

Perpetual Private

QUARTERLY MARKET UPDATE

March 2020

Perpetual 

QUARTERLY MARKET UPDATE – MARCH 2020



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SNAPSHOT



The first quarter of 2020 saw markets reckon with the emergence of a significant pandemic for the first time since the Spanish flu a century ago. All but the safest assets were affected, with Australian equities down 23.41% and international equities down 19.97%. As central banks sought to minimise the impact, the RBA reduced policy rates twice in March, with the Australian 10-year government bond gaining 3.81% as yields fell.

AUSTRALIAN EQUITIES

The ASX 300 made a great start to the year before being impacted by the effects of the coronavirus and oil price war. Having made steady gains until 20 February, it sold off heavily before finding composure toward the end of March. By the end of the quarter, it was 23.41% below where it finished 2019. Amongst the sectors, energy was the worst performer, being hit by both the broad market sell-off and impacts from an oil price crash. For the period, the sector lost 48.21%. On the positive front, the health care sector benefited from the situation and gained 1.51%. Unsurprisingly, smaller companies underperformed larger companies, as distressed selling was exacerbated by lower liquidity in these less-traded names (ASX 100 -23.01% vs ASX Small Ordinaries -26.72%).

INTERNATIONAL EQUITIES

Global stock markets lost 9.69% over the period (as measured by the MSCI All Country World) on an unhedged basis. However, in local currency terms, the index dropped 19.97% over the quarter, demonstrating the impact of a weakening Australian dollar (AUD) as markets became increasingly risk averse. Consistent with the sense that we'd witnessed an indiscriminate sell-off, emerging markets fell 19.05%, with frontier markets down 24.26% over the quarter. Japan and Europe, too, gave up value, losing 17.34% and 21.80% respectively. In the US, the tech-heavy Nasdaq outperformed the S&P 500 by nearly 6% (-19.72% vs -13.95%) as technology companies were deemed to be better placed to remain insulated from the economic challenges.

FIXED INCOME

Australian bonds were key beneficiaries of central bank actions, gaining 2.99% as the RBA reduced rates to their stated lower bound of 0.25%. Overseas bonds (hedged to AUD) also gained, though not to the same extent, delivering 1.27%. With uncertainty high for the coming months, it is unlikely we'll see monetary authorities expressing a desire to increase rates any time soon. This is supportive for bond values for the foreseeable future.

REAL ESTATE

Australian real estate investment trusts (as measured by the S&P/ASX 300 A-REIT index) were heavily impacted by the market stress, as isolation measures and falls in economic activity has led to tenants being unable to pay their rent. A-REITs were down 34.31% over the quarter, particularly impacted from a structural overweight to retail assets.

Global real estate trusts (G-REITs) were down just 17.93% on an unhedged basis, losses partially offset by the drop in the AUD relative to foreign currencies.

CASH RATE

The RBA twice reduced the cash rate over the quarter, taking it to a record low of 0.25%. Stating that negative interest rates are off the table, RBA Governor Dr Phillip Lowe will seek to use alternative monetary policy tools should our economy require further monetary support, as seen through the RBA's recent purchases of Commonwealth bonds.

AUSSIE DOLLAR

The Australian dollar was challenged over the quarter, losing 12.38% against the US dollar, falling from US\$0.70 at the start of the year to US\$0.62. This was consistent across most major currency pairs as our economy's high degree of commodity exposure and leverage to the Chinese economy weighed against it. Against GBP it depreciated by 6.42%, EUR by 11.14% and JPY by 13.47%.

ALTERNATIVES

COVID-19 has seen short-term activity across private markets grind to a halt, which will delay the pace of realisations previously expected across the portfolios. On the positive side, the stress in financial markets appears to be generating opportunities for managers of alternative assets and we are picking up reports of attractive assets becoming available at similarly attractive valuations.

GLOBAL ECONOMIC OVERVIEW



‘It was the best of times, it was the worst of times,
it was the age of wisdom, it was the age of foolishness...’

– Charles Dickens, *A Tale of Two Cities* (1859)

WHAT HAPPENED

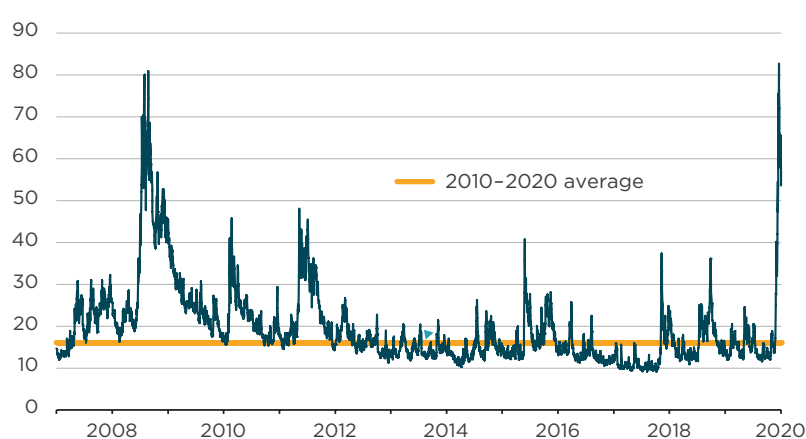
The year began, much as 2019 had ended, with financial markets imbued with the confidence of over a decade of economic expansion. January alone saw Australian shares gain by 4.89%.¹ In their meeting on 4 February, the RBA noted that ‘the easing in trade tensions between the United States and China, and ongoing stimulus delivered by central banks, had supported a modest improvement in the growth outlook for a number of economies’.²

