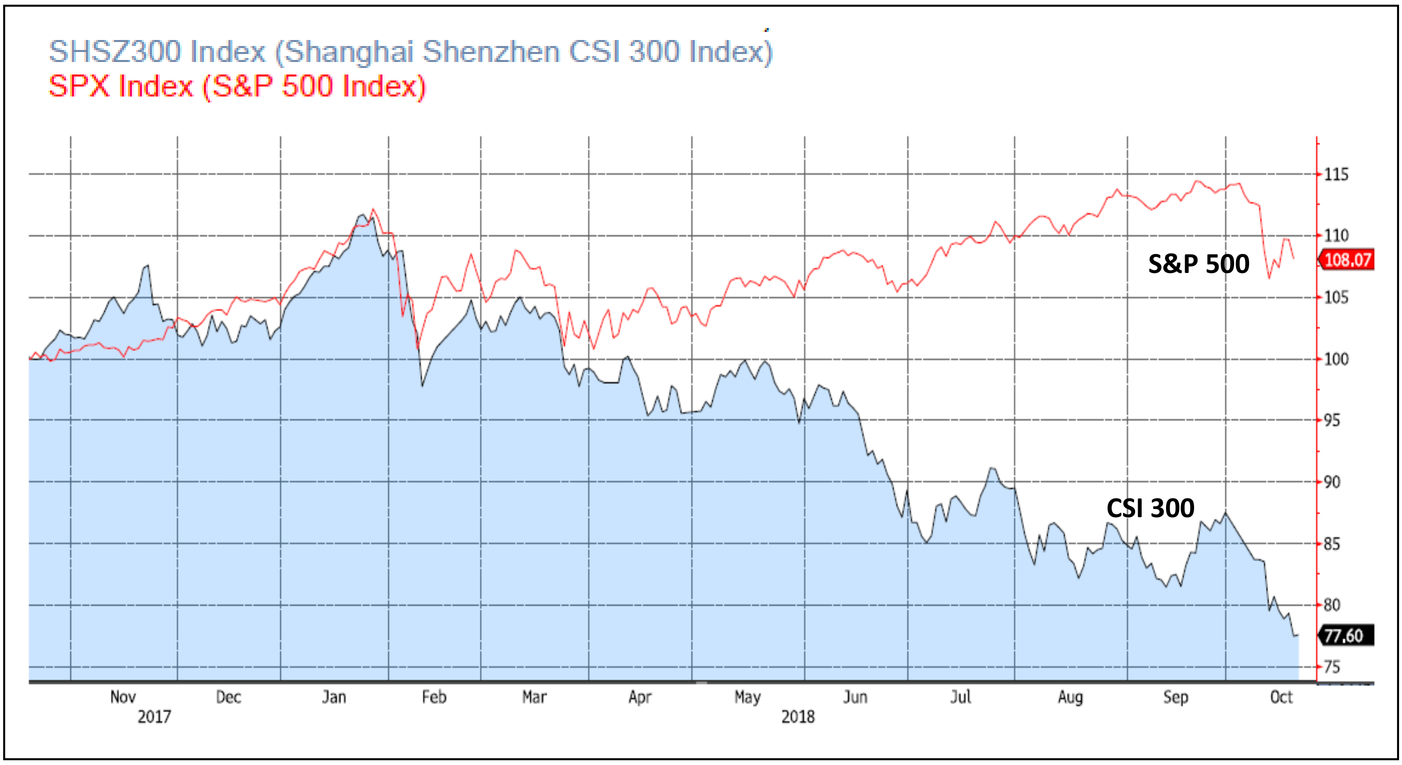
Market Commentary

October 2018

EXECUTIVE SUMMARY

- The current market and economic cycles now stand as amongst the longest in history. This is making investors cautious.
- The recent breakout of the US 10 year bond above 3.19%, as inflation pressures are rising, brings a 35 year trend to an end.
- The combination of a strong $US and higher energy prices have triggered a clear divergence in trends between the US and the rest of the world.
- Threat of a US trade war has forced China to move to a clear easing in both monetary and fiscal policy. China share indices have declined more than 20% and the RMB has devalued near 10%. Growth seems resilient.
- Despite pessimistic forecasts, Australian GDP, household income, construction and exports remain robust, supporting corporate earnings, at least in FY19.
- Our key concern is that things are “as good as they will get”. Earnings growth in FY19 of 12.3% may fall sharply in FY20 to near flat. A change of government is unlikely to be helpful to financial markets.
- A defensive approach is warranted. We suggest a combination of stable, predictable earnings growth and troubled sectors where valuations have priced in bad news. For capital protection, increase cash and fixed income investments.



Inflection Point Reached?

