

### EXECUTIVE SUMMARY

- Most developed markets delivered returns above 3% for the quarter-the ASX200 index declined 2.5% weakened by banks, resources and retailers.
- Leading indicators (PMI's) positive for the global economy in second half of 2017, supportive for corporate earnings.
- Prospects of higher interest rates and rising inflation may put downward pressure on equity multiples, partly offsetting the positive earnings impact.
- Australia's economic outlook is mixed. Housing sector has peaked, strengthening non-residential construction and infrastructure will provide an offset. Consumption subdued - low wages growth, rising energy costs and high debt.
- Corporate earnings growth will be largely driven by overseas earners, healthcare, transport, gaming, internet, technology, energy, diversified financials and food. Domestic businesses-retail, banks, telecoms-to struggle, resources also.
- ASX200 is trading at 15.2x 2018 earnings, 5% above 20 year average (Goldman Sachs), and relatively attractive compared to the US. Anticipate 6,000 by year end.

### ASX200 Underperforms Global Indices

With a heavy weighting to Banks, Resources and mature Industrials, the Australian ASX200 index declined 2.5% during the June quarter, with Industrials and Resources sub-indices declining by similar amounts. Apart from the healthcare stocks, the key drivers of the index were cyclical stocks such as insurance, building materials, airlines, chemicals and mining services-sectors that have historically been poor performers. Sectors making negative contributions to performance included banks, telecoms, energy and retail.

In contrast, the US market performed strongly. The S&P500 index rose 3% and the technology dominated NASDAQ index rose 4%. Asian markets also performed strongly during the quarter with Japan, China and Hong Kong generating returns of 4.8% or more. Europe was flat.

### Global Growth Outlook Constructive

The global economy continues to enjoy its first synchronised recovery since the GFC. Over the last quarter, growth has strengthened in the US, Japan, Europe and China. More importantly, leading indicators such as the Purchasing Managers Indices have remained strong, suggesting growth will remain buoyant through the second half. Supporting the positive outlook for the second half, financial conditions have eased in the US and China during the first half, and global trade flows have picked up.

Reflecting these positive macro trends, corporate earnings expectations for most major markets have strengthened during the first half. Key drivers of stronger corporate earnings have been better commodity prices leading to stronger investment spending, continuing growth in the technology sector, a reasonable performance from the consumer and a recovery in global bank sector earnings.

### Higher Interest Rates May Pressure PE Multiples

Now that the US is into a tightening phase and with some early signs of rising inflation via higher wages growth (from extremely low levels), interest rates in the US are set to increase during the second half. Policy settings in Europe and Japan seem likely to remain supportive at least until 2018.

The significance of this is that equity valuations are likely to come under some pressure from an earnings multiple perspective. So while the impact of stronger corporate earnings will be a positive, some of this benefit could be offset by lower valuation multiples.

### Australia's Economic Outlook Mixed

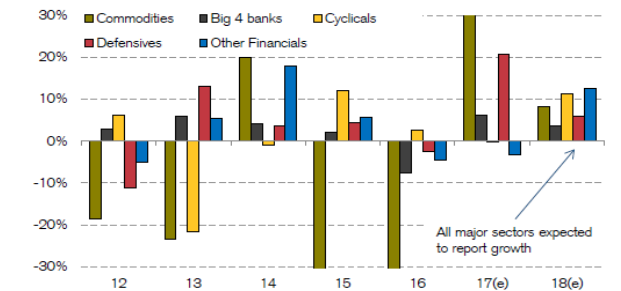
Following a poor first quarter, the Australian economy has rebounded during the second, with a reasonable contribution from the consumer economy-despite low wages growth and a heavily indebted consumer sector. Key drivers of growth are expected to be a stronger contribution from infrastructure and non-residential construction, offsetting a declining housing sector. Given the strong pipeline of new road, rail and airport construction projects in New South Wales, Victoria and Queensland, we are confident this will happen over the next three to five years.

The key risk remains the heavily indebted consumer sector, elevated level of property prices, and low levels of income growth. Any meaningful upturn in interest rates and unemployment may have negative implications for several sectors including banks, consumption related sectors and the currency.

Growth will continue to be supported by growing export volumes, \$A permitting. Continuing ramp up of LNG export volumes from both Queensland and WA will be supportive. Tourism and education continue to grow strongly. Wine exports to China are growing at more than 40% pa and now run at over \$560m pa.

