Perpetual Investments

THOUGHTS ON THE MARKET

4th May 2020

SUMMARY

- Although April recorded its largest monthly rise in the US sharemarket in the past 33 years (+12.7% m/m) underpinned by Fed front-runners, FANG fanatics and fans of credit challenged small caps, suddenly investors have refocused on the economic and earnings growth hole ahead and have sent prices lower in recent sessions. What seemingly turned sentiment around last week were the notions that risk valuations had become quite rich, near-term policy support was peaking (although more can and will be done) and economic data had confirmed a larger-than-expected activity plunge which will flow to corporate bottom lines, dividends and buybacks. This raises fresh question for the market bulls, who were able to find comfort in what is turning out to be the worst recession in 90 years, as to whether they are willing to keep buying stocks given worsening near-term risk-reward dynamics.
- There has been a lot of talk recently about markets moving higher, the worst being behind us and the Fed and other central banks being ahead of the game, but last week was a stark reminder of how quickly you can lose yourself when volatility and uncertainty is plentiful. While monetary stimulus and fiscal support has been enormous during the current malaise, the message is clear that the world and markets are not going back to how things were in 2019.
- Indeed on Friday night, weak US economic data, a large jump in COVID-19 cases and a potential ramp-up of US-China tensions meant it was risk-off with equities and credit markets both sold down, 10-year treasuries rallied with the 3m-10-yr curve flattening to a slope of just 0.51% (indicating a weak recovery ahead in 2020/21), the US dollar depreciated against both the Euro (-1.0%) and Sterling (-0.2%) but rallied against the Yen (+0.3%) and the AUD (+2.0%), gold finished down -0.9% and oil rallied +5.0% in choppy trading.
- Economic data was thin in volume, but it still indicated the type of environment we are in. On the surface the US ISM manufacturing PMI for April came in well above expectations at 41.5, but it was a 46-year high in the supplier deliveries component which boosted the headline number. As such, no one should be fooled that the details were extremely weak with new orders (-15 to 27.1), employment (-16 to 27.5) and production (-20 to 27.5) all coming in below their GFC troughs (with the latter two gauges at a 72-year low). Indeed, when the diffusion index is reweighed for these three activity sub-indices alone, it is very close to an all-time low and the decline is already enough to see an earnings decline of -35% for the S&P 500, and no one is yet suggesting that we are at the bottom of the growth dislocation.
- After an initial recovery, we expect the global GDP recovery to remain weak in FY21, underpinned by sustained household caution limiting spending (i.e. only a partial recovery in precautionary household savings) and balance sheet deterioration weighing on both business investment through capital and labour, and also government through reduced spending growth and likely higher taxes (not in 2020). Indeed, the early signs of the bounce in China activity suggests market forecasts of a boom-like improvement appear far too optimistic given the decline in the April PMI last week.
- In COVID-19 news, the number of global cases stands at 3.5 million with another +72.7k cases overnight with 8 countries now have more than 100k cases, 25 over 20k cases and 39 over 10k. It took 73 days to record 1 million cases, 13 days for the next million and 11 days for the last million, and in the past 6 days another 500k cases have been confirmed. Meanwhile, deaths rose +3.7k overnight (35-day low) to 247.1k, with the US now over 60k and the UK, Spain, Italy and France all over 20k, and the death rate sits at 7.0% (although final numbers are not yet in).

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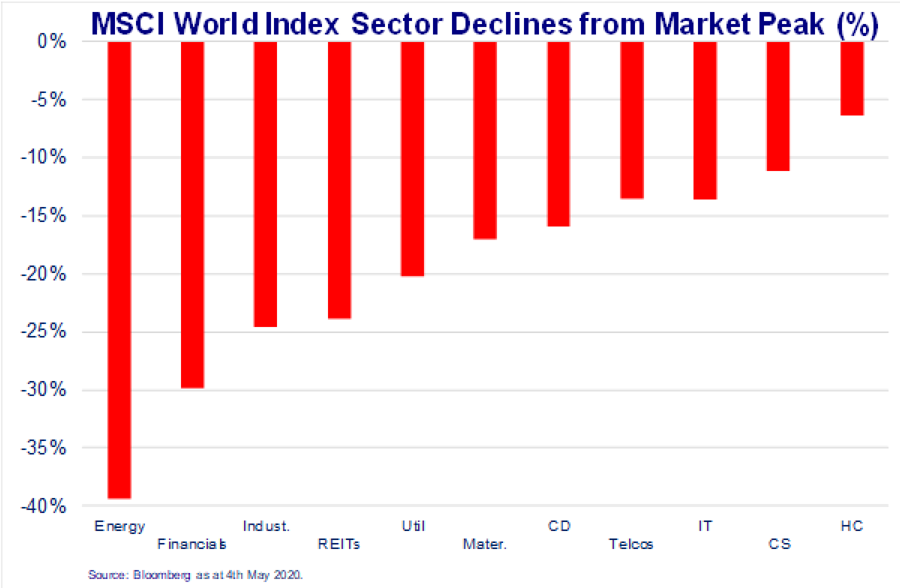
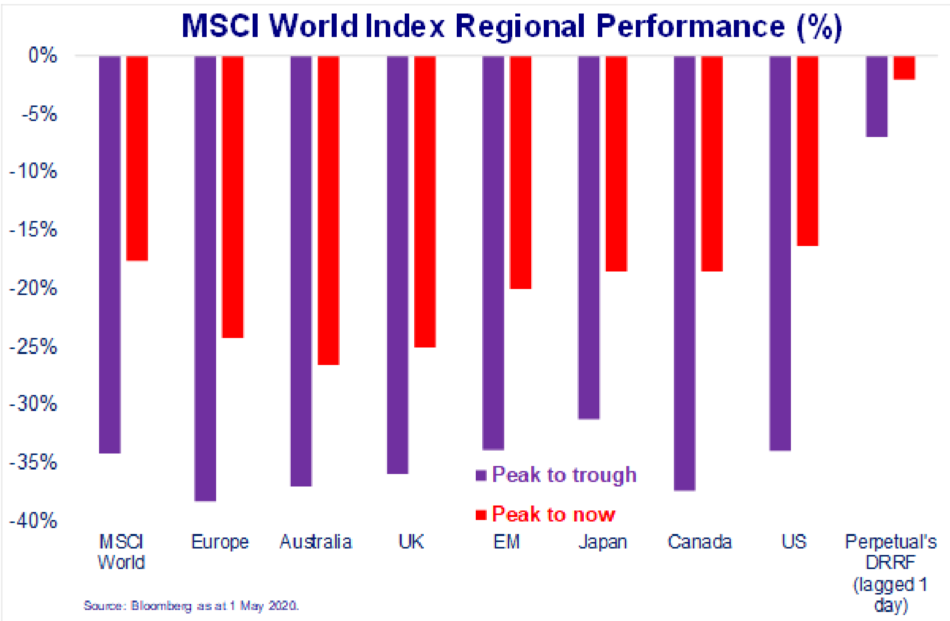
FINANCIAL MARKETS