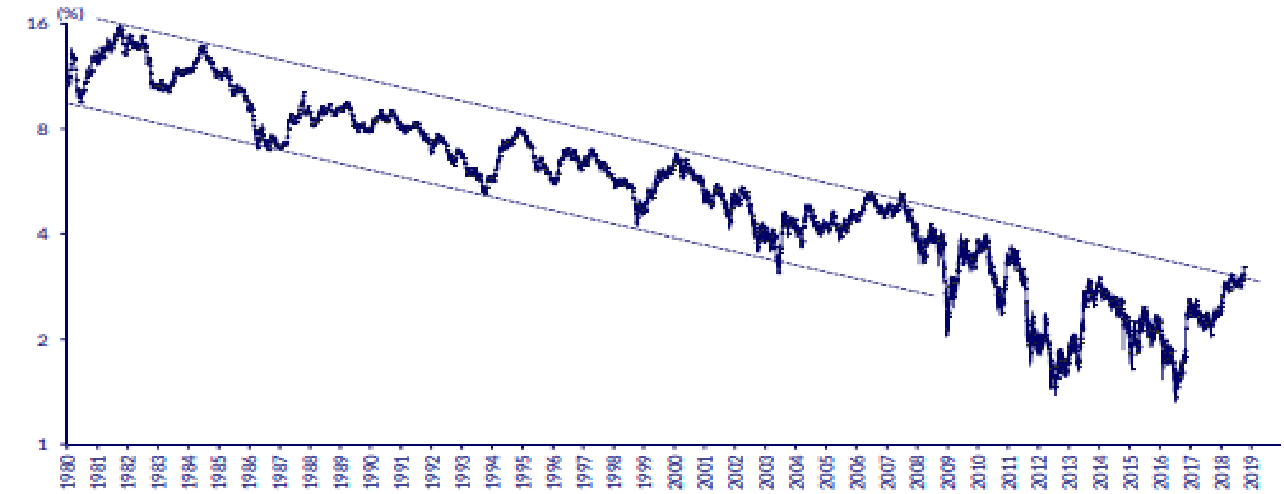
The last quarter has seen a clear divergence between a strong economic performance in the US contrasting with weakening momentum elsewhere. A strong USD, rising US interest rates and rising oil prices seem at the core of this trend. Nowhere has this been more visible that in performance of emerging markets including China. Equity market performance reflects this-as depicted in the chart above.

A decisive break out in US 10 year bond yields above 3.19% at a time when inflation pressures continue to build, may well see US interest rates increase significantly in the months ahead. The combination of tight labour markets, rising commodity prices and the impact of accommodative fiscal policy via tax cuts runs the distinct risk of seeing inflation rise beyond current expectations.

US Equities the Clear Outperformer. Is it Sustainable?

While the US equities market has been the clear outperformer since May, much of this is attributable to very strong corporate earnings trends. With revenues growing by more than 10% in the first two quarters (reflecting a very strong economy) and earnings rising 25% (reflecting strong growth and tax cuts), equities have remained strong. Despite Q3 trends expected to be similar to Q1 and Q2, it would not surprise to hear more management discussion on higher wage and other costs, leading to growing pressure on future margins. The all-important Technology sector that has been a key driver is beginning to underperform.

Figure 1
US 10-year Treasury bond yield (log scale)



Source: CLSA, Bloomberg

China Enters Easing Phase to Support Growth

Australia's major trading partner, China, has experienced a tough year to date. The combination of significant industry restructuring designed to clean up the environment, reduce the level of financial leverage, and a trade war with the US have contributed to a 27% decline in the CSI300 index. Over the last month it has been clear that the Chinese administration have moved to an easing of monetary and fiscal policy to stabilize the rate of growth. Policy changes have historically taken some 6 to 9 months to start delivering results.

On most investment metrics, the China market is now offering what appears to be good value. On one year forward forecasts, earnings are expected to grow by 11% and are being priced at 10x, with a PEG of 0.9x (MSCI China Bloomberg Consensus).

Despite the amount of economic restructuring, growth has been surprisingly stable and resilient. Major infrastructure projects such as the One Belt One Road and the Greater Bay programs have seen commodities such as iron ore and coal hold up well. LNG is also expected to be a major beneficiary of the clean air program.

Australian Market Prospects Mixed

We continue to be surprised by the resilience of the Australian economy. The housing sector has been stronger for longer than we anticipated. Consumption has continued to surprise on the upside, though we note a significant decline in the savings rate.

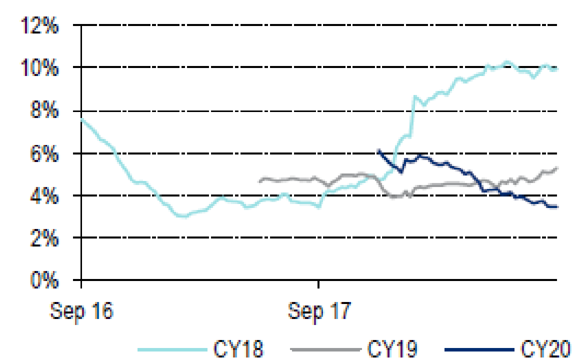
Total household income continues to rise, despite modest wages growth. Infrastructure growth remains strong and buoyant iron ore, coal and energy prices are seeing net exports a positive contributor to growth. Interest rates generally remain supportive and the lower $A is a clear positive.

