Market Commentary

April 2019

Peak Investment Partners

EXECUTIVE SUMMARY

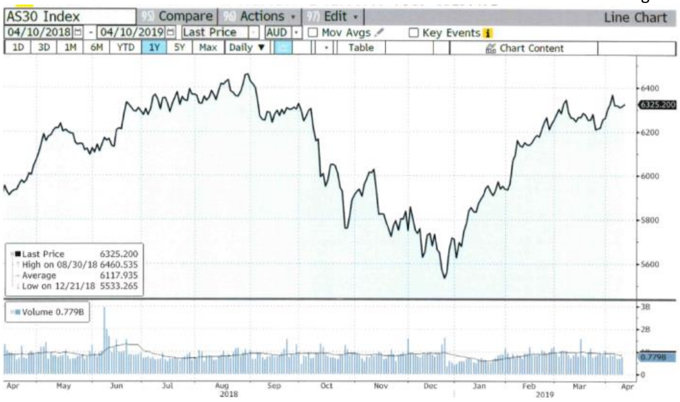
- **Following a period of policy tightening during 2018, Central Banks have resumed a more accommodative stance during Q1, resulting in a strong rally in global equity markets.**
- **Slowing global growth prospects and stress in credit markets have induced a decisive policy response. Early signs suggest that growth should stabilise later in 2019.**
- **The risk of macro shocks remain elevated. The US China trade dispute and Brexit remain unresolved. Key elections will occur in India, Europe, Israel, Indonesia and Australia.**
- **In Australia, economic growth remains weak. With a change of government likely in May, house prices falling and credit availability an increasing issue, the chance of recession is elevated.**
- **Having rallied strongly in early 2019, we see risks increasing as earnings growth momentum continues to weaken. Downgrades continue to outpace upgrades in the US and Australia.**
- **Equity valuations at 16x prospective earnings and 5% EPS growth appear reasonable provided interest rates and inflation remain low. Following a strong rally, a period of consolidation in the ASX200 is likely.**
- **Our preferred exposures continue to be healthcare, food, infrastructure, technology, overseas earners, resources and select international stocks.**

Central Banks Change Course: Markets Respond Positively

In early 2019, Central Banks in the US, Europe, Japan, China and Australia shifted from the tightening bias of 2018 to a more pro-growth, market friendly stance. The impact of the change has been profound. Global equity markets have rallied strongly. The MSCI World index has increased nearly 20% from Christmas Eve lows. The S&P500 is up more than 20%, China's CSI300 is up more than 35% and the ASX200 index is up more than 13%. In March, Purchasing Managers surveys (a leading indicator series) have looked more constructive for the first time in months, particularly in the US and China.

ASX All Ordinaries

Source: Bloomberg



Where are We in The Cycle?

In late 2018, markets were pricing in a high probability that the cycle which commenced in 2009 was near an end. Action taken by Central Banks during Q1 has increased confidence that there will be another leg to the current cycle as growth stabilizes through 2019. Markets will be supported by stable interest rates, benign inflation and modest growth.

One of the most widely discussed leading indicators of US recessions is an inverted yield curve (ie longer dated bonds trading below shorter dated securities). With US 10-year bonds falling sharply in yield during Q1, the yield curve has flattened. However, the difference between the 2- and 10-year bonds have remained positive so far. However, once the 2 and 10 year bonds invert, a recession emerges within 18 months.

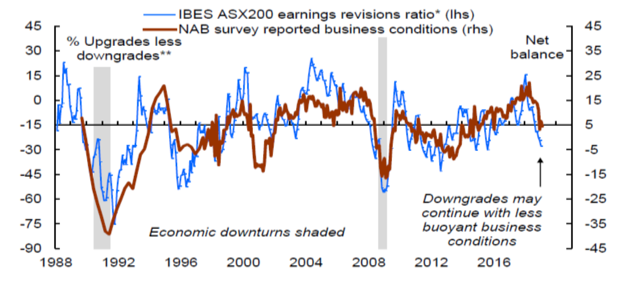
The Citi Bear Market Checklist is currently showing only 4 out of 18 variables pointing to a bear market in the US. These include shape of the yield curve, credit spreads, corporate debt levels in the US and analyst optimism.

Disconnect between Rising Markets and Lower Earnings Forecasts

Following a stellar period of corporate earnings growth in the US in 2018 when tax cuts fuelled a 25% increase, this is forecast to slow to 3.7% in CY19. With Q1 earnings results about to commence, expectations are for earnings of 3.9%. This is down by around 7% since December 2018, with Energy and Materials being the largest contributors to the downgrades.

In Australia, ASX200 index consensus estimates are showing EPS growth numbers of 5.4% in FY19, 4.7% in FY20 and 2.6% in FY21. During Q1 downgrades have continued to outpace upgrades (see chart below). Only the resources sector has seen upgrades running ahead of downgrades, reflecting buoyant iron ore prices. Sectors showing the strongest growth include Gaming, Healthcare, Food & Beverages and Diversified Financials. Sectors detracting from growth include Transport, Telecoms and Wealth Managers. Retailing and Banks remain low growth sectors. This disconnect underpins our cautiousness on the market.