- **EQUITIES**
  - The MSCI World Index declined -2.3% d/d on Friday night (which pulled the recovery rate down to 48%) with all open regions and sectors closing in the red. On a sector basis, the declines were led by the cyclical parts of the market including energy (-4.7% d/d), consumer discretionary (-3.6% d/d), IT (-2.7% d/d) and financials (-2.6% d/d) and these moves saw five sectors in bear market territory (see chart below) and all of these sectors have recovery rates below 40%.

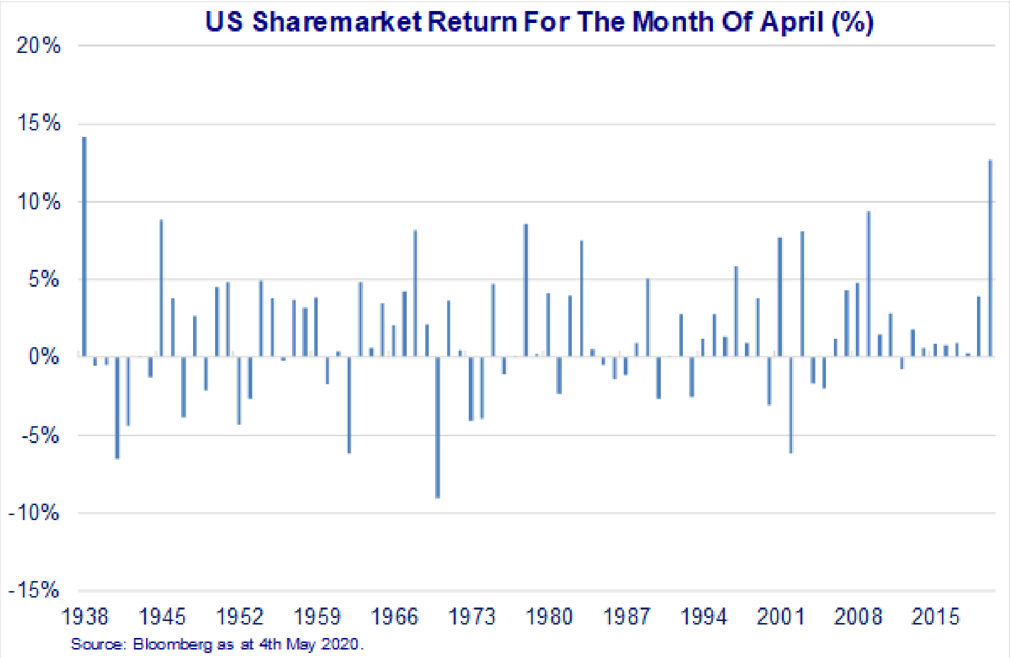


Among the regions, the pace of declines was led by Australia (-4.9% d/d) as statements from US tech giants during the Asia session provided a reality check about the economic impact of the COVID-19 pandemic and saw the local market record its worst daily result in five weeks. However, the Australian index had rallied +4.2% m/m over the prior month, which was the best April result since 2009 even though the price increase was less than in other markets, suggesting that the local corporates are struggling in the economy's first recession in 29 years. This is confirmed by our market's absolute (-26.6%) and relative performance (i.e. underperforming in the decline and the recovery of risk sentiment) since mid-February (see chart).