What concerns us is the sustainability of much of the above. Despite minimal action from the RBA, interest rates in Australia will not be isolated from international trends. While the $A may have further downside, the fall from $1.09 to $0.71 against the USD has delivered the majority of benefits. The savings rate has fallen to almost zero and wages growth remains modest. Housing prices are falling with consumer debt at elevated levels. Finally, the chances of a "market unfriendly" change of government next year presents risks.

Earnings Projections Capturing Uncertainty

The consequences of this outlook is being captured in earnings projections for 2019 and 2020. Based on Citi numbers, EPS growth is forecast to be 10% in CY18, 5.5% in CY19, then declining to under 4% in CY2020. This suggests that on the basis of the share market looking forward 6-9 months, we are currently in the sweet spot, but about to head into more difficult times. A combination of declining earnings momentum, rising interest rates and rising inflation have historically not been good times for share markets.

Growth Forecast Trends

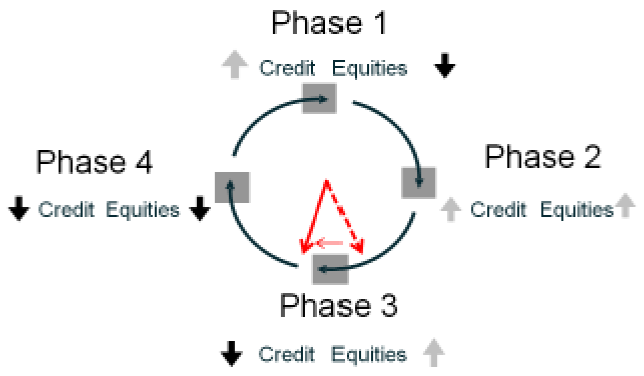


Source: Citi Research, Factset Consensus

Investment Strategy: A Defensive Approach Warranted

Citi strategists have the current market positioned at a mature point in the cycle; interest rates have become a headwind, but strong earnings are supporting equities. We are currently in Phase 3 where equity markets are positive and interest rate trends are negative.

Figure 20. The Clock According To Equities



Source: Citi Research

Sustainable Growth Key to Stock Selection, But Value Also Important

From an investment perspective, we outline some of the strategies that we are applying to portfolios to implement a more defensive portfolio structure.

Despite the overall growth number slowing in 2020, there are a number of stocks and sectors where growth prospects remain attractive. These include:

- Healthcare: CSL, Ramsay, Resmed, Cohlear have underlying growth rates in core businesses of circa 4%. All continue to invest heavily in R&D.
- Infrastructure: Transurban, Sydney Airport, Atlas own monopoly assets with inflation protected revenues.
- Consumer Staple: Woolworths and Wesfarmers (Coles and Bunnings) are defensive businesses. Costa, Tassal, Bega have similar characteristics.
- Platform businesses: REA, Seek, Carsales all continue to invest free cashflow back into their businesses in growth markets outside Aust.
- Asian Consumer: A2, Treasury Wines (and others) continue to invest heavily into developing logistics & distribution into Asia.
- Energy: Oil Search, Woodside and Origin should benefit from China's decision to increase LNG from 7% of energy mix to 15% by 2030.
- International: Technology, China, Healthcare, Financials the key focus.

In our view, this group of companies is well positioned to deliver above average EPS growth rates compared to the broader market, delivering superior returns to investors.

Banks Pricing in Much Bad News

Banks are clearly out of favour for a multitude of well-known reasons. With shares trading near 12 month lows, the majority of the bad news associated with the Royal Commission, lower earnings growth and rising property market risks is largely priced in. (CBA traded at a 5 year low recently). With strong capital bases, relatively secure dividends, some earnings growth via cost cutting and productivity gains, investment returns of 8-10% appear likely.

Where Could Consensus Be Wrong?

One persistent trend through 2018 has been analysts' upgrading forecasts on commodity prices and earnings forecasts for resource stocks. The over-arching expectation still remains for commodity prices to be declining in 2019 and 2020. Yet history tells us when China is in a policy easing phase, it has been positive for commodity prices and good for Australia. We tender some reasons why this may be repeated:

- China's focus on a cleaner environment will continue to cause supply disruptions during the northern winter
- Demand growth for LNG in China, Japan, Korea, Europe continues to pressure supply, with higher prices likely
- A decade of austerity in mining companies, reduced capex, exploration and tougher regulation has constrained medium term capacity expansion
- Recent experiences in oil, alumina and coking coal are clear demonstrations of markets that are structurally tight

If current spot price forecasts are used in analysts' models, on UBS numbers, there would be a 12 and 17% upgrade to BHP and RIO's earnings projections. (It is also worth noting that both BHP and RIO are in the midst of returning billions of dollars of capital to shareholders).

Summary & Conclusions

Following the recent sell off, markets are due for a bounce going into the year end. On Macquarie Bank numbers, the market PER is now 14.6x FY19 earnings. The recent increase seen in volatility does suggest market risks are increasing, making a relatively defensive stance the appropriate investment strategy.

We see the upside and downside risk reward equation pretty evenly balanced at the moment. Our views and thoughts are designed to give you the benefit of having targeted exposure to those areas where we see good, longer term prospects of performance, regardless of the economic cycle.

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