CIO MONTHLY NOTE

June 2017

Strong returns as we head into financial year end…

It looks like some investors took the *Sell in May and Go Away* investor maxim to heart with the ASX/S&P200 down 3% for the month. However, almost all global equity markets, both emerging and developed, posted solid monthly gains. This reinforces the importance of a blended portfolio, with exposure to both global and domestic equities. They tend to complement each other well - local equities have a bias for consistently higher dividends, whereas global equities provide exposure to sectors and companies under-represented in the local market.

The domestic market's underperformance during May in comparison with offshore equities was primarily due to the weaker local banking sector. This was due to a combination of factors including limited earnings upside on lending with a mature domestic housing cycle, higher regulatory capital requirements and the Federal Governments new Budget levy. The discretionary retail sector was also a poor performer as the market reacted to the anticipated invasion of online reatailer Amazon

The recent GDP numbers released in early June confirmed what the market had already priced in. That is, economic activity in the March quarter slowed down brining the annual rate down to 1.7%, well below trend. It's important to note here however that GDP data is backward looking and does not offer any meaningful forward guidance. Equity markets, on the other hand, price in forward guidance. With a slower pulse in the underlying economy the RBA will simply need to keep the official cash rate at historic lows of 1.5%.

There is always a silver lining. Australia can now formally claim to be the most resilient economy in the world following the GDP data release. Domestically we have notched up 104 consequtive quarters without a recession, eclipsing The Netherlands record. Despite some well-flagged imbalances in the Australian economy, there are still some positives developing. The current account balance continues to improve considerably. This is important as we depend on global savings over the long run. Further, while wage growth is very anaemic, the unemployment rate remains low. We simply need to be more productive going forward. Finally, the AUD works as a good automatic stabiliser. When there are global shocks the AUD tends to fall further, adding the appropriate stimulus to the doemstic economy.

As we head into the 30 June financial year-end, the good news is that markets are positive over the past year with a good contribution from the local market (particularly the dividend) and the strong global equity returns. The solid consistent gains to superannuation funds help drive positive wealth effects as investors continue to build for their retirement.

What is the market outlook for the next fiscal year?

Domestic economic activity is anticipated to pick up marginally towards trend growth and the RBA will keep rates steady with the possibility of cutting in 2018 if required. It is clear the RBA is not keen to cut rates further, however, lower rates combined with a lower AUD will be a good boost to economic activity.

Regarding domestic equities, investors should continue to see the benefits of exposure to quality large cap health care. Both **CSL** and ResMed (**RMD**) will continue to benefit from the rising global middle class tailwind. The offshore earnings will continue to be the core driver of their future growth. Further, many global equity managers continue to prefer these two bellwether Aussie healthcare exposures. Admittedly, their valuations are not cheap.

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Lately the performance of consumer sectors – both discretionary and staple – have had a big impact on market movements as the retail sector in Australia deals with all the challenges from the northern hemisphere invasion.

The old duopoly of Woolworths (**WOW**) and Wesfarmers (**WES**) in consumer staples had serviced investors well for many years. But the healthy Australian supermarket margins attracted global discount chains such as Aldi and Costco **(COST)** to our shores, who have subsequently managed to successfully expand and derive solid profits. While the old duopoly complacency invited the global competition both **WOW** and **WES** are finally getting their act together and are responding to the challenge ahead.

When it comes to the consumer discretionary sector, the marginal retail dollar has been hurt year-to-date because households have become a little cautious and have pulled in their spending. Also, many investors are concerned by the potential disruption from the Amazon (**AMZN**) invasion. Australia is a prime market for the likes of Amazon as we already have the existing infrastructure to facilitate the quick delivery of online goods. In the US, for example, an online purchase can be at your door in 2 hours if you subscribe to Amazon Prime. What consumer wouldn't want that kind of service? In anticipation of the well flagged Amazon expansion the retail sector has sold off significantly and it looks to be overdone in the short term.

The other big challenge in the year ahead is the Australian banking sector, which will struggle to expand its margins. The banks will however continue to deliver dividends to yield-hungry investors. Most of these investors are in pension phase and therefore have a long investment time frame and insatiable demand for the dividend plus franking. Global fund managers will continue to remain negative towards the local banking sector and challenge their ability to maintain their return on equity (ROE) targets. The good news is that the banks are streamlining and focusing on core businesses as they exit businesses that are a drag on margins. The higher regulatory capital requirements for insurance and wealth management businesses are also valid reasons for the banks to continue to exit.

As we head into financial year end, investors will go through their annual financial health check. The equity asset class continues to offer good risk / reward return as global rates look set to remain low. Global equities are very well placed to help deliver earnings from the rising middle classes of the emerging world. Yield-hungry investors depend on the domestic market for dividends and the franking boost that comes with it. That is why you need a good blend of both domestic and global equities as part of your portfolio for the years ahead.

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