Perpetual Investments

THOUGHTS ON THE MARKET

3rd June 2020 - All regional sharemarkets are out of bear market territory, but is the US Fed's answer to record corporate leverage the right one?

SUMMARY

- Global stock and credit markets rallied for a third consecutive day amid new hopes about stimulus and signs that economies have stabilised after their worst downturn in 80 or 90 years. In other assets, 10-year US treasuries sold off -3 points with yields up to +0.69% amid curve steepening to 0.55%, gold declined -0.4% from Monday's close at USD1,728 per troy ounce, energy was up +4.0% to USD36.87 per barrel and nearly all G10 currencies rose against a weaker Greenback including the AUD (+2.5% to 0.6897 which is a post-January peak), Sterling (+1.3%), the Yen (+0.9%) and Euro (+0.6%).

- Markets seem to be of the mind that valuations, debt, geopolitical tensions and a potentially weak recovery simply don't matter as long as there are re-openings and stimulus in the pipeline. It is interesting to note that 12 weeks ago investors were fretting about US corporate leverage in an economic climate which would produce a large cashflow crunch, but last week new US corporate bond issuance topped USD1 trillion for 2020 (by far the largest 5 month rise on record), so the solution to a leverage problem is a record surge in new leverage in response to US Fed policy.

  All this new debt could potentially create a much larger set of risks. Indeed, US companies were already highly leveraged coming into the crisis and by helping them place a heap more debt onto their cash constrained balance sheets, the Fed runs the risk of deepening the dislocation if many of them fail to survive the virus.

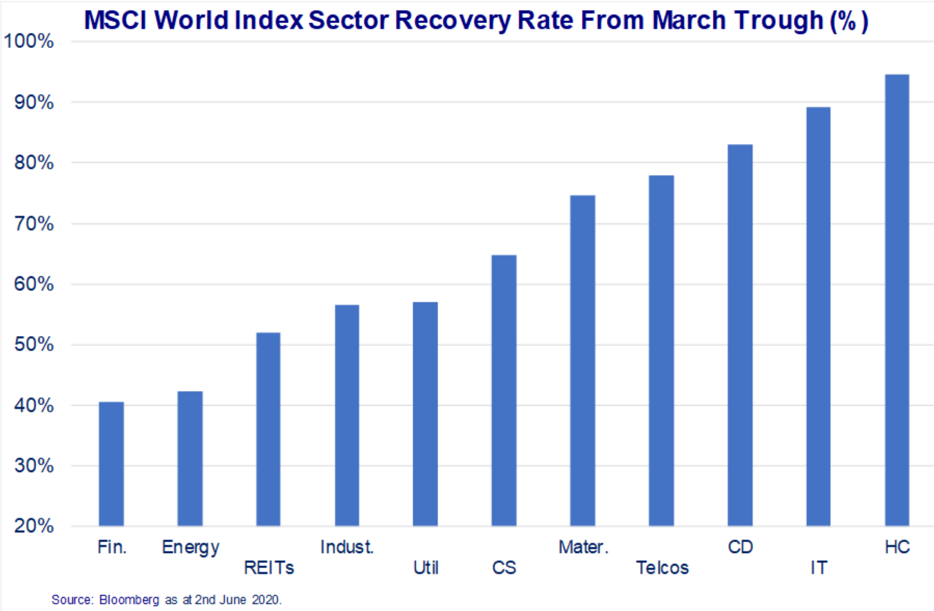
- There wasn't much newsflow overnight in the macro space, but stimulus hopes underpinned the European sharemarket rising to a twelve-week high as Angela Merkel sought to thrash out a new stimulus package with her fellow parliamentarians. There are no details here, so it might be a case of buy some on the rumour, buy more on the fact. Meanwhile, OPEC+ moved towards a compromise deal to extend its recent supply cuts which boosted energy prices and President Trump appears to be ready to sit down with advisers and Congressional leaders and talk about another stimulus boost. That said, there still remains considerable scepticism about the rally, but at least the recent rotation from growth to cyclicals/value seems to lend some credibility, whereas thematics of re-opening, trillions of fiscal/monetary support and vaccine hopes have been in play for several months and would be in the price by now.

