

THOUGHTS ON THE MARKET

6th May 2020

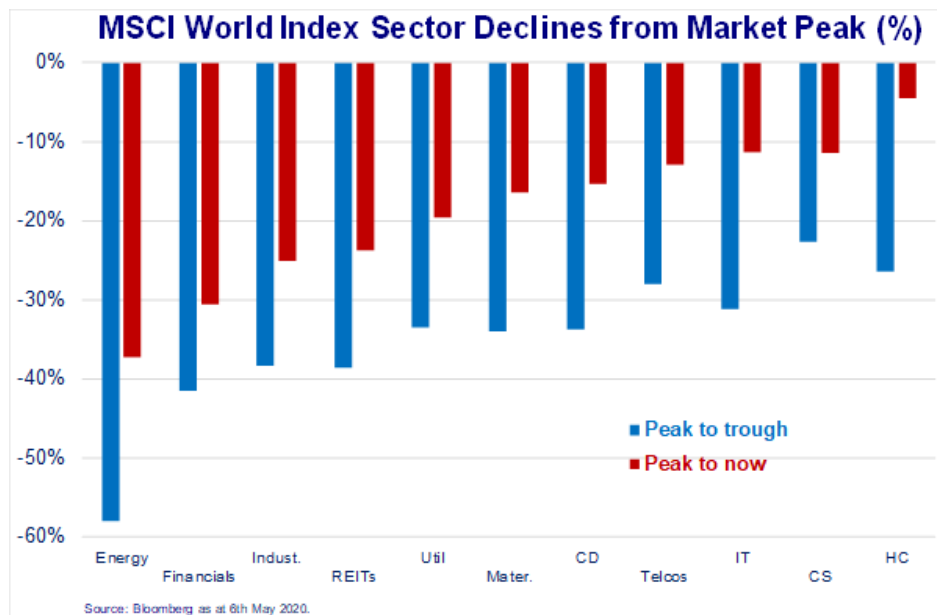
SUMMARY

- Markets rallied overnight led by equities with solid, although not spectacular, gains in most open bourses. In contrast, defensive assets were mixed, with 10-year Treasury yields up four points with curve steepening, but the US Dollar was stronger against the AUD (+0.2% to 64.33) but flat against the Euro (108.4) and down against the Yen (-0.2%) and Sterling (-0.1%), gold rallied +0.4% to USD1,705 per troy ounce, and oil rallied another +20.5% (to USD24.56 per barrel) with the June contract price having nearly doubled in the past five sessions.
- Overnight, the April US ISM service sector PMI was better than street estimates (41.8 vs 37.5), but the composition was grim in that activity, employment and new orders were at all-time lows. However, economists mostly talked about economic bottoming and the shape of the recovery and while that is a more constructive tone for risk markets, indices have rallied a long way from the troughs in mid-March. Yet in the past month global equity and credit markets have overall struggled for upward momentum as concerns persist about a second wave of infections, and worse-than-expected US earnings results. In the US reporting season, most of the key firms have delivered results and the key themes have been hashed out - the most prevalent of which have been widespread guidance withdrawals, balance sheet restructuring, suspension of buyback programs and the uncertainty surrounding the duration of the downturn and shape of the recovery. Accordingly, markets are flying blind about the outlook but with some bearish positioning and negative sentiment persisting, suggesting the pain trade still remains to the upside.
- While many have a view that the worse is now behind us, the first hurdle for markets is whether this view is right and what happened with respect to infection rates, or more precisely, if there is a second wave of new cases. Government here, will be very cautious and markets will soon find out if they have correctly priced the 'new normal' as most policy makers and macro analysts agree on a slower and staged rebound which will take several years to recover lost output. This slow recovery will be accompanied by sustained damage on several fronts, which means it will take even longer for firms and markets to recoup lost earnings and so relative performance and index composition will be key drivers of global capital flows and key considerations for asset allocation. We think it's fine for economies like Australia and China to re-open, but risks are high for the US as infection rates are still elevated, which tells me the timing of their desired re-opening may be too early.
- In COVID-19 news overnight, the number of global cases rose +72.9k to 3.7 million, which means the world has recorded 40 consecutive days of case numbers rising +60k or more. Indeed, it took 73 days to record 1 million cases, 13 days for the next million, 11 days for the last million with another 690k cases added in the past 8 days. That said, the growth rate of daily confirmed cases continues to grind lower (+2.2% since Saturday), but deaths rose +5.1k overnight (4-day high) to 256.9k, with the US, UK, Italy, Spain and France all over +25k with the global death rate at 7.0% (although final numbers are not yet in).

