Market Commentary

October 2019

EXECUTIVE SUMMARY

- **Central Banks continue to cut interest rates taking long term rates lower, the prevalence of negative interest rates increases, supporting equity markets-despite weakness in corporate earnings**
- **Lower rates are showing signs of stabilising the recent downward slide in economic activity. Leading indicators, US housing, money supply trends and improved bank lending appear supportive**
- **A weak reporting season in Australia has reset earnings expectations to conservative levels. Risks now may be on the upside, following tax and interest rate cuts and the likelihood of further policy easing**
- **Over the long term, we note global outperformance of technology stocks and Australian stocks with significant overseas earnings. We also maintain a bias to "growth" over "value".**
- **Markets have absorbed a lot of bad news. Our expectation is that there will be some resolution to the growth slowdown, the US China situation, Brexit in the months ahead**
- **Investment strategy should remain defensive, but balanced. Portfolio strategy is a mix of sustainable growth stocks, businesses in defensive sectors and companies with sustainable dividends through the cycle**
- **Based on the above assessment, our expectation is for markets to retest all time highs in the months ahead**

Equities Continue to be Supported by Central Banks and Bonds

Central Banks have continued to cut rates during the September quarter in most countries including the US and Australia, and market expectations expect more to come in the period ahead. Bond markets continue to rally, pushing rates to record lows, while providing a positive catalyst for equity valuations, in a relative sense. One important side effect of having a swathe of countries with negative interest rates, is the strong liquidity flows to those markets such as the US and Australia that still have positive yields, resulting in further price distortions.

On the basis that negative interest rates are not sustainable long term, we do worry about potentially disruptive effects on financial markets as rates start to normalise. In our view, the strong flows into bond markets have taken bond markets to record highs. The artificial support this is offering to equity valuations in the short to medium term, in our view, should not be taken for granted, nor should it be regarded as sustainable long term.

"Greenshoots" Need to Gather Momentum

Our base case continues to be that all the work by Central Banks through 2019 will gradually start to stabilise economic activity in major economies late in 2019 and into 2020. While we recognise the abundant risks associated with this view, we also highlight a number of "greenshoots" offering support. These include global leading indicators, still favourable services PMI's, better US housing activity, increased US money supply trends, and some improving trends in China.

In Australia growth has remained positive, if somewhat sluggish and narrowly based. The main drivers of activity are the public sector and a strong trade performance. Consumption is making a small positive contribution, as is infrastructure spending. While construction is a distinct negative as housing starts retract from 230k pa to 155k, there are clear signs that the overall outlook for the housing market has improved significantly since the May election.

Reporting Season Weak, Though Some Positive Surprises

in aggregate the reporting season was one of the weakest in recent history with more misses than beats. FY20 Industrial EPS growth has declined from 7.1% in July to 3.4% according to Macquarie. Generally defensive sectors tended to see the most upgrades (healthcare, consumer staples, large cap REIT's), while largest downgrades were in Materials, Food & Beverages and Software. Reflecting these trends, Consumer stocks and Healthcare were the two strongest performers during the September quarter, while Materials were the worst. As the Citi chart below highlights, one leading indicator of earnings trends is the NAB business conditions survey. In recent months it appears to have stabilised.

Figure 10. Business conditions and consensus earnings revisions

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

Several key themes emerged throughout the reporting season. These included:

- Several companies were rewarded for prioritising longer-term growth ahead of shorter-term prospects (Seek, Car Sales, REA)
- Costs across the mining sector are now rising. This includes both operating costs as well as costs associated with capital expenditure
- Disruption is becoming increasingly apparent. Growth in ecommerce is having a clear impact on department stores, in retail property. It is apparent in energy markets, energy distribution and transmission and in financial services
- Borrowing costs continue to fall, providing a tail wind to highly geared businesses

Some Interesting Longer-Term Trends

There has been much debate recently over whether the long-term trend of so called “growth” stocks outperforming “value” was about to change in favour of value. Simplistically, growth stocks tend to be those that have demonstrated a long-term pattern of growth in earnings eg technology, healthcare, compared to value stocks that tend to be more cyclical, industrials, resources and financials. History shows that value stocks tend to outperform during recessions, growth underperforms. To the extent that we are not forecasting a recession at this stage, we are inclined to remain more growth biased within portfolios.