- Although final numbers are not in for another 4 hours, the number of global cases of COVID-19 stands at 6.34 million with another +72.3k cases so far overnight (before Brazil, Mexico and some US states report their numbers) which means that Tuesday was the 64th occasion in the past 65 days where daily increases have topped 70k). This means 3 countries have more than 400k cases, 7 countries have more than 200k cases India joined this group overnight), 13 countries have more than 100k cases, and 57 over 10k (. It took 73 days to record 1 million cases, 13 days for the next million, 11 days for the third million, 12 days for the fourth, ten for the fifth million and 11 for the six million, and in the past three days +341k cases have been confirmed. That said, the growth rate of daily confirmed cases is trending lower (+1.5% since Saturday). Meanwhile, deaths stand at 378.4k, with the US now over 100k (28.1% of global deaths even though they have only 4% of the global population), the UK and Italy over 30k, with Spain and France over 25k, and the death rate dropped for a twenty seventh straight day to 5.93%.

FINANCIAL MARKETS

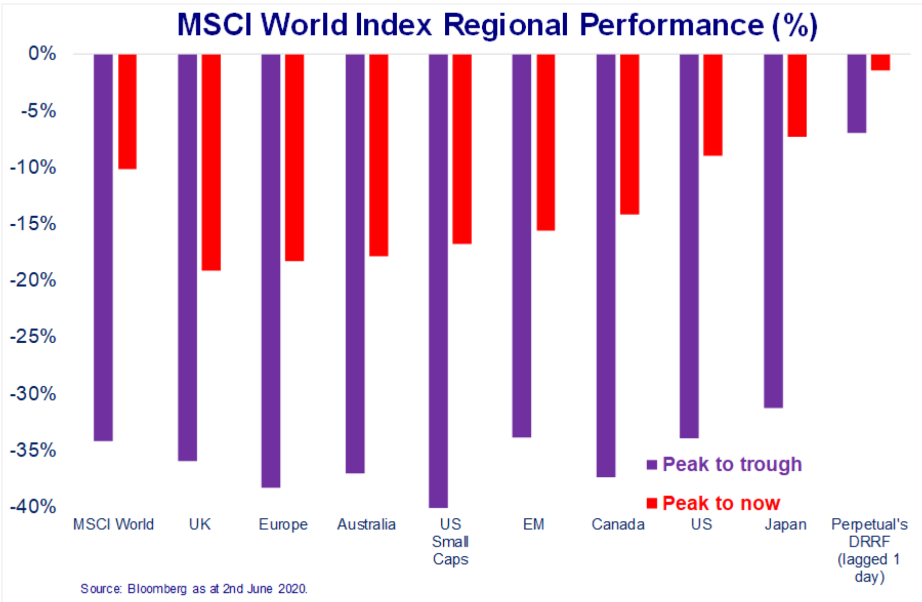
- **EQUITIES**
  - The MSCI World Index closed +1.1% higher with advances in every market and every sector. The traditional cyclical/value sectors led the price gains overnight with energy +(1.9%) the standout (again)

and crude prices rose to 12-week highs on efforts by OPEC+ to continue supply cuts to rebalance the market. Recent price gains have seen the energy sector's recovery rate rise to 42.3% which is now ahead of financials (40.0%) which rose +1.6% overnight. Other century gainers were industrials (+1.5%), materials (+1.2%), REITs (+1.1%) and IT (+1.0%).



