CIO MONTHLY NOTE

July 2017

New financial year, new opportunities

A recap of the last financial year reinforces the value of a diversified equity strategy. That is, a blended strategy pairing Australian stocks for dividend income, with global shares for growth.

For the 2017 fiscal year the local market returned around 9.4 per cent, or 14 per cent including dividends, which was a better than average result. Global equity markets had an even bigger year with returns delivered between 20 and 25 per cent for the same period. Equity market performances over the past year have been well above long term averages and have delivered significant excess returns compared to both cash and fixed income. The strong returns have also helped boost investors superannuation holdings. This would generally lead to more positive wealth effects as investors tend to feel better, for obvious reasons, when their investments grow and perform well.

What can investors expect in fiscal year 2018?

For the fiscal year ending June 2018 we are targeting the ASX200 to be around 6,250. Including the dividend this should deliver a total return of around 10-11% for local equities, marginally above average expected returns. There are some key preconditions that need to happen for equities to have another solid year.

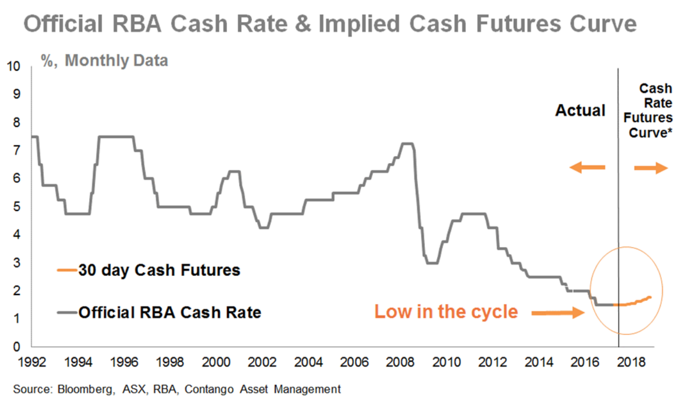
Cash rates to remain low

The cash rate will need to remain at the current historic low of 1.5%. The RBA has at times been more hawkish and would like to find the opportunity to raise rates following the recent strong performance of house prices in Sydney and Melbourne. However, there are no signs of any price pressures in the foreseeable future. Outside of electricity there are no signs of broad based price rises, or real wage growth throughout the economy. With a subdued inflation outlook the case for interest rates to remain at 1.5% over the next year remains strong.

Chart 1 illustrates the Australian official cash rate since 1992 and also the implied cash rate as determined via the 30 day Cash Futures. The market is now beginning to price in a 25bps rate hike in second half of 2018. However, economic conditions will need to improve for rate hikes to be delivered over the next eighteen months and a rise in 2019 is our preferred view.

Global central banks appears to be faced with a different scenario than the RBA. The US Federal Reserve remains set to deliver another rate hike in December as US economic conditions and corporate profits have been improving for a number of years. The proposed unwinding of some of The Feds massive balance sheet will be keenly watched by markets. If some of the bonds held on those balance sheets are unwound in a measured way, and it is well flagged then markets will not panic. Constant communication with the market and carefully flagging policy and meeting expectations will go a long way in keeping volatility down in the next twelve months.

Chart 1: Australian Official Cash Rate. Market beginning to price in rate hikes in the second half of 2018.



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The European Central Bank (ECB) has also given some guidance that the days of excessive quantitative easing are behind us. While markets are sympathetic to this view the ECB will not be in a position to remove liquidity in an aggressive manner. While the days of coordinated excessive and persistent global central bank stimulus are over, the unwinding will need to be measured. Further, not all global central banks are unwinding quantitative easing, with the Bank of Japan particularly remaining very committed to long term stimulus. Easy monetary policy is still required in broader Europe and the recent surge in long bond yields is indicative of what could happen if the communication strategy is not concise and meeting expectation.

The Australian Dollar

The AUD will also have an impact on the economy, particularly corporate profits. In general, a lower AUD is more beneficial to Australian earnings, especially local companies that operate offshore and receive non-AUD earnings. Some examples are CSL, ResMed, Ansell, Computershare, Brambles, CSR, James Hardie to name just a few. The recent AUD strength will be a cause for concern to the RBA as this creates some challenges for policy. A lower AUD is the preferred view and a sub 0.70 level would be a welcome boost to the local economy, albeit making our holidays and online global purchases more expensive. Our view is for an AUD range of 0.70-0.75 in the year ahead. This would go some way to supporting economic activity and earnings in the year ahead.

Chart 2: Iron Ore Outlook. Anticipate shorter term support for iron ore on infrastructure investment and inventory restocking however a lower price range by year-end.

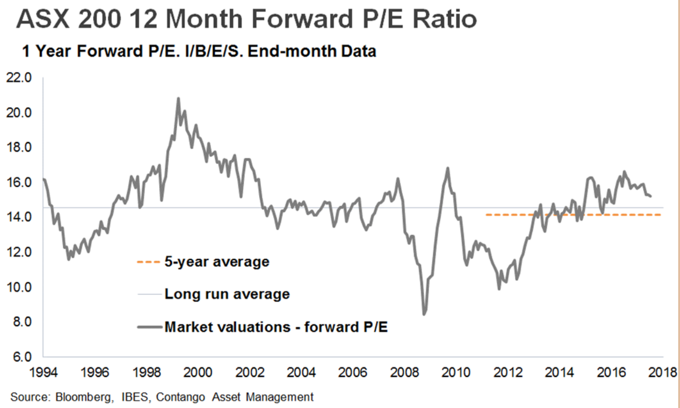
Commodity Outlook

Commodity prices always have a big influence on our economy and earnings. Bulk commodities such as iron ore and coking coal are very much pivotal to demand from China. The infrastructure growth has been strong and is expected to continue in the year ahead which will compensate some of the Chinese property slowdown. This is set to be supportive of Iron Ore prices for the September quarter, however following the anticipated steel mill inventory accumulation of higher quality Australian iron ore the expectation is for a lower year end iron ore price. Short term price range of USD 60 – 65 and a year-end range of USD 50 – 55 is anticipated.