At a similar time, the International Monetary Fund (IMF) was forecasting global growth to pick up in 2020 and 2021. In focusing on Australia, the RBA’s forward expectations were unchanged since November, looking for 2.75% over 2020 and picking up to 3.00% in 2021. At this point in time, whilst acknowledging the impact on our economy from the bushfires and coronavirus, both issues were expected to have short-term impacts, with ‘the recovery from the bushfires expected to add growth in the second half of 2020’.²

When we look at the VIX index (Figure 1), a measure of investor stress, we see that the attitude of market participants at this point remained relaxed, with the index sitting below its 10-year average. This calm is consistent with the messaging being projected at the time by many governments and institutions alike. Only a few days prior (1 February), the US and Australia had closed their borders to Chinese arrivals.

In the meantime, the World Health Organization (WHO) had publicly warned that closing borders could accelerate the spread of the virus and was recommending screening at official border crossings. Over the following 16 days to 20 February, markets continued their upward trajectory, with Australian and international³ shares delivering year-to-date returns of 7.33% and 3.57%, respectively.

FIGURE 1. CBOE VOLATILITY INDEX (VIX)



Source: FactSet, Perpetual.

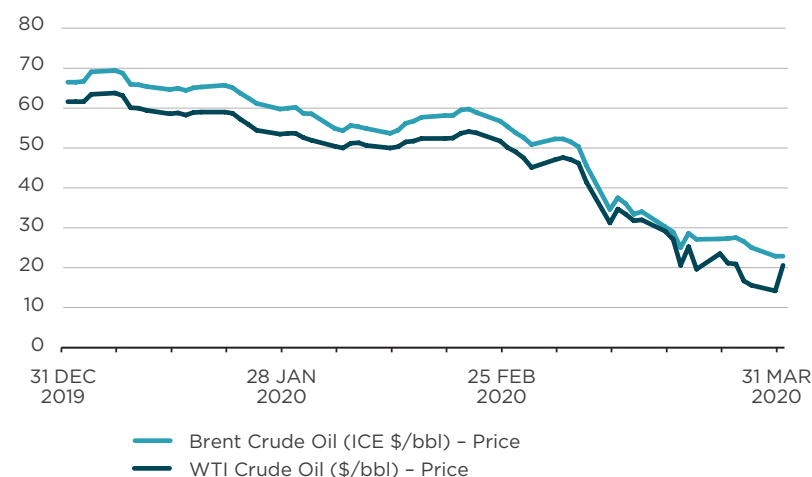
Over that short period, the detection of clusters of infection became alarming. In northern Italy, eleven municipalities were identified as the centres of the two main Italian clusters and placed under quarantine. The Diamond Princess cruise ship was found to have an outbreak, with infections jumping from 35 cases to 621 in two weeks.

As the market digested the fact that the impact was no longer contained to China, investors began to look for exits in earnest during the last week of February. On 11 March, with markets already selling off, the WHO declared COVID-19 to be a pandemic. This in turn triggered private and public emergency planning initiatives and brought into focus the enormous economic disruption of what would later be referred to by the IMF as the 'Great Lockdown'.

Between 20 February and 23 March, global equities fell by over 30% before retracing off lows to the close of the quarter. The VIX index rapidly broke through the range established over the preceding 10 years, rising from 15.56 to 66.04 (Figure 1).

Adding fuel to the fire, a simmering dispute between Russia and Saudi Arabia, two of the world's largest oil producers, escalated, causing the price of oil⁴ to collapse from near \$60 to \$27 a barrel. Though this would normally have a number of benefits to economic activity, demand has plummeted as industries reliant on oil have ground to a halt, such as travel and aviation, while the Great Lockdown keeps people at home and out of their cars. As with the proverbial frog-in-a-pot, the concern here was not the degree of change, rather the rate of change.

FIGURE 2. OIL



Source: FactSet, Perpetual.

With a wall of monetary and fiscal countermeasures being deployed by governments, the white-heat of the situation subsided with financial markets, finding some rationale for optimism. Coming into the end of the quarter, international shares regained 14.09%, Australian shares regained 11.81% and the VIX settled back to 53.34 (having peaked above 80), although the price of oil continued to remain depressed.

WHAT ARE THE KNOWN AND EXPECTED IMPACTS?

With the combined effects of a pandemic and an oil market shock, the ability to predict asset prices (a difficult-enough task in the best of times) is greatly reduced.

In their World Economic Outlook, the IMF notes: 'There is extreme uncertainty around the global growth forecast. The economic fallout depends on factors that interact in ways that are hard to predict,'⁵ listing:

- the pathway of the pandemic
- the intensity and efficacy of containment efforts

- the extent of supply disruptions
- the repercussions of the dramatic tightening in global financial market conditions
- shifts in spending patterns
- behavioural changes (such as people avoiding shopping malls and public transportation)
- confidence effects
- volatile commodity prices.

By seeking to address a medical crisis through the Great Lockdown, a significant economic impact has been accepted. Whilst this certainly appears to be the humane approach, only time will tell if the cure has been worse than the disease.

As the presence of the virus begins to subside over the coming months, we will increasingly have to reckon with the economic aftershocks. This will likely cascade from first-order effects (such as the impact to the global travel industry), to second- and third-order effects which, by their very nature, are less predictable.