FINANCIAL MARKETS

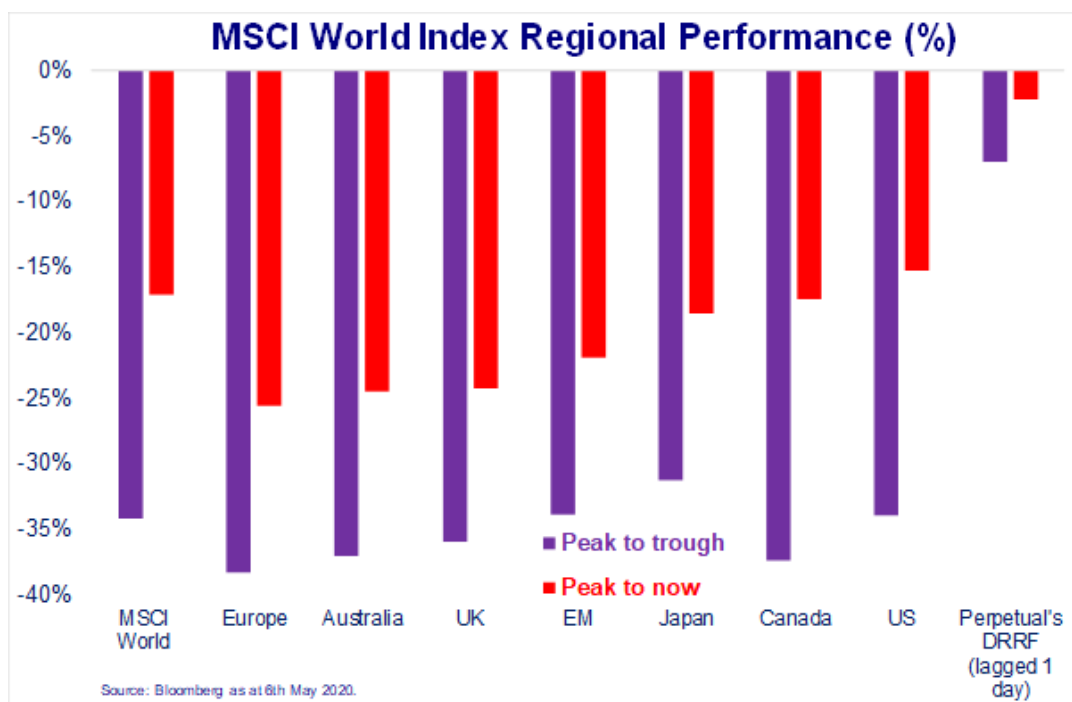
• EQUITIES

- The MSCI World Index rallied +1.0% overnight with gains in all sectors led by energy (+2.0%) for a second consecutive day, with talk of economic re-opening potentially boosting demand lifting sentiment and raising the spectre that the worse of price dislocation now being behind the sector. This flowed through to its cousin with materials (+1.0%) also rising solidly and posting its first rise in four sessions, and Tech (+1.5%), as usual, was among the best performers (see chart) with investors continuing to hoard into semiconductor producers and internet names.



Among the regions, Europe (+2.1%) led the race to the tape with strong gains in all bourses led by Germany (+2.5%) which lifted despite a mixed decision by the country's Constitutional Court about the ECB's support mechanisms. Elsewhere, France (+2.4%) advanced strongly as did Sweden (+2.2%) Italy (+2.1%) and the UK (+2.1%). The US matched the gains in Europe for most of the session but in the last hour of trade, comments from the Fed's deputy Chair Clarida that the economy will still need more government support, reminded investors of the mass uncertainty ahead and the market's daily advanced had halved by bell.

