Market Commentary

July 2018

EXECUTIVE SUMMARY

- For the first time in a decade, the ASX200 index has closed the quarter and financial year above the 6,000 level. We see this as being technically significant.
- Market volatility has been elevated by the Trump factor. Trade tensions, US tax cuts, unsettled long term political relationships are destabilising markets.
- Solid corporate earnings growth continues to provide support for equity markets in the face of rising interest rates.
- After a long period of underperformance, the financials dominated ASX200 outperformed global indices over the June quarter, with a broadly-based performance across most sectors.
- Valuations are elevated, though not at levels we would regard as extreme compared to previous market peaks. We acknowledge however that this has become one of the longest market cycles in history.
- Our investment focus continues to be around sectors offering secular growth such as Healthcare, Food, Overseas Earners, Technology, Mining and Energy.

ASX200 Finally closes above 6,000: Technically Significant

After numerous attempts to break convincingly through the 6,000 level, a strong performance during the June quarter finally saw the ASX200 index close above that level. Supported by a robust performance from the challenged Banks and a continuing rally in Mining and Energy stocks culminated in an 8.5% total return for the quarter. Key factors underpinning the rally included:

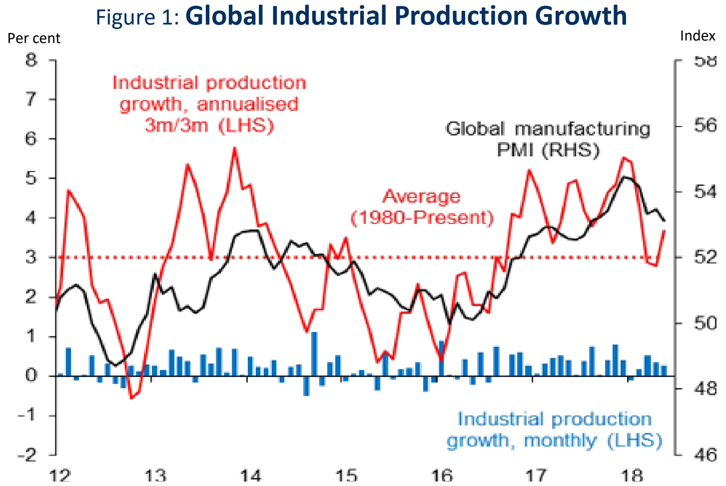
- a weaker $A (reflecting more a strong $US)
- solid economic numbers, supporting a positive outlook for corporate earnings
- a marginal improvement in the prospects of the government being returned to power again next year following successful passage of personal tax cuts
- increased corporate activity

Markets continue to climb a "Wall of Worry"

Market volatility has increased in 2018. One of the key measures of market volatility is the Vix index. This traded consistently around 10 during 2017, however in 2018 it traded above 20 for much of the first quarter and around 14 in the second quarter. Some of the factors behind higher volatility include:

- Concerns over Trump tariffs and the heightened risk of a global trade war
- Lead indicators such as PMI's (Purchasing Managers Index) declining from high levels experienced in late 2017 and early 2018
- China equities entering a bear market, having declined more than 20% from peak levels experienced in January
- Inflation concerns emanating from tight labour markets and higher energy prices to keep the Fed raising rates in the US. This raises the risk of an inverted yield curve - an historical indicator of a US recession
- Political risks abound. The US mid-term elections, Europe, Brexit, Federal and state elections in Australia, Indian and Indonesian elections are all on the horizon.
- With the current market cycle now more than 10 years old, it has become one of the longest. Late cycle characteristics are on the increase (recovery in investment spending, shape of yield curve, rising interest rates, tight labour markets)
- High consumer debt, high property prices and tightening credit conditions in Australia

Figure 1: **Global Industrial Production Growth**



While not being dismissive of the above points, we would note that generally the global economy remains robust. There is a high level of cautiousness by business, investors and financial markets. While equity markets are not cheap in price/earnings terms, nor are they at extreme or speculative levels.

