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By Brad Potter,
Head of Australian Equities

Nikko Asset Management

FROM THE AUSTRALIAN EQUITIES DESK

Market Commentary

The S&P/ASX 200 Accumulation Index rose 1.4% during the month.

The Australian equities market rose in August, despite the change in Prime Minister and the ups and downs of the local reporting season. In major global developed markets, the US led returns with the S&P 500 up 3.0%. Japan's Nikkei 225 ended the month up 1.4%. Europe lagged with the Euro Stoxx 50 returning -3.7% and the UK's FTSE 100 returning -4.1%. Developed markets outperformed emerging for the fifth consecutive month.

During the month, the Reserve Bank of Australia (RBA) maintained the cash rate at 1.50%. The RBA continues to maintain its view on the economy, with global growth continuing and global inflation remaining low.

Domestic economic data releases were mixed in August. Employment retraced in July following the massive surge in June, falling by 3,900 positions. Meanwhile the unemployment rate fell unexpectedly to 5.3%, the lowest rate since November 2012. The NAB Survey of Business Conditions eased to +12 in July, while business confidence rose 1 point to +7. Retail sales exceeded expectations, rising 0.4% in June. Building approvals were below consensus, falling 5.2% in July.

Following a busy reporting season, the earnings outlook remains strong, with 9.8% growth in net profits after tax for FY19 expected, despite a moderation during the period. The modest downward revision of 1.9% is not surprising given the high expectations going into results season. Capital management is an ongoing theme, driven by the combination of strong balance sheets and modest capital expenditure plans together with management being acutely aware of shareholder claims on profit. The capital has largely been delivered by a combination of on-market buybacks and special dividends. Payout ratios were a little higher than expected during the results, albeit continuing to moderate after reaching historic highs.

Cost pressures are emerging within Australia after years of cost-out initiatives. Electricity prices and labour costs (particularly in the resources sector in WA) were highlighted. However, in aggregate, labour costs remain quite benign, with little evidence of domestic wage pressure outside of the construction and mining sectors. Cost inflation within the US has also impacted a number of Australian companies, including James Hardie, Brambles, Amcor and Ansell. Some of the companies have the ability to pass on the costs but often with a lag. These ongoing cost pressures warrant further attention given some are stock specific raw material costs, whereas others, such as rising freight and energy costs, are market wide.

In the banking sector, results and trading updates showed little sign of deteriorating asset quality and in fact bad debts remain at extremely low levels. Mortgage loan growth continues to slow as expected, with little sign of life in business lending. Net interest margins are under pressure but recent out-of-cycle rate rises alleviate this concern and the ongoing increase in compliance costs shows no sign of abating given the Financial Services Royal Commission.

Sector returns were mostly positive in August. The best performing sectors were Telecommunications (13.1%), Information Technology (12.9%) and Health Care (10.7%). Consumer Discretionary (3.5%), Industrials (3.2%), Consumer Staples (2.8%), Real Estate (2.7%) and Utilities (0.6%) were all positive. The Financials ex Real Estate (0.0%) sector was flat. Energy (-1.2%) and Materials (-4.8%) were the worst performing sectors during the month.

The Telecommunications sector continued its recent outperformance, driven by TPG Telecom's announcement of a merger of equals with Vodafone Hutchison Australia. TPG rallied by 50% during the month. Telstra (13.0%) also outperformed, following on from a full-year result that broadly met guidance.

The Technology sector outperformed the market. Key drivers included Wisetech Global (40.0%), Altium Ltd (37.4%) and Xero Ltd (19.3%). Wisetech surged after posting positive FY18 results.

The local Healthcare sector also had a strong month, as did the sector globally. Sector heavyweight CSL (15.6%) drove the outperformance, having delivered a FY18 result and outlook that was in line with market expectations. Resmed (10.2%) and Cochlear (6.1%) also contributed to sector outperformance.

The Financials sector was flat for the month. While the insurers and diversified financials were broadly positive, a number of banks posted negative returns. Key detractors included Westpac (-3.1%) and the Commonwealth Bank (-1.8%). The banks remain under the cloud of the Financial Services Royal Commission and Westpac disappointed the market with its 3Q update, having reported lower net interest margins than expected. Amongst the Insurers, QBE (11.2%) was one of the key contributors, with the stock outperforming after the market saw evidence of an underlying improvement in the business.

The Energy sector underperformed, as the change in the political landscape and abandonment of the National Energy Guarantee unsettled the market. The risk of further regulatory intervention has lifted, including the re-regulation of retail electricity markets. Origin Energy (-18.6%) was a key laggard, where in addition to the sector risks above, Origin made the stunning admission that their prior disclosure of underlying earnings in the Energy Markets business had been overstated for a number of years.

The Materials sector was the worst performer in August, as the ongoing trade war impacted a number of commodity prices and the stronger US dollar negatively impacted metal prices. Sector heavyweights Rio Tinto (-8.4%) and BHP Billiton (-4.7%) underperformed.

Outlook

Global growth continues to show positive signs, confirming the debt deflation cycle is rolling over to a more traditional industrial cycle. Global PMI data has retracted slightly, but continues to support the first synchronised global growth cycle seen in many years and this is being reflected in strong earnings growth. However, geopolitical risks will continue to weigh on the market. The Trump initiated trade dispute is ongoing, as the US continues to introduce new trade tariffs.

In China, the 19th Party Congress charted a course that involves less pollution, less reliance on property construction and further increases in the services sectors that should result in a more balanced economy. The expectation is that over the next five years, fixed asset investment will slow and GDP growth will move from around 6.5% to circa 5%, as China's economy becomes consumption driven.

During the August reporting season, high growth, high PE names were squeezed higher, often on poor results and outlooks. It seems the market is becoming lost in its desire to chase growth, with little or no attention to the price they are paying. The divergence between value and growth stocks has been widening over the past five years and has certainly picked up over the past 12 months. This reporting season has seen this divergence take a further incredible step up with the top PE quintile stocks expanding their one year forward PE by a further 10%, despite earnings in fact falling by 2-3% on average.

We maintain our view that a retracement of this bubble-like trend must be a high probability, given the extreme levels we are seeing. We believe that the rotation towards cyclicals and value, albeit stalled, still has some way to go and should be driven by rising global inflation, and therefore earnings growth in the more economically-sensitive sectors.

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