Market Commentary

January 2018

EXECUTIVE SUMMARY

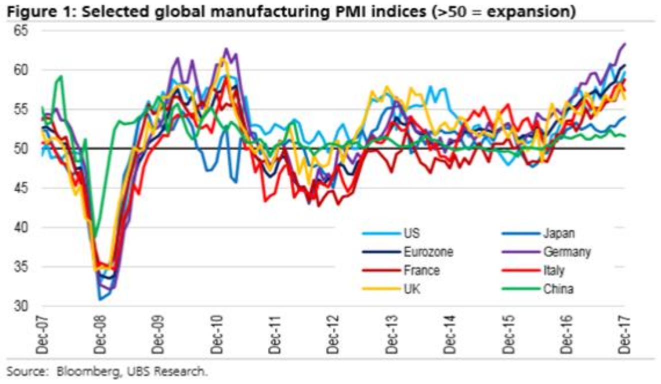
- Buoyant, synchronized global growth should support equities in H1, 2018. We are more cautious on H2 as rising interest rates and inflation could impact. Increased M&A activity expected to be supportive.
- Australian economy challenged by low wages growth and high consumer debt. Declining house prices, tighter lending likely to slow activity. ASX200 underperformance in 2017 has priced much of this in.
- Australian equities expected to underperform. Consumer, housing exposed sectors and banks appear challenged. Infrastructure, Resources, Energy, Technology and Small Caps should outperform.
- Elevated valuations no longer provide much protection to investors for unexpected outcomes. Gold should be considered.
- Growth opportunities are more prevalent outside Australia. Technology, Asia's emerging middle class, Electric Vehicles, Automation and Artificial Intelligence look attractive.

2017 the Easy Year: 2018 Could be More Challenging

Global markets in most cases experienced their best performance in 8 years. The FTSE All World index increased 22%, with strong performances in the US, Europe and Japan. Emerging Markets contributed positively with Hong Kong and India both recording gains of more than 30%. Bonds also performed strongly with the Bloomberg Barclays Global Aggregate index increasing 7%-its best performance in a decade. Commodity markets performed strongly, especially industrial commodities and energy.

The favourable drivers of markets in 2017 included strong, synchronized economic growth in virtually all regions, enabling solid earnings growth. Inflation remained subdued. Central banks remained supportive, other than the US. Fiscal policy is transitioning towards being supportive via increasing infrastructure spending and lower tax rates.

Figure 1: Selected global manufacturing PMI indices (>50 = expansion)



Source: Bloomberg, UBS Research.

As we enter 2018, we are not convinced that this set of factors will remain as supportive as they have been for markets in 2017. At the outset, Central banks are likely to increase rates in the US, China and the UK, perhaps in Australia. Policy is likely to become less accommodative in Europe and Japan in 2018.

Stronger labour markets have, so far, not led to materially higher wage costs; at some stage this may change. Higher commodity prices are already seeing higher producer prices. Stronger growth will eventually lead to higher bond yields, impacting negatively on equity multiples.

In summary, we see some of the "following winds" experienced in 2017 turning less friendly for markets in 2018, even as the overall macro environment remains constructive.

Australia An Underperformer…

Having enjoyed an outstanding track record of 27 years of economic growth, and survived the worst of the GFC, the Australian market was a relative underperformer in 2017. The ASX200 index rising just 7%, or 11.8% if dividends are included. While Resources performed broadly in line with global indices, heavily weighted sectors such as Banks, Telecoms, REIT's and Retailers all declined. Given the confluence of low wages growth, high consumer debt, higher energy costs and flat to declining housing prices, we expect these trends to continue in 2018.

…However there are some bright spots

- Stronger infrastructure spending especially on the East coast. The pipeline is of a sufficient scale to sustain activity at elevated levels for 4-6 years. Infrastructure stocks, Building Materials and Construction companies are beneficiaries.
- Strengthening commodity prices-as well as an end to the mining sector investment boom downturn. China's focus on a cleaner environment appears to be a net positive for global commodity markets. Also higher demand for commodities associated with electric vehicles and renewable energy such as graphite and lithium, remains supportive
- Business opportunities for Australian companies arising out of Asia's rapidly expanding middle class. Companies providing food, healthcare and tourism related services will continue to be beneficiaries.
- Strong performance in Small caps, especially Food and Technology. In contrast to the ASX200, the ASX Small Ords Accumulation index increased 20% in 2017. Given the structural challenges faced by major sectors in the ASX200 index, increased exposure to select smaller companies is expected to deliver future outperformance.