Figure 1: Source: IHS Markit, IMF, Macrobond, Macquarie

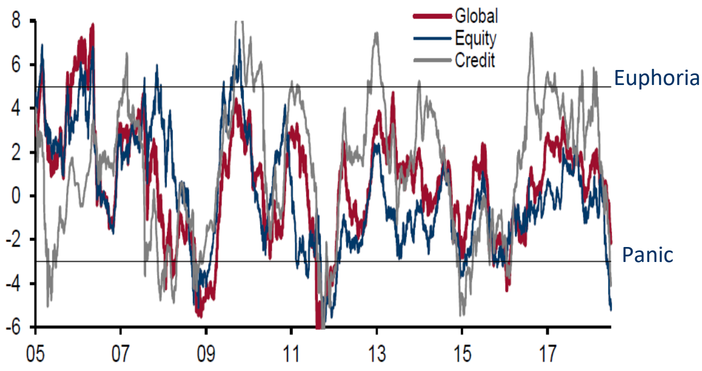
How Should Investors Approach Such Times?

Ahead of the formal introduction of trade tariffs by the US, financial markets outside the US had built in significant risk for such an event. The Credit Suisse Risk Appetite measure recently had equity markets at dangerous levels. China financial markets and base metal prices similarly had built in a significant risk premium. The recent equity market rally would appear to be another example of "sell the tariffs rumour, buy the fact"!

Figure 2: Horizontal lines at +5 and -3 indicate 'euphoria' and 'panic'

Source: Credit Suisse, Thomson Reuters Datastream, National Sources

Figure 2: **Credit Suisse Risk Appetite Index**

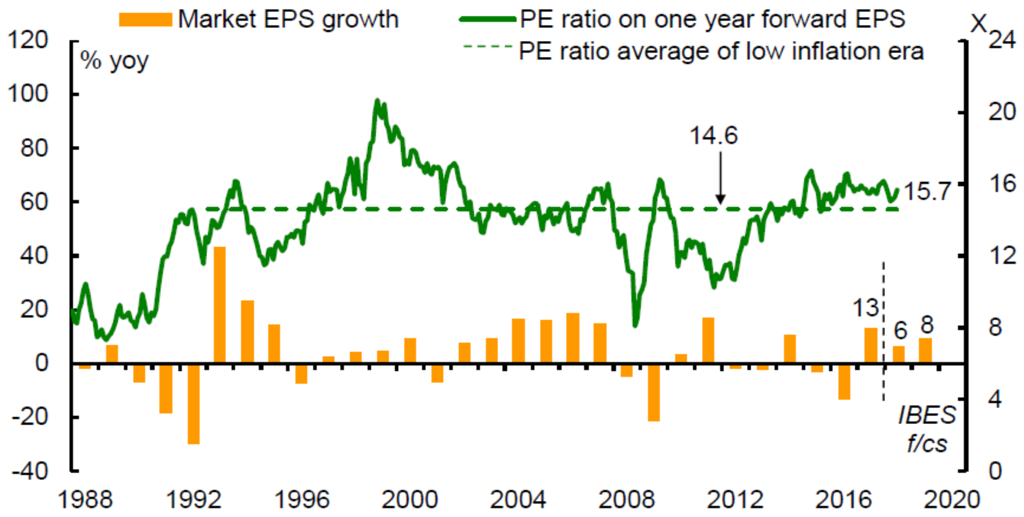


Outlook for Corporate Earnings Remains Constructive

Despite the broad macro concerns, corporate earnings in most markets remain positive. The US has entered its Q2 reporting season. Consensus numbers are forecasting more than 20% growth in 2018 and 10% in 2019. European corporate earnings are forecast to increase 8% in CY18 and 9% in 2019. In Australia, Citi is forecasting 6% growth in EPS in FY18, strengthening to more than 8% in FY19. The major contributors to this growth are Resources, Industrials ex Financials and Listed Property Trusts, Financials and Small and Mid-cap stocks - outside the top 100.

