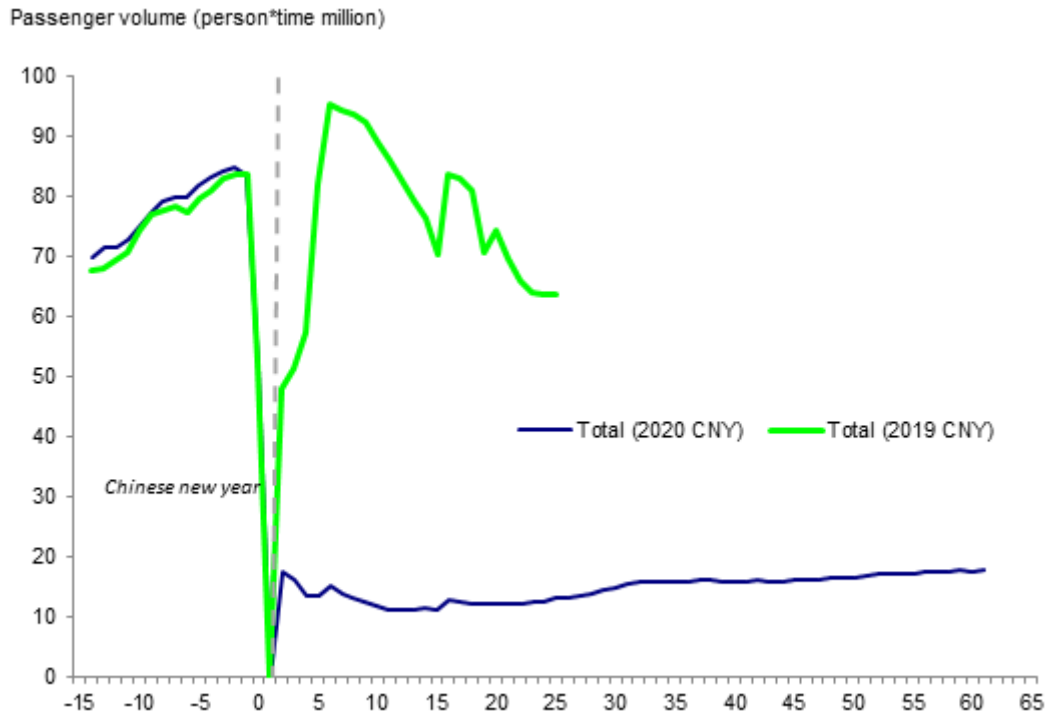


THE GLOBAL ECONOMY

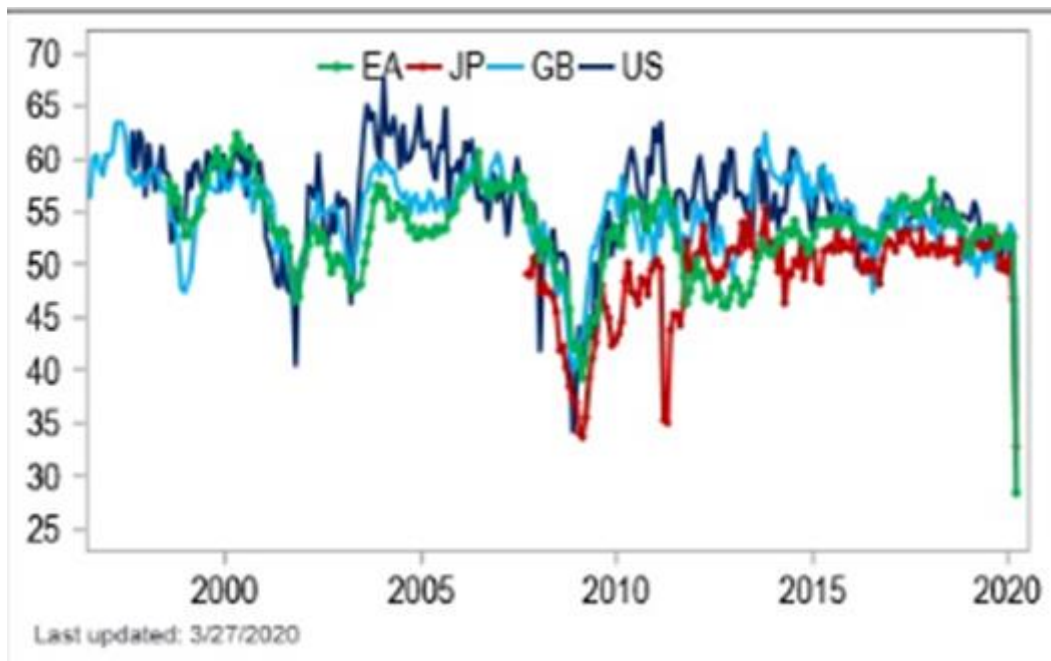
- Lead indicators, in the form of the regional PMIs and initial US jobless claims, have foreshadowed an unprecedented growth dive in coming months. The global data flow for March is set to begin soon, but given the unprecedented stoppage in global activity, there is enormous uncertainty about the extent of the damage.

