Market Commentary

January 2017

Peak Investment Partners

EXECUTIVE SUMMARY

- 2016 been a year of inflection. The post GFC era has dawned. Deflation has given way to reflation, interest rates and commodity prices have broken long term downtrends. Growth expectations are rising. Political outcomes may reshape the future, according to markets
- Market trends too have been quite dramatic. Successful strategies over recent years ceased to deliver. Defensive underperformed cyclical, equities outperformed bonds, large caps outperformed small caps. Risk tolerance increased.
- Equity markets in 2017 should be supported by rising corporate earnings. A recovery in commodity prices and stronger growth prospects appear supportive. Headwinds for resource companies and banks are turning to tailwinds.
- Equity valuations are not cheap, and will need delivery of earnings projections. Though not ideal, politicians too will need to deliver in the US, in Europe, the UK and China to spare disappointment.
- Portfolio rebalancing will continue in 2017. Defensive, interest rate sensitive investments will be reduced, redirected to increased cyclical exposure and resources. A 5-10% return from equities appears achievable again in 2017.

Review of 2016

At our client luncheon post the Trump victory, we made the observation that 2016 appeared to be a Year of Inflection. 2016 started with deep concerns over deflation, slowing growth, a China hard landing, only to end in a very different place. The important drivers of this transformation emerged out of the G20 meeting in Shanghai in February. It appeared that global leaders reached the conclusion that monetary policy had reached the end of its effectiveness. Negative interest rates were becoming a hindrance rather than a help, and growth needed to be supported by fiscal policy.

From that point on, 2016 ended very differently. The key elements of this were:

- The 35 year bull market in bonds ended in July when US 10 year bond yields reached 1.35%, closing the year at 2.45%
- Commodity prices that had been declining since 2011 began a recovery as oil, iron ore and coal prices rose more than 100% during the year
- Concerns over deflation, that have been pervasive since 2009, gave way to reflation as producer prices increased for the first time since 2012
- Monetary policy controlled by central banks that had dominated since 2009 reached its pinnacle of influence and fiscal policy started to assert itself again
- After several years of declining corporate earnings, 2017 appears set to see a recovery in most markets

Market Performance Summary		
	Qtr to 31st Dec	12 Mths to Dec 31
ASX 200 Accumulation	5.20%	11.80%
ASX 200 Industrials Accumulation	4.50%	7.50%
ASX 200 Resources Accumulation	8.70%	42.40%
Financials	12.70%	10.40%
Healthcare	-8.80%	1.90%
Telcos	-4.30%	-7.10%
Real Estate	12.80%	7.30%
Consumer Staples	-1.70%	4.80%
Gold	-15.60%	-55.50%
Small Ords Accumulation	-2.50%	13.20%
Small Industrials Accumulation	-2.60%	6.20%
Small Resources Accumulation	-1.70%	59.40%

Source: Iress

Profound Adjustment in Financial Markets

At a stock and sector level, the movements have been just as volatile. Strategies that have worked successfully over recent years suddenly reversed, while those that haven't performed delivered stellar results. In the last quarter particularly, holding defensive industrials such as infrastructure, REIT's, healthcare and telcos have all declined in absolute terms. In contrast cyclical stocks such as resources, steel, mining services, second and third tier industrials have performed very strongly. High quality stocks have been de-rated, cyclical stocks have been re-rated. The impact of these trends has seen the majority of portfolios underperform benchmarks over the last quarter.

Where To from Here?

At a broad macro level, we have made adjustments to our base case following events during 2016. These include:

- The risks of deflation have given way to rising inflation.
- Interest rates both long and short term are now in a rising trend
- Global growth is more likely to be supported by fiscal policy
- Commodity prices are expected to be high enough to facilitate a robust recovery in corporate earnings
- Rising inflation will see a de-rating of equities, especially the more highly rated defensive industrials
- The investable universe has broadened out following the rebound in commodity prices and somewhat brighter global growth prospects
- Sector rotation, global asset allocation changes and a changing market structure (where hedge funds and exchange traded funds dominate liquidity) are destined to see elevated volatility
- Large cap stocks likely to outperform smaller caps in the short term

Post Trump Markets Pricing in Optimistic Outcome

While we can understand the basis of the post Trump victory rally, courtesy of tax cuts, capital repatriation holidays, fiscal expansion etc, we do see a strong possibility of a "pause for breath" in early 2017. Given the recent track record of political leadership in major western democracies, it would be somewhat optimistic to think that major policy changes will come easily and swiftly, despite Trump controlling both houses.