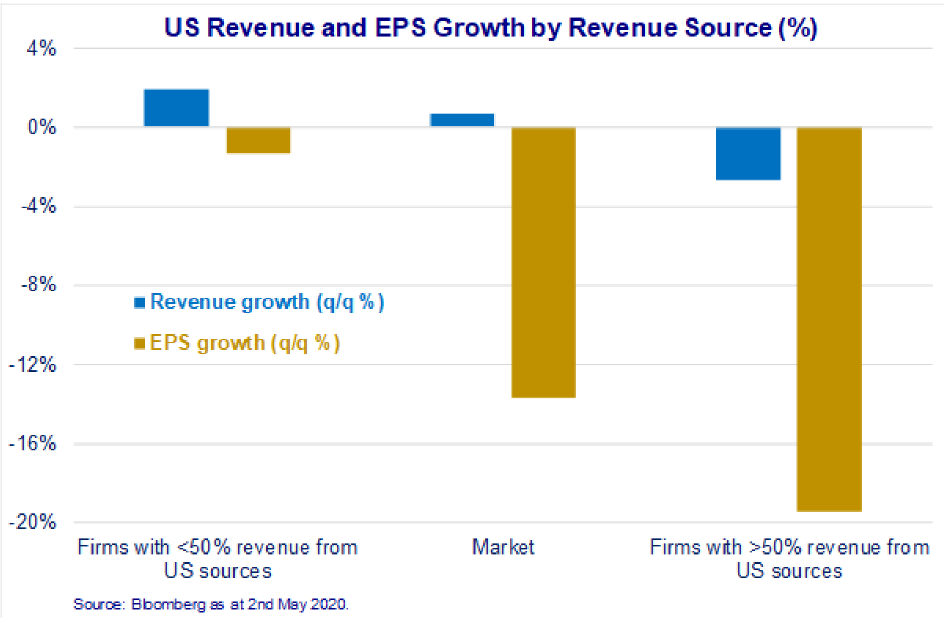


In other markets, the US (-2.8% d/d) recorded its second largest decline in the past three weeks, but during the week the S&P 500 index closed April up +12.7% which is the largest monthly rise in 33 years and the best April result since 1938 (see chart below). Earlier in Asian trading Japan (-2.8% d/d) recorded its worst daily movement in the past month and China and European markets were closed for Labour Day celebrations. The movements on Friday indicate that Australia, Europe, UK and EM remain in bear market territory with Japan and Canada (both -18.5%) potentially one day away from joining that group.

Futures markets suggest on Monday that markets in Australia (-0.1%) and Japan (-0.8%) will both open lower on today at 10am.



- **The US reporting season** continued with 55% of companies having now reported results which have culminated in a quarterly revenue rise of +0.7% q/q and an EPS decline of -13.7% q/q (expectations were -6.9% q/q at the end of March). However, US-based firms have fared much worse with companies where at least their revenue comes from domestic sources have weaker EPS (-19.4% q/q) and revenue growth (-2.7% q/q) relative to their global-based peers (-1.3% q/q and +1.9% q/q, respectively – see chart).



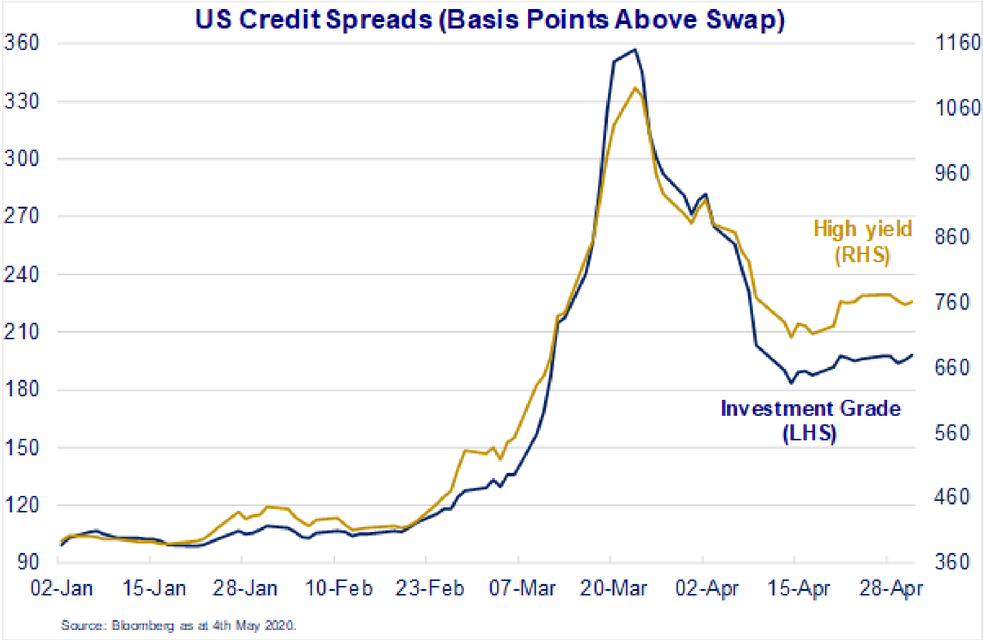
If the market's overall blended corporate bottom line is unchanged by the end of this reporting season, EPS growth will be the lowest since the September quarter 2009 (-15.7% q/q). So far, 65% have beaten street estimates on earnings and 63% on revenue (both of which are below their respective 5-year averages) but those numbers will change with another 148 companies reporting this week.

Although only 9 firms have provided specific June quarter guidance, analysts have been busy downgrading EPS estimates by -28% for June which is extremely large as over the past 20 quarters the average first month downgrade for the next quarter has been -1.9% q/q. The forecast for calendar year 2020 is now a revenue decline of -2.9% y/y and an EPS moderation of -17.8% y/y and while these are moving closure to reasonable expectations, to me they remain far too high and the rate of downgrades needs to more than double.

