Perpetual Investments

THOUGHTS ON THE MARKET

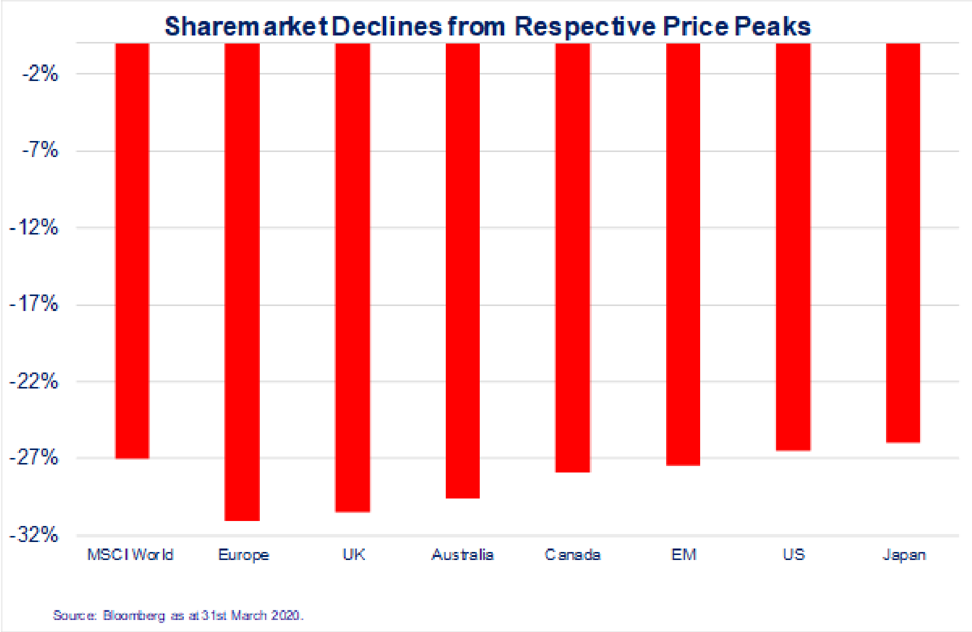
6th April 2020

SUMMARY

- Last week provided the first real data points to ascertain the magnitude of the global economic dislocation from the COVID-19 pandemic and the containment responses which kicked into gear mid-March. Overall, it made for sober reading and confirmed that the global economy contracted in the March quarter (-3.8% q/q or -15% q/q annualised) at a faster pace than was recorded in the 2007/09 GFC, and that worse is ahead for the US, Europe, Australia and Japan in the June quarter.
- Key data points last week were a 6.7 million deterioration in US initial jobless claims, a weak labour market report with -701k of job losses and the US unemployment rising +0.9% to 4.4% (which would have been 5.4% had the participation rate not dropped sharply) and in between those points, the European service sector PMI halved to 26.4 (and Italy fell by two-thirds to 17.4) which are numbers we have never seen before in any country or region. This tells us that there is an unimaginably large growth hole ahead for the global economy with unemployment likely to be 12%-15% in Australia and the US, and 20% in Europe. This has two effects - firstly, it potentially sets to stage for economic and financial aftershocks, and secondly will make it harder for the global economy to record positive growth in the September quarter.
- The current global recession is something not seen before as nearly all global downturns are driven by falling demand, as a shock contracts manufacturing activity which slowly spills over into the labour market and other parts of the economy. In contrast, the 2020 recession has been driven by closure of the supply side of the economy sparking a large service sector contraction which has spilt into the labour market in a matter of a few weeks. This is likely to underpin a halving of global corporate earnings and dividends in 2020.
- Oil prices have risen +32% in the past week after President Trump tweeted that oil producers will cut 10 to 15 million barrels per day of production and Saudi Arabia called for an emergency meeting of OPEC+ members today to discuss the issue. Given global oil demand has declined by circa -25%, the production cuts needed to balance the market will be unprecedented, but even modest cuts would help alleviate the near-term storage problem. That said, a -7% cut from OPEC and non-OPEC producers would probably see market prices decline from current levels, and an -11% cut would likely see a modest gain, but nearly all producers would still be below levels that enables them to fund their Budgets, so we are yet to be convinced that enough supply can be taken out to lift prices above USD40 per barrel, and keep all parties happy.