### Australian Earnings Growth Sector Specific

**Figure 1: The Aussie earnings expansion broadens**  
Actual and expected EPS growth for ASX 200 major sectors\* calendarised to June year-end



\* Major sectors include Commodities (Metals & Mining, Energy), Big 4 banks (ANZ, CBA, NAB, WBC), Cyclical (basic materials other than metals & mining, Consumer Discretionary, Info Tech, Industrials excluding the three infrastructure stocks), Defensive (Consumer Staples, Health Care, REITs, Telecoms, Utilities, MQA, TCL, SYD), Other Financials (all financials other than big 4 banks and REITs). Source: Company data, IBES estimates, Credit Suisse estimates

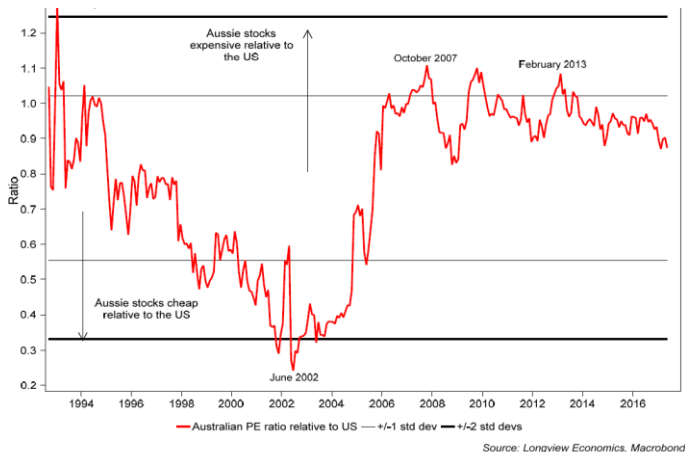
As the above chart from Credit Suisse highlights, for 2018, most sectors are expected to contribute to earnings growth. Key drivers of growth are expected to be healthcare, transport, gaming, utilities, industrials, and diversified financials. Companies with extensive overseas operations are expected to significantly outperform more domestically focused businesses, partly offset by a stronger \$A.

Sectors facing headwinds include resource sectors where commodity prices seem likely to remain subdued, banks (declining credit growth as indicated in the chart below), telecoms (increased competition) and retail (increased competition).

Technological disruption is also expected to be a feature of some sectors, similar to H1 2017. The move to a lower carbon world will continue to disrupt energy markets. The impact of Artificial Intelligence, 3D Printing, Electric Vehicles and increased use of robotics are bound to cause surprises in the year ahead.

### Investment Strategy for H2 2017

#### Australian PE relative to US at Lowest since 2008



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Despite lower earnings growth prospects relative to the US, the above chart from Longview Economics highlights the point that the Australian market forward PE multiple relative to the US, is near a post October 2007 low.

Valuations, while not cheap, are not excessive as far as Australia is concerned. Goldman Sachs currently has the ASX200 Index at just over 15x one year forward PE, 5% above its 20 year average. There are however some sectors offering the highest growth prospects such as healthcare, internet, gaming, diversified financials where valuations look stretched at more than 20x 2018 earnings.

Given the divergent earnings trends, our focus is to concentrate on stocks that can deliver growth independent of the economic cycle, where the threat from disruption or changing regulation is relatively small and where funding costs are manageable in a rising interest rate environment.

We have a bias towards overseas earners when evaluating more attractive growth prospects. There is also a bias to stocks with high exposure to the rapidly growing Asian middle class such as tourism, food and wine.

Technology remains an attractive sector, and with limited domestic plays, we will continue to seek exposure via international stocks. Technology stocks such as Amazon continue to cause disruption to sectors such as the retail sector in Australia, leading to large differences in relative performance.

Sectors facing structural and cyclical headwind such as telecoms and retailers are now beginning to attract the interest of private equity funds. This suggests they, at least, consider much bad news is now in the price. It is worth noting that both sectors have performed similarly in most developed markets.

While stronger global growth should lead to some recovery in investment spending and be supportive for commodities demand, we anticipate expanded supply to keep prices relatively subdued.

Our base case is for a volatile quarter ahead in a seasonally weak period, followed by the usual end of year rally, with the ASX200 closing the year near 6,000.

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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