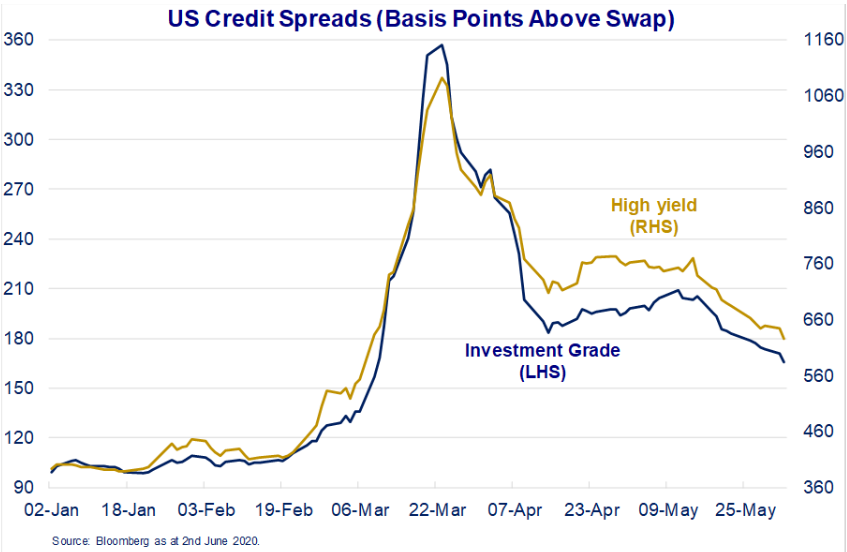
- All regions posted century gains led by Europe (+2.6%) which were buoyed about talk of stimulus plans in Germany (+3.8%) which helped push the Stoxx600 to a 12-week high, which sparked a broader rally in periphery markets such as Portugal (+3.0%), Spain (+2.6%), Greece (+2.4%) and Italy (+2.4%). While larger markets such as France (+2.2%) and the UK (+0.9%) lifted, they lagged. The positive sentiment in the world's largest trading bloc sparked a positive session on Wall Street, where indices closed near their best levels with advances led by the Dow Jones (+267 points, +1.1%) to 25743), then the Russell 2000 (+0.9%), S&P 500 (+0.8%), but the NASDAQ (+0.6%) underperformed as value/cyclical stocks outperformed growth.

  Earlier, the MSCI Asia Pacific index closed 1.0% higher with gains in Japan (+1.2%), Hong Kong (+1.1%), Korea (+1.1%), Australia (+0.3%) and China (+0.3). These moves meant for the first time in a long time all major international markets are out of bear market territory (see chart), despite the fact that there is not one sign that the global economy is out of recession.

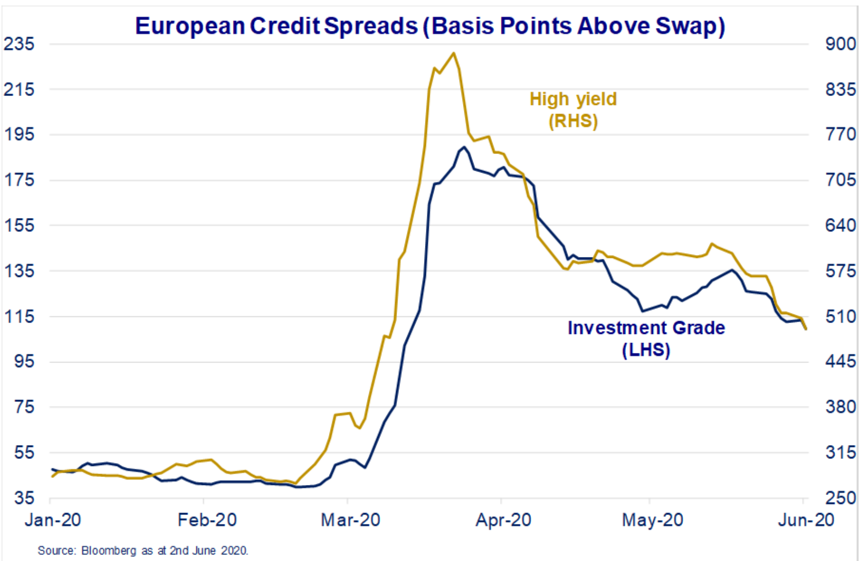


Futures markets suggest a positive session in Asia with all regions expected to open higher - China (+0.5%), Australia (+0.6%), Hong Kong (+0.7%) and Japan (+1.0%).

