

# Market Overview

## Australian Shares

- The Australian market, as measured by the S&P/ASX 200 Accumulation Index, put on 5.14% for the quarter:
  - The market leadership rotated away from 'low volatility' and bond proxies as resources led performance with a return of 13.37% due to increased market confidence in the price outlook for iron ore and bulk commodities
    - Both the iron ore and coal markets are being driven by the prevailing policies of the Chinese government towards infrastructure investments and supply curtailment among Chinese thermal coal producers
- The worst performing sector for the local equity market during the quarter was the telecommunications sector, which was down 6% on the back of increasing concerns about the level of profitability for the broadband retailing in a post National Broadband Network (NBN) world.

## International Equities

- World share prices rose in July, August, and into early September as the impact of the Brexit vote in June wore off.
  - Late in September, however, prices dropped as investors have worried about the possibility of higher interest rates and about the potential vulnerability of the U.S. economy
- The MSCI World Index was up 5.12% for the quarter for Australian investors, however, the gain was reduced to 2.04% due to the appreciation of the Australian dollar against the U.S. dollar
- The regional breakdowns show that, among developed economies, overall performance continues to be dependent on the U.S. stock market, where the S&P 500 is up 6.4% calendar year to date:
  - There has been a surprising post-Brexit rebound in the U.K. market, where the FTSE 100 Index is now up 8.58% year to date.

## Australian Property

- The S&P/ASX 200 A-REIT Accumulation Index returned -1.95% over the quarter, underperforming the Australian equities market, as measured by the S&P/ASX 200 Accumulation Index, which rose 5.14%:
  - However it is important to note that for the year to September 2016, the S&P/ASX 200 A-REIT Accumulation Index returned 20.80% and has significantly outperformed the Australian equities market which has put on 13.17%.

## Australian Cash and Fixed Interest

- There was little change in short-term interest rates from when the Reserve Bank last cut the cash rate, from 1.75% to 1.50% in August:
  - The yield on 90-day bank bills has been around 1.75%. Longer-term rates continue to move largely in sync with trends in overseas markets, and they track U.S. moves particularly closely.
- The 10-year government bond yield reached a low point of 1.82% on Aug. 2 but rose to end the quarter at 1.91%

# Market Overview

## International Fixed Interest

- The key development over the past month has been a rise in the 10-year U.S. Treasury yield:
  - It had been slowly increasing, from its low point of 1.36% on July 8 to 1.60%
    - The yield actually peaked at 1.73% on September 13 but drifted back at the end of the quarter
- The rise in U.S. yields has had modest knock-on effects in other markets
- However, the recent moves have not hugely changed the international fixed-interest landscape:
  - There are still large swathes of negative-yielding securities, for example, most notably in Switzerland, where the 10-year government bond yield is still negative 0.57%
  - But there is no longer the one-way-buying traffic that characterised the earlier months of the year

## Australian Dollar

- The Australian dollar has been somewhat erratic
- Most recently it has been impacted by increased nervousness in global markets and has been sold down (it tends to trade more strongly when investors are more comfortable):
  - The net effect of its cycles is that at its current USD 0.763, it was up by 2.69% over the quarter

# Reporting Season Wrap

During the months of February and August, the majority of Australian listed companies reveal their profit results. Most also provide guidance as to how they expect their businesses to perform for the upcoming six to twelve months. Market expectations heading into the 2016 August reporting season were at their lowest since the global financial crisis. But despite the low expectations there were not many major disappointments.

## The key highlights from the August reporting season were:

### ▪ *Minimal Growth:*

The earnings environment remains subdued, with fewer positive surprises than normal and many company results reflecting a much stronger first half of the financial year compared to the second half.

### ▪ *Capital Management:*

Capital management was again a prevalent theme and while this remains a key focus for investors, it was less of a feature this reporting season than it has been in the past.

It appears as though capital management is the preferred course of action from Australia's major corporates, with global and domestic political instability making many management teams quite cautious to open their cheque books. As such, there were not many instances of companies significantly reducing their dividends to shareholders and the profit pay-out ratio of the market (approaching 80%) remains at elevated levels.