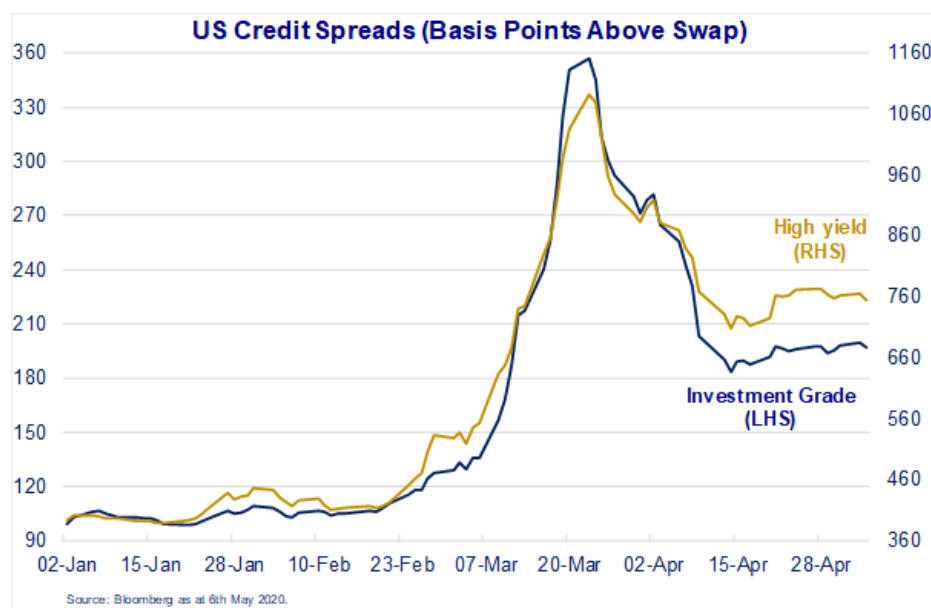
Earlier in Asian trading, Japan remained closed, but Australia (+1.6%) recorded the highest regional gain for a second consecutive day, with China (+1.2%) and Hong Kong (+1.1%) also scoring centuries. The overnight movements mean that Europe remains at the bottom of the pack in terms of peak-to-now performance and is grouped with the UK and Australia, and is joined with EM in bear market territory (see chart below). Japan has performing surprisingly well, but the US is the standout despite having the most COVID-19 case numbers and deaths with the index now only -15% below its all-time high.



• CREDIT

- Reuters noted overnight that US investment grade companies raised USD163 billion in the corporate bond market in April, which was below the March record, but the second-best month on record. The agency noted also that US high yield raised USD30 billion last month, which was the tenth busiest month on record, and that investment grade issuance in Europe hit USD350 billion which was a fresh record high. So central banks have seemingly, stabilised credit markets with their support programs, but investors seem hesitant to push spreads materially lower.
- Global credit markets lifted overnight, but the gains were minor. US credit spreads inched lower overnight with risk premiums in the investment grade sector down -2 points +197 bpts which lifted the recovery rate to 63%. There were declines in all sectors led by energy which came in -7 points overnight to +324 bpts (60%) after crude prices rallied for a fifth session and closed at USD25.02 per barrel. The positive sentiment here flowed through to subordinated financials (-3 points, +242 bpts, 62%) and their senior counterparts (-3 points, to +183 bpts, 60%).

In the high yield universe, risk premiums declined -11 points which drove the recovery from the blow outs over the prior three sessions and saw spreads close at +755 bps (see chart) and the recovery rate lifting to 49%. The large index mover was energy (-60 points, +1293 bpts, 66%) but other cyclicals were fairly quiet as defensives outperformed led by both utilities (-10 points, to +491 bpts, 62%) and healthcare (-15 points to +583 bpts, 64%).



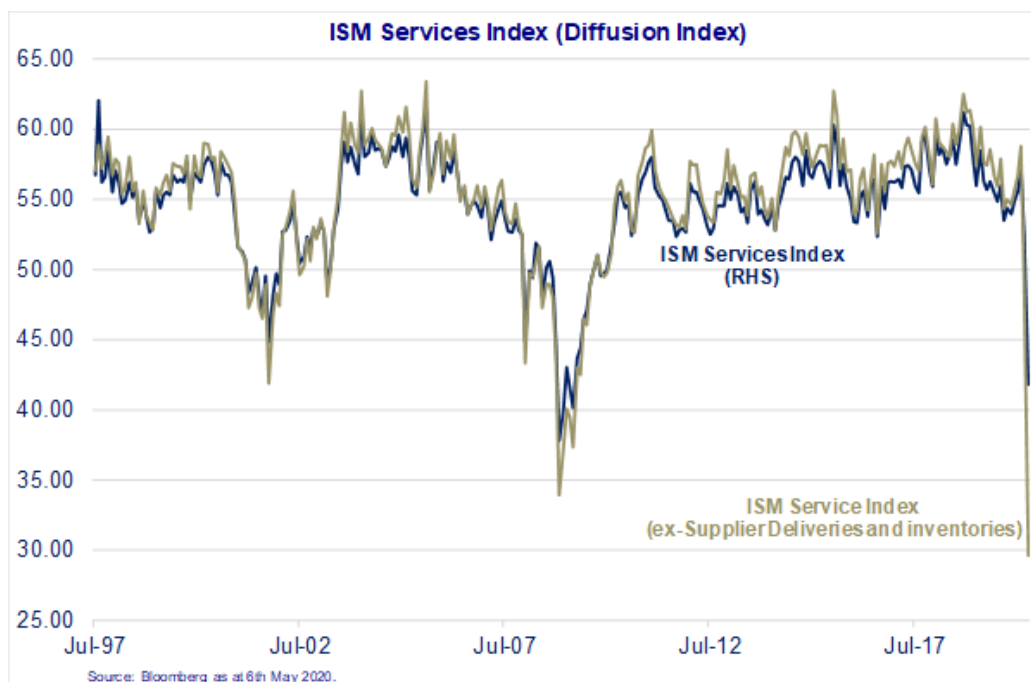
- European credit markets recorded their first gains in the past four sessions, but movements were modest and did not alter the plight of the region. Among the components, spreads in the investment grade sector fell -1 point to +119 bpts which kept the sector's recovery rate to 47%. Trading was subdued with utilities (-2 points, 79 bpts, 48%) being the largest mover and energy (+1 point to +125 bpts, 29%) responding positively although it still has a long way to go in a recovery sense. In the high yield universe, spreads also came in one point (to +600 bpts, 47%), however, the vast bulk of sub-sectors recorded higher risk premiums led by senior financials (+4 points, to +748 bpts, 29%) and consumer staples (+3 points, +603 bpts, 74%), but these were outweighed by declines in healthcare (-6 points, +395 bpts, 57%) as investors