- **CREDIT MARKETS**
  - Regional credit indices rallied strongly overnight with investor unperturbed by news that US corporate bond sales in the first five months of 2020 have smashed all annual sales records with issuance soaring over USD1 trillion. Putting that to one side, spreads in the US investment grade universe contracted -5 basis points to +165.8 bpts (12-week low) with the recovery rate up three notches to 75%. All sub-sectors rallied, but the cyclical sectors outperformed led by energy (-9 points, +224 bpts, 83%) as crude prices responded positively to OPEC+ inching towards a supply cut extension, whereas subordinated financials (-7 points, +211 bpts, 72%) and senior financials (-6 points to +153 bpts, 71%) were bid given their lagging recovery. In the high yield space, spreads came in an impressive -19 points to +625 bpts (12-week low, see chart), which took the recovery rate up to 69%. Like their IG peers, all sub-sectors improved led by tech (-30 points, +526 bpts, 64%), subordinated financials (-24 points, +687 bpts, 49%) and energy (-23 points, +993 bpts, 86%).



  - European credit markets were also upbeat with spreads in the investment grade space coming in -4 points to +100 bpts (11-week low), which lifted the recovery rate two notches to 53%. There were advances in all 11 sub-sectors led by energy (-6 points, +100 bpts, 48%), consumer discretionary (-6 points, +151 bpts, 56%) and subordinated financials (-5 points, +198 bpts, 63%). In the high yield space, there were similar performance contours with spreads in -15 points to +492 bpts (11-week low), with the recovery rate up three notches to 64%. Among the sub-sectors, there were some large gains but they were more patchy than in the US HY market, with the spread decline led by energy (-33 bpts, +562 bpts, 71%), subordinated financials (-25 bpts, +583 bpts, 53%) and consumer discretionary (-20 points, +614 bpts, 65%) as investors embraced lagging cyclicals underpinned by thoughts of economic re-openings and increase German fiscal support.



THE GLOBAL ECONOMY

- All the known partials are in and **Australian GDP** should be around -0.2% q/q for the March quarter when the local National Accounts are released at 11.30am AEST, which would lower the annual rate to circa +1.5% (which would still be one of the highest growth rates in the G20). Services consumption is the big unknown, but over the past few days other data has generally come in better than expected with yesterday's current account surplus rising from +0.5% (December quarter 2019) to +1.1% of GDP (AUD8.4 billion) with imports dropping (-4.8% q/q) by more than exports (-0.6% q/q). This means net exports will add about +0.5% to March quarter GDP growth.

- The public sector should add about +0.2% to growth as public sector consumption (+1.8% q/q) is partially offset by lower public capex (-0.7% q/q). Meanwhile, corporate profits fell -0.6% in March after adjusting for inventories which suggests the corporate sector should be somewhat neutral to slightly negative for growth (-0.1%). In contrast, inventories are the major drag taking -0.5% off growth with large declines in both retail (expected) and manufacturing (larger than expected). Normally a large fall in inventories is offset by a surge in consumption, but given the current environment that relationship is likely to have broken down for the time being.

POLICY

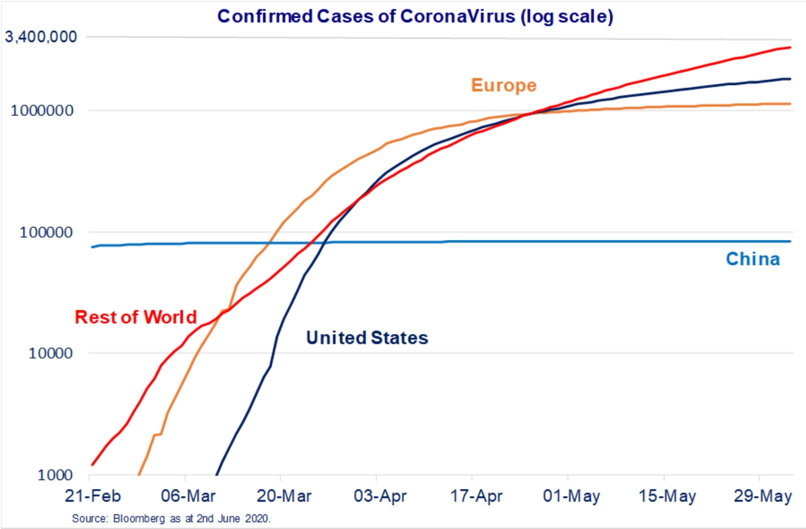
- No major policy announcements. However, **President Trump** appears set to meet with advisors this week in order to discuss proposals for next round of coronavirus stimulus. White House officials have hinted at extending but halving the enhanced unemployment benefits to $250-300 per week in H2 from the current $600 per week (which expires in July) and limiting payouts based on workers' income. They are also considering a tourism tax deduction or credit to encourage vacation spending, making some provisions of the 2017 corporate-tax cuts permanent, and also providing additional aid for states facing budget shortfalls. Factset reports that the Republicans are aiming for bill as high as USD1 trillion which is far below USD3.5 trillion bill recently passed in House earlier this month, which President Trump dismissed as dead on arrival.