### ▪ *Gearing and the cost of debt declines:*

The de-gearing of balance sheets was widespread amongst corporate Australia and sets the scene for this excess capital to be used in either a spate of acquisitions or returned to shareholders going forward.

Companies are now paying much less for the debt they have, primarily by accessing the offshore debt markets. Falling debt costs has delivered profit growth in an environment where revenue growth has been hard to achieve.

### ▪ *Cost cutting:*

In the absence of revenue growth, Australian companies are also holding onto their wallets and delaying or halting significant investment spending. The large diversified miners were again very vocal about their focus on shareholder returns and their reductions in capital expenditure.

## Analysis of the Reporting Season

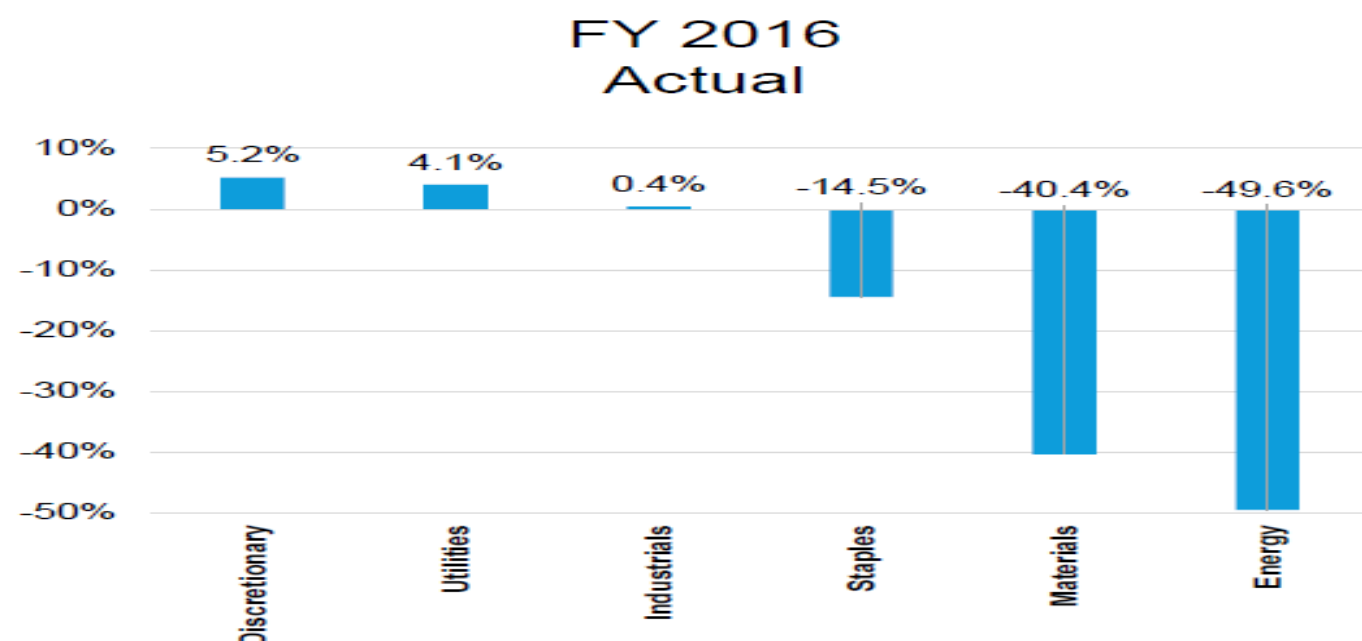
Last August, it was the mining and energy sectors dragging down underlying earnings of the market, but this was offset by earnings growth from the financial sector and the free kick that offshore earners received from a falling AUD.

For the 2016 financial year, Earnings per Share (EPS) growth for the S&P/ASX 200 Index companies was up 4.3% on the previous year. Sectors that produced above average underlying EPS growth rates included Airlines, Health Insurers, Healthcare, Building Materials, many of the companies in the Technology sector and the large Retailers leveraged to residential building completions.

