Market Commentary

January 2020

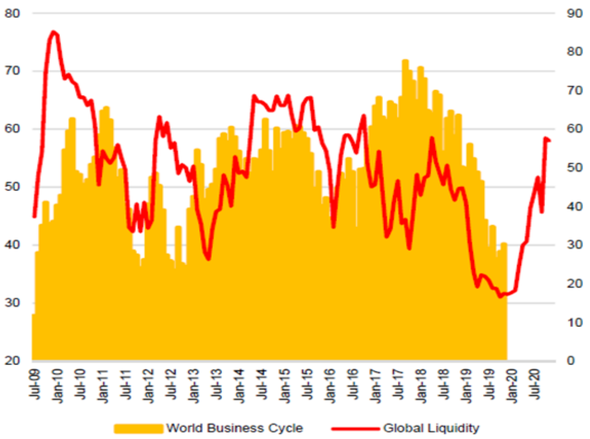
EXECUTIVE SUMMARY

- **Financial markets enjoyed their best year in 2019 in a decade. A reversal in Central bank policy in early 2019 saw equities, commodities and bonds deliver strong returns**
- **The year ahead is expected to show a rebound in growth-reflecting easing in 2019, progress with the US China trade dispute, Brexit and an end to the global manufacturing recession**
- **Australia enters 2020 with headlines focussed on bushfires and drought. While tragic for many, we anticipate the scale of the public response will finally cajole the nation out of complacency. The rebuild, the policy changes, the scale of the problems will impact positively on growth**
- **In 2020, equity markets will face somewhat improved earnings trends, partly offset by the risk of higher bond yields. Abundant liquidity is supportive in the short term, though does pose risks as Central banks begin to normalise policy in 2H**
- **We forecast flat equity returns in 2020, with a strong first half followed by a more volatile second half. Preferred sectors include Healthcare, Technology (international), leading International Industrials, major Resources, domestic growth Industrials and select Small caps. We remain underweight Banks, Insurance, Airlines, Discretionary retailers**

Policy U-turn in Early 2019 Drives Best Market Returns in a Decade

Following a terrible end to 2018, financial markets surprised most by delivering the strongest returns in a decade. Equity markets delivered 20%+ returns, oil increased over 30%, gold more than 20% and bonds 5-10% returns, despite historically low interest rates. The key to the turnaround was the Fed's decision in early 2019 to switch from a tightening stance to easing-a move followed by most other Central Banks including Australia's RBA. As the chart below highlights global liquidity has significantly increased.

Figure 1
Global Liquidity and World Business Cycle
Indexes 0-100 2009-2020



Source
CrossBorder Capital, US Federal Reserve, People's Bank of China, ECB, Bank of Japan, Bank of England

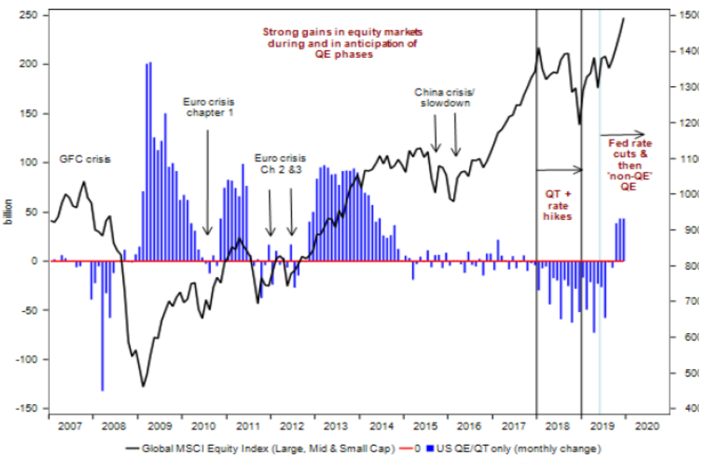
Through 2019, market sentiment shifted from discounting a high risk of global recession (that did eventuate in manufacturing, driven largely by a collapse in global trade and the US China trade conflict) to one of cautious optimism looking towards 2020. Enhanced liquidity provided by Central banks, resolution of sorts to the US China trade dispute, Brexit and prospects of improving economic activity in 2020 contributed to a general improvement in most financial markets through the latter part of 2019.

