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AUSTRALIA 2019 MARKET OUTLOOK

Turning more cautious, but volatility is creating opportunities.

Randal Jenneke

For the better part of the last two years, we have been positive about the broader economic outlook, confident that improving global growth and strong corporate earnings would drive markets higher. At the same time, reasonable valuation levels only added to our positive view. And this view turned out to be largely correct, with the key economies of the U.S, China and Europe, experiencing a period of synchronised market and economic improvement.

Meanwhile, the local environment has also held up well. Growth has been solid, if unspectacular, the strength of the labour market has been a surprise, corporate earnings growth has been strong throughout, and we have had the benefit of the end of the property cycle.

As we move into 2019, however, a range of headwinds present distinct challenges – playing out in the geopolitical arena, in the form of trade wars, on the policy front, in the form of divergent monetary policies, as well as a slowing Australian housing market. While rising headwinds present challenges, positive features of the Australian equity market support our cautious optimism in 2019.

Trade and tariffs: What are the consequences?

The trade conflict between the US and China has been escalating – and it may get worse before it gets any better, given neither side is willing to yield first. The U.S. wants to secure a better deal for the U.S. and is becoming increasingly isolationist when it comes to its global trading relationships. This is not just about trade and tariff issues, it's about one super power trying to assert power over another, and how they maintain that dominance moving forward.

A less visible, but potentially greater risk, of the trade conflict is the impact on US inflation – higher prices caused by tariffs could lead to an upside surprise in inflation data, and a subsequent sell-off in US rates and equities. In addition, companies with big supply chains through China, for example, are beginning to see costs rise, leading to margins being squeezed and, ultimately, to corporate earnings coming under pressure. So, as a direct result of trade and tariff frictions, the outlook for corporate earnings is now more uncertain.

Although the potential fallout from a U.S./China trade war on global growth is a source of ongoing concern, the 90-day trade and tariff ceasefire agreed by the respective leaders in early December is being viewed as an important and welcome breakthrough. As part of the truce, the two countries have agreed to temporar-

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ily halt increasing tariffs as they work towards a more permanent agreement. However, there is still some way to go in the trade story and this theme is likely to play through 2019.

U.S. growth rate has peaked

More broadly, the fiscal stimulus that has underpinned U.S. equities, and the economy, in 2018, has also likely peaked. While we do not anticipate a sharp decline in growth in 2019, we do expect to see a slowdown. U.S. GDP grew by more than 4% in Q2 2018, and by 3.5% in Q3, and we anticipate that this might drop back to 3%, or possibly even 2%, in the near term. While a slowdown in growth, and the impact on corporate earnings, may concern some investors, this is not something we are particularly worried about – in a lower, but still healthy, growth environment, good companies will still deliver healthy profits.

The slowdown in our housing market

The weakening Australian housing market is another headwind that is clouding the outlook (Figure 1). The current environment is very different to previous property market downturns, in that it has been principally driven by policy regulation. With previous downturns, the initial trigger has typically been rising unemployment. People lose their jobs, so they lock down spending, which has a knock-on impact on the economy, ultimately leading to rising defaults within the housing market.

While it feels like we are in the early stages of a slow-moving downturn, this is new territory, so it is difficult to know how it will play out from here. Our base case scenario is that house prices could potentially fall somewhere between 10 and 20%. But outside factors, such as the upcoming federal election, which is expected to reduce housing credit demand if the Labor Party pushes through changes to negative gearing, could see a further setback for the sector.