- **The RBA** held its regular monthly meeting where it left the target cash rate and the 3-year yield target unchanged at 0.25%. The accompanying statement was consistent with Governor Lowe's remarks to the Federal Parliament last week where he indicated that the economy is tracking between the Bank's baseline and upside scenarios that were published in the May Quarterly Statement. The Board notes that COVID-19 infection rates had declined significantly which had allowed parts of the economy to reopen earlier than anticipated, which means that the downturn won't be as severe as first thought. The forward guidance was unchanged in that the cash rate won't be lifted until progress was made towards full employment and inflation being sustainably within the 2%–3% inflation band.

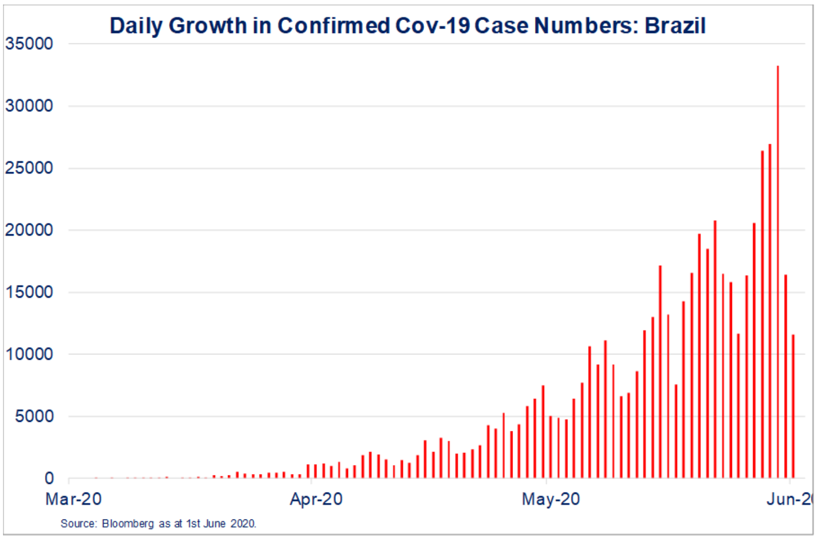
  Interestingly, with financial markets more stable, the Bank only purchased government bonds once since the last board meeting with the total purchases to date being AUD50 billion but as its holdings of total Commonwealth bond issuance is very small, the RBA could easily do more. With ample room for more QE, the likelihood of negative rates in Australia is extremely low, especially as the empirical evidence is that such a tool is highly ineffective.