Figure 2. Business conditions and earnings revisions (monthly to February 2019)



*3 month moving average. **Upgrades less downgrades as a percent of all stocks in the index. Source: NAB, IBES, S&P, Datastream, Citi Research

Election Unlikely to Be Helpful

With a May election and the strong possibility of a change of government that appears committed to a number of wide ranging reforms. Capital gains tax, dividend imputation, healthcare, health insurance and negative gearing, provide potential for disruption. GDP growth in the September and December quarters was barely positive at 0.3% and 0.2% respectively. A reform program in the midst of a weakening economy and falling property prices comes with significant risks to corporate earnings and the ASX200 index. We are also concerned about tighter credit conditions having a negative impact on the broader economy.

On the positive side, both parties appear to be committed to maintaining a high level of infrastructure spending, to increasing expenditure on healthcare and education and to tax cuts. The Coalition has the Budget back to a surplus, providing a solid fiscal base to support the economy should conditions deteriorate. Along with other central banks, the RBA has also moved to a more neutral position on future trends in Australian interest rates being evenly balanced. Financial markets in Australia are now pricing in a 0.25% rate cut in 2019.

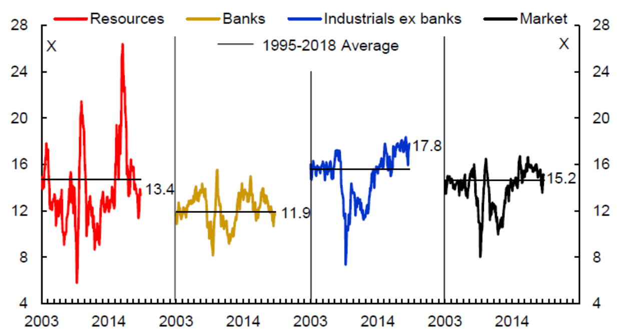
Market Outlook

Following the strong rally in Q1, and given the above discussion on slower growth, declining momentum in corporate earnings and a likely change of government in Australia, a period of consolidation in the ASX200 appears likely. Downside risk to markets has been reduced via more "market friendly" policy settings put in place during Q1. Fundamentals at this stage offer some downside support, though are not sufficiently strong to take markets higher. Perhaps more than usual, prospects across stocks and sectors seems particularly diverse.

Market Valuations Mixed

Based on Macquarie Research forecasts, the Australian market is trading on 16.4x FY19 and 15.3x FY20 earnings. With interest rate and inflation trends now widely forecast to remain neutral over the medium term, valuations overall look reasonable. However with Banks making up 25% of the ASX200 index and trading at less than 13x FY19 and FY20 earnings, the overall PER is reduced. Higher growth sectors such as healthcare and technology along with overseas earners trade at multiples much closer to 20x earnings. While the overall market multiple appears reasonable, there appears to be valuation risk in some higher growth sectors of the market such as technology, healthcare and smaller cap stocks.

Figure 14. Major sector PE ratios



Source: IBES, MSCI, Datastream, Citi Research

Sector Prospects

The Resources sector remains in earnings upgrade mode as iron ore prices approach $100/T are supporting earnings and future dividends. Higher oil prices continue to provide medium term support for Energy stocks, despite weaker spot LNG prices. We continue to like gold. Central Banks in China and Russia continue to be net buyers of gold. A $A/US exchange rate remains highly supportive to the Resources and Energy sectors. Core holdings include BHP, RIO, Northern Star, Woodside Oil Search and Origin.

We remain overweight Healthcare. CSL, Resmed, Cochlear and Ramsay have world class businesses in their respective niches, have consistently delivered strong growth that is independent of the economic cycle.

We continue to see strong growth prospects in the Food & Beverage sector. Our preferred stocks include Costa, A2 and Treasury Wines. Strong businesses in Australia coupled with exposure to the emerging middle class in Asia and elsewhere also provide growth that is somewhat independent of the economic cycle.

Companies with a strong presence overseas also offer superior growth prospects. Macquarie Bank, Aristocrat, James Hardie (along with the healthcare stocks and food) have a strong presence in overseas markets.

Technology represents a small part of the Australian market. Our three large cap preferences are REA, Seek and Webjet. Each has a strong position in the domestic market, complemented by significant growth opportunities offshore, providing some protection against low activity in Australia.

Infrastructure spending will be a key driver of economic activity in the medium term. Our preferred exposures include Transurban, Sydney Airport and Qube. Low interest rates continue to support the sector.

Major Banks are struggling to grow earnings in a low credit growth environment. With tighter lending standards introduced in 2016, we don't foresee major problems arising from the housing market downturn. We are concerned about the tighter lending standards impacting negatively on the small business sector, potentially increasing bad and doubtful debts. An underweight position is warranted.

Our preferred International exposures include Alibaba (China online leader), Microsoft (global software leader), Google (global search engine) and Erikson (a major player in 5G)

Ian Wenham **Director** | **Richard Nicholas** **Director** | **Andrew Martin** **Director**

Contact details
GPO BOX 2058 Sydney NSW 2001
Phone: (+61 2) 8274 5800 **Fax:** (+61 2) 8274 5899
Email: info@peakinvest.com.au **www.peakinvest.com.au**