Policy response readily recognises the challenges ahead, with fiscal stimulus packages seeking to directly inject relief into the most acutely affected areas. In the US case, the litany of fiscal programs, all with their associated acronyms, have already begun to be described as an ‘alphabet soup’. The clear conundrum in the short term is the availability of useful information. Whilst we have many fast-moving indicators reacting to the situation, meaningful economic indicators are structurally unlikely to give us truly actionable data for some months to come. Though we have issues with the media describing the current situation as unprecedented, it is certainly true that there is a lack of useful corollaries.

As such, we acknowledge that any forecasts we receive are likely to involve a large margin of error. Bearing that in mind, and respecting that ‘all models are wrong, but some are useful’, we will discuss the current analysis of the most pertinent information that we have available now. The IMF is projecting that the global economy will ‘contract sharply by -3% in 2020’.⁵ Should the pandemic fade in the second half of 2020 and containment efforts can be gradually unwound, they project that the global economy will grow by 5.8% in 2021.

For Australia, they are expecting a more significant hit (-6.7%) in 2020, as softer commodity prices exacerbate the global slowdown. For 2021, they are more constructive, possibly optimistic in forecasting a rebound of 6.1%. Noting the ‘fluidity of the situation’, the RBA has declined to provide updated forecasts, merely stating that ‘it was likely that Australia would experience a very material contraction in economic activity,

which would spread across the March and June quarters and potentially longer’.

Meanwhile, the oil market continues to face enormous challenges. A deal to cut production by as much as 9.7 million barrels per day (bpd), is historic in its magnitude but does not go far enough to address what could be a 20 million bpd drop in demand. To put this in context, an imbalance of 1 million bpd in normal markets is enough to significantly impact price levels. Outside of the energy industry, low oil prices usually acts as a positive tailwind for consumers, reducing costs throughout the economy. However, with economic activity grinding to a halt, the benefit of low oil prices will have limited impact until after lockdown measures are reduced.

Here in Australia, we have seen three economic stimulus packages put in place at the Commonwealth level, with total expenditure and revenue measures of \$194 billion.

WHAT IS BEING DONE IN RESPONSE?

In this environment, the task at hand is significant. Never before have economies been intentionally placed into hibernation. In the words of the IMF: ‘This requires substantial targeted fiscal, monetary, and financial measures to maintain the economic ties between workers and firms and lenders and borrowers, keeping intact the economic and financial infrastructure of society.’ Restarting economies will be a challenge.

Here in Australia, we have seen three economic stimulus packages put in place at the Commonwealth level, with total expenditure and revenue measures of \$194 billion. Measures include sizeable wage subsidies, income support to households, cash flow support to businesses, investment incentives and targeted measures for affected regions and industries. In addition, parliament approved an advance authorisation of \$40 billion for unforeseen events. Separately, the Commonwealth government has committed to spend almost an extra \$5 billion to strengthen the health system and protect vulnerable people. State and territory governments have announced stimulus packages together amounting to \$11.5 billion.

Other financial measures include loan guarantees between the Commonwealth government and participating banks to cover the immediate cash flow needs of SMEs, and the government is allocating up to \$15 billion to invest in residential mortgage-backed securities and asset-backed securities to help funding for small banks and non-bank financial institutions. On the monetary front, the RBA twice cut its policy interest rate by 0.25%, to their stated lower bound of 0.25%. At the same time, it is providing liquidity into markets to ensure proper functioning of our financial infrastructure.

In the US, an estimated US\$2.3 trillion has been made available via the Coronavirus Aid, Relief and Economy Security Act (‘CARES Act’). The US Federal Reserve lowered the federal funds rate by 1.50% in March, alongside a raft of measures to support the flow of credit and protect the financial backbone of their economy.

China has announced RMB 2.6 trillion (AU\$570 billion) of fiscal measures or financing plans, with its central bank, the People's Bank of China, injecting over RMB 5 trillion (AU\$1.1 trillion) into their banking system. The European Union is implementing a package worth about €540 billion, as well as €37 billion from the EU budget to help shore up medical systems of member states and support those who are hardest hit. On the monetary front, the European Central Bank has decided to provide monetary policy support through asset purchases of €120 billion under an existing program and an additional €750 billion to purchase private and public sector securities under a 'Pandemic Emergency Purchase Program'.

WHERE TO FROM HERE?

We now face a conundrum where, on one hand, we face a significant economic shock, even once the virus subsides. On the other hand, global authorities are responding with the largest-ever fiscal and monetary stimulus packages. With the immediate outlook unclear and the inevitable emergence of new issues arising from both the medical and economic responses, we are fortunate that history provides some guide as to how to navigate the coming months and years. Though the current situation is unique in many ways, the behaviour of markets during periods such as these bear many similarities across time. As the saying goes, 'History doesn't repeat, but it often rhymes'.

When we think about how to respond in times such as these, the following rules serve us well:

- **Stay calm.** This too shall pass. Studies have shown that investors tend to overtrade and destroy value when reacting to market events in the heat of the moment.
- **Stick to the plan.** Investment strategies have been devised for the long term. Our asset allocations have been optimised using many years of data, which include numerous periods like this.
- **Rebalance.** Where asset exposures have moved meaningfully away from their long-term target, there is potential to add long-term value by reducing expensive assets in favour of cheap assets.
- **Scan the market.** Whilst we don't seek to trade heavily during times like these, the extreme levels of volatility are likely to provide opportunities for patient investors. We do this by continuing to favour active asset management in client portfolios.