While markets are focused on the decline, unlike previous global contractions, the size of the downturn will not be a good guide to its rebound with the latter governed more by the effectiveness of efforts to contain the virus and policy supports that limit lasting damage. While some signs in China appear promising such as coal consumption which is now back to 90% of previous levels since 2017 (see chart below), but other areas are not (see chart after that) including urban traffic which remains far below normal levels.





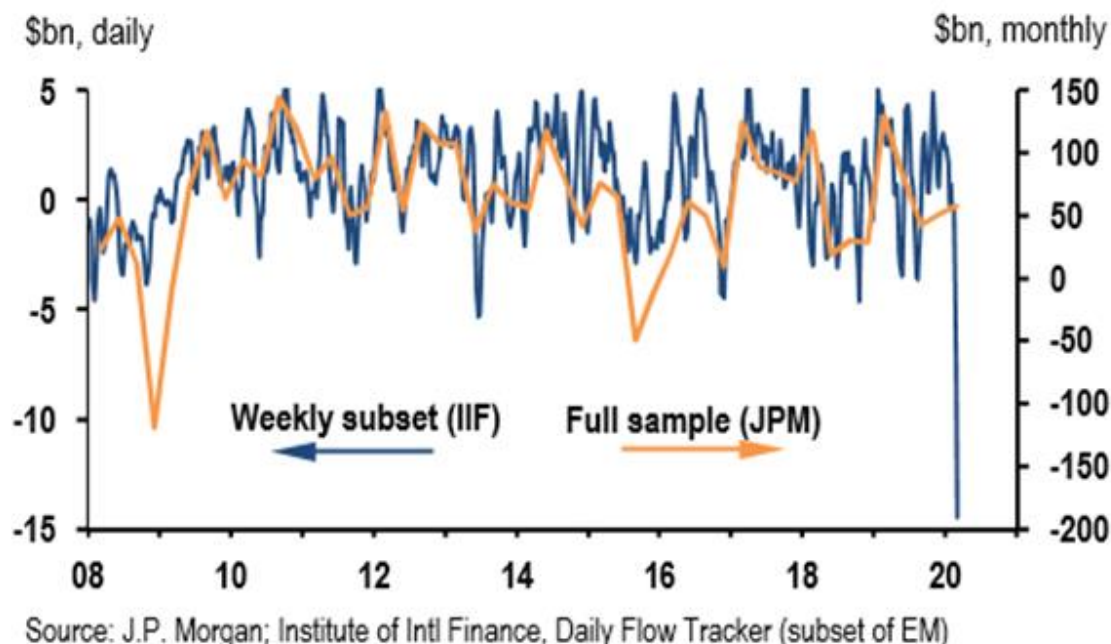
- Over the past week the G4 manufacturing and services sector PMIs were released and it indicated that key economies were seeing record levels of economic contraction in response to economic closures and disruption from COVID-19. The COVID-19 is proving itself to be the biggest supply shock in history, but the impact is being driven by the normally more resilient services sector (around 75% of production, employment and GDP in a modern economy) which has recorded larger declines than in their manufacturing counterparts. Indeed, March saw a record decline in European and Japanese non-manufacturing diffusion indices, but the US was less negative due to timing and the US services plunge will be evident in April. This has culminated by large growth downgrades in all major economies by sell-side analysts.



- A deep contraction in services has implications for the consumption recovery in the household sector who are likely to hold discretionary spending lower to rebuild cashflow and this will weigh on service driven economies such as Europe where Citigroup has growth contracting in all four quarters in 2020 and a total decline of -8.4% for