	Utilities	Info. Technology	Health Care	Consumer Staples	Real Estate	Comm. Services	Materials	S&P 500	Financials	Consumer Disc.	Industrials	Energy
Today	2.4%	2.2%	-0.5%	-0.5%	-2.0%	-7.2%	-15.8%	-17.8%	-35.0%	-37.4%	-38.6%	-111.0%
31-Mar	3.3%	6.0%	4.8%	2.8%	3.5%	4.0%	-6.4%	-3.6%	-7.0%	-11.8%	-13.7%	-71.9%

- **CREDIT**
  - The negative sentiment evident in equities engulfed the credit markets, but as usual, the volatility in credit was considerably less. Indeed, US investment grade spreads widened +2.7 points to +198 bpts, which lowered the sector's recovery rate to 62.6% with wider risk premiums recorded in all sectors led by telcos (+ 4 points to +216 bpts, 65%) and subordinated financials (+4 points to +244 bpts, 62%) but moves outside these were minor. Despite the spread increase on Friday, US investment grade risk premiums came in -76 bpts in April, which was the largest rally since April 2009.

    In the high yield space, the index widened +5 points to +762 bpts (see chart) which dragged the sector's recovery rate down to 48%. A weak ISM manufacturing activity saw cyclical parts of the markets hardest hit with industrials (+12 points to +837 bps, 28%), senior financials (+9 points, +806 bpts, 31%) and tech (+8 points, +639 bpts, 43%) all wider. In contrast, energy (-12 points, +1354 bpts, 62%) rallied behind another rise in global oil prices (+5.0% to USD19.78 per barrel), although it needs to more than double from here to get above the average break-even level for firms in this sector. Despite the recent sell off, US high yield credit spreads declined -125 bpts in April which was the largest HY spread decline in 11 years.

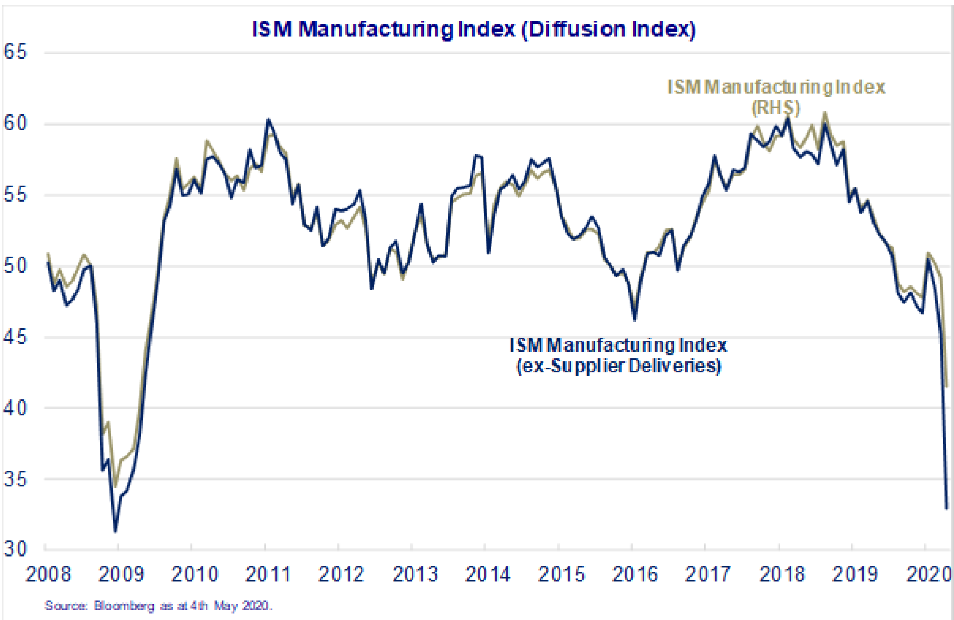


- Elsewhere, European credit markets were closed for labour day holidays.