Those sectors which showed a significant slowing in earnings and profit growth in the second half relative to the first half and where margins came under pressure, included the Banks, Wealth Managers, Telcos, media, Non-discretionary Retailers and Oil & Gas companies.

# Reporting Season Wrap

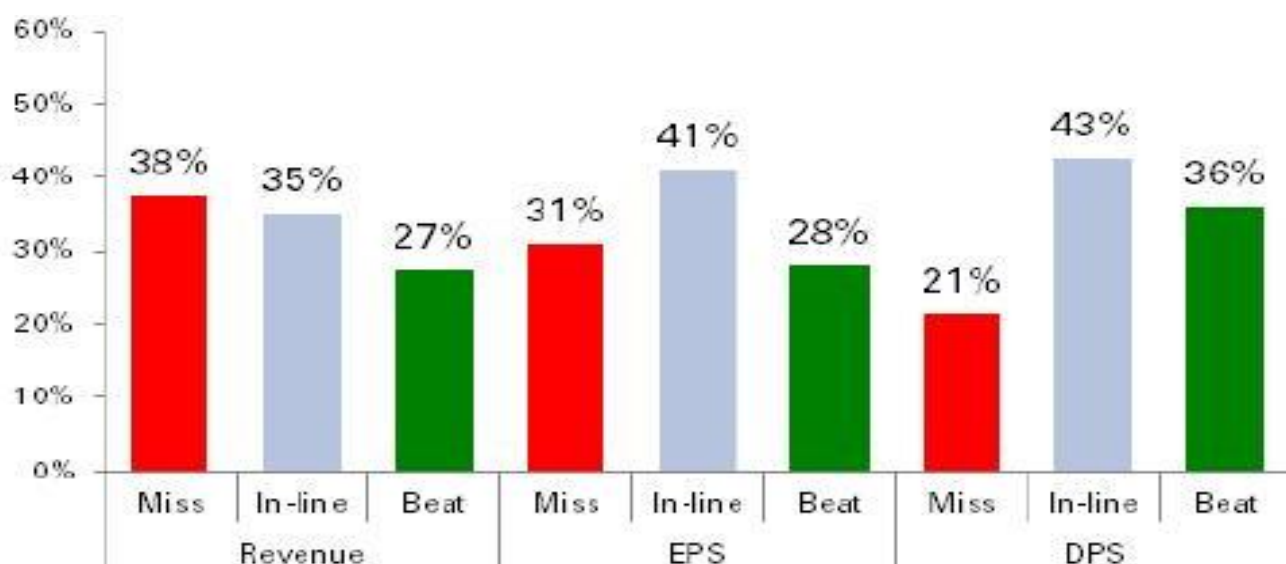
## Earnings per Share (EPS) Growth – Winners and Losers



Source: Morgan Stanley (IBES)

Indicating a very difficult trading environment, the graph below shows that around 38% of S&P/ASX 200 companies missed consensus revenue estimates and 31% missed on EPS, just above the 20-year average. Only 28% of firms beat consensus EPS, a new low, compared with 40% of firms in the first half.