It is clear that the coming months will feature many twists and turns, with heightened volatility likely to remain a feature. Just as the isolation measures that we are all currently adhering to are uncomfortable, market volatility is never pleasant. Accepting the discomfort and battening down the hatches will help preserve mental and emotional energy for making key decisions once the path ahead becomes clearer.

References: 1. As measured by the ASX 300 index. 2. RBA minutes, 4 February 2020. 3. As measured by the MSCI AC World index. 4. As measured by Brent Crude. 5. IMF World Economic Outlook, April 2020.

AUSTRALIAN CASH RATE

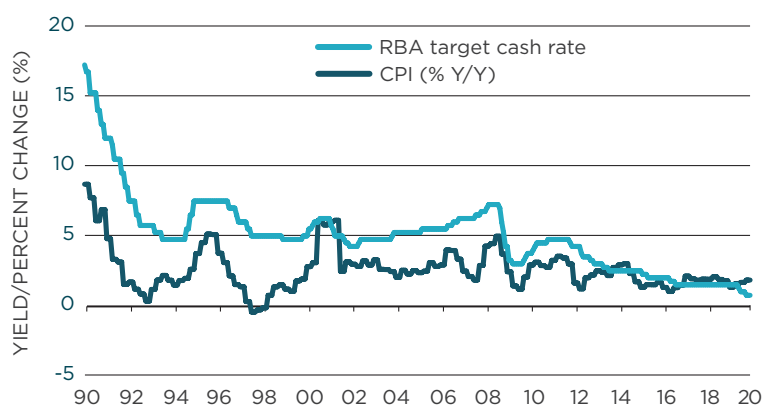
Three months ago, prior to the appreciation of the economic risk posed by COVID-19, the RBA seemed content with holding its policy rate at 0.75%, with the implicit belief that it might have done enough to facilitate economic buoyancy. However, much has changed since then.

Over the 3 March and 18 March meetings, the Reserve Bank Board twice reduced the policy rate by 0.25%, leaving the official rate at an all-time low of 0.25%.

AUSTRALIAN CASH RATE OUTLOOK

Given the challenges facing our economy, it seems unlikely that the cash rate will be lifted any time soon. Whilst Governor Lowe has publicly spoken against the idea of taking the cash rate to zero or beyond, investors can't entirely rule the possibility out. It is more likely that, in line with central bank peers globally, it will increasingly move to less-conventional policy measures such as quantitative easing.

FIGURE 3. AUSTRALIAN LONG-TERM INTEREST RATE VS INFLATION 1990 - 2020



Source: FactSet, 2020.

AUSTRALIAN DOLLAR



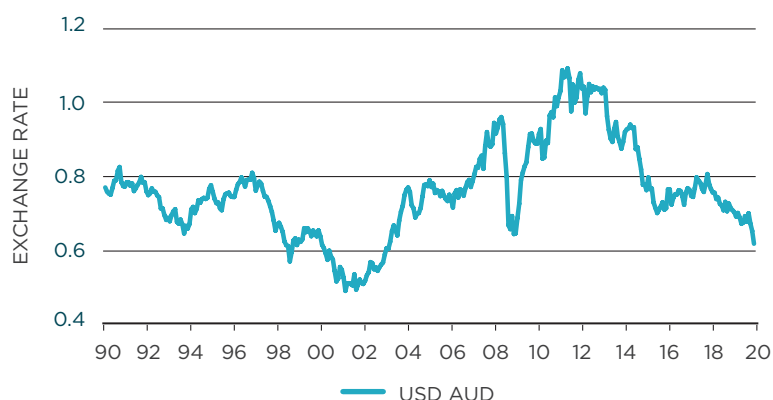
The Australian dollar had a difficult quarter. Even whilst many in the global community viewed coronavirus as a localised China issue, the impact on commodities prices, combined with the RBA dropping interest rates to all-time lows, translated into downward pressure on our dollar.

Starting January at US\$0.70, the AUD steadily tracked downward to US\$0.66. As asset markets fell across March, the AUD reached a low of US\$0.57, before settling back up at US\$0.61 at the end of the quarter. It's worth bearing in mind that currencies are relative in value by their very nature. Some of the depreciation in the value of our dollar is more attributable to strength in the US dollar, which acts as a safe-haven asset and tends to strengthen at times like these. As a result of AUD underperformance and USD outperformance, the AUD lost 12.38% in US dollar terms over the quarter.

AUSTRALIAN DOLLAR OUTLOOK

Near-term performance of the Australian dollar will likely hinge on signs of meaningful resumption of activity in the Chinese economy. All else equal, this would lead to gains in commodity prices and is likely to translate into AUD strength. Such a situation would also reduce the demand for USD, as it would feed into a sense of optimism and reduce the desire for

FIGURE 4. AUSTRALIAN DOLLAR VS. US DOLLAR (DAILY)
USD PER AUD LONG-TERM EXCHANGE RATE



Source: FactSet, 2020.

safe-haven assets. This outlook is just focusing on economic activity and currencies are subject to numerous moving parts which are also path-dependent (meaning the order in which things occur is just as important as what happens).

AUSTRALIAN EQUITIES



The Australian equity market, as measured by the S&P/ASX 300 Accumulation Index, fell heavily during the quarter, erasing the previous three quarters of gains to close down 23.4%, underperforming global equities, even when accounting for currency effects.

