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FROM THE AUSTRALIAN EQUITIES DESK

Market Commentary

The S&P/ASX 200 Accumulation Index returned -6.1% during the month.

The Australian equities market had its worst monthly performance since August 2015. Global equity markets sold-off during the month on risks including tightening US monetary policy, trade issues, higher crude oil prices and weakness in emerging economies. In major global developed markets, Japan led the sell off with the Nikkei 225 down 9.1%. The US S&P 500 returned -6.9% followed by the Euro Stoxx 50 and the UK FTSE 100 which returned -5.9% and -5.1% respectively.

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 broadly positive in October. Inflation eased with the Q3 CPI recording a 1.9% increase year-on-year, in line with expectations. Employment rose by 5,600 positions in September (mostly in full-time positions). Meanwhile the unemployment rate fell to a six year low of 5.0%. The NAB Survey of Business Conditions remained strong at +15 in September and business confidence rose 1 point to +5. Retail sales were up 0.3% in August, marginally ahead of expectations.

In stock specific news, AMP announced the sale of its ANZ wealth protection and mature business to Resolution Life for AUD 3.45 billion. Commonwealth Bank announced it has entered into an agreement to sell its global asset management business, Colonial First State Global Asset Management to Mitsubishi UFG Trust and Banking Corp for AUD 4.13 billion Sector returns were all negative in October. The best performing sectors were defensive sectors such as Real Estate (-3.8%), Utilities (-4.0%) and Consumer Staples (-4.8%). Financials ex Real Estate (-5.9%), Materials (-5.2%) and Industrials (-5.1%) also outperformed the market. Growth stocks sold off sharply with Information Technology (-11.2%) the worst performing sector during the month. Energy (-10.5%), Consumer Discretionary (-8.0%), Communications (-7.2%) and Healthcare (-7.0%) all underperformed.

Despite the interest rate sensitivity of the Real Estate and Utilities sectors both outperformed the market during October. Top performers in the Real Estate sector were SCA Property Group (7.1%) and Vicinity Centres (1.1%). Within the Utilities sector, Ausnet Services (5.2%) and Spark Infrastructure (2.7%) were the better performing stocks.

The Consumer Staples sector was one of the better performing sectors during October. Sector heavyweight Woolworths (1.2%) performed strongly relative to the market, on the back of a flight to defensive assets.

The Information Technology sector was the main casualty in October's risk-off market. Xero (-18.8%), Afterpay Touch (-30.4%) and Wisetech Global (-27.3%) were the key detractors within the sector.

The Energy sector was the second worst performing sector impacted by falling crude oil prices. Crude oil was weaker over October following the US Government directing OPEC to lift its production rate to reduce prices. Sector heavyweights Woodside Petroleum (-9.7%) and Oil Search (-14.0%) were sold off during the month. Origin Energy (-11.7%) was also impacted by the Australian Government's announcement that it will adopt a number of the ACCC's recommendations in its retail electricity price enquiry.

The Consumer Discretionary sector underperformed the market during October. Key detractors included Aristocrat Leisure (-6.8%), Corporate Travel Management (-34.3%) and Crown Resorts (-8.6%).

Outlook

Global growth remains mixed with China, Europe and Japan showing a moderation in growth, while the US remains robust. Nevertheless, benign global financial conditions, including highly accommodative monetary policy in Europe and Japan and more stimulus in China, should limit the extent of the slowdown. Geopolitical risks will also 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.

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. The most recent reporting season saw this divergence take a further incredible step up with the top PE quintile stocks expanding their 1 year forward PE by a further 10%, despite earnings in fact falling by 2-3% on average.

We have held a 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. The aggressive sell-off in growth stocks witnessed in October, as well as the ongoing increases in bond yields, is consistent with this expectation.

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