FINANCIAL MARKETS

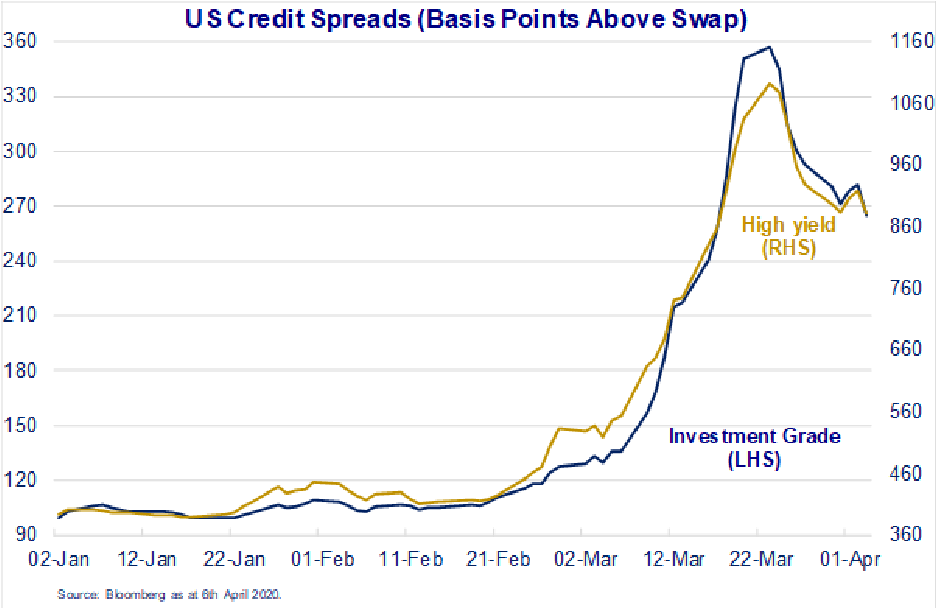
- **EQUITIES**
    - Global equity markets closed -2% lower last week. There remains very little disparity between regional gauges since their respective February 2020 peaks, which suggests that regional diversification has had less success than it did for example in the 1990 recession and the tech bust when price corrections had a considerably wider range. Australia (+4.8% w/w – see chart below) led the pace of gains and Canada (+2.0% w/w) also advanced. In contrast, most bourses declined with EM (-1.3% w/w) doing okay followed by the US and UK (both -2.1% w/w), Europe (-2.4% w/w) and Japan (-8.1% w/w).



- There is also only modest incongruence on a sector basis outside energy and financials – which remain at the epicentre of the economic impact of the energy rout and economic closures. Outside of these stocks, most company groups are quite close to the MSCI World Index's -27% decline. Over the past week only three sectors advanced led by energy (+8.1% w/w) and healthcare and consumer staples (both +2.6% w/w), whereas declines were largest in IT (-5.8%) and financials (-6.1% w/w).

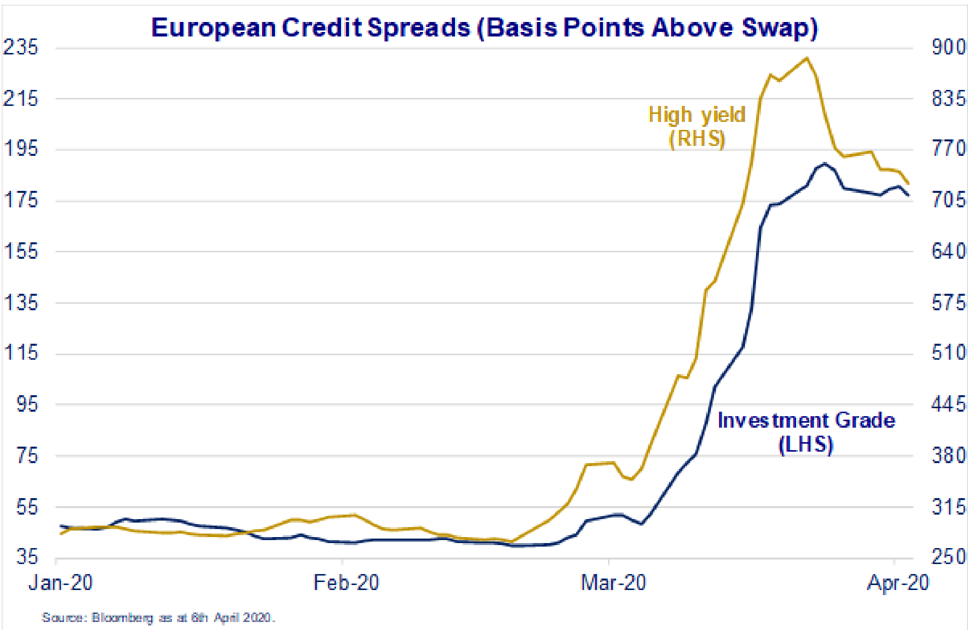
- **CREDIT**
  - Despite the sell-off in equities, credit spreads continue to grind in. In the US investment grade space, spreads came in -28 basis points last week led by declines in energy (-103 to 445 bpts a near-two week low), consumer discretionary (-90 to 321 bpts) and subordinated financials which contracted -22 to 315 bpts, but changes in other sub-sectors were modest.

In the high yield space, spreads contracted -47 to 881 bpts with energy (-254 to 1864 bpts) the big improver as the crude price rose +32% last week on expectation that supply cuts involving Saudi Arabia and Russia were likely, even though both sides are hosing down that expectations. In other sub-sectors healthcare (-71 to 697 bpts) and telcos (-70 to 696 bpts) were large improvers, and other than that, it was inches and feet, not miles, in terms of falling spreads.



- It was a mixed story in Europe, with IG spreads fairly steady over the past week as previous ECB purchases limited the blow out in the first place to 220 bpts, which is less than the US. However, the spreads contraction there is hitting more resistance as the region seems the most exposed to risks from COVID-19, financial sector deleveraging and government balance sheet blow-outs, with Italy likely needing financial assistance from the ECB and/or IMF.

  There wasn't much in terms of sector news with financials the only group to record spread declines over the past week led by bank subordinated debt (-17 to 302 bpts), whereas energy and materials both recorded increased spreads despite improved commodity prices. In the high yield space, there was more action with the sector spreads coming in -34 to 727 bpts led by energy (-86 to 1001 bpts) and senior financials (-69 to 694 bpts).

