Market Commentary

October 2017

Peak Investment Partners

EXECUTIVE SUMMARY

- Australian equities continued to underperform global benchmarks during the quarter, delivering a flat outcome. Resources outperformed, Banks were flat and Telco's, Insurance and Healthcare declined.
- A synchronised global recovery continues to support solid earnings growth. This, together with low inflation, is providing a favourable background for equities. Tightening labour markets and accelerating wages growth represent a risk in 2018.
- Australia's economic outlook remains mixed. Housing sector has peaked, strengthening non-residential construction and infrastructure will provide an offset. Consumption is subdued as low wages growth, rising energy costs and high debt impact negatively.
- With Financials and Resources accounting for more than 50% of the ASX200, Australia is challenged in a Technology driven world. Attractive sectors include Healthcare, Food, Infrastructure, Tourism and select Resource plays.
- ASX200 is trading at 15.7x 2018 earnings (Macquarie) is reasonable in a global context. Anticipate 6,000 by year end.

ASX200 Underperforms Global Indices

Despite having a superior rate of growth to most advanced economies, the Australian sharemarket has underperformed the US, Europe and Japan during the September quarter. Emerging markets significantly outperformed developed markets over the period. The key features of the quarter included a weak $US, stronger commodity prices and broadly stable interest rates and inflation trends that were supportive of equity markets.

The S&PASX200 index traded in a very narrow range (5800-5660) over the quarter as volatility declined to near record lows. At a stock level however, share prices have been far more volatile. Positive sectors were Materials, Consumer Staples and Energy. Negative contributors included Insurance, Healthcare, Telcos and Utilities. At a stock level, key positive contributors included NAB, Westpac, BHP, RIO, Wesfarmers (Peak stocks), S32 and Santos. Negative contributors included CBA, CSL, Ramsay, Telstra, AGL (Peak stocks), Suncorp and QBE.

Global Outlook Supportive of Earnings Growth

We continue to experience a broad, synchronized global recovery for the first time since 2007. Lead indicators have remained constructive through the quarter in the US, Japan, Europe and most of the Emerging economies including China and India. Most forecasters are expecting acceleration in global growth from 3.9% in 2016 to 4.5% in 2017 and 4.7% in 2018. This should support earnings growth. One risk associated with the positive growth outlook is Central Banks continue to hold policy settings at "crisis levels", especially if inflation begins to rise on the back of higher wages and producer prices.

Australian Outlook: Will it be a Merry Christmas?

Australia remains a quandary. The housing sector remains strong though is at a peak. The large pipeline of infrastructure and non-residential construction continues to build, especially on the East coast. Population growth remains robust at 1.5% pa, providing a solid floor to growth. Labour market indicators have also been constructive. Consumption trends remain mixed as low wages growth, high levels of household debt (and rising mortgage rates) and material increases in power and gas prices are more than offsetting the impact of increased household wealth. These cross currents dictate an investment bias towards investment focus sectors and away from consumption.

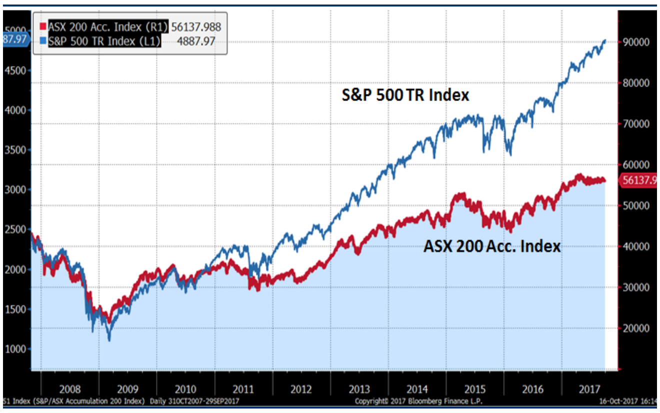
Observations from China

Goldman Sachs held their annual China Conference in Shenzhen in September. As always, this provided insight and perspective on China's journey towards becoming a fully developed, modern economy. Shenzhen has become a Technology centre for China. The clear message from the conference was that China has moved substantially beyond being a manufacturer and copier of low value add goods to a sophisticated innovator and manufacturer of high end technology. China is now making more patent applications to protect intellectual property than the US and Japan combined.

The second key observation was the rapid growth of China's middle class and the scale of the consumer market. China is experiencing real growth in wages of around 4% pa, in contrast to most developed countries real wage growth has been around 1% post the GFC. Consumption is the key economic driver of growth in China, now larger than investment and exports.