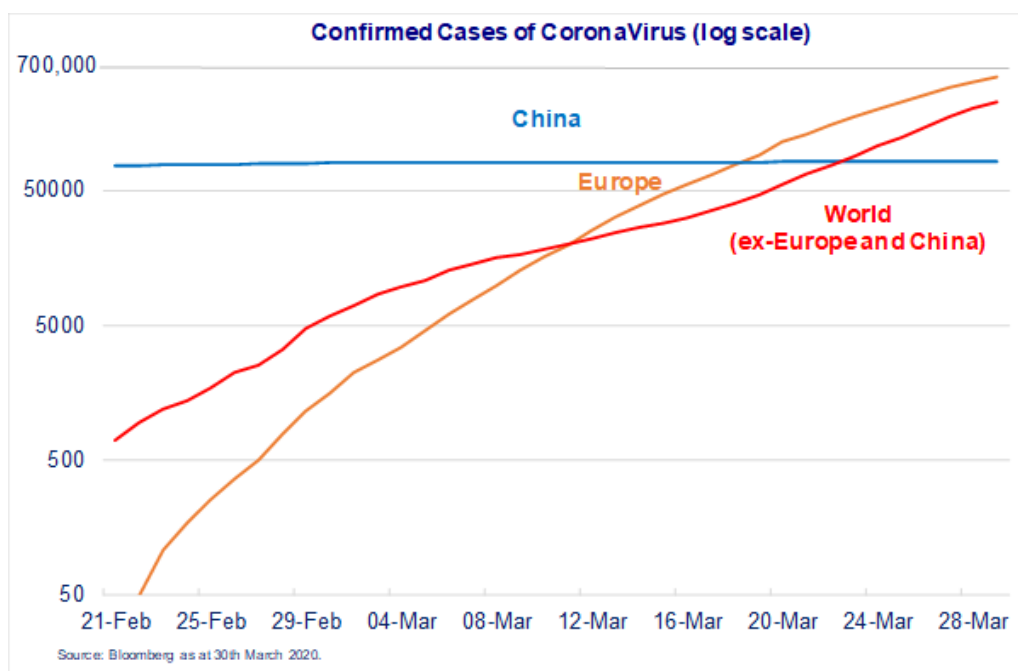
2020. This is lower than JPMorgan's 2020 Europe forecast (-3.5% y/y), but all respected sell side houses are now expecting weaker than normal recoveries with 2020 global GDP lower to -2.6% y/y led by the US (-5.3% y/y), Australia (-4.1% y/y), Canada (-3.3% y/y) and Japan (-3.1% y/y), with China (+1.1% y/y) positive but still recording its lowest growth rate ever.

- While the markets question whether the policy response to the Cov-19 crisis is enough, another issue is funding pressure in EMs as foreign outflow have accelerated and are now at a pace not seen even in 2008, which is increasing balance sheet pressure on the region. In this environment policy makers have opted to support growth rather than defend currencies. However, nothing will be able to stem the large scale and persistent capital outflows in EMs and many countries have or will have to have the IMF intervene.