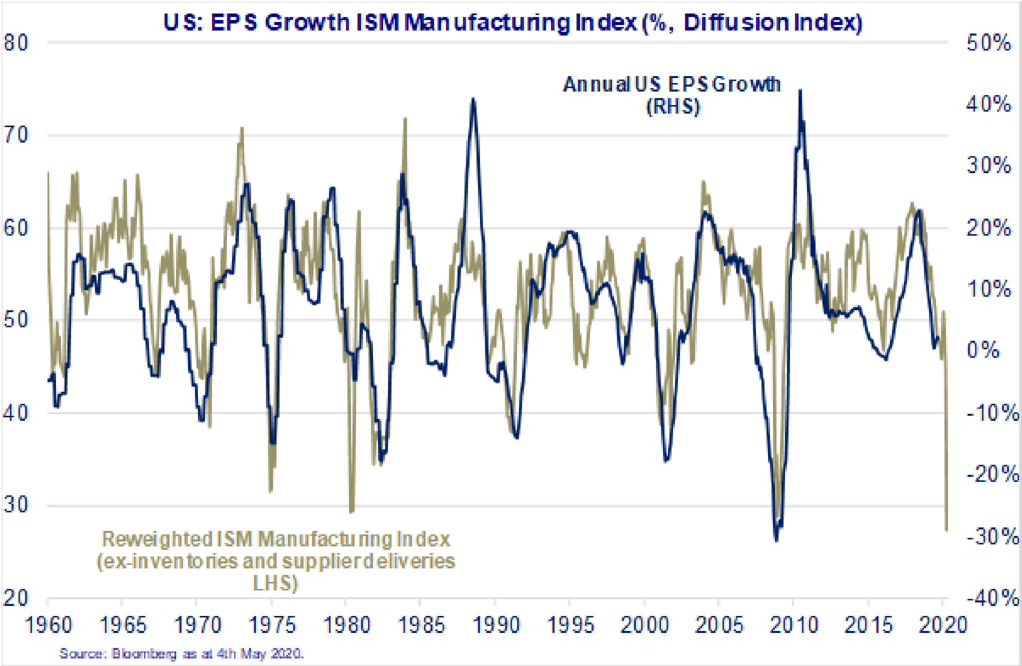
THE GLOBAL ECONOMY

- **The US manufacturing ISM index** fell -7.6 pts to 41.5 in April which was much higher than street estimates (36.0), but the three components which are most indicative of activity were much weaker than the headline number - new orders fell -15 points to 27.1, employment fell -16 points to 27.5 and production dropped -20 points to 27.5 with all three sub-indices below their respective GFC troughs and the latter two sub-indices at all-time lows. What lifted the headline gauge was much slower supplier deliveries (+11 to 76.0 which is a 46-year high) and a slightly smaller contraction in inventories (+2.8 to 49.7), both of which are normally positive signs for the production side of the economy, but in a supply shock like Cov-19 and the associated economic closures, that is not the case.

  The sub-index of supplier deliveries has risen from 53 in January to 76.0 in April, underpinned by mobility restrictions, but it has a tendency to record historic extremes during supply shocks such as during the first (96.8 in 1973) and second oil shocks (75.6 in 1979). The rise in this sub-index in April added 2.2 points to the ISM index this month, rather than subtracting -3 or -4 points as the orders and production indexes did, and removing the former and reweighting each component to 25% (from 20%) sees the index just shy of its 2009 lows (see chart below).



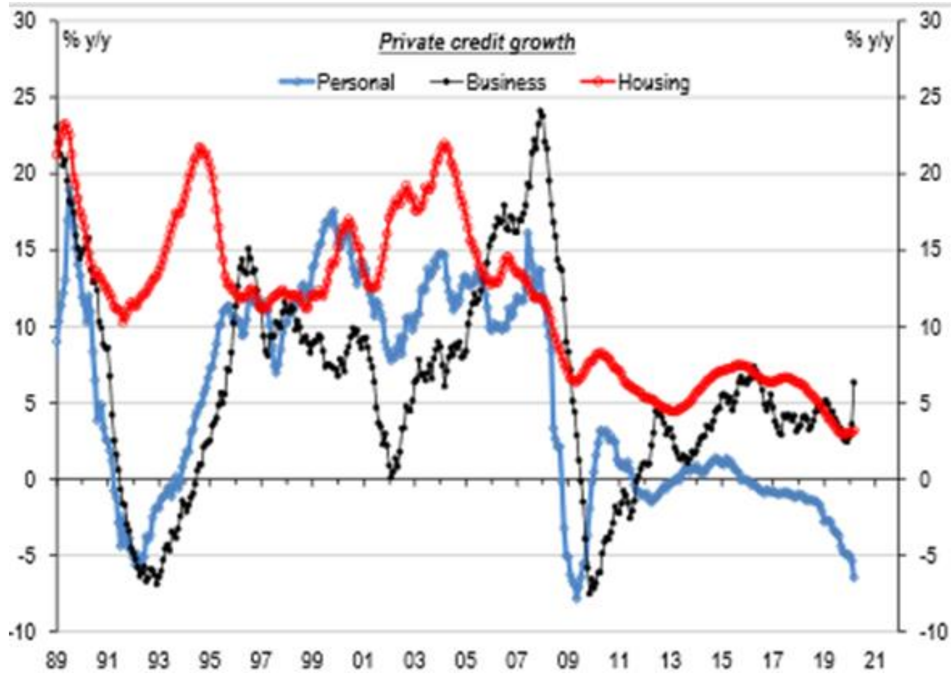
While a narrower more cyclical ISM index is yet another sign of cratering US growth, a key question for investors is what is the **likely impact on corporate earnings and dividends**. To ascertain that, we have removed both the inventories and supplier deliveries components of the headline manufacturing PMI in the chart below and re-weighted the remaining three components. This approach suggests that the March and April declines are enough to have US EPS growth decline -35% peak to trough, but no one is suggesting that we at the end of the growth dislocation (and it has to be remembered that a model of US EPS growth will have more variables than just the ISM gauge). Next week, we will be able to provide a more detailed outlook for US EPS growth when the second last of our model inputs are released for April.



Clearly, the US economy is not the only major contraction in the first half of 2020. There are wide variations on the timing and size of the economic contraction, but the earlier economic closure occurred in the March quarter the deeper the Q1 decline has been – China had economic closure in the first two months of the year and March quarter GDP was -35% q/qa, Europe went into lockdown in March and the economy contracted -14.4% q/qa and the US was last to close things down and it recorded a -5% activity slide. Chine will clearly expand in the June quarter, but Europe, the US, Australia, UK and all other major economies are still in lockdown, which means global economic output is likely to decline about -18% - -20% h/ha in the first six months of this year which is more than double the pace of contraction during the depth of the global financial crisis.

- **Australian private sector** credit for April recorded its strongest monthly increase since 2007 with a +1.1% m/m increase pulling the annual rate up to a 1-year high of +3.6% y/y. However, the rise was underpinned by a rise in business credit (+2.9% m/m, +6.3% y/y) who took the opportunity to draw down on existing intermediated credit lines, amid the uncertainty from COVID-19 - however, this is a 'cashflow' issue and will not be used to fund investment. In contrast, the contraction in personal credit accelerated sharply (-1.4% m/m, -6.5% y/y) which is a 12-year low and a very negative sign for consumption, but this is aligned to our view of a rise in the household savings rate to circa 10%.

