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AUSTRALIAN EQUITIES MONTHLY

Market Commentary

The S&P/ASX 200 Accumulation Index returned -0.1% during December.

The turmoil seen across global markets in recent months continued into December and despite the weakness of the Australian equities market, it was the best performing major market over the month. In other major global developed markets the UK FTSE 100 and the Euro Stoxx 50 were the best performing markets returning -3.6% and -5.4% respectively. The US S&P 500 returned -9.2% trailed by Japan's Nikkei 225, which fell 10.5%.

During the month, the Reserve Bank of Australia (RBA) maintained the cash rate at 1.50%. The RBA maintains its view that the Australian economy is performing well and that while the global economy is still expanding there are signs of a slowdown in global trade. Further progress in reducing domestic unemployment and a return to target inflation is also expected, albeit gradual.

Domestic economic data releases were mixed in December. The Australian economy grew by only 0.3% over Q3 2018. Employment rose by 37,000 positions in November (mostly in part-time positions). Meanwhile the unemployment rate rose from 5.0% to 5.1%. The NAB Survey of Business Conditions eased 2 points to +11 in November and business confidence fell 2 points to +3. Retail sales rose 0.3% in October, which was above expectations.

In stock specific news, the ACCC announced its preliminary view on the TPG-Vodafone merger application and expressed concern that the merger will lessen competition in both the mobile and fixed broadband segments. During the month APRA issued a show cause notice to IOOF, which saw the stock fall 25.1%.

Sector returns were mixed during December. The best performing sector was Materials (5.1%). Healthcare (2.7%), Utilities (2.8%), Real Estate (1.1%), Consumer Staples (1.2%) and Industrials (-0.3%) all outperformed the market. The worst performing sector for the month was Communications (-5.1%). Information Technology (-4.1%), Financials (-3.1%), Energy (-2.0%) and Consumer Discretionary (-1.9%) all underperformed.

Materials was the top performing sector during December. Sector heavy weights BHP Billiton (11.5%), Rio Tinto (7.1%) and South32 (8.1%) were the major contributors within the sector. The iron ore price rose in December, providing support for these names. BHP and Rio Tinto were also buoyed by capital management initiatives, including a special dividend for BHP and the ongoing Rio Tinto PLC buy-back. Notably smaller miners (those outside the S&P/ASX 100) underperformed the index by 5.4%.

The Healthcare sector outperformed the market during December. The key contributor was sector heavyweight CSL (4.4%) which rallied following its R&D briefing which detailed their pipeline of clinical programs.

The Utilities sector also outperformed the market during the month. AGL (9.5%) was the key contributor during December. During the month AGL announced Brett Redman as the CEO and Managing Director on a permanent basis, having been the interim CEO since August 2018.

The Communications sectors was the worst performing sector during December. Telstra (-2.7%) and Nine Entertainment (-21.4%) were the key detractors. Nine Entertainment confirmed the merger with Fairfax media was implemented during the month, with a number of cost savings already realised upon implementation.

The Information Technology sector underperformed the market during the month. Computershare (-5.3%) and Afterpay (-14.0%) were the key detractors within the sector, losing most of last month's gains.

The Financial sector also underperformed the market. ANZ (-8.7%) and Westpac (-3.6%) were the key detractors amongst the big four banks, while Macquarie Group (-5.0%) was the key detractor within diversified financials and QBE Insurance (-10.8%) was the biggest detractor amongst the insurance sector.

Outlook

While the global economic expansion is continuing, there has been some divergence in relative growth rates in recent months as the policy-induced slowdown in China and the stronger US dollar has slowed growth in emerging markets. This, in turn, has resulted in slower growth in Europe and Japan. While US economic activity remains extremely buoyant, unsurprisingly, growth momentum is flattening.

The recent sell-off in equity markets appears to be in response to a litany of concerns – slowing and divergent global growth, increasing volatility, trade wars, Brexit, disagreement over the Italian budget, the oil price collapse – to name a few.

While the sell-off has been painful and seen already cheap cyclical stocks further sold-off, we continue to believe that the accommodative financial conditions in most advanced economies and an easing of Chinese financial conditions in the last few months, will support the global economy in the medium term, albeit with some lags. Further evidence of the change in Chinese policy direction is the rebound in fixed asset investment in October after declines in prior quarters.

In Australia, the economy remains in good health and the RBA is forecasting 3.5% GDP growth in 2019. As well as high levels of Government-funded infrastructure investment, the RBA have also noted that business conditions remain favourable and that non-mining business investment is expected to increase. The much publicized correction in Sydney and Melbourne house prices is the result of both tightening credit supply and lower credit demand. Importantly, the price declines are not a function of household financial stress and recent falls in mortgage interest rates are also supportive of household budgets.

The divergence between value and growth stocks has been widening over the last five years and has certainly picked up over the past 12 months. During the most recent sell-off, both growth stocks and value stocks fell, with a significant rotation to defensive, low volatility and quality stocks. In our view, these stocks were already priced in 'bubble territory'. Despite the 16% correction in growth stocks, they are still trading well above the 25-year average. Typically, value stocks outperform when bond yields are rising as they tend to be more sensitive to better economic conditions. The relationship has broken down recently as rising bond yields in the US have resulted in the market becoming overly concerned over inflation and thus both value and growth stocks have corrected. The tempering view from the US Fed together with the deflation of trade tensions should see underlying fundamentals becoming the primary driver of markets rather than fear.

The heavily stretched valuation gap between value and defensive, low volatility stocks implies the market is pricing in either recession or further deflation. Given our view is that neither is likely in the short to medium term, we believe this continues to provide an attractive entry for rotation into extremely cheap economically-sensitive cyclicals.

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