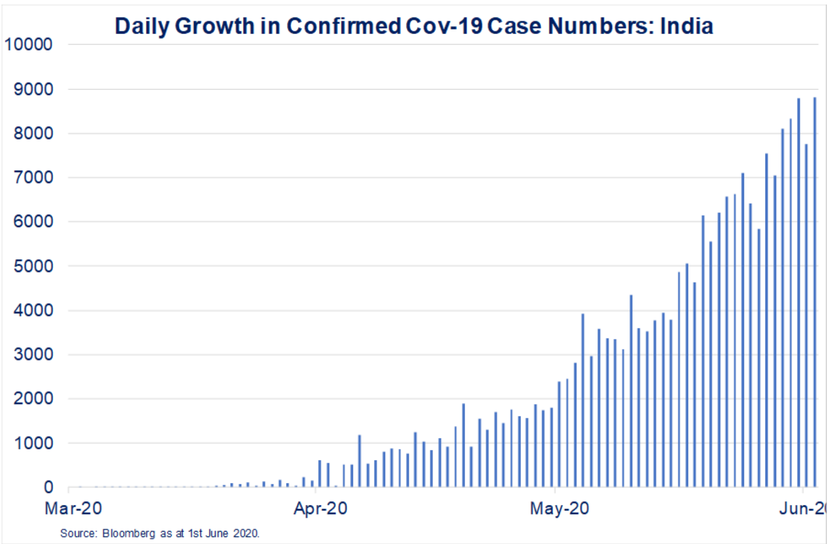
VIRUS UPDATE

- Although final numbers are not in for another 4 hours, the number of global cases of COVID-19 stands at 6.34 million with another +72.3k cases so far overnight (before Brazil, Mexico and some US states report their numbers) which means that Tuesday was the 64th occasion in the past 65 days where daily increases have topped 70k). This means 3 countries have more than 400k cases, 7 countries have more than 200k cases India joined this group overnight), 13 countries have more than 100k cases, and 57 over 10k (. It took 73 days to record 1 million cases, 13 days for the next million, 11 days for the third million, 12 days for the fourth, ten for the fifth million and 11 for the six million, and in the past three days +341k cases have been confirmed. That said, the growth rate of daily confirmed cases is trending lower (+1.5% since Saturday). Meanwhile, deaths stand at 378.4k, with the US now over 100k (28.1% of global deaths even though they have only 4% of the global population), the UK and Italy over 30k, with Spain and France over 25k, and the death rate dropped for a twenty seventh straight day to 5.93%.



- We break the infections into four groups – the US, Europe, China and 'others' and the rest of the world outside the G3 economies now has the most total cases (+42.5k to 3.325 million) and highest daily new cases (and by a considerable margin) followed by the US (+17.4k to 1.83 million) and Europe (+2.1k to 1.13 million), with the latter two's daily increases, in terms of percentages, grinding lower which shows that social isolation works to reduce the spread of the virus, even though it comes at an enormous economic cost. In the rest of the world, the three concerns here are Brazil (not reported, +526.4k, which is the second highest in the world), Russia (+8.9k to 423.2k third highest) and India (+8.8k (record high) to 207.2k, seventh highest).