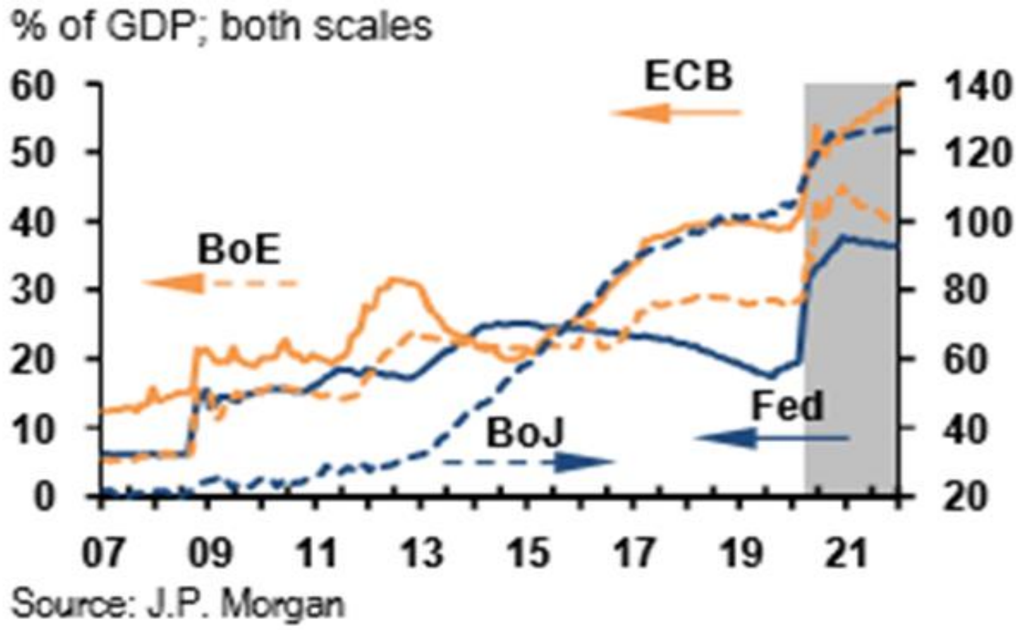
  Meanwhile, housing credit held close to a record low (+0.3% m/m, +3.1% y/y) as 'investor' activity continued to weaken (-0.1% m/m, -0.4% y/y), while owner-occupiers ticked up (+0.5% m/m, +5.2% y/y). Looking ahead, business credit will be supported in coming months by both continued drawdowns on credit lines and potentially deferral of debt repayments for the next 6 months. But unlike previous stress periods, we do not expect any sustained improvement - credit growth likely to trend towards zero in 2020 and contract in 2021 as record low rates see loans amortise faster than credit is issued.



- CoreLogic data indicated dwelling prices rose +0.3% m/m in April (an 8-month low) which pushed the annual rate up to +8.3% y/y on base effects, which is still a 30-month high. The strength is still led by Sydney (+0.6% m/m, +14.3% y/y) and Melbourne (+0.1% m/m, +12.4% y/y), but clearly this won't last.

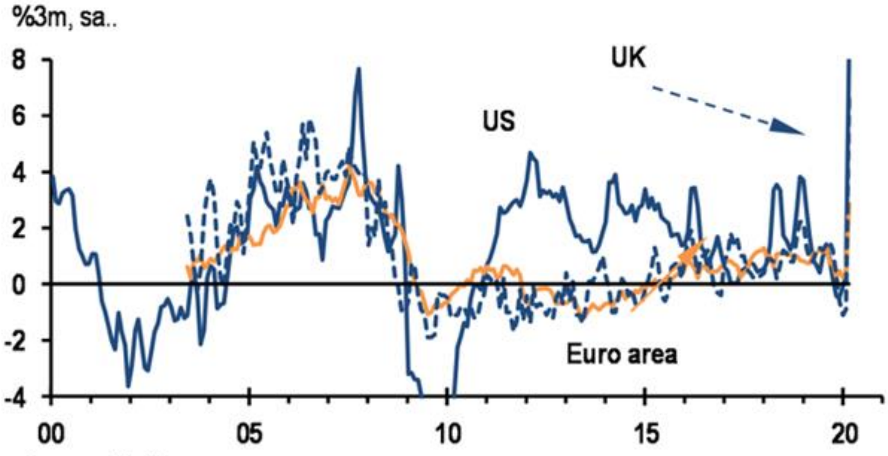
THE POLICY RESPONSE

- Policymakers have attempted to address the activity collapse and prevent or reduce as many second-round effects as possible. A wide range of tax and spending policies are expected to add +3.6%-pts to global GDP growth this year which is a considerably larger impulse than was implemented in 2009 (close to zero). The process here is about income support for households during closures and providing business with access to credit through numerous avenues including providing off-budget loan guarantees. While central bank rate cuts have been relatively modest, JPMorgan estimate G-4 central bank balance sheets will expand +17% this year (see chart below).



However, the central bank balance sheet aims are different to 2008/09 in it is not about asset purchases boosting the transmission of policy through lower-for-longer rates, but rather provide support to credit market liquidity, and boosting corporate lending either directly, or in partnership with the banking/private sector. While credit growth has lifted in several key major economies (see chart), we expect the economic recovery to remain weak after an initial bounce underpinned by household caution limiting spending (i.e. only a partial decline in precautionary household savings) and balance sheet deterioration weighing on both business investment through capital and labour, and also government through reduced spending growth and likely higher taxes. Indeed, the early signs of the bounce in China suggests market forecasts of a boom-like improvement appear far too optimistic as evidenced by decline in the April Manufacturing PMI (-1.2 to 50.8).