THE GLOBAL ECONOMY

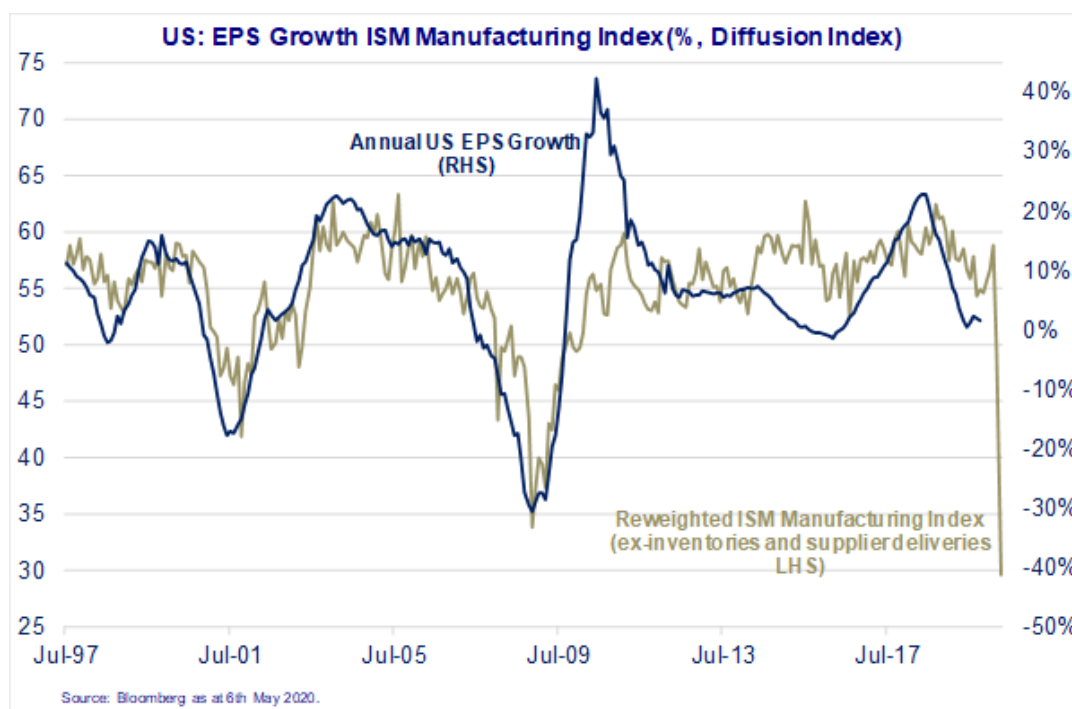
- The April gauge for the ISM services sector PMI recorded its first contraction since December 2009 having decreased by -10.7 points to 41.8, but the result was above street estimates for a much larger decline (37.5). However, like its manufacturing peer, the underlying composition was very weak with the business activity sub-index declining to an all-time low (-22.0 points to 26.0), with new orders (-20.0 points to 32.9, record low) and employment (-17.0 points to 30.0, record low) also down sharply.

However, the headline index was held up, again, by a surge in supplier deliveries (+16.2 points to 78.3), with inventories contracting by less (+5.4 to 46.9). So, the April services had the same profile as its manufacturing peer

from two days ago with both headline gauges declining but not to all-time lows, but when supplier deliveries and inventories are removed, the index is at its weakest level ever.