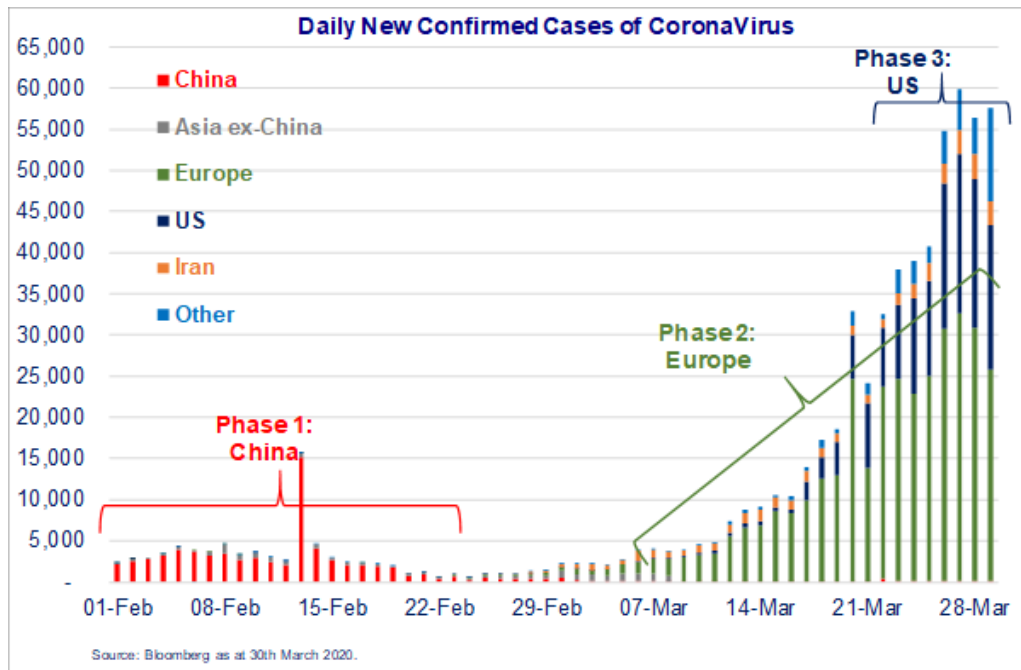


VIRUS UPDATE

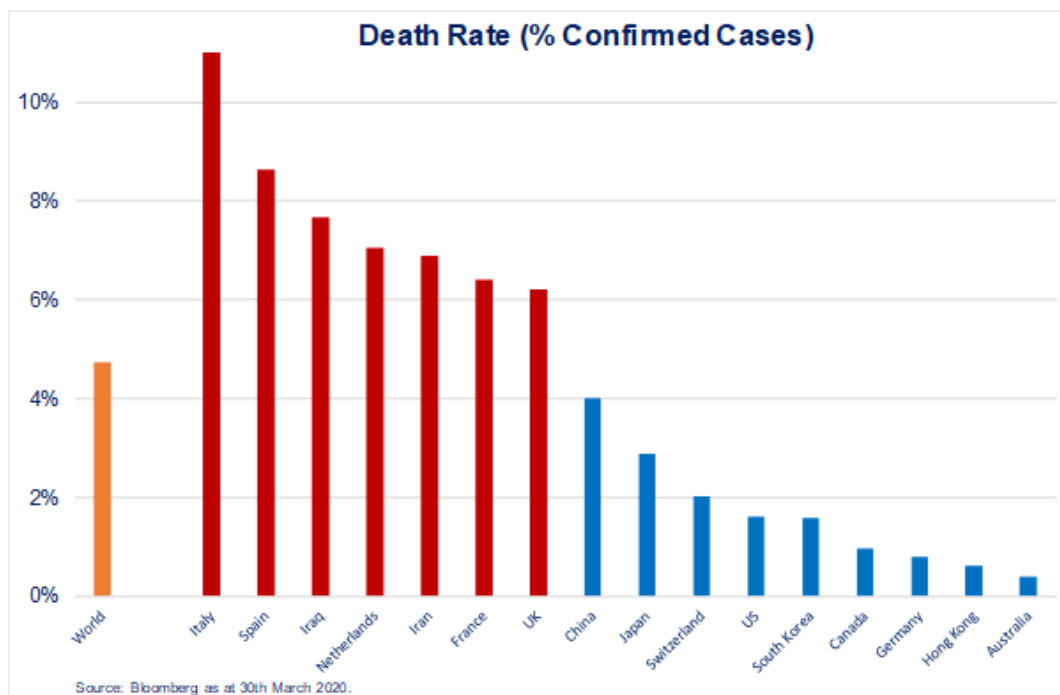
- Corona cases rose +55.5k overnight to 716,101, deaths rose +2,945 to 33,597 and the death rate rose to 4.7% (19th rise in the past 22 days despite surging case numbers);



- Europe (+23,985 to 343.0k) continues to lead the world in terms of total cases and daily new cases, and Italy (+756 to 10.8k) has more deaths than Spain (+624 to 6606) and China (+5 to 3300) combined. However, there has been a recent slowing in case number in the world's largest economic region, so this bears watching.
- Among countries, the most cases are in the US (+17.5k to +137.2k), Italy (+5.2k to 97.7k), China (+123 to 82.1k), Spain (+7.7k to 80.0k), Germany (+4k to 62.1k) France (+2.6k to 40.7k) and Iran (+2.9k to 38.3k). Australia confirmed cases has increased (+340) to 3,980 which placed us 18th in terms of total infections.



- The death rate has risen to +4.7% with another 3,202 fatalities bringing the global total to 33.8k. Death rates are highest in Italy (+0.2% to 11.0%) and Spain (+0.3% to 8.6%) where the health systems have collapsed and are above the global average in Iraq (-0.6% to 7.7%), Netherlands (+0.6% to 7.1%), Iran (-0.2% to 6.9%), France (+0.3% to 6.4%) and the UK (+0.3% to 6.2%).



KEY UPCOMING EVENTS THIS WEEK

- **US:** March ISM manufacturing PMI (2nd April), March US nonfarm payrolls (3rd April).
- **Euro area:** February unemployment (1st April) Final March Markit composite PMI (1st April);
- **China:** March Markit composite PMI (1st April);
- **UK:** no major releases;
- **Japan:** February unemployment (31st March) and February industrial production (31st March); and
- **Australia:** February retail sales (3rd April) and building approvals (3rd April).

Yours sincerely,



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