Market Commentary

October 2016

EXECUTIVE SUMMARY

- Low volatility a surprising feature of September quarter
- Commodities and resource stocks join rise in bond yield to reflect improving US economy
- Clinton victory discounted in markets – buy the rumour; sell the fact?
- Global earnings to grow by over 10% in 2017 & 2018 to support markets
- Fallen interest rate sensitive stocks – infrastructure, telcos and utilities- showing value again
- Chinese middle class expansion stocks – food, travel, education - to continue as key holdings
- Banks rally into results, rising bond yields

Key features of the September quarter have been:

- For what has seasonally been the most volatile quarter for equities, this year was different. Most markets have delivered positive returns, including Australia, with August and September seeing low volatility.
- Perhaps the major feature of the quarter was the rise in longer dated bond yields (interest rate expectations), especially in the US and Australia. Factors behind this include economic growth, a rising trend in inflation in the US, some pick up in wages growth along with a gradual policy shift towards fiscal expansion.
- Currency markets were restricted to narrow trading ranges, with a clear absence of significant trend, with the exception of Sterling – on the timing of Brexit and increasing deficit perceptions.
- Commodities, apart from gold, continued to show recovery, with oil, coking coal and thermal coal showing greatest strength. This drove outperformance in resource related equities.

Why are Markets so calm ahead of US Election?

We have been surprised at how calm markets appear to be ahead of the US election. US equities, the $US, VIX (Volatility Index) have all been stable over the last two months. The Gold price has seen a meaningful correction, only rising bond yields appear to have priced in some additional risk.

In the context of Brexit and the election outcome in Australia, we are mindful of placing too much reliance on opinion polls ahead of major elections in this modern populist era.

It appears to us that markets are pricing in a Clinton victory and disregarding any possibility of a Trump victory. Perhaps this is appropriate following recent events.

Implications of a Trump Victory

There is clearly a view that Trump may be a positive for America. Consensus suggests that a Trump victory would be negative for financial markets, rendering the Brexit reaction benign. However diminished globalisation, reduced tradeflows, increased protectionism would seem unhelpful for longer term global growth prospects, especially in emerging markets.

For Australia, the biggest risk from a Trump victory would be on our major trading partner China, along with other north Asian economies closely linked by trade to the US.

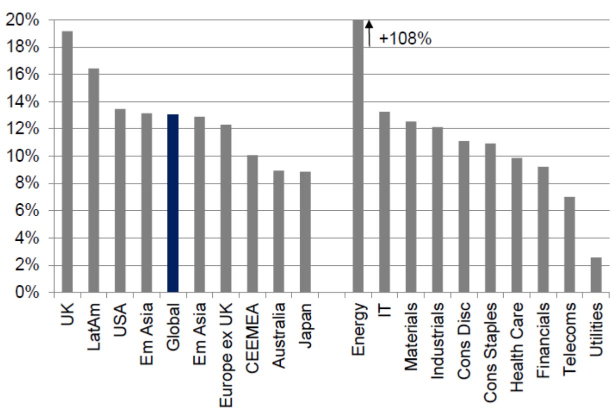
Recovery in Corporate Earnings to Support Equities in 2017 and 2018?

Chart 1 below shows current consensus earnings forecasts for 2017 and 2018 indicate **global** earnings will grow by 13.1% and 11.6% respectively, based on bottom up Citi projections. The Energy sector is a major driver of this growth, though supported by IT, Materials, Industrials and Consumer Discretionary.

According to Citi numbers, this growth is relatively consistent across the developed and emerging worlds, with both delivering double digit growth in both 2017 and 2018. Strongest growth is anticipated in Canada, the US, and the UK. In the emerging world, growth is driven primarily by China, India and Russia. Australia, by comparison, looks set to experience more sluggish growth outside resources.