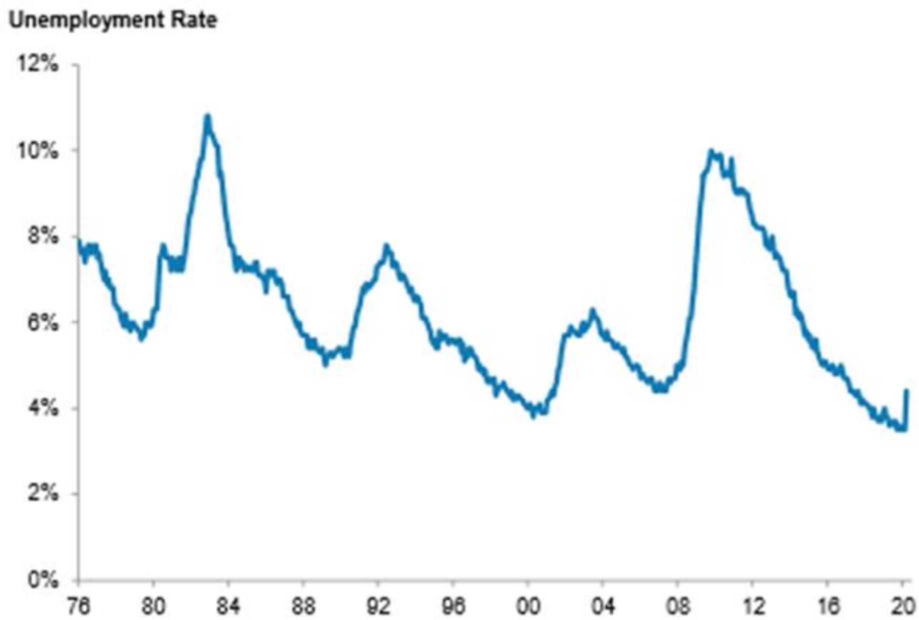


THE GLOBAL ECONOMY

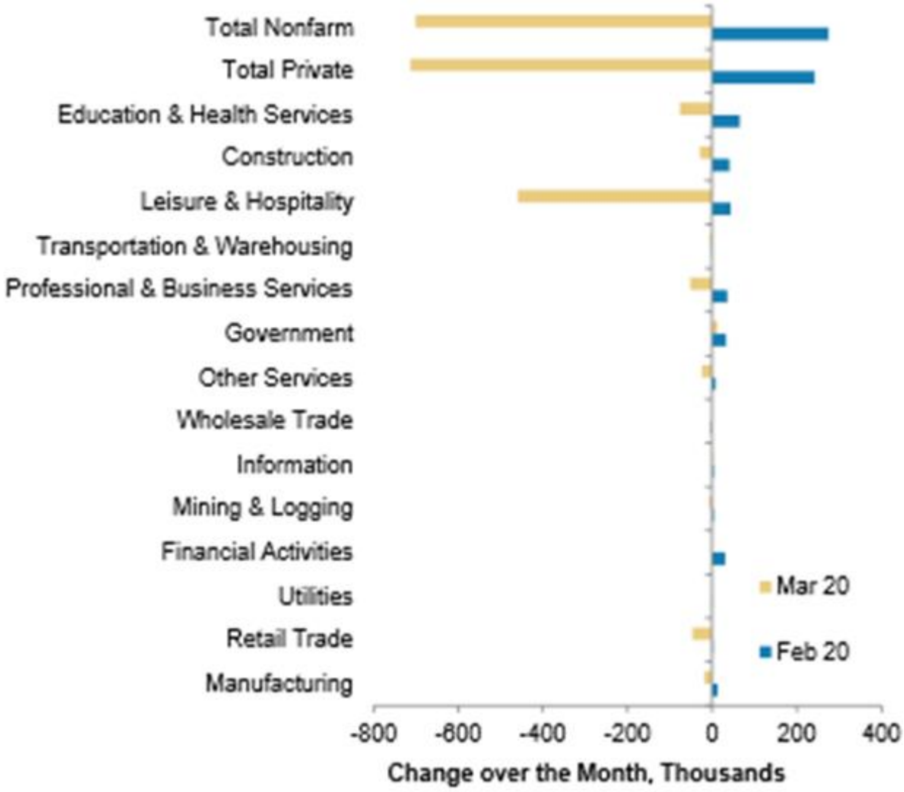
US LABOUR FORCE DATA

- An additional 6.65 million US workers filed for jobless claims in the week ending 28th March (see chart – which is ten times the record rise in the GFC), which combined with the previous week's +3.3 million surge has meant that in the past two weeks about 10 million US workers have registered as unemployed. This is around 6.5% of the 165 million US labour force, and if the participation rate was unchanged, it is already enough to see a 10% unemployment rate by end-April.

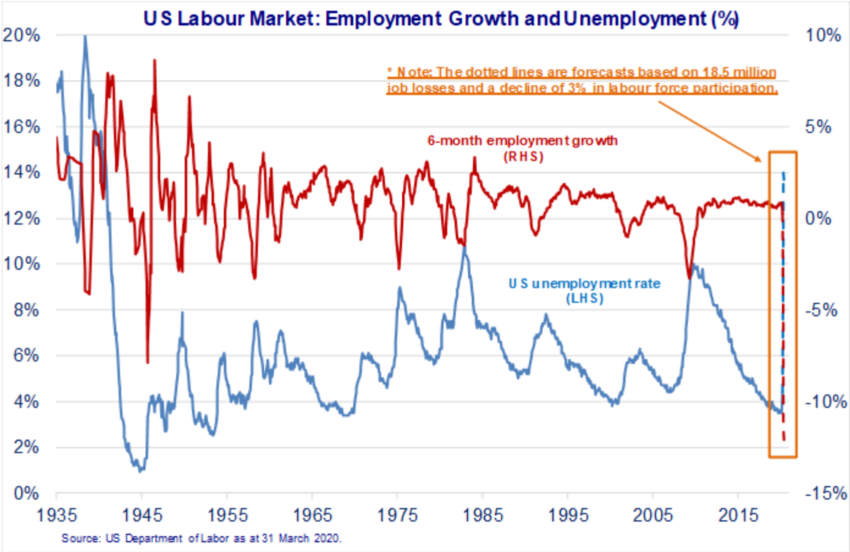
- The March US non-farm payrolls survey was taken for the week starting March 12th and has not captured the above-mentioned surge in jobless claims. It did, however, capture the early stages of the impact of service sector shutdowns with non-farm payrolls declining -701k in March (with a net downgrades to February and January totalling -116k) which ended the US's longest streak of positive payroll reports at 113 months. The US unemployment rate rose to 4.4% (see chart). Other details include:



- There was a major decline in the participation rate (-0.7% to 62.7%) as 3 million workers left the labour force and had they remained unemployment would been about 5.4%.
- Job losses were seen across a wide range of industries (see chart below) led by a sharp -459k decline in leisure & hospitality employment as restaurants laid off staff in bulk (-417.4k) in what was the largest sub-sector displacement since the Great Depression, with another -80k losing jobs at healthcare offices (where elective procedures have been cancelled) and childcare facilities (many of which will have closed).

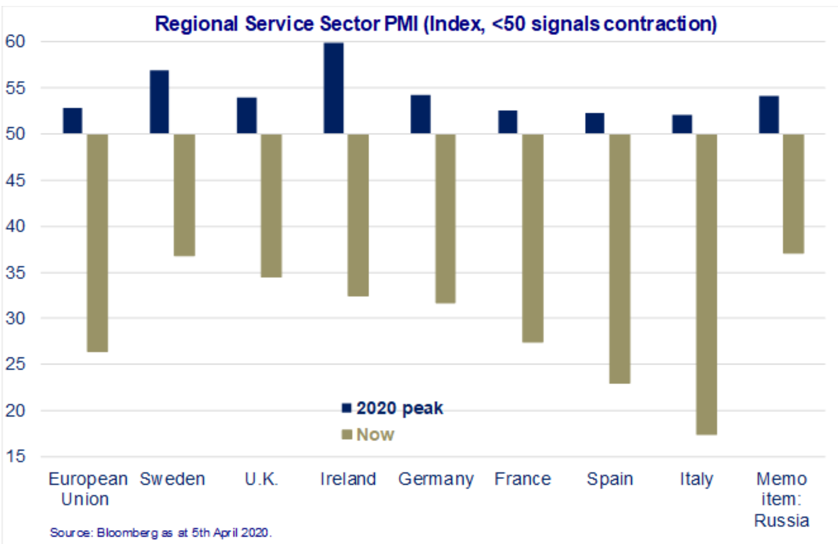


- Wages growth was upbeat (+0.4% m/m) which pushed the annual rate up to +3.1% y/y, but the number is meaningless as job losses were dominated by low-wage workers and when this occurs the labour market's compositional shift up pushes up the average wage rate and therefore biases the data higher. If these biases are removed, the AHE gains was around +0.1% m/m which is around a 5-year low and the 3-monoth rate annualises at around +2.4% q/qa which is an indication that spending power is diminishing.
- **Looking ahead**, the 10 million registrations for jobless claims reverses the last 4.5 years of job growth. Another two week's at 3 million claims will take out the prior 3 years of jobs growth and even if things rachet lower from there (say 4 weeks of only 500k of new claims) it is still enough to have total job losses at 18.5 million and US unemployment at 14% in June quarter before participation changes, so we suspect US unemployment will rise to somewhere between 12% - 15% by end-June. This would represent the highest rate since the aftermath of the 1937 recession which lasted until well into the US's declaration of war in December 1941 (see chart).