Investment Implications: Addressing Australia's Underperformance

The ASX200 Index has underperformed global benchmarks for much of the post GFC era (see chart). With a market structure that is composed of 36.7% Financials and 16.8% Mining and Energy, performance has struggled to match the more Technology based markets such as the S&P500, NASDAQ and many of the Asian markets.



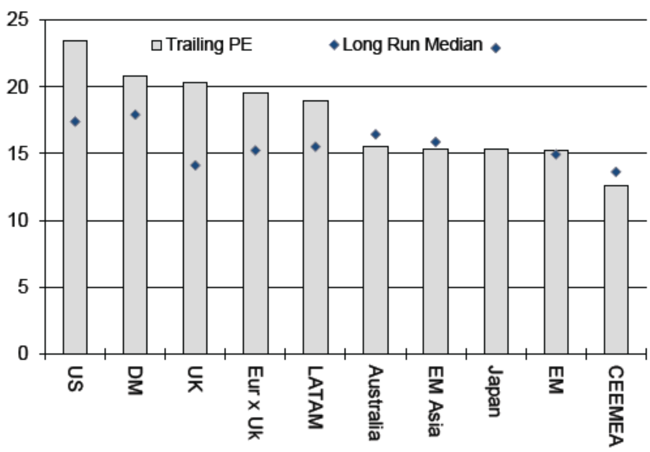
ASX 200 v's S&P 500
Source: Bloomberg

Technology remains one of the key drivers of global equity markets, particularly in the US, China and India. Electric and autonomous vehicles, artificial intelligence, renewable energy, cloud computing, advanced battery technology, 3D printing, 5G networks all continue to evolve rapidly. Valuations are somewhat elevated, although strong balance sheets, decent earnings growth, high ROE's and attractive free cashflow multiples do offer solid fundamental support. Companies such as Apple, Google, Microsoft, Tencent, Alibaba all demonstrate these characteristics.

Entering the Strong Seasonal Period:

Globally (including Australia), equity market returns have historically been concentrated in the months between October and April. For the balance of the year they have been minimal. Australian seasonality has traditionally been led by Banks performing strongly ahead of full year result announcements and dividend payments in November. Positive trends in interest rates and low bad debts should again be supportive of the upcoming full year results.

Despite the lackluster growth prospects, where Macquarie Equities are forecasting earnings per share growth of 4.4% in FY18 and 1.5% in FY19, it appears to us that the forward PE of 15.7x reflects a subdued outlook. The chart below highlights the point that in a global context, Australian equites currently look more attractive from a valuation perspective than most developed market counterparts.



MSCI Regional PEs
Source: Citi Research, Datastream, MSCI

Stock & Sector Selection Important

Healthcare continues to be one of Australia's success stories. Notwithstanding a poor performance over the last quarter, this sector does draw together several global investment themes. It is one sector where Australian universities and research bodies (CSIRO) are delivering world class outcomes. CSL, Cochlear, Resmed are all global businesses, including a growing presence in China.

Food and Agriculture are also domestic themes that tie into the Asian middle class. A2 has been the absolute standout re capitalizing on the China opportunity. Treasury Wines is another that is now well positioned. Nufarm has been added to our watchlist as a potential player in the China food space. We also note that Costa is also investing in China and will continue to do so.

The Infrastructure and non-residential construction pipeline continues to build and we are seeking appropriate investment opportunities in this sector. Recent analysis suggests that this cycle is destined to last into the early 2020's. Our key exposures to the sector include Transurban, Sydney Airport and Adelaide Brighton, and we have CIMIC and Lendlease under consideration as possible additions.

The Resources sector is likely to be positive. Capex spending appears to be on the rise globally, and this should support demand for commodity prices. Over the last quarter we have seen base metal prices and energy well supported. With accelerating global growth, this trend should continue. Analysts forecasts may prove too conservative. A market weight position is maintained in BHP and RIO. We also continue to closely monitor emerging commodity demand trends around electric vehicles, batteries, renewables that increase demand for lithium, cobalt, rare earths, copper and nickel.

We continue building our international exposures. Portfolios have benefitted from a number of international exposures including global technology and healthcare exchange traded funds, regional funds and stock specific investments such as Google, Amazon, Alibaba, Tencent and Zillow. For most portfolios, our intention is to expand international exposure, especially to the Asia Pacific region.

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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