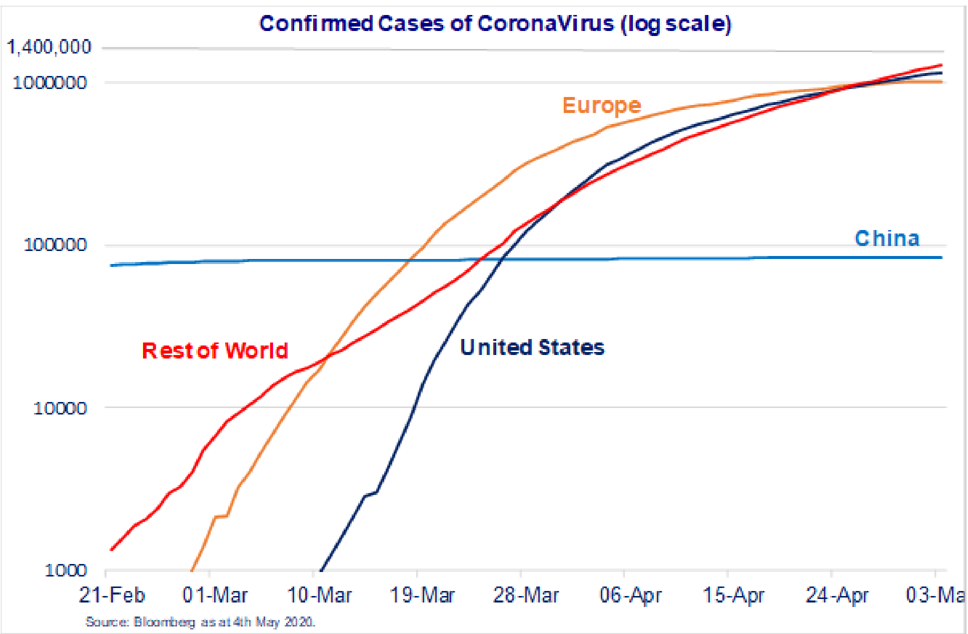
Figure 3: DM business lending



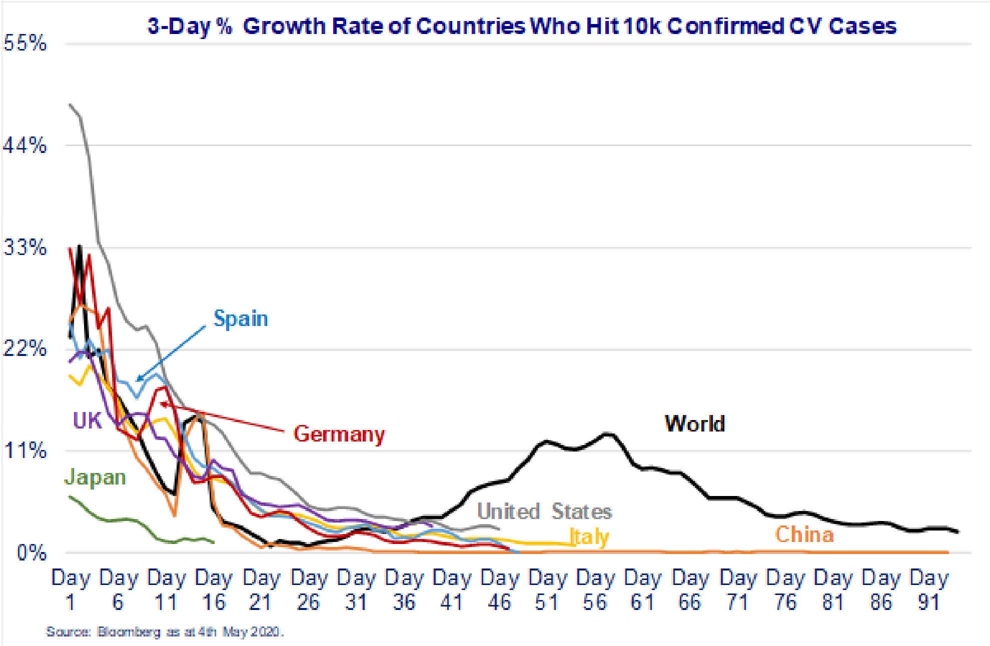
Source: J.P. Morgan

VIRUS UPDATE

- The number of global cases of COVID-19 stands at 3.5 million with another +72.7k cases overnight. That increase means 8 countries now have more than 100k cases, 25 over 20k cases and 39 over 10k. It took 73 days to record 1 million cases, 13 days for the next million and 11 days for the last million, and in the past 6 days another 502k cases have been confirmed. That said, the growth rate of daily confirmed cases continues to decline (+2.3% since Thursday). Meanwhile, deaths rose +3.3k overnight (35-day low) to 247.1k, with the US now over 60k and the UK, Spain, Italy and France all over 20k, and the death rate sits at 7.0% (although final numbers are not yet in).