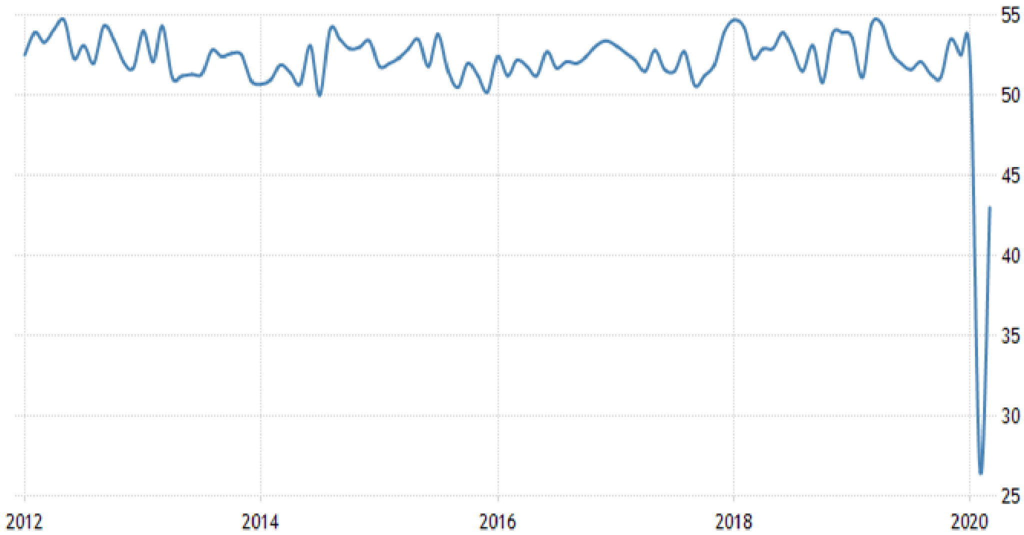


REGIONAL SERVICE SECTOR PMIS

- European, UK and Swedish service sector PMIs all fell around 20 points in March, from levels indicating a majority of companies was seeing business activity improving in February, to levels below those seen at the worst point of the GFC. This confirms that a severe economic contraction is underway in the world's largest economic region. Among countries:
  - Italy (which went into lockdown first) saw its service activity gauge fall by two-thirds (-34.7 points) to a record low at 17.4 (see chart below), and this suggests that the economy (which has the world's third largest bond market) is now contracting faster than other any other occasion in its peacetime history and suggests that activity weakness in March is set to significantly intensify in April and this will continue until the spread of COVID-19 is brought under control and restrictions can be lifted.
  - Spain (-29.3 to 23.0), France (-25.1 to 27.4) and Germany (-20.8 to 31.7) all recorded their largest monthly decline and their lowest reading in their respective surveys since they started in 1998.
  - Even in Sweden, the service sector activity (-20.1 to 36.8) was hit almost as hard as in other European countries despite having far less draconian people movement laws and a currency which can depreciate independent of the Euro. This suggests that the economic consequences of the virus cannot necessarily be avoided even if governments allow the virus to spread more freely;
  - The UK painted the same picture with its index down -18.7 to 34.5.
  - The Eurozone's composite PMI index dropped -21.9 to 29.7 in March, the lowest reading since the survey began 22 years ago.

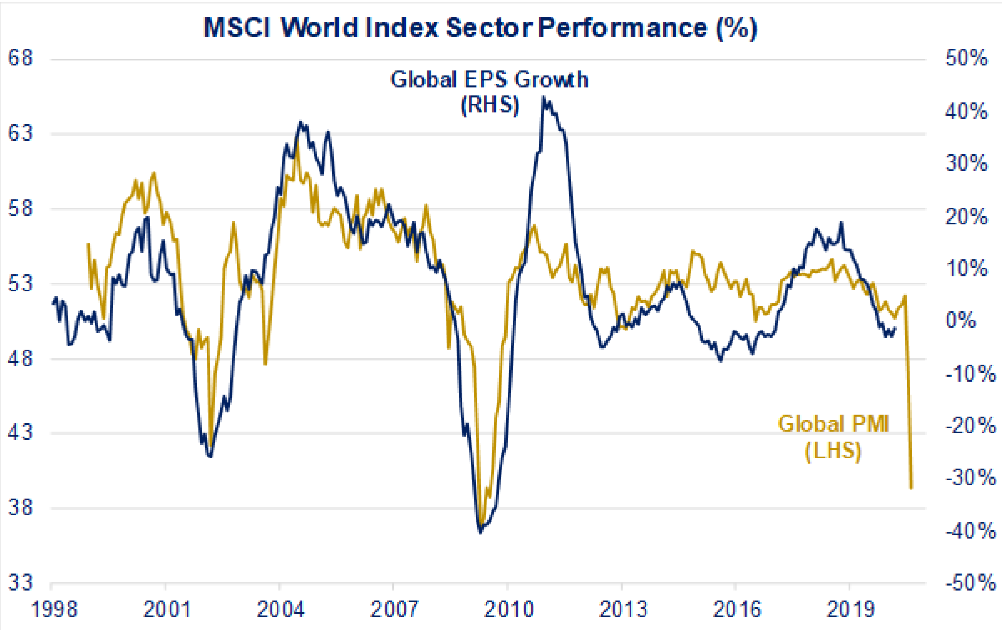


- All eyes will be on China to see whether its economy rebounds in April after lockdown restrictions begin to be relaxed. Even though some Chinese business surveys recorded incremental improvement in March, the service sector in the world's largest economy remains under strain with the non-government Caixin PMI survey of service sector activity lifting to 43 (see chart below), which signals a lower level of contraction, but a further contraction from February no less, with the overall gauge now at its second lowest level in its 8 year life, which is indicative of very low business confidence. Interestingly, Caixin reports that smaller private sector companies reported March activity worse than in February.



WHAT DOES GLOBAL GDP GROWTH IMPLY FOR THE GLOBAL PMI, AND HENCE EARNINGS?

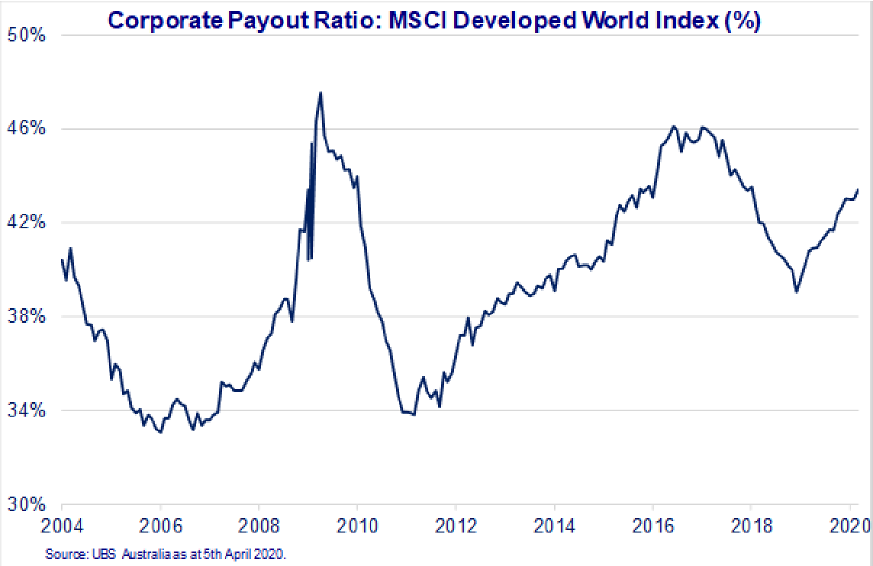
- Sell-side forecasts for 2020 GDP growth centre on a calendar year growth rate of between -2% and -3.5%) and the middle of this range implies a global composite PMI in the low 30s and a total EPS decline of around -50% (see chart). There are ranges around this and Citigroup forecasts that Japan (-60%) will see a larger corporate contraction than Europe (-55%) with the US and EM (both -45%) doing relatively better, but still recording a huge corporate retracement.