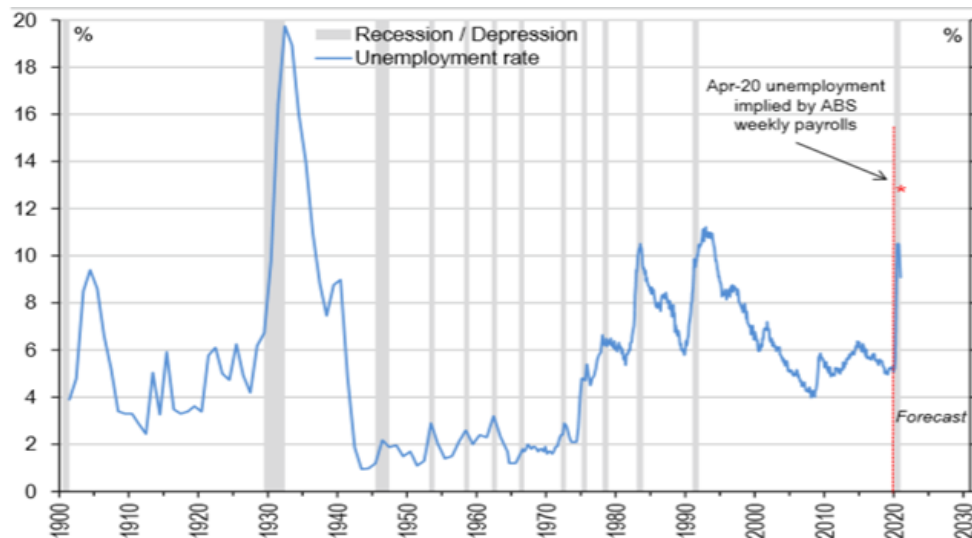


The gauge which excludes supplier deliveries and inventories also suggests a very challenging time ahead for the US corporate sector, which is set to record one of the largest declines in earnings per share in the market's history (see chart below).



- The new ABS payrolls release noted that employment declined a further -1.7% 2w/2w which is equivalent to another -227k job losses, taking the total since mid-March (when Australian COVID-19 cases hit 100 and the government began to implement draconian lockdown rules) to -975k (or -8.5% of total employed persons). This may modestly overstate the employment dislocation (as around 7% of the labour force have more than one job), but it shouldn't disguise the wages hit. The number of job losses in the past six weeks now total -975k which is similar to what PM Morrison indicated on Monday (namely 900k new people accessing the Jobseeker allowance). If there is no decline in participation, the near-1 million of displaced workers is enough to have local unemployment hit

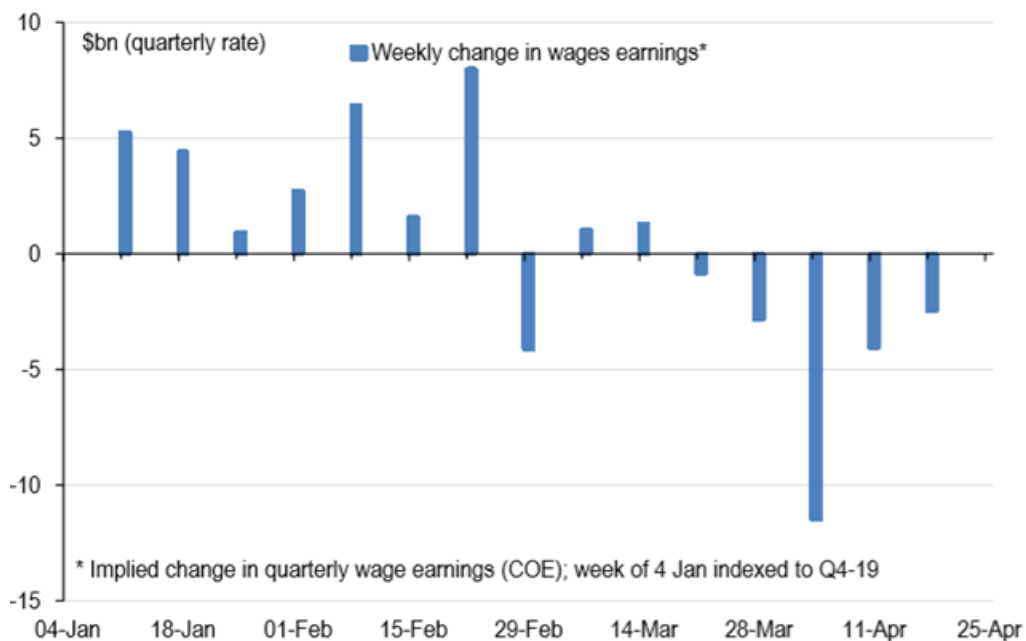
12%, which would be the highest since 1936 (see chart), but even if one-third of workers displaced have left the labour force, that still implies unemployment at 10% by June.