Some Thoughts and Opportunities for 2018

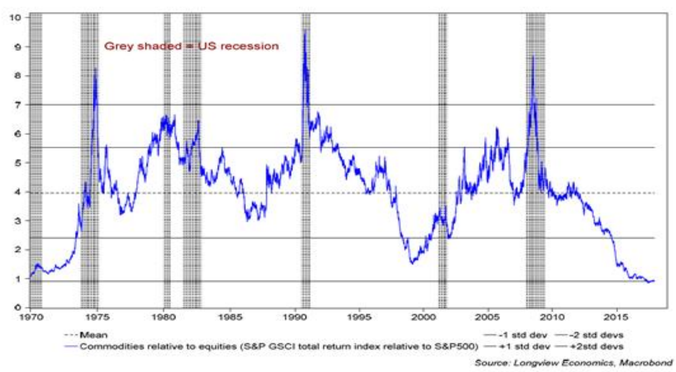
Australian Market Remains a Stock Pickers Market

In a global context, the Australian market is less overvalued than a number of others, though relative valuations vary widely across sectors. Sectors such as healthcare, technology, companies with overseas earnings with relatively high growth prospects, are expensive. Banks, Retailers, Telecoms, REIT's are relatively cheap, but have very low growth prospects. The resources and energy stocks have attractive free cashflow yields, and have some upside earnings growth potential. From a liquidity perspective, international investors are underweight Australia. Local investors hold significant cash, suggesting a lot of bad news is priced in.

Will 2018 be the year for commodity stocks?

While 2017 ended up being a reasonable year for resources and commodity related investments, we recently came across an interesting chart that highlighted just how much commodities have underperformed equities since 2008. For several years mining companies have been cutting back on production expansion and exploration. We wonder whether the current recovery in investment spending could trigger a new commodity price cycle akin to 2003 and 2010. Given currently attractive free cashflow yields of all global majors, we expect to capital management initiatives to be supportive.

Fig 9ii: Commodities relative to US equities (S&P GSCI total return index relative to S&P500)

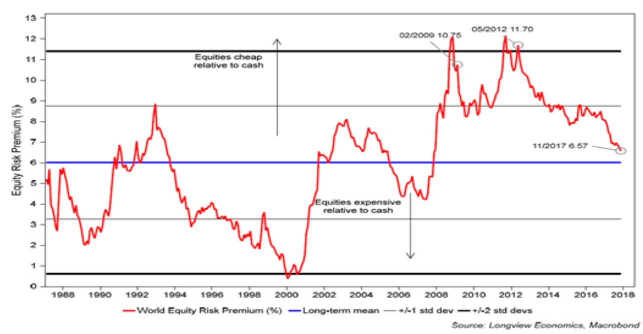


*albeit its notable that oil (BRENT & WTI) has a 40% weighting in this index

Will historically high valuations lead to a major correction?

The strong performance by equity markets has resulted in valuations moving to "beyond fair value" levels, with the US to the extreme. The Equity Risk Premium has fallen significantly since 2009, so the valuation protection investors have for an unexpected event has materially diminished.

Fig 9i: World Equity Risk Premium (earnings yield less real cash rates)



Secondly, we note that bear markets are always accompanied by recessions, something that is not an immediate prospect. This suggests that markets should do well in the early part of 2018. Thirdly, we note that historically gold has performed strongly during major sell offs in equity markets. During 2017, we have continued to add some gold exposure to most portfolios, and there is a case for more of this in 2018.

In these 10 episodes of peak-to-trough market drops, gold proved to be a better hedge than Treasuries on average.

	Start	End	S&P 500 index	U.S. Treasuries	Gold
1987 crash	25/8/87	19/10/87	-33.2%	-7.2%	5.0%
Iraq invades Kuwait	17/7/90	12/10/90	-17.6%	-0.4%	7.6%
Asia crisis	7/10/97	28/10/97	-6.2%	0.0%	-4.6%
Russia/Long-Term Capital Management crisis	20/7/98	8/10/98	-18.7%	5.3%	1.2%
Sept. 11	10/9/01	11/10/02	-22.3%	11.2%	16.6%
Global financial crisis	11/10/07	6/3/09	-54.5%	15.8%	25.6%
2010 euro zone crisis and flash crash	20/4/10	1/7/10	-14.5%	4.5%	5.1%
U.S. sovereign debt downgrade	25/7/11	9/8/11	-12.3%	3.6%	7.8%
Taper tantrum	22/5/13	24/6/13	-4.8%	-2.0%	-6.4%
China worries	18/8/15	11/2/16	-11.8%	3.5%	11.5%
Average			-19.6%	3.4%	6.9%

Source: Bloomberg

Global growth themes that could assist portfolio performance in 2018?

The structure of the Australian market remains heavily skewed to Financials, REITS, Retailers and Telcos where growth prospects are limited. We are increasingly focusing on structural trends that are generating stronger growth and investment returns outside Australia. Some of these include:

- Technology
- Electric Vehicles
- Ecommerce & rising middle class in China and India
- Artificial Intelligence
- Automation & Robotics

Exposure to these is via a combination of ETF's and direct shares listed outside 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.

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

Contact details

Level 11, 56 Pitt Street, Sydney NSW 2000
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**