Source: Absolute Return Strategy as at 5th April 2020.

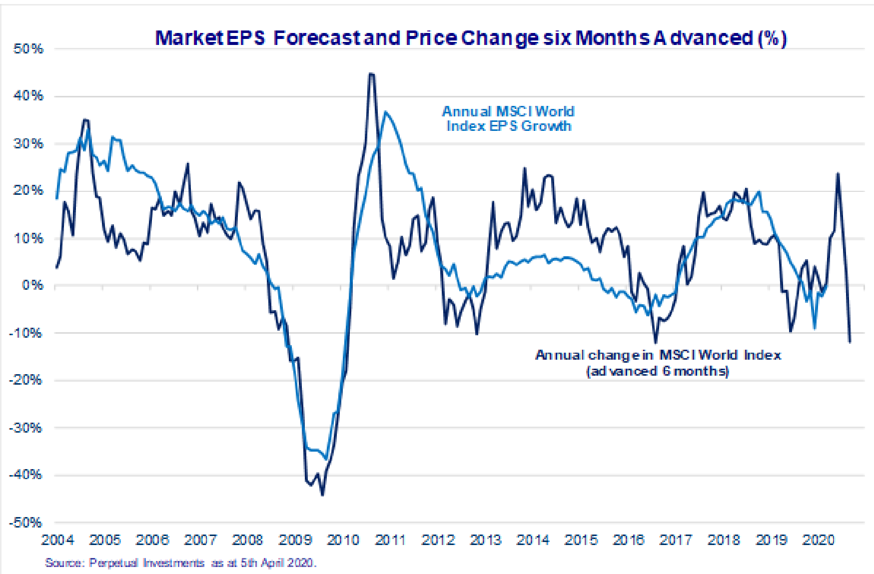
- Analysts are a long way behind the changing landscape with bottom-up consensus currently forecasting flat EPS performance in 2020. While they may be busy in the next month cutting estimates, it is clear that cyclical sectors of the global and regional sharemarkets will be hit hardest – Citigroup reminded us all over the weekend that in the GFC global EPS growth declined -37.5%, but global cyclicals dropped -74% peak to trough, and global defensives fell a more respectable -7%.

  In a crisis period, dividends are usually cut less than earnings as firms lift their payout ratios, but that has already occurred in 2019 and early 2020, with the MSCI Developed World Index's payout ratio already up +4% to 43.4% in March, which is reasonably close to its GFC peak (47.5%), so it is possible that the decline in earnings and dividends may be closer than usual in this crisis period. That is reinforced by regulators urging banks and other financial to ditch dividend payments and share buybacks for 2020 and also a push by businesses to strengthen balance sheets given corporate debt is at an all-time high in terms of both dollars and as a share of GDP.



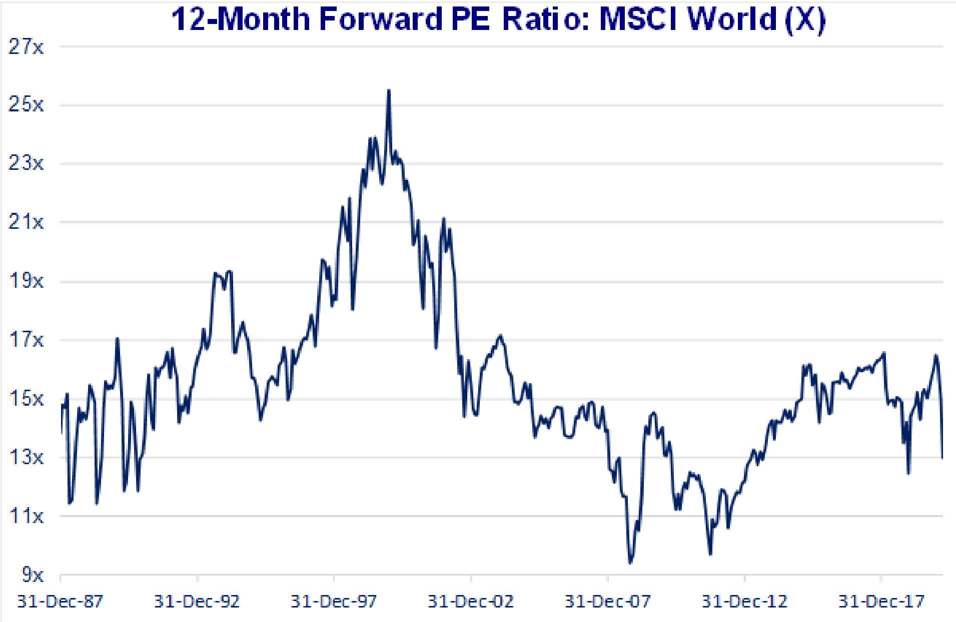
Source: UBS Australia as at 5th April 2020.