## Beats/misses for S&P/ASX 200 companies



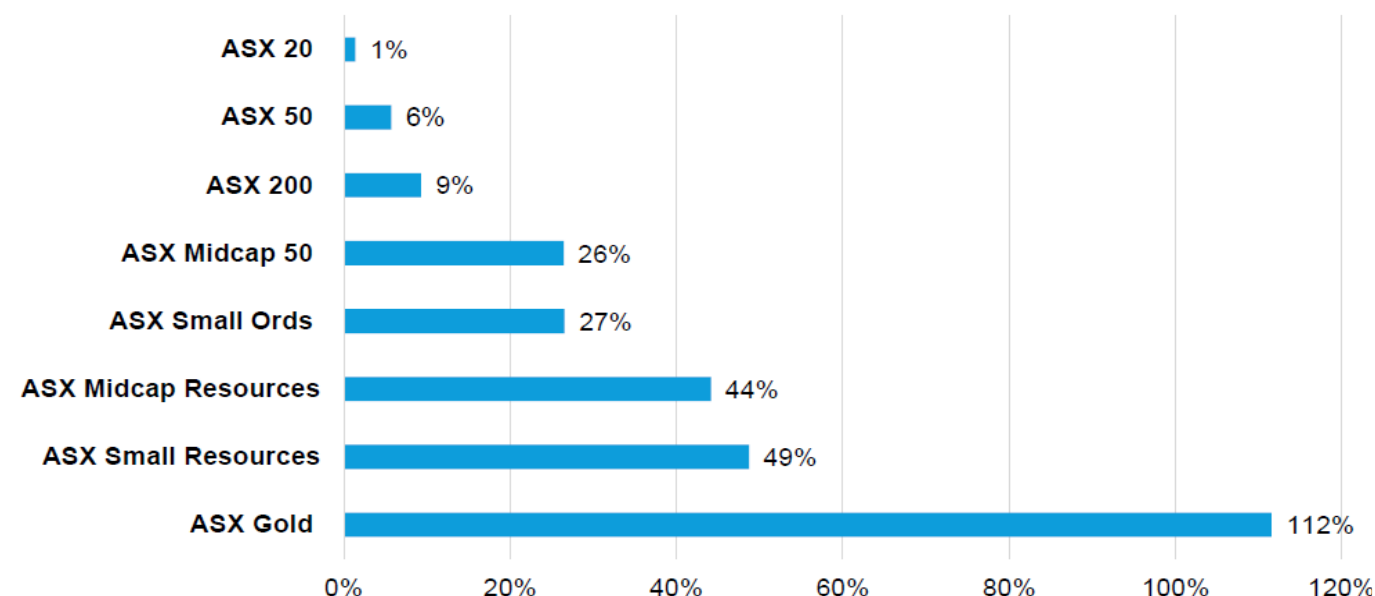
Source: Goldman Sachs, (FactSet)

As a result, the returns of those segments of the market that beat or were in line with consensus earnings significantly outperformed, as can be seen the graph below.

# Reporting Season Wrap

## Market Segment Performance

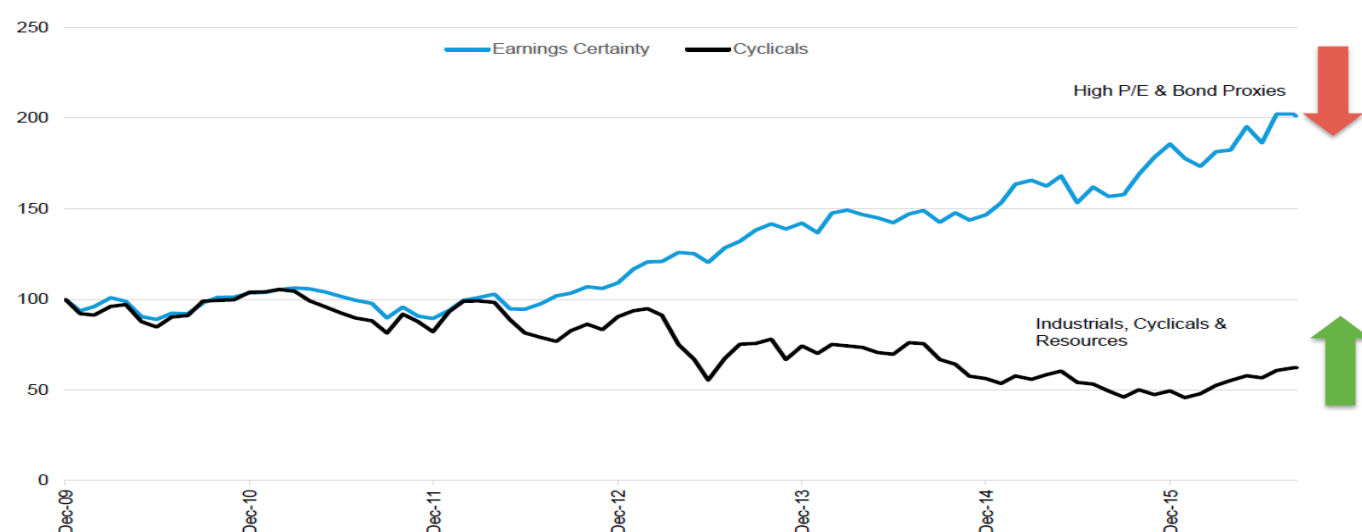
12 months to August 2016



Source: Ausbil (IRESS)