It is hard to estimate how high unemployment may get and there are many reasons to believe the official unemployment rate may be lower:

- the ABS only surveys 50k people;
- those who lose their jobs but are not looking for or available to work will not be counted as unemployed; and
- those on JobKeeper deemed to have a 'job to return to' will count as employed despite working zero hours.

The bi-weekly payrolls report also provided another update on wages which has now slumped -8.2% in the past five weeks, which is equivalent to -4.5% of quarterly GDP. On a positive note, the rate of decent is now declining that the majority of the income hit has been seen, but at the same time, 30% of local businesses have cut headcount in a large hit to consumption and production, although the total reduction has been limited as 75% of businesses have said that the reduction has been less than 10 people. Importantly, while the Government has indicated they will move towards opening the economy in coming weeks, but it will take considerable time before this can occur and while there was a modest recent easing in some mobility restrictions, this is not addressed the regulated shutdown of many businesses.



POLICY

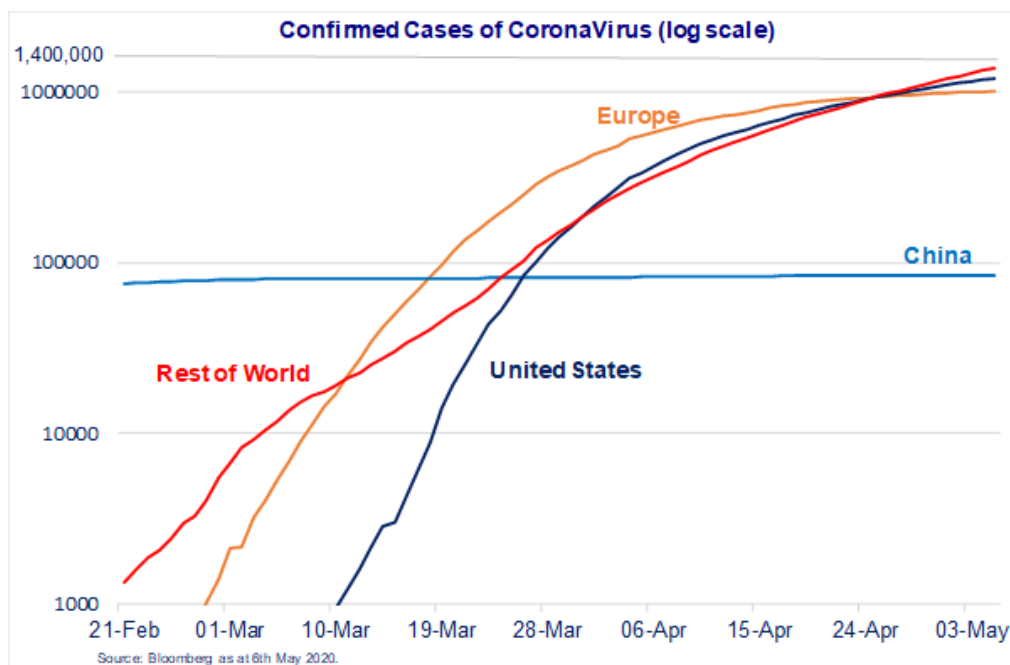
- The RBA left the official interest rates (both the target cash and the 3-year yield target) unchanged at 0.25% at its May meeting. However, the bank expanded its range of eligible collateral for repo operations to include investment grade non-bank corporate bonds to help with "the smooth functioning of Australia's capital markets". This was a bit strange as their previous guidance of the Bank tapering of Open Market Operations.

The Bank slightly downgraded their central economic forecast of -6% in 2020 (seems reasonable) with a bounce back of 6% in 2021 (too high) and an unemployment peak of 10% (seems to low) in 2020 with the rate not below 7% by end-2021, but they acknowledged downside risks to unemployment "if the reduction in labour demand is accompanied by a larger reduction in average hours worked, rather than by people losing their jobs". That seems quite likely to us. Lastly, the Bank noted its expectation for inflation to turn temporarily negative in the June quarter, but to recover to 1% to 1½% in 2021 and gradually picks up further from there. That seems a stretch given the sustained large output gap. All their views will be detailed in Friday's Quarterly Statement on Monetary Policy.

- The German Constitutional Court ruled that some of the ECB's actions under its long-standing QE plan (PSPP) does not violate EU law, but added that the Bundesbank may no longer be able to participate in the plan after the transition period of three months, unless the ECB can demonstrate that the plan is not disproportionate to its monetary policy objective. Most importantly, the decision does not prohibit the ECB in its deliberations, but it reduces its flexibility and could potentially expose ECB to future legal challenges.

