CIO Monthly Note

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Stock picking in a low growth environment

The Aussie economy is stuck in the growth 'slow lane' as it transitions from mining to non-mining activity. Investors need to be aware of this and its impact on their portfolios.

Although growth in the domestic economy is still positive, it is running at a sub-trend pace of about 2%. This pace is not fast enough to bring down the unemployment rate or deliver the kinds of gains in real income that were experienced prior to the GFC.

This low growth phenomenon is not unique to Australia. Global growth is also subdued as the large developed economies de-lever and as the emerging economies suffer from weak global trade and an unwind of significant over-investment.

A low growth environment has implications for the equity market via expectations for company earnings growth and the performance of certain sectors.

Most importantly, low growth means low interest rates. Although the Fed appears set to raise rates soon, even the Chair Janet Yellen expects the pace of rate rises to be gradual. Outside of the Fed, central banks from around the world are continuing to ease policy including the ECB, BoJ and PBoC. In other words, global interest rates are going to remain low.

The situation in Australia is no different. Just recently, the Governor of the RBA said that if the bank was to change policy, the next move would be a cut rather than a hike in rates. Given the recent mortgage rate hikes by the commercial banks, I would not be surprised to see the RBA cut rates in an effort to offset this unofficial tightening in policy.

In addition to low rates, low economic growth also means low earnings growth. Although there is a saying in market that 'GDP' is not 'S&P', the two are highly correlated. It will be very hard for the market to deliver strong earnings growth in an environment of slow economic growth.

To highlight this, estimates of earnings growth for the top 30 stocks in the ASX are currently flat at best. These are the large cap stocks that have mostly saturated their product markets and are now mostly bound by the growth in the broader economy.

So the question is where can I find earnings growth in this current market? The answer is in the ex-30 segment where growth is estimated at around 10% for the year ahead.

But investors need to tread carefully when venturing outside of the top 30 stocks. Often these companies are less well known and more work is required to find the ones that will perform and deliver on their promised earnings growth.

With low growth and low interest rates, we prefer companies that offer an attractive dividend yield and those that can grow their earnings independent of the broader economy. These may include companies that are in a structurally growing industry like IT and FinTech, or those benefiting from the lower AUD in industries like tourism.

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