Outperformance was concentrated at the small cap end of the market, particularly in some of the resource companies as a result of rebounding commodity prices from cyclical lows in the second half of the financial year. Further to that, it's been the sectors of the market that generate earnings certainty, like the growth (or high P/E) Healthcare sector and the so called "bond proxies" of Utilities and Listed Property that have significantly outperformed most of the industrial and cyclical stocks as well as the resource and energy companies.

## Performance Dispersion

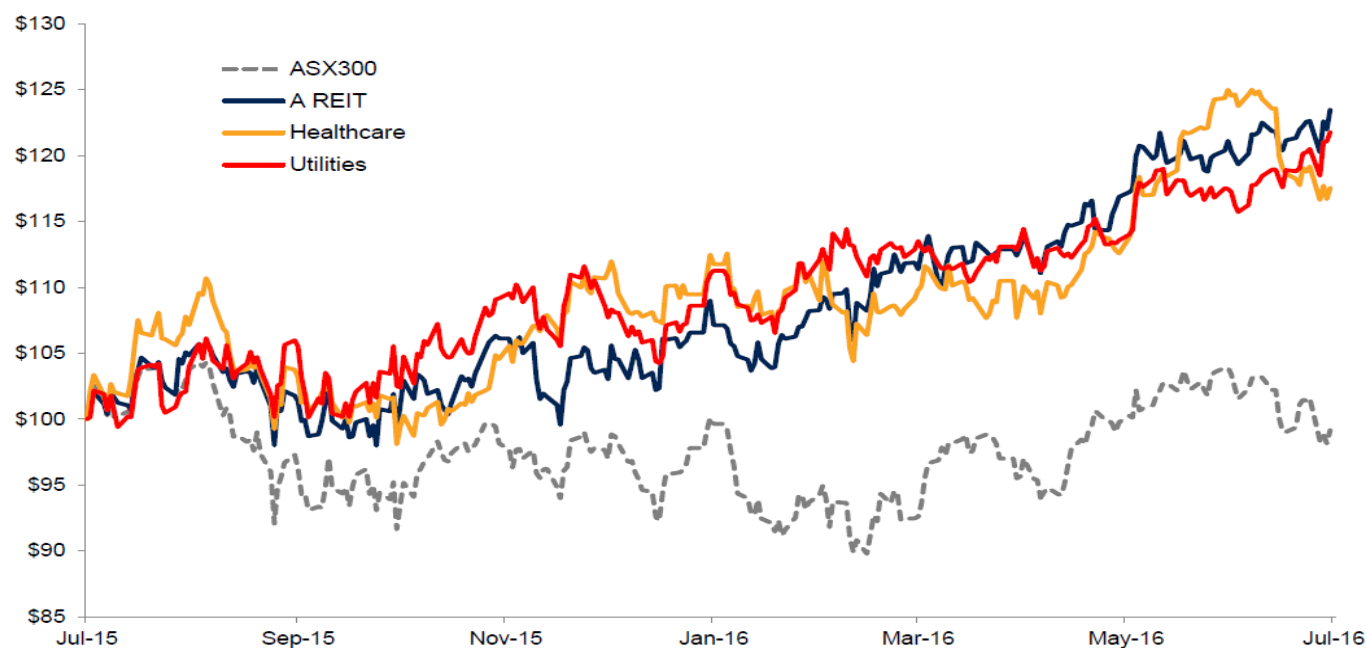


Source: Goldman Sachs (FactSet)

The search for growth and earnings certainty has had a dramatic flow on effect and has led to a major outperformance in the HIP (Healthcare/Infrastructure/Property) sectors as seen in the graph below. However investors need to be cautious about stretched valuations with these sectors of the market.