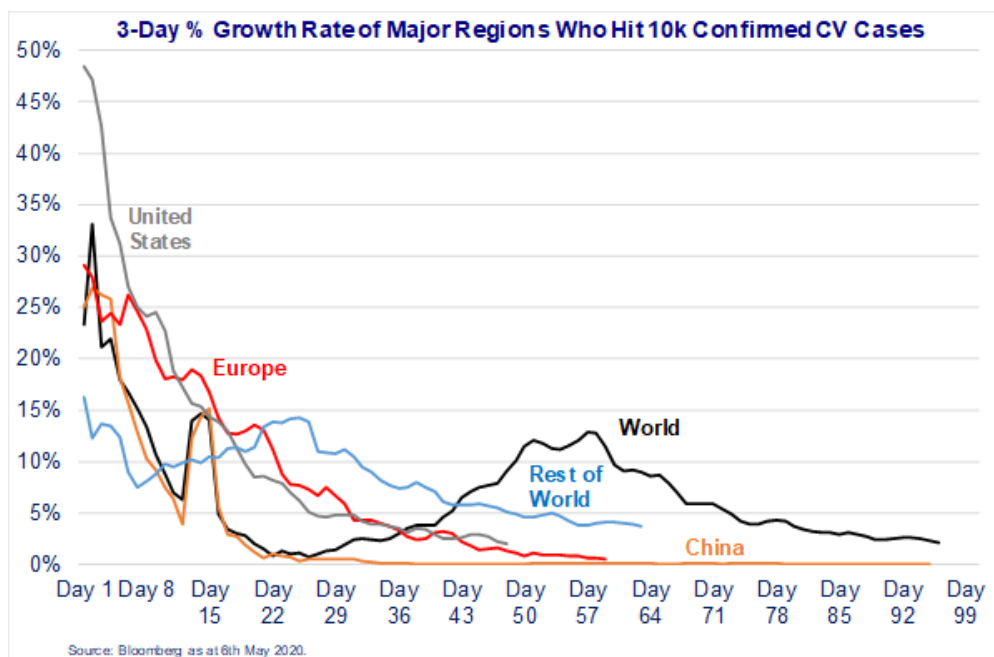
VIRUS UPDATE

- The number of global cases of COVID-19 stands at 3.7 million with another +72.9k cases overnight. That increase means 3 countries have more than 200k cases, 9 countries 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, 11 days for the last million, and in the past 8 days another 690k cases have been confirmed. That said, the growth rate of daily confirmed cases continues to grind lower (+2.2% since Saturday). Meanwhile, deaths rose +5.1k overnight (4-day high) to 256.9k, with the US now over 70k and the UK (29.5k), Italy (29.3k), Spain (25.6k) and France (25.5k) all over 25k, and the death rate rose for the first time in six days to 7.0% (although final numbers are not yet in).



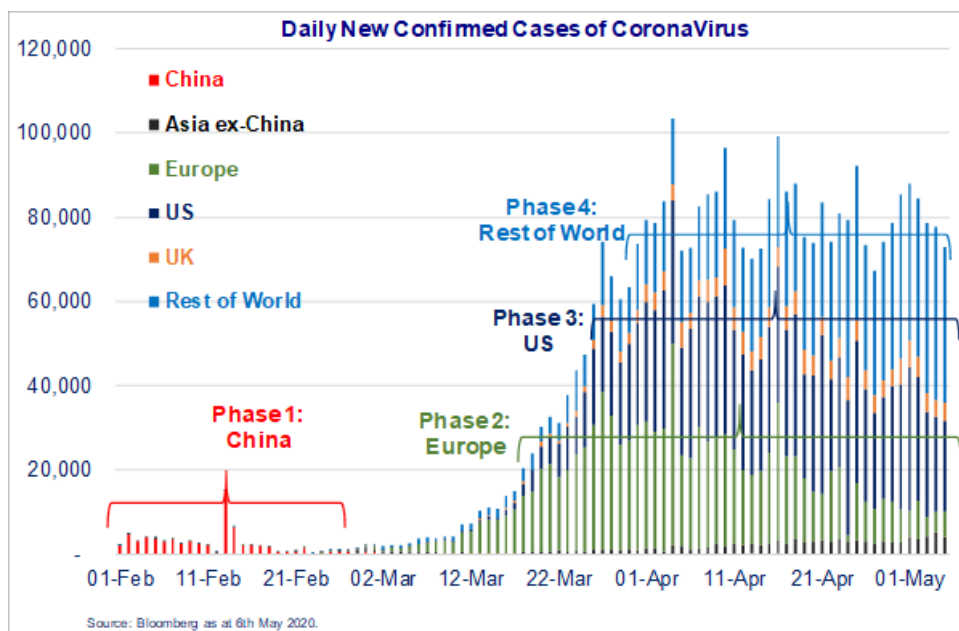
- We break the infections into four groups – the US, Europe, China and 'others' and the rest of the world outside the G3 economies (+45.4k to 1.39 million) now has the most total cases and highest daily new cases followed by the US (+21.6k to 1.20 million) and Europe (+5.9k to 1.02 million), with the latter two's daily increases, both number and percentages, trending 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 two concerns here are Russia (+10.0k to 155.4k) and Brazil (+6.1k to 114.7k) where cases continue to surge.