Domestically, all sectors outside of healthcare generated negative returns over the quarter with energy, REITs and consumer discretionary stocks the worst performers, falling by 48.2%, 34.4% and 30.0%, respectively.

On the currency front, the AUD fell heavily over the quarter, falling by 12.9% against the USD. On the commodity and energy front, Brent crude collapsed by 65.5% as the COVID-19 pandemic and an oil supply glut, caused by Saudi Arabia and Russia, sent prices

lower. Copper also fell heavily, dropping by 19.8% to reverse the previous quarter's rise of 8.9%, while gold continued to rally, rising another 4.8% to add to the previous quarter's gain of 3.4% as safe-haven buying accelerated.

AUSTRALIAN EQUITIES OUTLOOK

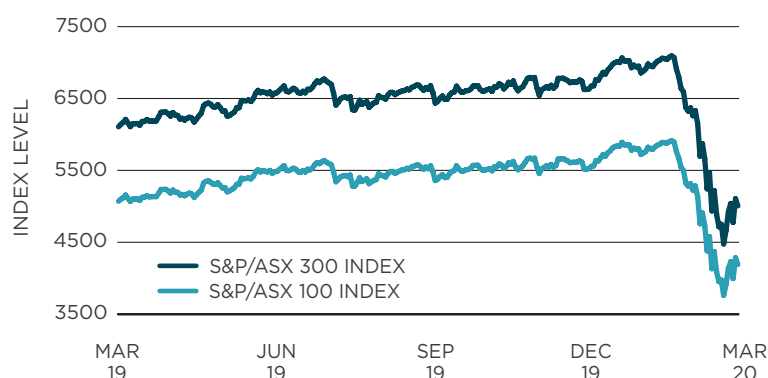
The domestic share market began the new year on a strong footing but has since turned on its head, as the COVID-19 outbreak escalated and expanded. The pandemic has

thus far spread across the world to every continent except Antarctica.

In a desperate effort to combat the spread of the virus, world governments, including Australia, have implemented strict quarantine and social distancing measures, which have effectively shuttered large parts of the economy. Consequently, cyclical stocks have fallen heavily and the market has seen a spike in volatility, indiscriminate selling, and a retreat to safe-haven assets like the USD and gold.

Despite the bearish outlook, long-standing excessive valuation multiples across multiple assets classes have retracted, with some investors now looking to buy quality companies that have been heavily oversold. Although this period of uncertainty still has some time to play out, we maintain a long-standing belief that it is fundamentals that drive returns in the long run. This is particularly relevant now, when investors seek the security of companies with strong balance sheets and sustainable earnings.

FIGURE 5. AUSTRALIAN SHARES - LARGE COMPANIES



Source: FactSet, 2020.

INTERNATIONAL EQUITIES



Global equity markets closed the quarter with widespread losses, ending the longest bull run in history. Coronavirus, coupled with the Saudi/Russia oil price war, sent security prices tumbling, at one point wiping out all of 2019's equity gains before a slight recovery in the last week of March.

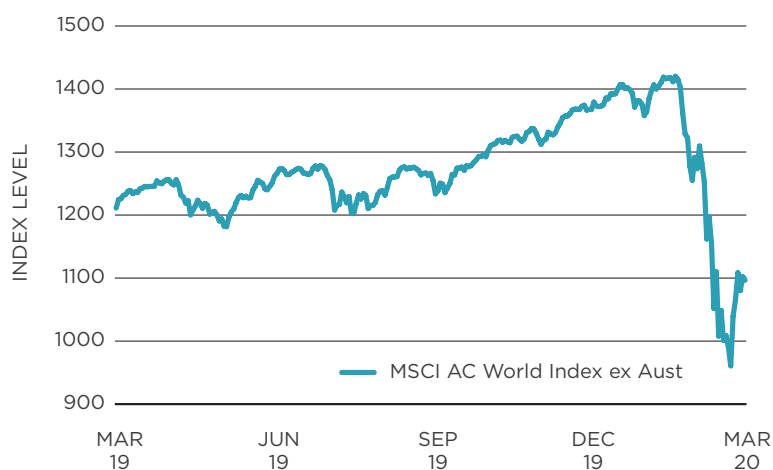
The MSCI All Country World Index fell by 19.97% in local currency terms. US equities outperformed both international developed and emerging market peers; the S&P 500 returned -19.72%, the MSCI EAFE -20.55% and the MSCI Emerging Markets -19.05% (all local currency terms). The USD's strength relative to all other major currencies helped emerging market countries with US dollar linked securities: for example, China's

Hang Seng Index fell 15.88% during the quarter. Small-cap benchmarks underperformed large-caps, and value stocks underperformed growth stocks, with the MSCI World Value underperforming its growth counterpart by around 11.80% over the quarter – widening a multi-year gap of relative performance.

'Cash is king' became the mantra in March as stocks with any perceived debt or liquidity issues

were sold off hard. Investors fled to safer areas of the market such as healthcare, tech, utilities and consumer staples, all outperforming cyclical sectors. These industries returned -10.61%, -13.25% -13.44% and -12.00%, respectively. In particular, the energy sector had a disastrous quarter, losing 41.13%. A renewed decline in longer-term bond yields hit interest-rate-sensitive sectors, including financials and real estate shares, whilst materials also underperformed.

FIGURE 6. INTERNATIONAL SHARES (LOCAL CURRENCY TERMS)



Source: FactSet, 2020.