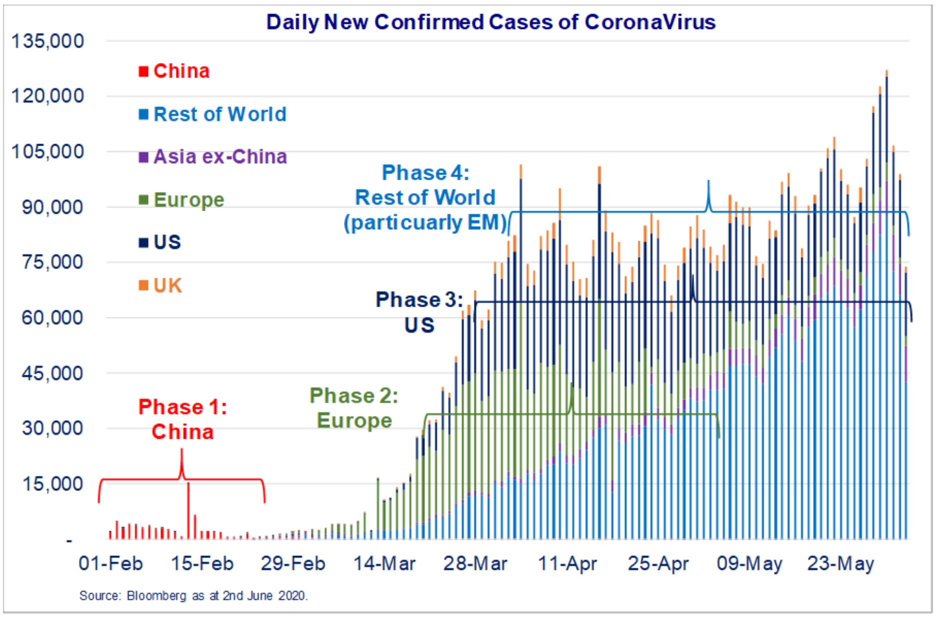




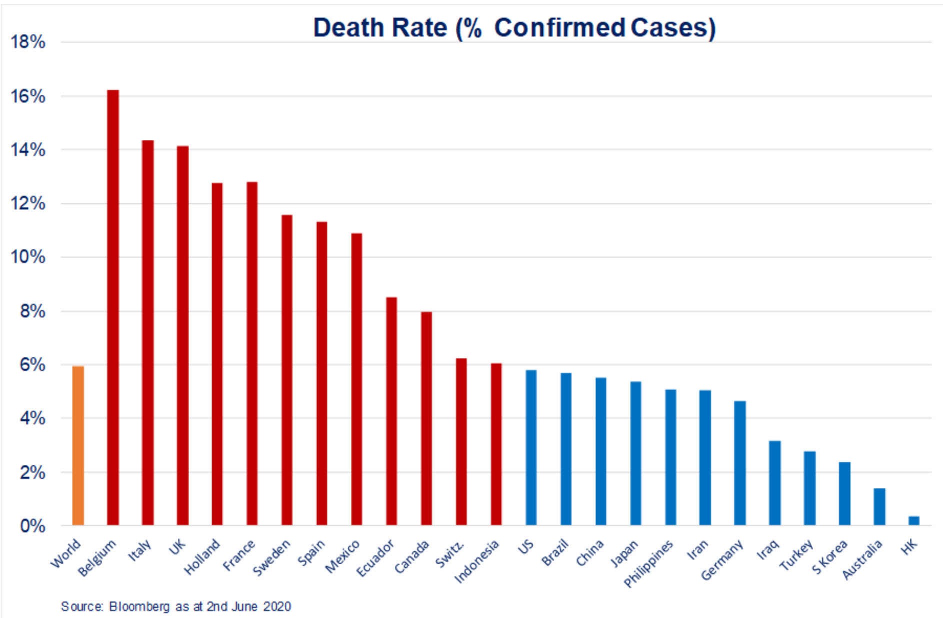
Perpetual

- Among countries, the most cases are in the US (+17.3k (so far) to 1.83 million), Brazil (not reported, 526.5k), Russia (+8.9k to 423.2k), the United Kingdom (+1.7k to 279.4k), Spain (+0.3k to 240.0k), Italy (+0.3k to 233.5k), India (+8.8k to 207.2k), France (+0.3k to 189.0k), Germany (+0.3k to 183.9k), Turkey (+0.8k to 165.6k), Peru (+0.1k to 170.0k) and Iran (+3.1k to 157.6k) and Australia confirmed cases were unchanged at 7,221 yesterday which placed us 65th in terms of total infections.

  Elsewhere, Singapore recorded +554 new cases to 35.8k 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 (+609 (third highest) to 27.5k) and the Philippines (+359 to 19.0k). Note final numbers for yesterday at not in yet so these numbers can rise.



- Although final numbers are not in until 11am AEST, the global death rate declined for a twenty seventh straight day to 5.93% with the global total to 378.4k. The US (+0.9k) has the most deaths at +106.0k, with the UK (+0.3k to 39.5k), Italy (+0.1k to 333.5k), France (+0.1k to 28.9) and Spain (steady for a second day at 27.1k) all over +25k. The death rate is highest in European countries where the health systems have collapsed led by Belgium (steady at 16.2%), Italy (+0.1% to 14.4%), the UK (+0.1% to 14.1%), the Netherlands (steady at 12.8%), France (+0.1% to 12.8%), Sweden (-0.1% to 11.6%) and Spain (steady at 11.3%). However, several emerging markets are now on the leader board including Mexico (-0.3% to 10.9%), Ecuador (-0.1% to 8.5%), Indonesia (-0.1% to 6.0%) and Brazil (-0.1% to 5.7%).



Yours sincerely,

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