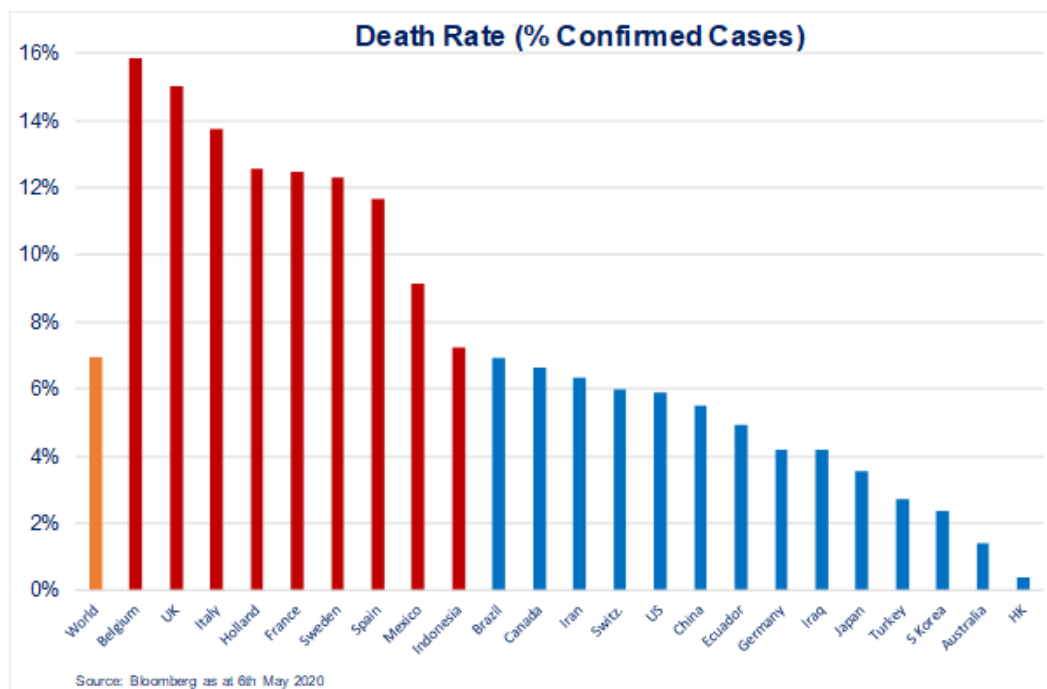
- Among countries, the most cases are in the US (+20.8k to 1.20 million), Spain (+1.3k to 219.3k), Italy (+1.1k to 213.0k), the United Kingdom (+4.4k to 196.2k), France (+1.4k to 170.7k), Germany (+554 to 167.0k), Russia (+10.1k (second highest on record, to 155.4k), Turkey (+1.8k to 129.5k), Brazil (+6.1k to 114.7k), Iran (+1.3k to 100.0k) and China (steady at 84.0k). Australia confirmed cases rose +33 to 6,858 yesterday which placed us 49th in terms of total infections.

Elsewhere, Singapore recorded +632 new cases to 19.4k 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 (+484 to 12.1k) and the Philippines (+199 to 9.7k). Note final numbers for yesterday at not in yet so these numbers can rise.



- The global death rate rose fractionally to +7.0% (first rise in the past 6 days) with another +5.3k fatalities overnight (5-day high) bringing the global total to 256.9k. The US has the most deaths at +71.0k, with Italy (+0.2k to 29.3k), the

UK (+693 to 29.5k), Spain (+185 to 25.6k) and France (+333 to 25.5k) all over +25k. The death rate is highest in European countries where the health systems have collapsed led by Belgium (+0.1% to 15.9%), the UK (steady at 15.0%), Italy (+0.1% to 13.8%), the Netherlands (+0.2% to 12.2%), France (+0.1% to 12.5%), Sweden (+0.1% to 12.3%), and Spain (steady at 11.7%). However, several emerging markets are now on the leader board including Mexico (-0.1% to 9.1%), Indonesia (-0.3% to 7.2%) and Brazil (+0.1% to 6.9%).



Yours sincerely,



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