INTERNATIONAL EQUITIES OUTLOOK

Given the mandatory shutdowns being instituted across the globe, we expect equity markets to continue to endure pain as the first, second and third-order effects of dramatically lower (or, in some industries, zero) revenues are felt.

The swift and large monetary and fiscal policy response can be expected to see global equities transition from anguish to gradual recovery. The time and speed of this recovery will depend on the

duration of the shutdown and how businesses survive through the Great Lockdown.

Our long-standing bias toward active, bottom-up stock-picking managers across the portfolio remains unchanged, which we feel is well suited to the current situation – risk can be actively managed through a focus on quality balance sheets and low levels of leverage, while portfolios can be rotated into stocks which are oversold and trading at attractive valuations – setting investors up well for long-term value creation.

A-REITs AND G-REITs (LISTED PROPERTY SECURITIES)



In Australian dollar terms, global real estate investment trusts (G-REITs) fell 17.92% over the quarter to the end of March 2020 (as measured by the FTSE EPRA/NAREIT Developed Index).

On a hedged basis, the FTSE EPRA/NAREIT Developed Index fell by 28.63%. The response to the COVID-19 pandemic is unprecedented in peacetime, whether it be changes to societal norms (i.e. the introduction of ‘social distancing’), the fiscal response by governments globally with ‘stimulus’ packages upwards of 10% of GDP, or the central bank liquidity facilities being implemented on a scale that dwarfs the actions taken during the global financial crisis in 2008/09.

In Australia, A-REITs fell 34.31% over the quarter, underperforming the broader equity market (S&P/ASX 300 Accumulation Index), which fell 23.41%. Most of the underperformance (relative to the broader equity market) occurred in the month of March.

Unsurprisingly, those sectors that were most heavily impacted by social distancing measures, closure of borders, or suspension of travel, were impacted the most. Hotel and resort REITs fell by 39.76%, while retail REITs fell by 46.24% during the quarter.

Those REITs that were linked to technology or changing work practices benefited from the COVID-19 pandemic, and niche sub-sectors such as data centres and self-storage REITs rallied 27.91% and 5.17% respectively.

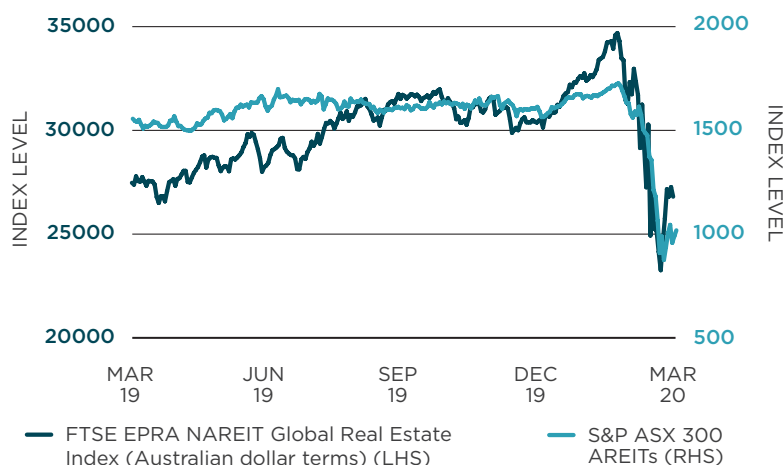
REITS OUTLOOK

As with all market crises, those assets with weak balance sheets or severely negative earnings prospects are sold off the most. While many REITs were in good

shape coming into the crisis, operating conditions have changed meaningfully for some sectors, including hotels and retail, and it is still unclear as to what the near- and medium-term impacts will be on revenue and earnings.

For retail, it’s likely that management teams will use this crisis to further ‘right-size’ their retail footprints. With working from home the norm for many companies during this period, it is possible there might be a shift

**FIGURE 7. REAL ESTATE INVESTMENT TRUSTS
(A-REITS & G-REITS)**



Source: FactSet, 2020.

in thinking about office space requirements by many corporates as leases expire over the coming months and years.

Given the recent drawdown in markets, valuations appear to be more attractive relative to the recent past. However, we remain cautious on the robustness of short-term earnings underpinning current valuations. Despite the expected near-term volatility, we believe that REITs are well placed to benefit once the economic recovery begins to take hold. Furthermore, we expect the accommodative monetary policy and quantitative easing to remain a feature of markets for some time to come, supporting real estate values.

FIXED INTEREST

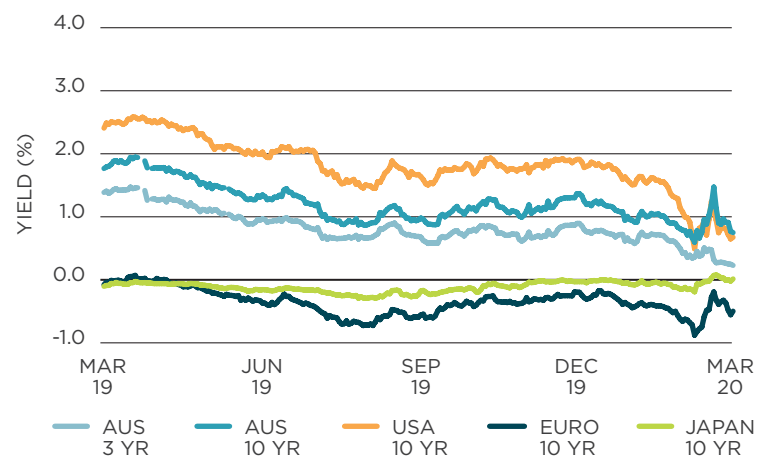


The Bloomberg AusBond Composite Index (a broad measure of Australian bonds) returned 2.99% during the March quarter, whilst the Bloomberg AusBond Bank Bill Index (effectively ‘cash’) returned 0.26%.