Two other long-term trends are worth highlighting. We have observed that earnings growth globally has been largely driven by technology related businesses over the post GFC period.

This is important in the context of portfolio construction in the case of Australia where the ASX200 is more than 50% Financials and Resources with Technology being just 2.4%. The second trend of significance is the relative outperformance by companies that have significant overseas earnings. It highlights the importance having successful business strategies in markets much larger than those within the 25m Australian market place.

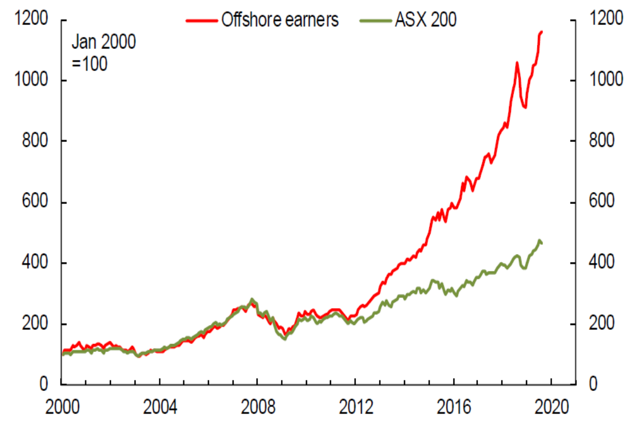
Market Outlook and Investment Strategy

Following the normal volatility between June and October, markets normally perform strongly between November and April. 2018 was an exception re November and December, though rallied hard in early 2019. We note that Central Bank behavior this year is in stark contrast to last year, and on balance should lead to a much better outcome.

Markets are discounting significant geo-political risks, some recession risk, and minimal probability of a trade war resolution. We would be surprised if we didn’t start to see some better news on some of these fronts going into year end. The US Presidential election now comes into clear view, Brexit is moving towards some form of resolution, China has multiple forms of stimulation underway.

Our investment strategy continues to be defensive, based on providing insulation to quality businesses that could deal with a recession should one eventuate. Companies in defensive industries such as Healthcare, Infrastructure, Transport, Consumer Staple generally have relatively predictable and stable earnings. Resources exposure is concentrated around iron ore, gold and nickel. Property exposure is concentrated around industrial property, logistics and ecommerce. Small cap exposure is biased to technology, online services and healthcare. Overall we expect markets to retest all time highs in the months ahead.

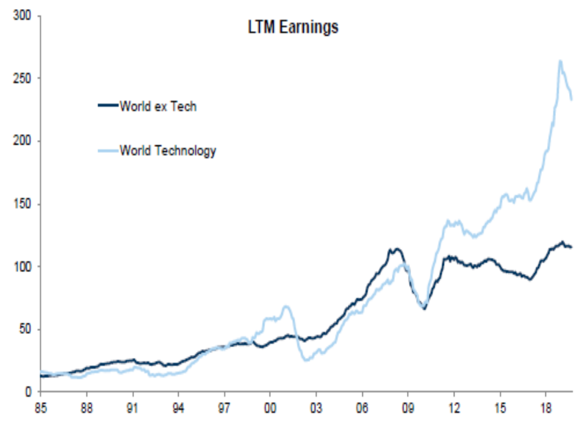
Offshore earning stocks and the ASX200 total return indices



Offshore earning stocks are those with half or more of earnings from offshore, excluding the resource sector.
Source: S&P, Factset, Datastream, Citi Research

Tech earnings have outstripped those of the global market

12m trailing EPS- Indexed to 100: Jan-09



Source: Datastream, Worldscope, FactSet, Goldman Sachs Global Investment Research

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