Implications for the Outlook for 2020

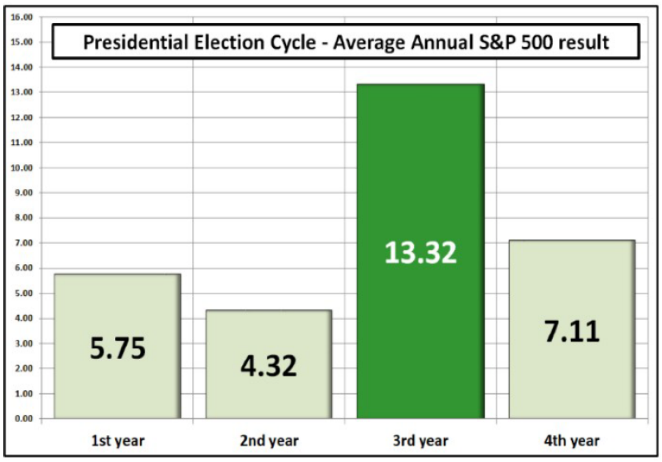
As a result of the events of 2019, the outlook has improved materially-despite the point that this is now the longest US economic cycle. Lower interest rates have stabilised economic activity in the US, China, Europe, the UK and Japan as well as in Australia. Leading indicators are now improving, interest rate sensitive sectors have been at the forefront-housing, autos along with semi-conductors and commodities including energy.

Of some concern to market participants is the prospect of higher longer-term interest rates. With the US 10 year bond having fallen from near 2.8% one year ago to a low of 1.4% in May and now back to 1.8%, risks seem skewed to the upside. Our base case is for inflation to remain relatively benign, based on growth remaining in the 2-3% range and wages growth quite orderly. Some prospect of global supply chains returning to a more stable position will follow a trade deal agreement of sorts.

Aside from higher rates, key risks for 2020 include the possibility of market disruption as Central banks begin to normalise availability of liquidity to the banking system. History is littered with examples how turning points in provision of available liquidity can be difficult for financial markets. Some examples include 2000 Y2K, 2015 Shanghai meeting of Central banks, December quarter 2018, as highlighted in the Longview chart below.



This is also a US presidential election year. Nothing to date has been predictable, other than the fact that it will remain unpredictable! According to work done by Richard Coppleson at Bell Potter, the best year of a presidential cycle is in the third year for the S&P500, followed by the election year as being the second best. The best market returns come when the incumbent is re-elected and he/she is a Republican. At this stage it appears that a Trump re-election is being priced into US equity markets.



Source: Thomson Financial; Janney Investment

Australian Prospects for 2020

Having had the positive benefits emerging from the re-election of the Morrison government in May, followed by tax and interest rate cuts that normally would impact positively, to date the evidence has been scant. Business and consumer confidence levels have not shown material improvement. Retail sales have been subdued and private investment remains low. Recently the impact of the drought and bushfires has been visible to all, impacting negatively on short term economic activity.

Looking ahead, there are some positives. There are clear signs that with population growth of near 300k people per year, underlying demand for housing remains strong. With housing starts declining from 230k to 160k, there are tentative signs construction activity will improve in the months ahead.

Investment in infrastructure is currently running at record levels, and pipeline remains lengthy. Regardless of the lack of coherent and co-ordinated government policy around climate change and renewable energy, major investment is taking place. The bushfires have highlighted the urgent need to upgrade infrastructure to more securely connect supply with demand, including across borders in a secure manner.

In summary, we don't see major downside risks to the Australian economy in 2020. There will be short term negatives from the drought and bushfires. The two big risks to Australia are a major slowdown in China and sharply higher interest rates negatively impacting highly leveraged households. China has done a lot to stabilise its growth outlook. Australian households are actively taking advantage of low interest rates to pay off debt, such that banks are struggling to generate meaningful credit growth.

Market Prospects for 2020

In our view there are generally five key drivers that determine the outcome for equity markets. These are:

- Earnings growth
- Interest rate trends
- Valuations
- Long term inflation expectations
- Fund flows

In assessing each of these over the next 12 months:

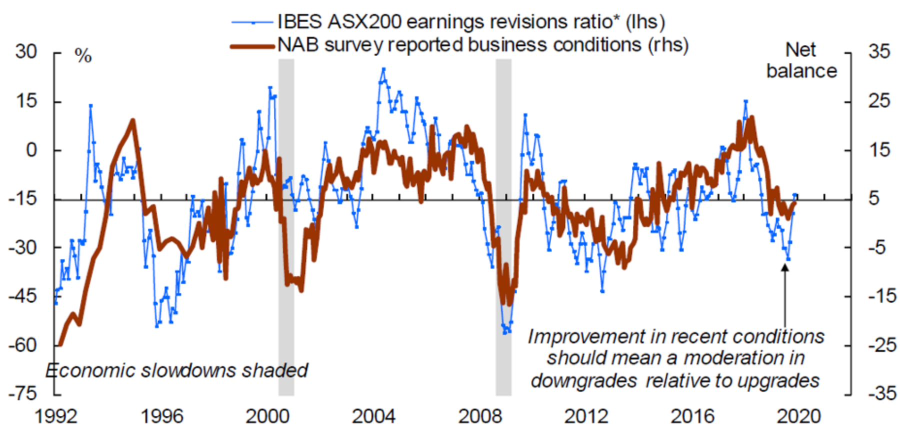
Earnings growth to generally show an accelerating trend, though sector specific as it has been in recent history. Both the S&P500 and ASX200 forecasts are for 5% growth in 2020, somewhat better than flat for the year to 2019 (refer to Consensus earnings and business conditions chart below)