# Reporting Season Wrap

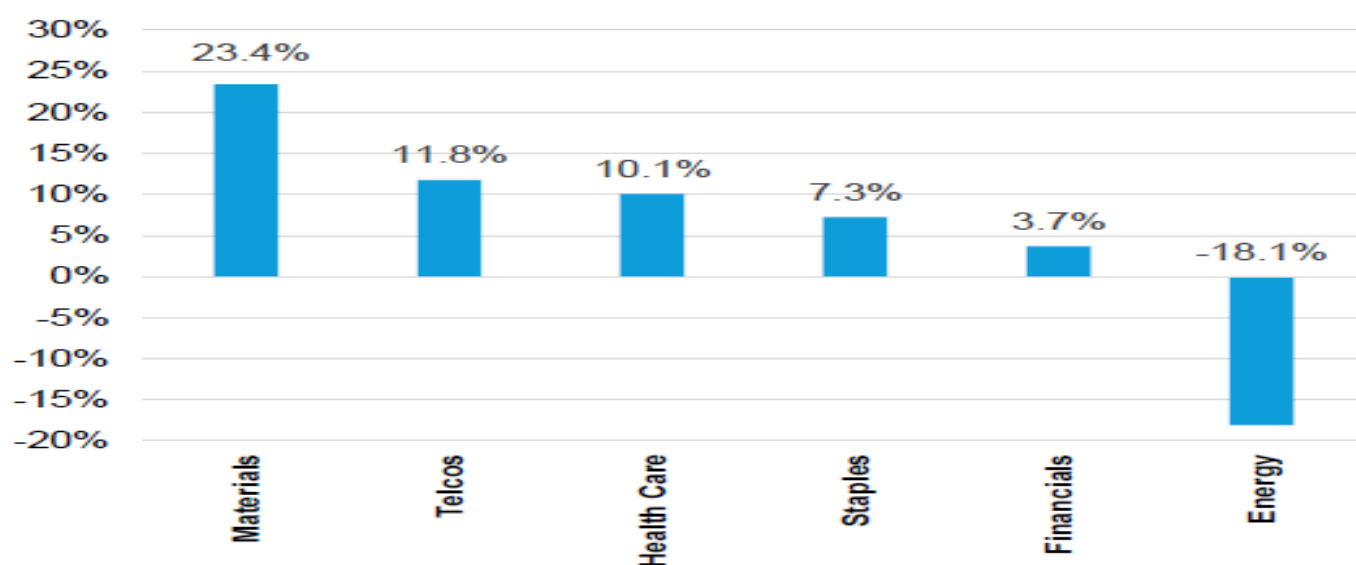
## A "HIP" bubble in Australia



Looking forward, the 2017 financial year is expected to remain a challenging one for many of our major corporates. However some sectors of the market are expected to grow earnings significantly from the previous year as a result of margin expansion and cost containment.

## Earnings per Share (EPS) Growth – Winners and Losers

### FY 2017 Expected



Source: Morgan Stanley (IBES)

# Reporting Season Wrap

At this early stage of Financial Year 2017, the consensus forecast for EPS results are:

- EPS on the Industrial sector is expected to grow by a respectable 5%, driven by margin expansion and cost containment.
- Resources are expected to bounce off significant lows with strong growth in EPS expected. However risks remain, as the sustainability of Chinese demand is uncertain and Australian miners needing to show supply discipline.
- Banks are expected to grind out 1% EPS growth. It is certainly a period of forecast anaemic growth for the banks. Dividend growth is also not expected.
- Competition remains fierce for the non-discretionary retailers, particularly supermarkets where margins will remain under pressure and new entrants into the industry will command a growing market share.
- Pressure is also intensifying in the Telecommunications sector. Whilst technology consumption demands are exploding, margins are under pressure with operators constantly reviewing their cost structure and pricing.

The outlook for the Healthcare sector remains upbeat with low regulatory risk and anticipated strong earnings growth.