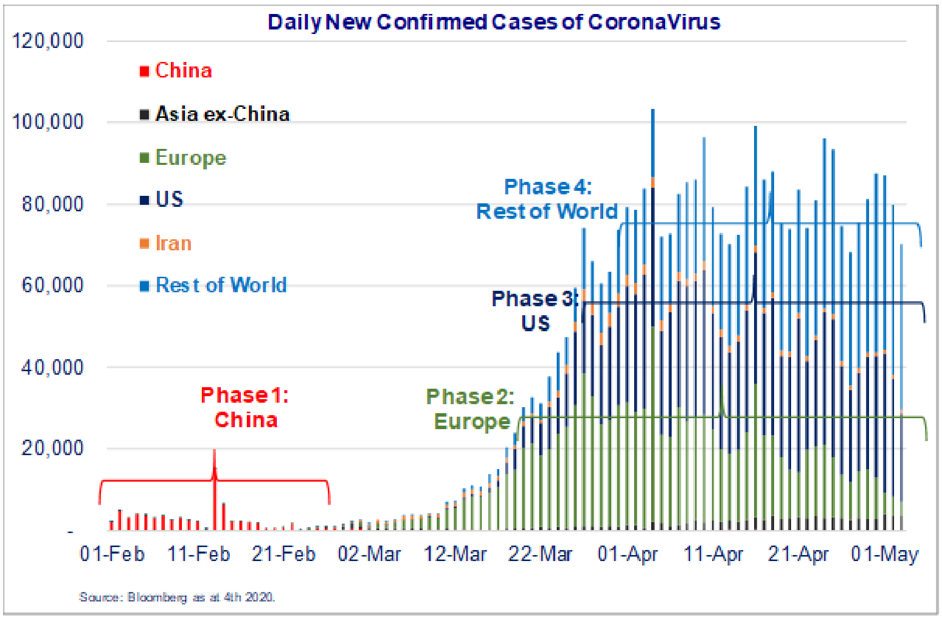


- We break the infections into four groups – the US, Europe, China and 'others' and the rest of the world outside the G3 economies (+40.3k to 1.29 million) now has the most cases followed by the US (+21.6k to 1.54 million) and Europe (+3.0k to 1.02 million although there are some data quirks here such as Spain and France not reporting any case increases in the past 4 days, which means the growth and regional total are most likely inaccurate) 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 (+21.6k to 1.54 million), Spain (239.6k), Italy (+1.4k to 210.7k), France (199.1k), the United Kingdom (+4.3k to 187.8k), Germany (+598 to 165.6k), Turkey (+1.7k to 126.0k), Russia (+10.6k (record daily increase to 134.7k), Brazil (+4.0k to 101.1k), Iran (+1.0k to 97.4k) and China (steady at 83.9k). Australia confirmed cases rose to 6,799 yesterday which placed us 49th in terms of total infections.

  Elsewhere, Singapore recorded +657 new cases to 18.2k 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 (+349 to 11.2k) and the Philippines (+295 to 9.2k). Note final numbers for yesterday at not in yet so these numbers can rise.



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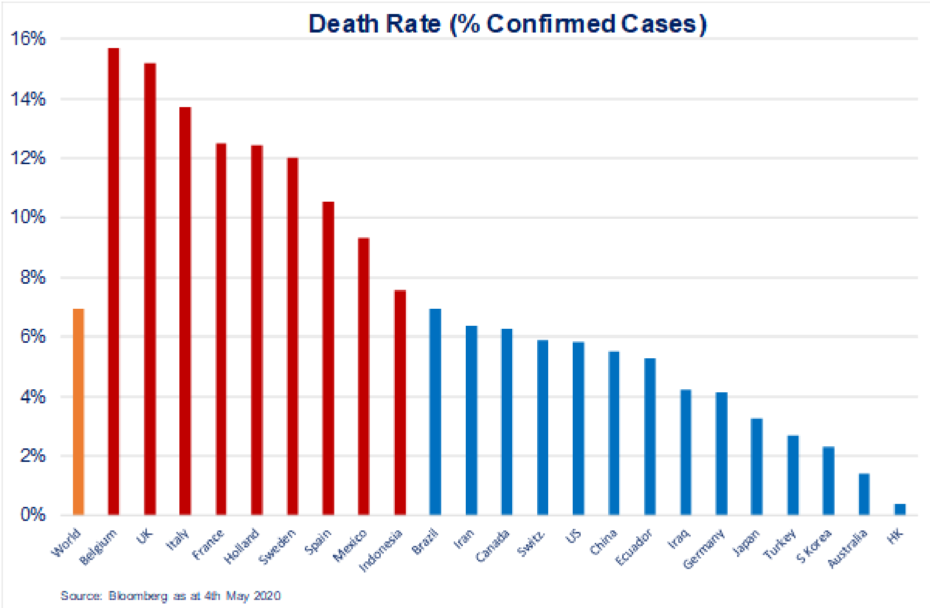
- The global death rate declined to +7.0% (fourth consecutive decline) with another +3.3k fatalities overnight (35-day low) bringing the global total to 247.1k. The US has the most deaths at +67.5k, with Italy (28.9k), the UK (28.5k) and Spain (25.3k) all over +25k. The death rate is highest in European countries where the health systems have collapsed led by Belgium (steady at 15.7%), the UK (-0.2% to 15.2%), Italy (steady at 13.7%), France (+0.1% to 12.5%), Sweden (-0.1% to 12.0%), the Netherlands (steady at 12.4%) and Spain (steady at 10.5%). However, several emerging markets are now on the leader board including Mexico (steady at 9.3%), Indonesia (-0.1% to 7.6%) and Brazil (-0.1% to 6.9%).



Yours sincerely,

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MORE INFORMATION

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