The Bloomberg Barclays Global Aggregate Bond Index (AUD-hedged) returned 1.27% during the March quarter. Australian 10-year bonds were yielding 0.76% at the end of the quarter. The US 10-year bond rallied strongly due to its safe-haven status.

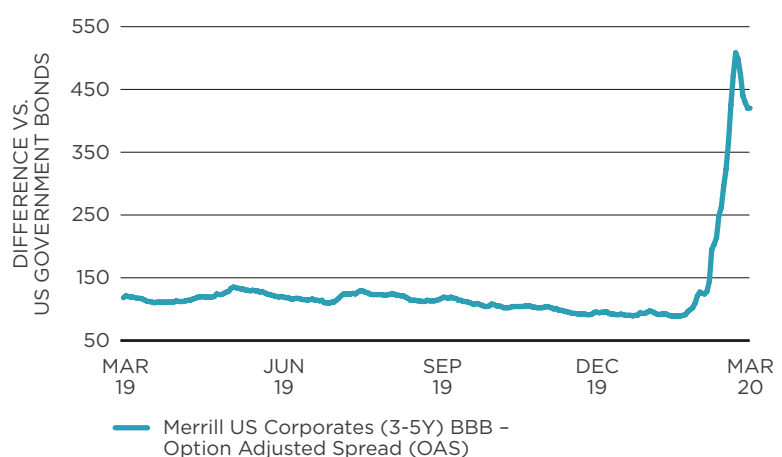
The RBA cut the cash rate by 0.5% during the quarter, to a record low 0.25%, in response to the global COVID-19 pandemic. In addition, the RBA implemented unconventional measures to further support the economy during this period, which included a target yield for Australian Government bonds of around 0.25% and a funding facility for the banking system to support credit for SMEs.

FIGURE 8. AUSTRALIAN & GLOBAL GOVERNMENT BONDS



Source: FactSet, 2020. *Note: Bond prices are inversely correlated with bond yields.

FIGURE 9. GLOBAL CREDIT MARKETS



Source: FactSet, 2020. *Note: Bond prices are inversely correlated with bond yields.

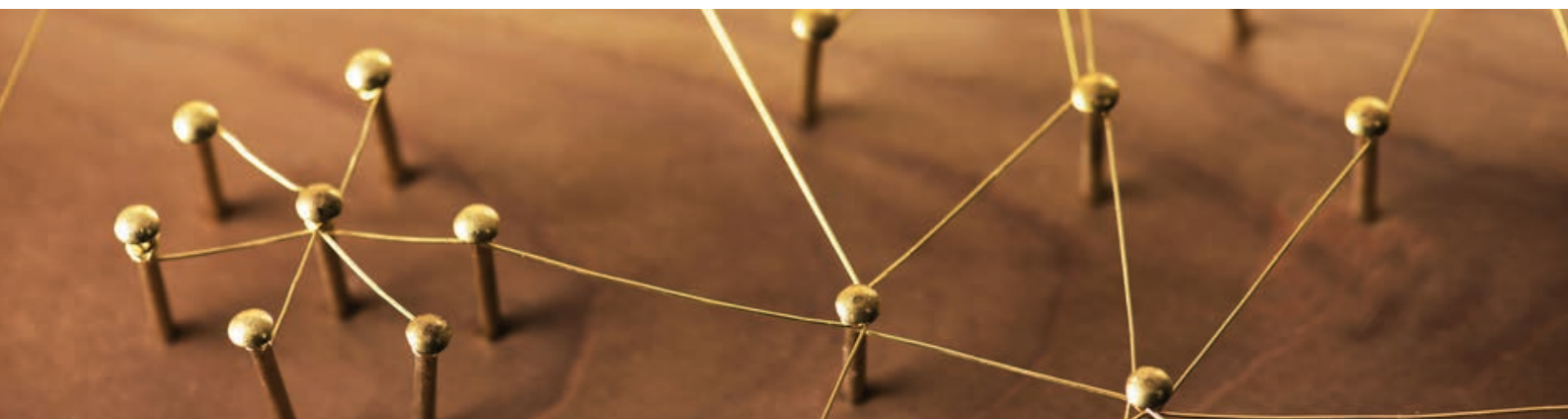
The US Federal Reserve (the 'Fed') also significantly reduced its target fund range by 1.5% to 0.00–0.25% during the March quarter. This was supplemented by the Fed announcing open-ended purchases of treasuries and mortgage-backed securities as needed, and new programs to buy corporate bonds for the first time (both in the primary and secondary markets). The US labour market has been adversely impacted by the pandemic, with the unemployment rate increasing by 0.9% to 4.4%.

Credit markets experienced significant volatility in March, with both investment-grade and sub-investment-grade sectors experiencing negative returns. It is believed that a significant amount of selling in credit markets was driven by forced selling from passive index tracking funds and leveraged hedge funds.