Equity valuations

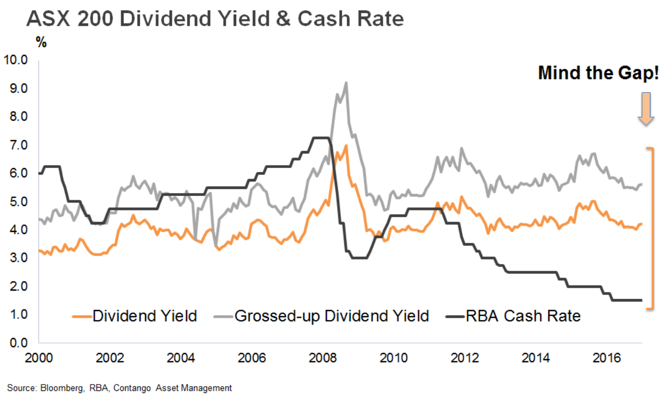
The upcoming domestic reporting period in August will give us an important health check on the earnings landscape of corporate Australia. The 6,250 ASX200 target for 30 June 2018 will be a function of earnings growth and the guidance given by the CEOs of listed companies. Low cash rates, a lower AUD and commodity prices holding current levels should all lead to earnings expansion in the year ahead. **Chart 3** shows the 1 year forward price to earnings (P/E) ratio. It is around a multiple of 15 which is reasonable given the expectation of low cash rates and a lower AUD outlook in the year ahead. The past twelve months have delivered the long-anticipated earnings pick-up following a long period of subdued activity.

Chart 3: Australian Equity Valuations. The past year has delivered the long overdue earnings growth. Going forward the upcoming August reporting period will give further confirmation of earnings quality and momentum.



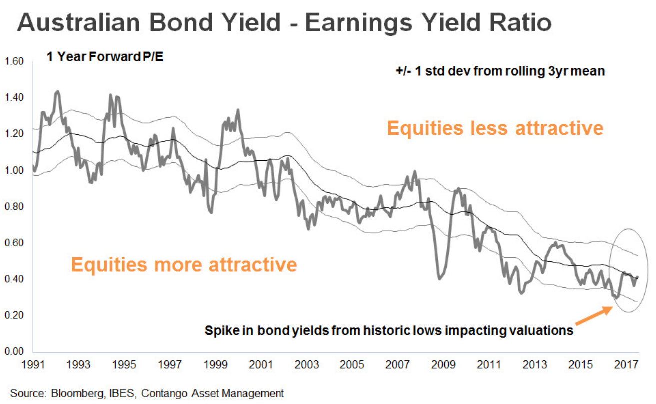
Going forward, while earnings growth will be lower on a 1-year outlook compared to the past year, we are heading in the right direction. However, it is really about the dividend. **Chart 4** reinforces the key standout of the local equity market vs global equities. Australian equities offer a much higher and consistent payout ratio vs other global equity bourses. It has tended to do this over a very long period. The consistent and high dividend yield will remain compelling for long term investors and therefore will be able to tolerate equity market volatility to receive the relatively high yield. The franking is an added bonus.

Chart 4: Dividend Yield remains compelling for investors



As some global central banks start to unwind large bond holdings on their balance sheets there will be the expected spike in long bond yields. However, the unwind will not be coordinated. The US Fed has started to raise rates from historic low levels in a measured manner. The unwinding of their bond holdings will be important for markets to absorb.

Chart 5: Higher long bond yields impact interest rate sensitive sectors



Higher long bond yields are not particularly alarming if there is a pickup in economic activity matched by earnings expansion. Therefore, the communication of some balanced sheet unwinding of bonds held by The Fed will be keenly watched. **Chart 5** illustrates the Australian bond yield (BY) – earnings yield (EY) ratio. Generally, the higher long bond yields will impact interest rate sectors such as REITs, infrastructure and Telco more negatively vs the broader market.

Summary

The long overdue domestic earnings-led recovery over the past year has been delivered. For corporate earnings to grow there will need to be several key pre-conditions. The RBA cash rate to remain at 1.5% combined with a lower AUD would be supportive of earnings expanding. The upcoming reporting period in August will be a key litmus test on how corporate Australia is progressing. The domestic equity market will continue to offer a relatively high and consistent dividend yield vs offshore markets. Conversely, global equities will offer domestic investors good diversified exposure to growth in sectors not represented in the local market.

The risks will be how some global central banks led by The Fed and the ECB, unwind some of the excessive quantitative easing. A controlled and measured communication strategy is required to help markets adjust to the change in the excessively easy monetary conditions of the past. However, the very subdued global inflation outlook and trending economic conditions still suggest that some form of conducive and supportive central bank monetary policy will be in place for some time. This will remain supportive for equities in the year ahead with some pockets of market volatility. As always, as I like to remind investors - investing is simple but never easy. Therefore in times of elevated market volatility, remain alert but not alarmed.

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