- A key question for investors is, what is in the price? While it's unknown, one potential way to estimate this, which worked well in previous downturns, is that share prices are around 6 months ahead of earnings trends (see chart below). So far, the MSCI World is down just under -30% from its peak, so if EPS is set to decline by around -50%, then this implies further declines are likely ahead. However, central bank intervention could limit the downside for asset prices, but we struggle to think that at -30%, the market has seen the bottom.



Source: Perpetual Investments as at 5th April 2020.

- While valuations have declined from near-cyclical highs it is well off previous crisis lows. Indeed, the MSCI World Index saw a lower P/E ratio than current levels in December 2018, October 2011, March 2009 and October 1990 (see chart).

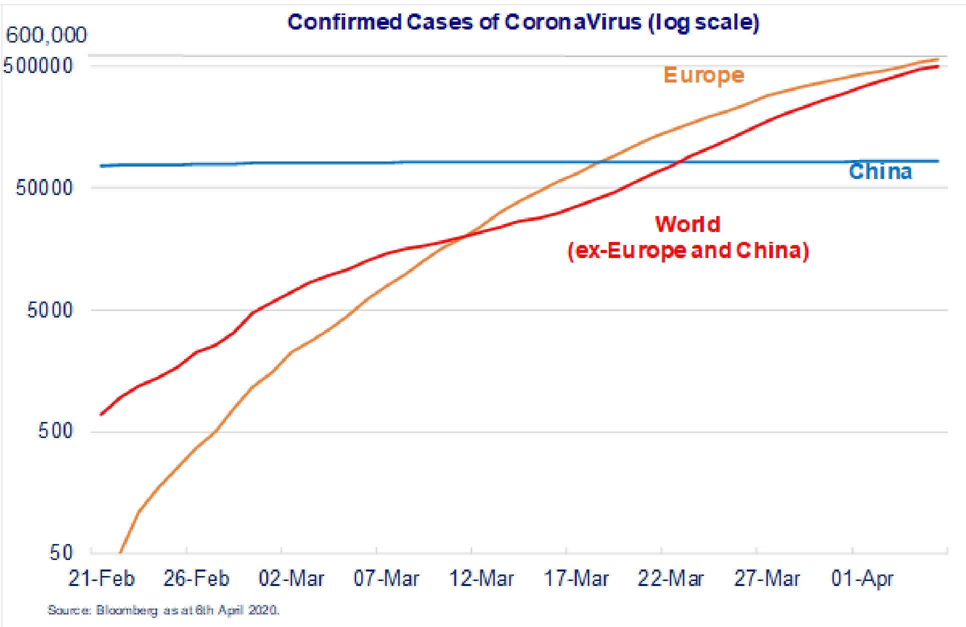


POLICY

- There were no major policy announcements over the weekend, so the discretionary 2020 fiscal impulse at present remains at +2.5% of global GDP, and the monetary impulse is around +1.5% of GDP.

VIRUS UPDATE

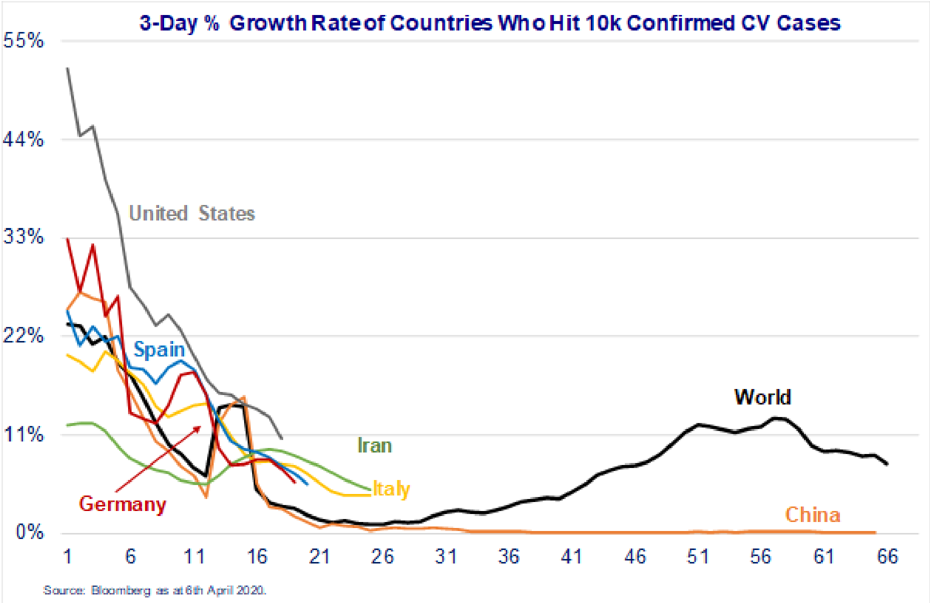
- Even though the percentage of daily confirmed Coronavirus cases continues to decline, the number of daily increases is rising at a rapid rate with another record +67k of cases counted overnight which took the global total to 1.27 million. Meanwhile, deaths rose a record +5,626 to 69.3k and the death rate rose to 5.5% (26th rise in the past 29 days despite surging case numbers).