Solid earnings growth prospects have kept valuations in check, despite the ASX200 index currently trading at its highest level in more than 10 years. Again, using Citi numbers, the Australian market is trading at 15.7x FY19 earnings. Industrials ex Financials and LPT's are the only sector that appears relatively expensive on 19x: healthcare, technology related and some overseas earners are the major contributors to this.

Figure 3: **Australian Market Fundamentals Favourable**



Source: IBES, S&P, MSCI, Datatream, Citi Research

Australian Equities Outperforming, Despite Banks

After a long period of underperformance, the ASX200 index (up 8.5%) has outperformed the MSCI Global index (up 2.0%) as well as the S&P500 (up 3.4%) over the last quarter, in both local currency terms as well as in $US. Unlike the US market, which continues to be driven primarily by a small group of technology names, the ASX200 has experienced a relatively broad base of contributors to performance. During the June quarter, Financials, Materials, Healthcare, Consumer Staples, Real Estate, Energy, Consumer Discretionary, Information Technology and Utilities all outperformed the ASX200 Accumulation index return of 8.5%. The two major underperformers were Banks and Telecoms.

In our view, this broadly-based market performance does suggest a somewhat more positive assessment on the state of the Australian economy than a lot of the more pessimistic commentary would suggest. The RBA has been more positive on Australian economic prospects than market commentators. A combination of stable growth, low interest rates, low $A and modestly increasing household income support a positive outlook for corporate earnings growth.

Banks & Telecom Underperformance Over?

With a weighting of 26.5% in the ASX200 index, a -1.1% total return from the Banks for the 12 months to June 30 2018 was a distinct headwind for the overall market. This was complemented by the Telecom sector that saw a total return of -30.9% for the year, with the sector declining to just 3% of the index.

While we continue to run an underweight position in Banks-based on limited growth prospects, a slowing housing sector, increased regulation and remedial action out of the Royal Commission, we do acknowledge they are strong businesses in a well-regulated market. The recent rally from very oversold levels has not been a surprise. However, if it continues, we may be tempted to reduce exposure further.

We have exited Telstra, and see no fundamental reason to re-enter, apart from being very oversold at lower levels. Competition in most of Telstra's core businesses has materially increased in recent years and we are unconvinced about Telstra transforming itself into a successful technology company. 5G maybe a catalyst for a recovery, though it is unlikely to impact before 2021.

Key Investment Themes for the Year Ahead

Healthcare: Australia has several world class businesses, including CSL, Resmed, Ramsay (derated on lower growth) and Cochlear that have delivered superior long-term returns based on high earnings growth

Infrastructure: Current infrastructure spending boom taking over from housing as a key driver. Main exposures are Transurban, Adelaide Brighton, Seven Group and Goodman Group (Amazon)

Food: An expanding sector based on Australia's position as a high quality, secure provider of food products to the rapidly growing Asian middle class. Exposures include Costa, Bega, A2 Milk, Treasury Wines

Overseas Earners: Several companies have successfully expanded beyond the small domestic market and established successful international businesses. These include several of the names mentioned above along with Aristocrat, Amcor, James Hardie

Diversified Financials: Key drivers of growth include global operations - Macquarie, Magellan, Janus Henderson and superannuation/annuities -Challenger

Tourism: Australia continues to rank highly as a favoured destination for the rapidly growing Chinese tourism sector. Sydney Airport is a major beneficiary

Energy: Australia is a major exporter of energy via coal, LNG and uranium. Preferred exposures include Origin, BHP and Oil Search

Technology: Insignificant part of ASX200 (less than 2%). Exposure concentrated via international investments. Major holdings include Global Technology ETF, Google, Alibaba, Tencent and Baidu.

Floating rate hybrid Securities: Bank hybrids currently gross running income yields of 5-6% for income seeking portfolios.

Summary: With the ASX 200 index having broken out above the 6,000 level and given the expected increase in corporate earnings for 2019, we expect the ASX200 index to challenge the 2007 high of 6,851 over the next 12 months. The current quarter is often the most difficult for markets, and based on events so far in July, this year is unlikely to be an exception.

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	**Richard Nicholas**	**Andrew Martin**
Director	**Director**	**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 w**ww.peakinvest.com.au**