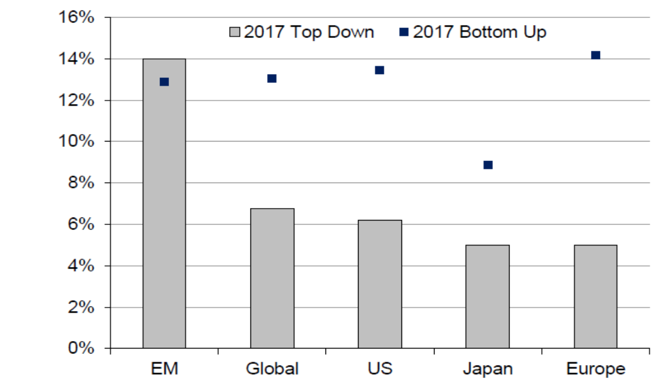
Historically, initially optimistic trends end up being consistently downgraded during the course of the financial year. Citi (Chart 2)also highlight the present differences in forecasts between stock analysts (typically more bullish – bottom-up) and strategists (typically more sceptical – top-down).

Chart 1: Consensus 2017 EPS Growth Estimates



Source: Citi Research

Chart 2: Top-down vs Bottom-up 2017 EPS Growth



Source: Citi Research, Factset Consensus Estimate

Can the Fallen Angels again spread Wings?

One of the features of the last quarter has been the underperformance of stocks and sectors that have been strong outperformers in much of the post GFC era. This has primarily been interest rate sensitive stocks - ie Infrastructure, Telcos, Utilities - and high quality industrials that have continued to deliver strong earnings growth such as Healthcare and overseas earners. This underperformance is attributable to a rise in long term interest rates, high valuations and sector rotation towards resource stocks and cyclicals.

The key question in our minds is making an assessment of how quickly interest rates may rise. Growth seems likely to remain sluggish. Excess capacity seems here to stay, holding back any sharp rebound in investment spending. The retirement demands of baby boomers will act as a constant headwind. Wages growth appears stable, especially in the context of low rates of population growth. This does not look like a particularly inflationary background. Therefore while interest rates might trend up in a long term cyclical sense, they seem unlikely to rise dramatically.

Better Value in Infrastructure Stocks

So based on this assessment, we are thinking that 15 -20% adjustments in share prices of the likes of Transurban, Sydney Airport and APA against a backdrop of minimal change to earnings prospects fully reflects the changing landscape. Value has re-emerged in these names.

More Attractive Opportunities in China Middle Class Sector

The emerging Chinese Middle Class are another group where recent share price corrections have restored valuations of exposed companies to much more realistic levels, especially in the context of regulatory risk. Stocks offering far better value today include Blackmores, Bellamys, Mantra, Costa and Bega.

Valuations also improve in the Telecoms Sector

A recent realisation that the economics in the NBN world are challenging has seen a significant sell off across the sector. Telstra declined 10% over the quarter, however smaller players such as Vocus and TPG have seen prices fall more than 30%.

Our assessment here is that current NBN arrangements are unsustainable, and the Minister has acknowledged as much. Current prices of the stocks however seems to be implying nothing will change. This seems an overly harsh view. Again we argue that value has been restored.

Strategy for the Final Quarter

Despite elevated risks associated with the US elections on November 8th, and an Australian market that is not cheaply-priced on 16x forward earnings - we are beginning to see pockets of value emerging.

On the back of better commodity prices, we are now seeing earnings upgrades on a more frequent basis, with Wesfarmers being the beneficiary of higher coal prices. According to UBS, if current spot prices are sustained, BHP's 2017 earnings would be more than 20% higher and RIO's would increase more than 40%.

Conditions in the banking sector appear to be relatively benign, certainly compared to some predictions earlier in the year. Recent results continue to highlight some pressure on margins, low and stable bad debts, slowing but modest loan growth and reasonable valuations. Dire predictions on the residential property market, so far, have been wide of the mark.

Having added some exposure to resources via BHP, this may be increased as the recovery in commodity prices becomes more widespread.

Our preferred international sectors continue to be technology, including China (Alibaba and Tencent), healthcare and infrastructure (mainly via ETF's), major overseas earners (Brambles, Amcor, CSL) and the Chinese emerging middle class (A2 Milk, Blackmore's, Bega, Costa – listed in Australia).

We look forward to catching up with you soon to discuss your portfolio and any change of circumstances or issues that we might be able to help you with.

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