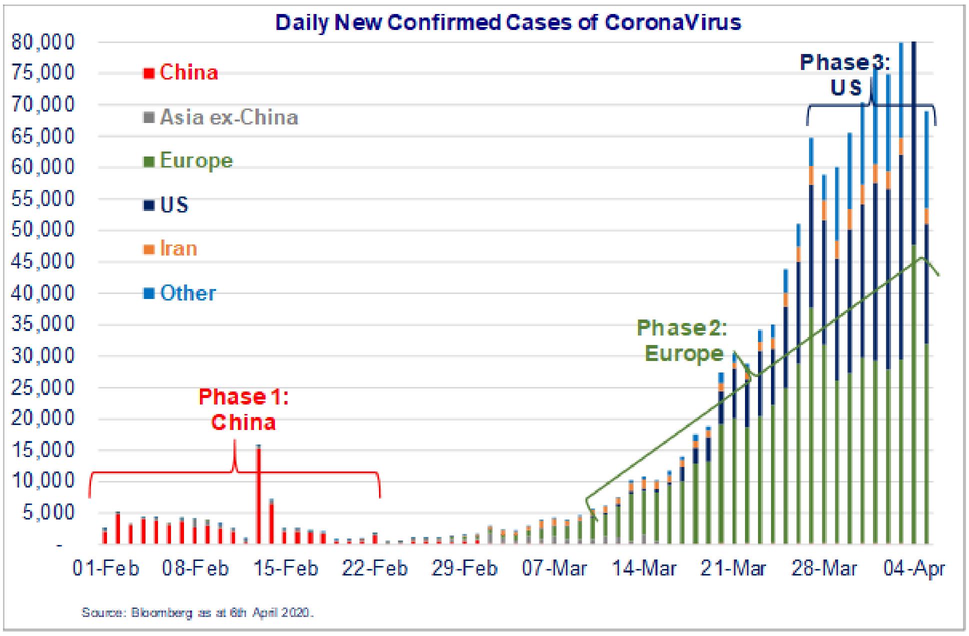
Perpetual

- Europe (+32k to 562k) continues to lead the world in terms of total cases but its daily increase (number, not percentage) is flattening out from its elevated base but it is still recorded its third largest daily increase overnight - the next stage is to have this decline like China's number has apparently. It does show that social isolation works to reduce the spread of the virus, even though it comes at an enormous economic cost.

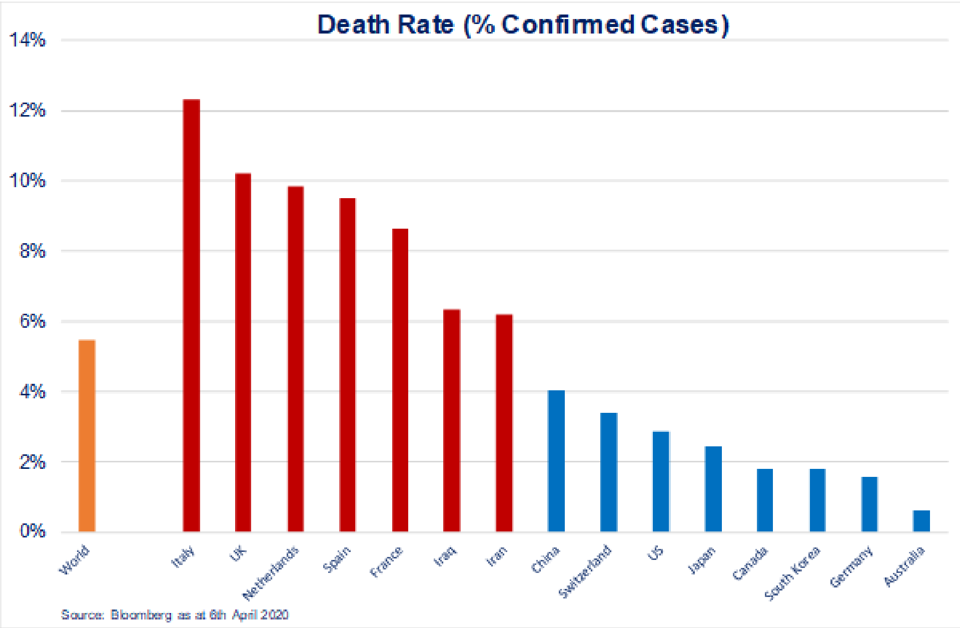
  In contrast, the US had its smallest daily increase of new confirmed cases in the past week overnight (+19.1k to 331k) but its the 3-day US compound growth rate remains well above the global and other country averages 18 days after they reached 10,000 cases, but they are working from a much higher base. The slow and piecemeal lockdown of the US meant that its base grew so quickly that the daily 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 (+19.1k to 331k), Spain (+5.5k which is its fourth consecutive daily increase) to 131k), Italy (+9121 to 129k, which is a record daily increase), China (+28 to 82.6k), Germany (which recorded its third daily decrease of +3.9k to 100.0k), France (+2.9k to 93.8k) and Iran (+2.5k to 58.2k). Australia confirmed cases has increased (+137) to 5,687 which placed us 20th in terms of total infections.



- The global death rate has risen to +5.5% (having doubled in the past 6 weeks) with another +4.5k fatalities overnight bringing the global total to 69.3k. The death rate is highest in European countries where the health systems have collapsed led by Italy (+0.2% to 12.3%), the UK (steady at 10.2%), the Netherlands (-0.1% to 9.8%), Spain (steady at 9.5%) and France (+0.3% to 8.6%).



Yours sincerely,

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MORE INFORMATION

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