FIXED INTEREST OUTLOOK

Whilst financial market volatility is likely to remain elevated over coming months, we believe that fixed interest markets are well positioned for the eventual economic turnaround, and continue to invest in the sector as a source of diversification against an uncertain economic backdrop. Looking forward to the beginning of a recovery, central banks are likely to remain very accommodative and keep interest rates low. This should result in the Australian and global yield curves remaining steep, allowing active managers to generate returns through active management at the long end of the yield curve. After the recent sell-off in equities and widening of credit spreads, credit markets should be the primary beneficiaries of any recovery as investors begin to deploy excess cash into corporate bonds.

ALTERNATIVES



PUBLICLY TRADED ALTERNATIVE MARKETS

INCOME ALTERNATIVES

For the Perpetual Income Opportunities Fund (IOF), our focus across non-investment-grade credit remains within senior secured leveraged loans, predominantly in the USA and Europe. This is a floating rate, liquid bank loan syndicated market. Recent declines caused by the COVID-19 pandemic have pushed current investor yields (to maturity) to approximately 9.95% pa, with an equivalent average credit spread of 8.55% pa, at an average price of 82 cents in the dollar. Whilst current default rates remain relatively low across both sides of the Atlantic, they are expected to rise as the impacts of the crisis are felt throughout various sectors of the economy. On a positive note, this market has little exposure to the energy and energy-related sectors, which have faced particular difficulties on the back of a contraction in demand, and a breakdown in negotiations between OPEC producing nations and their allies.

We had trimmed into strength the IOF's exposure to the leveraged loan market at the back end of 2019 and early 2020 due to the impact we observed in the last quarter of 2018 from illiquidity in loan markets. We believe the market is now starting to look attractive, after adjusting for higher expected default rates and lower expected recovery rates. We intend to opportunistically allocate capital in the medium term as we continue to monitor the ongoing developments of the COVID-19 pandemic.

Whilst current default rates remain relatively low across both sides of the Atlantic, they are expected to rise as the impacts of the crisis are felt throughout various sectors of the economy.

To further diversify our traded credit exposure, we continue to research managers and strategies across diversified credit strategies which, in addition to syndicated bank loans, incorporate high yield and structured credit opportunities. We believe now is a very good time to fast-track this research,

given the impact to liquidity that COVID-19 has had across broader credit markets, particularly those of a structured nature, such as residential and commercial mortgage-backed securities.

GROWTH ALTERNATIVES

Listed infrastructure, in our view, is one of the few sectors of the equity market which exhibits a relatively low correlation with broader equity market returns, hence our allocation to this sector as part of the Perpetual Growth Opportunities Fund. Unfortunately, despite a lower interest rate outlook (which would benefit these assets), this sector has been adversely impacted, most pronouncedly in areas such as airports and toll roads, which are expected to incur significant revenue declines. We had opportunistically lightened the Fund's exposure following a bounce in the sector during late March. We do not expect to be adding to current exposures in the short to medium term as we are likely to see more compelling opportunities elsewhere.

Absolute return funds, including the Fund's investment into Invesco's Global Targeted Return Fund ('Invesco GTR'), delivered flat to slightly negative returns during the March quarter. Thus

far, the sector has provided solid capital protection attributes during the COVID-19 crisis, given the relatively low to neutral market exposure exhibited.

PRIVATE ALTERNATIVE MARKETS

COVID-19 has seen short-term activity across private equity and debt markets grind to a halt, which will delay the pace of realisations previously expected across the portfolios. Valuations across private markets; private infrastructure, private equity, private property and private debt are likely to come under pressure over the short to medium term. At this stage, it is too early to ascertain the impact, with a lot still dependent on the duration of the crisis. However, we are comfortable that the managers and strategies we have invested with are of a quality nature, and that value will be realised over the longer term.

Throughout late 2018 and calendar year 2019, we maintained a cautious approach toward private equity and private infrastructure, given heightened levels of deal activity, rich valuations and heightened levels of leverage within some strategies.

We allocated minimal capital to these sectors and our approach remains to selectively invest with managers and strategies that operate in niche markets, which are relatively less competitive and well sized to provide flexibility when exiting. Our biases away from sector specific strategies (e.g. energy, consumer) add an additional layer of diversification, which will protect the downside in the current environment.

INCOME ALTERNATIVES

As both Australian and global banks continue to consolidate their loan books, we continue to see opportunities to invest in strategies that conduct direct lending to companies that require capital. Our focus is on lending strategies that are senior in the capital structure and secured against assets. Across the IOF, we have identified and built material investments in four key credit sectors: infrastructure debt, private corporate debt, senior bank loans and commercial real estate mortgages. COVID-19 is likely to create significant private debt opportunities, going forward. The funds are invested in private debt strategies, which have ample dry powder to take advantage of such opportunities.

The specialist credit allocation within the portfolio is currently yielding approximately 3.5% per annum (net of fees). In comparison, the Australian cash rate is currently yielding 0.25%.

GROWTH ALTERNATIVES

The Perpetual Growth Opportunities Fund's exposure to distressed debt and restructuring strategies will incur some volatility in the current environment. We had opportunistically increased the exposure to distressed debt and restructuring strategies during late 2017 and early 2018. With a significant amount of dry powder left to invest, these strategies are well placed in today's environment. We have long held the view that we are still in a post-GFC environment where there remains an overhang of companies and sectors that will undergo restructuring and consolidation due to market dislocation. COVID-19 has proved to be the event causing such market dislocation, which will necessitate further restructuring and consolidation sooner rather than later. As providers of capital in this market, we believe we are taking on debt-like risk, where the downside is protected, for equity-like returns.

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