Interest rate movements are expected to turn from being supportive for equity returns to neutral / negative in 2020. While short rates aren't expected to move (other than perhaps one cut), longer rates are expected to move somewhat higher (2.5% US 10 yr, 1.5% Aus 10 yr).

Valuations overall continue to appear somewhat expensive. The equity risk premium remains consistent with where it has been since 2015. Some sectors such as Healthcare, Technology and some international Industrials are trading at significant premiums to the overall market. These companies generally are delivering much superior growth in a low growth world. In such cases price to growth multiples are far more useful than price to earnings ratios.

Inflation is expected to remain relatively benign. This is a key driver of equity valuations ie PE's. Provided the outlook for inflation remains relatively subdued, equity valuations will continue to "appear" expensive. Inflation along with growth impact on bond prices

Consensus earnings revisions and business conditions



*3 month moving average. Upgrades less downgrades as a percent of all stocks in the index.
Source: NAB, IBES, Datastream, Citi Research

Funds flows are perhaps the "wild card". We note the increasing complexity of flows in financial markets, with respect to market participants. Things to watch include Central bank behaviour, money supply, mergers & acquisitions, share buybacks, market leverage such as margin lending and speculative activity.

Key Investment Themes for 2020

- **Healthcare:** Continue to see strong longer-term growth prospects for the sector. Australia and New Zealand have several globally competitive companies that have provided attractive, consistent, long term investment returns. An increasing proportion of household budgets is being allocated to healthcare, improved efficiency in medical research, aging population all supportive. High growth, high PE's
- **Technology:** Sector continues to be driven by innovation, consumer demands, productivity enhancements, improved efficiency, the roll-out of 5G, autonomous vehicles, internet of things, robotics and cyber security. This is a key focus of our international exposure.
- **Australia's Global Leaders:** In addition to the healthcare sector, several other companies have established strong global footprints. Macquarie Bank, Aristocrat, Amcor, Treasury Wines, Goodman Group, Seek have each established strong positions in their respective markets. A new breed of smaller companies are trying to emulate them including Altium, WiseTech, Xero, AfterPay, Appen, IDP, IPH and A2 Milk.
- **Resources:** BHP, RIO and Fortescue (along with Vale) dominate the seaborne trade in iron ore. BHP and RIO are global leaders in copper. Newcrest, Northern Star and Evolution continue to build a global footprint in the gold sector. All have been leaders in using technology to improve productivity and efficiency of operations, reducing costs.
- **Domestic Growth stocks:** Qube continues to be a leader in the development of key infrastructure assets, along with Transurban. Coles and Woolworths along with Wesfarmers (in hardware) continue to run defensive positions in the retail space.
- **Smaller Caps:** We continue to be impressed by opportunities in the Smaller company sector. Our preferences include Money3, Corporate Travel, EML and Bigtincan.
- **Underweights:** Banks-other than Macquarie Bank, continue to struggle. Credit growth remains subdued, legal battles will continue for some time, fines and penalties will persist-placing strains on capital adequacy and dividends. Much of this is now largely discounted and downside risk appears limited.
- **International:** Key themes remain global Technology companies (Microsoft, Google, Apple, Alibaba, select ETF's). Global healthcare, Robotics, Clean Energy, the Asian consumer, the rise of Electric vehicles and batteries. Following disruption to trade flows, we expect the semi-conductor sector will continue to recover during 2020.

Summary

We enter 2020 with a much more constructive economic outlook compared to a year ago. In many respects, 2019 market performance has built in much of that current "constructive outlook". Market valuations now largely reflect better times ahead. Our expectation is for a flat year ahead, assuming no unexpected shocks. With earnings growth circa mid-single digit, dividends of 4% and a modest de-rating as interest rates increase. We expect the first half to be stronger than the second half based on liquidity and growth momentum being much more supportive of equity returns.

We are very mindful of the great stress many Australians are currently experiencing through the bushfires and drought. We intend to make a donation of $50,000 towards those affected by the bushfires and the drought.

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