contango ASSET MANAGEMENT LIMITED

CIO MONTHLY NOTE
RECORD DIVIDENDS CONTINUE

Australian and global equity markets remained relatively unchanged over August, returning low but positive returns. Australian equities returned 0.7% and global equities returned 0.9%. However, the low headline returns masked considerable volatility within markets which creates opportunities for good active managers to add value above index returns.

For Australian equities, industrials returned -0.2%, resources 5.4% and small companies 2.7%. After underperforming large caps for the last year, small caps have outperformed large caps over the last 3 months by 4.1% returning 5.1% in total. Attractive valuations and a stronger outlook for earnings growth particularly from small cap resources drove the small cap outperformance. For high growth, domestic focused investors, exposure to the small cap sector remains a compelling risk / reward opportunity.

The Australian market was pre-occupied by reporting season, with most companies reporting 30 June 2017 full-year results. Overall, results were subdued compared to expectations. However, the recent reporting season confirmed the very strong rebound in earnings, just over 17% compared to the previous year.

The strong rebound in earnings is now well behind us. Investing is always about future earnings, and guidance from CEOs of corporate Australia helps to determine the outlook for earnings for the coming financial year. Some key factors are required to get earnings upgrades in the year ahead. They include a lower AUD, the RBA maintaining low interest rates and improved confidence and guidance from CEOs. With this in mind, we expect an EPS target of 4% for FY18.

While the momentum of earnings upside is slowing, the ASX300 June 2018 target of 6,250 and the December 2018 target of 6,500 are still on track provided local interest rates hold steady, the AUD trades at below USD 0.75, and global economic activity continues to strengthen.

Some key regions of the global economy have continued to improve - led by the US, a recovery in Europe and stability in China. This backdrop will be supportive for global equity markets despite some stretched global valuations. For global equity markets the month started positively, with major market indices such as the S&P500 posting new record highs, until investors hit the 'risk-off' button as geopolitical tensions in North Korea intensified. Hurricane Harvey, in the USA, also added to concerns. US equities were unchanged over August returning 0.1%.

A strengthening global economy, higher commodity prices and strong growth from technology companies and a weaker USD all provided a tailwind for emerging markets equity returns. The best performing major offshore market was China returning 2.7%, and the worst was Japan, returning -1.4%.

GLOBAL INDICES	1 MTH	3 MTHS	12 MTHS
Dow Jones Industrial	0.3%	4.5%	19.3%
S&P 500	0.1%	2.5%	13.9%
NASDAQ Index	1.3%	3.7%	23.3%
Euro Stoxx 50 Price Index	-0.8%	-3.7%	13.2%
FTSE 100	0.8%	-1.2%	9.6%
German Aktien Index (DAX)	-0.5%	-4.4%	13.8%
France CAC40	-0.2%	-3.7%	14.6%
Nikkei 225 Index	-1.4%	0.0%	16.3%
Hang Seng Index	2.4%	9.0%	21.7%
Shanghai Composite Index	2.7%	7.8%	8.9%
India BSE 200 Index	-1.1%	4.1%	15.0%
MSCI ACWI (US$)	0.2%	3.2%	14.8%
MSCI ACWI Investible Market Ex Aust (AU$)	0.8%	-3.3%	9.0%
MSCI ACWI Ex Aust (AU$)	0.9%	-3.3%	9.0%
MSCI ACWI Ex Aust (US$)	0.2%	3.1%	14.9%
ASX 300	0.7%	1.0%	9.5%

Source: Bloomberg, as of 31 August 2017

Since the global financial crisis, central banks around the world have used a range of monetary policy tools to bring interest rates to historically record low levels to promote growth in their economies. The major central banks of the US, Europe and UK are now in various stages of increasing interest rates. The US Fed has raised its benchmark interest rate three times by 0.25% to 1.25% since the start of 2017. The Fed Funds implied futures rate now anticipates the next rate rise in mid-2018. This appears reasonable given subdued price pressures. More importantly, the Fed's approach to the start of the balance sheet unwind will be a key driver of market sentiment. Janet Yellen, the Chair of the Fed, is one of the best communicators of policy to the market.

Although the global low interest rate environment appears to be coming to an end, any interest rises are likely to be gradual and measured. Assuming interest rates rise in a controlled manner, equity markets should remain supported given synchronized global growth, although bonds may generate negative returns because as interest rates rise, bond prices fall.

On balance, equities (both global and local) remain reasonable on a one year view compared to bonds and cash. Domestically, the compelling dividend will remain a key contributor to your local equity portfolio returns. Exposure to global equities will give investors the appropriate diversification.

18 September 2017

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