Post the Trump victory, there has been a significant tightening of financial condition in the US via a strong rally in the $US and a substantial rally in long term interest rates. Financial markets have done considerably more tightening than Janet Yellen proposes in 2017. In reality, markets may limit what the Fed can realistically achieve in 2017. Alternatively we may well see a reversal in some of the trends observed during the December quarter.

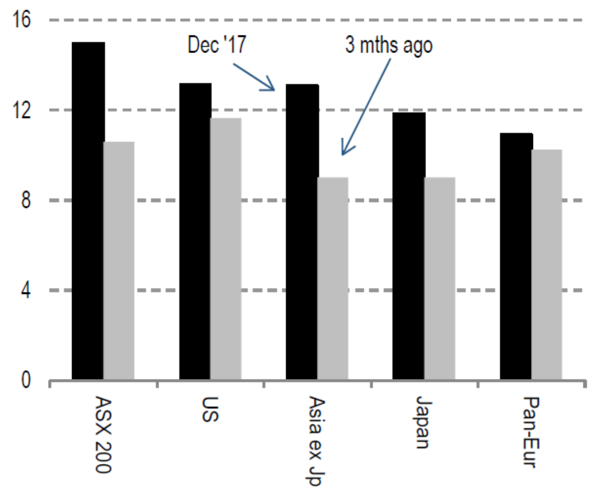
Australia More of a Quandary

Australia also appears to be at an inflection point. Having endured several years where the unwinding of the mining investment boom has presented Australia's GDP with a 1-1.5% headwind, this is set to moderate in 2017. Housing may well slow, although nonresidential construction and infrastructure will pick up some of the slack. Higher commodity prices will also lift national income significantly via higher taxes and royalty payments. Recent weakness in the $A will further assist. Unlike the US where wages growth is a factor, Australia continues to see record low wages growth and growth in the under-employed. This is likely to see consumption remain relatively subdued.

Valuations Need Earnings Support

While the one year forward PER is around 16.1x consensus earnings, it should be noted that the Australian market has recently seen a de-rating as a result of upgraded earnings trends, primarily driven by resource stocks. The following chart courtesy of Credit Suisse highlights this.

Dec 2017 EPS growth for various markets, local currency



Source: Credit Suisse

Implications at a Portfolio Level

Despite underperforming benchmarks over the last quarter, we are of the view that the majority of our clients main priorities are to generate sufficient income that can sustain their lifestyle and preserve their capital over the longer term. We are not convinced that selling Ramsay Healthcare and Transurban to buy Sims Metals and Fortescue is the right thing to be doing in order for us to beat the benchmark. Nor do we see that as being consistent with the objectives of maintainable income and capital preservation.

Consistent with our modifications to base case however we do acknowledge the need for some portfolio rebalancing, and indeed these are already underway. Exposure to defensive industrials will be modestly reduced freeing up capital for re-deployment into somewhat higher resources weightings (that have been negligible in recent history). Income biased portfolios will be rebalanced away from stocks that will be most sensitive to rising interest rates towards those stocks offering attractive yields but less sensitive to interest rates. For growth portfolios, exposure to small caps is being reduced t. Generally we are ensuring portfolios have reasonable exposure to the US where growth prospects remain globally attractive and where the $US remains strong.

Given the likelihood that the US economy growth rate will be higher than most other countries and the Fed will continue to raise rates in 2017, companies with earnings exposure to the US and the $US seem set perform well in the year ahead.

Our international exposures to technology, European equities (currency hedged), China's emerging middle class remain attractive. Exposure to global healthcare will be reduced (especially US where the Trump influence is likely to be negative). We will also look to increase exposure to Banks, where some of the headwinds that have been in place since the GFC appear to be easing (i.e. Interest rates increasing, growth strengthening, capital raisings largely completed and the era of heavy fines abating.

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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