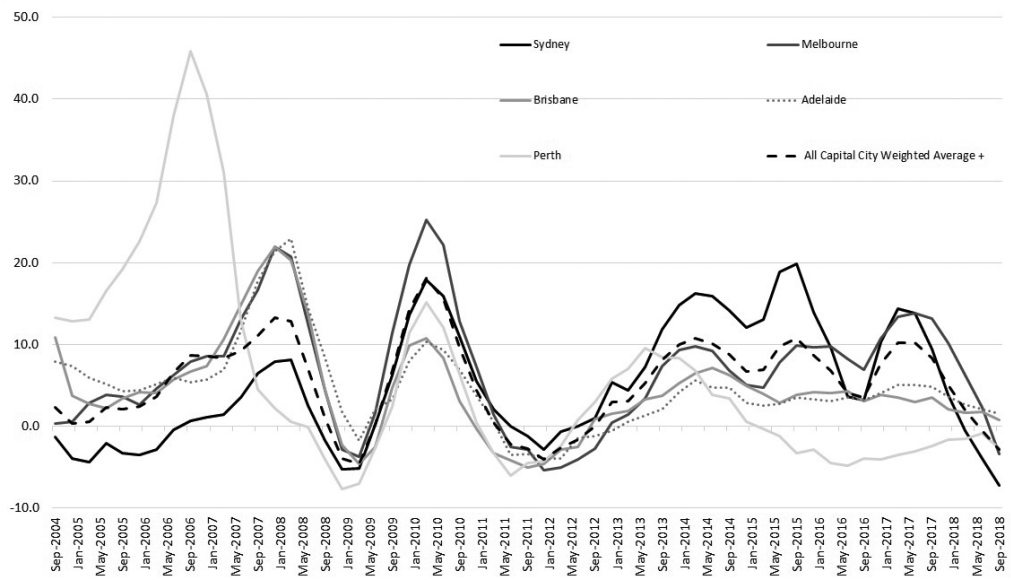
Another complicating factor is that the housing downturn comes at a time when there are limited tools available to fight it. Interest rates are very low, too low given the environment that we are in, and the Reserve Bank of Australia has a limited arsenal to stimulate growth and spending. From a fiscal standpoint, while the budget position has recently improved, it could easily slip back into large scale deficit, should the economy weaken. Given government debt levels are already quite high, this could be problematic.

Where we see opportunities and risks

What we are currently seeing is that any higher growth, higher valuation companies, or companies where there is any earnings risk, are being aggressively sold off. So, a lot of stocks are down between 10-30%. Over a long-

Figure 1. The weakening Australian housing market is a key headwind

Sydney and Melbourne are leading price falls, as other capital cities also slow



Source: Australian Bureau of Statistics. Residential Property Index, quarterly year-on-year percentage change. As of 30 September 2018.
+ Weighted average of 8 capital cities

term view, we think there are some very good opportunities, even if it means weathering some potential short-term volatility.

We have been selectively adding some new, growth-oriented, names to the portfolio, where the valuations are very attractive in our view – as well as adding to some companies we have owned for a long time. Ultimately, these high-quality growth names are the type of companies we build the portfolio around; the fundamentals remain strong, and valuations now look compelling.

We continue to be positive about the outlook for the general insurance sector. Premiums are ahead of inflation and rising, in the order of 4-5% p.a., while claims inflation is under control, resulting in good margin expansion for these businesses. Rising bond yields are also supportive, given insurers' large fixed income portfolios.

Conversely, we remain guarded about some of the commodity and cyclical stocks, given the earnings outlook for these companies, leading us to reduce some of our mining exposure. We also believe the potential for earnings growth appears limited in the banking sector, where the outlook is clouded by falling house prices, higher funding costs due to rising offshore interest rates, and growing business costs resulting from the Royal Commission, particularly as the Australian Securities and Investments Commission (ASIC) and the Australian Prudential Regulation Authority (APRA) step up their surveillance activities.

Also relevant is the fact that the probability of interest rates being cut appears to be increasing. The kind of scenario that could trigger a rate cut, such as a sharp slowdown in domestic growth, even a recession, is not beyond the realms of possible. From a purely risk management perspective, we avoid those areas that are most exposed in a weak domestic environment, such as the banking sector, along with domestic cyclicals, like building materials companies and retailers.

Cautiously optimistic moving into 2019

In conclusion, we head into 2019 with a cautiously optimistic slant to our Australian equity outlook. The market is likely to be more volatile as some of the headwinds mentioned impact corporate profits and earnings growth. However, a positive feature of the Australian equity market is that a good percentage of total returns come from dividends. The U.S. market, in comparison, is more capital growth oriented, with lower dividend yields. We believe that a 4-5% dividend yield and attractive valuations indicate a sound equity environment that can deliver healthy income and capital growth. FS