Market Commentary

January 2016

Peak
Investment Partners

EXECUTIVE SUMMARY

- Lower equity returns in low growth world
- Stock and Sector selection key to investment performance
- Prospects for 2016 remain challenging-Australia relatively attractive
- China's economic transition creates new risks and opportunities
- Prefer combination of earnings growth and dividend yield
- O/W healthcare, infrastructure, non bank financials, industrials & overseas earners
- U/W Resources, Energy, Insurance, Banks

Pessimism Induces Correction

2015 A Challenging Year, 2016 Starts Poorly

All in all, 2015 was a tough year for financial markets, characterised by significant volatility in all asset classes, and early 2016 has been more of the same. Global equity markets struggled against subdued earnings growth, currency volatility, falling commodity prices and rising interest rate expectations. In Australia all major banks raised new capital, and the resources stocks were decimated by declining commodity prices. Sector and stock selection were more important than normal in determining investment returns.

Sectors and Stock Selection key in 2015

Strongest sectors in 2015 were healthcare, infrastructure, non-bank financials, transport, retail and property trusts. The 20 Leaders substantially underperformed the ASX200. Small Caps substantially outperformed the ASX200. Industrials substantially outperformed Resources and Energy. As we enter 2016, it is hard to see any sudden change in these recent trends.

Prospects for 2016: Some of the key issues

Absence of growth in the developed world

One of the reasons developed world equity markets struggled in 2015 was the persistent trend of reduced earnings growth expectations. Major factors included lower commodity prices, particularly energy, dismal investment spending by the private sector A lack of public sector programs, a stronger USD and low wages growth acted as an offset.

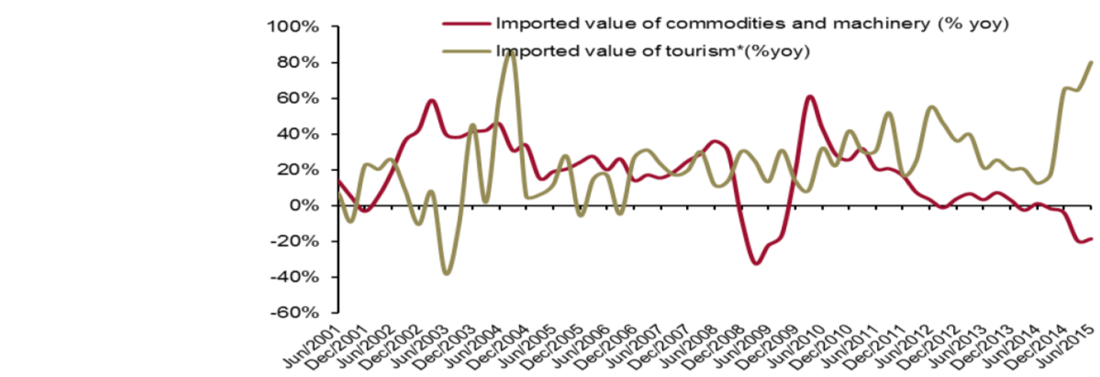
Will 2016 be any different? Notwithstanding the Fed finally raising rates in December, it is hard to make the case for any dramatic change in interest rates in the year ahead. Deflationary forces have diminished, but have far from disappeared. Commodity prices, especially oil and iron ore, remain under pressure. Ageing demographics see the trend of deleveraging continue at the personal level, while governments remain constrained. Companies are unlikely to raise investment spending materially, though M&A remains at record levels. In summary, the lack of earnings momentum remains perhaps the greatest risk to equity markets in 2016.

China: Transition, Structural Reform Elevate Risks

China's continuing transition from an investment and manufacturing driven economy towards consumption and services, seems likely to induce periods of volatility. Structural reform is a key part of this transition. For Australian companies, opportunities will continue to evolve. While resources and hard commodities struggled during 2015, soft commodity exposures such as food, along with tourism, education and property related services thrived-see chart below.

Significant risks remain for China as it steers a passage through this transition phase. In comparison with 2008, the economy is far more debt laden. Growth will continue to slow. Risks associated with an expanding presence in regional and global security issues will ebb and flow. However our base case is that China will continue to march on to become the world's largest middle class market, and will remain Australia's largest trading partner. This cannot be ignored from an investment perspective.

China's demand for commodities versus tourism



Note: BoP data.

Source: CEIC, Credit Suisse

Australia Perhaps a Bright Spot

China's economic transition has forced a similar economic transition in Australia via sharply lower commodity prices. Fortunately for Australia this has led to a sharply lower AUD as well. This has had a significant positive effect on several sectors, particularly tourism, agriculture, education and property investment. These trends look set to continue in 2016.

Driven largely by NSW, we are now seeing a solid pickup in infrastructure spending. There are currently 12 major projects either underway or at advanced stages of planning. Courtesy of asset sales, funding appears to be more robust than normal. This will see a material increase in activity over the period ahead. With luck, this might spill over into other states.

Housing construction activity is currently running at record levels. While we see this sector at a peak, the volume of work in the pipeline will continue to provide reasonable levels of activity during 2016. Whether housing ends in an oversupplied situation, remains to be seen, but away from the inner city apartment sector, a collapse in housing prices is not our base case.

We are also encouraged by the positive lift in business and consumer confidence post the change of prime minister in 2015. It appears that this has translated into a solid Christmas for most retailers.

Growth comes at a price

	PE 16-17	*EPS Growth 16-17*	*PEG**
Market	14.0	10.7%	1.3
Banks	11.7	3.4%	3.4
Other Financials	12.7	6.7%	1.9
Discretionary Retail	15.8	8.6%	1.8
Healthcare	20.0	13.7%	1.5
Telco	14.2	7.9%	1.5
General Industrials	16.2	9.1%	1.8
Information Technology	17.4	23.4%	0.7

Source: Bloomberg

***Price earnings to Growth*

Peak Strategy for 2016

Much bad news appears to have been captured in equity valuations as we enter 2016. While the ASX200 is trading at less than 14.5x forward earnings, earnings growth prospects across sectors are highly variable. We continue to base key investments on stocks with a combination of reasonably safe and predictable earnings growth offering decent yield, preferably franked. We remain very sector specific (healthcare, infrastructure, non bank financials, select overseas earners, select small companies), where earnings growth prospects are at or near double digit levels. We are neutral to underweight major banks, insurance, discretionary retailers, energy and miners.

As the table below highlights, earnings growth does not come cheap. In a world of low and stable growth, the opportunities around "cyclical" growth have diminished. Stocks and sectors with solid, predictable earnings growth emanating from structural trends have consistently traded a premium to the market, but have consistently outperformed.

One area we do intend to take more action in 2016 is that of increasing exposure to Small and Mid cap companies. Over the next month or so we will discuss with you such opportunities.

Another opportunity we see as important is food. As the China story evolves from hard commodities to food and services, there are some very interesting opportunities in Australia worthy of exploration.

Finally technology and innovation have taken on elevated importance under the Turnbull government and, this too, is expected to create some interesting opportunities.

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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