

# Market Overview

## Australian Shares

- The S&P/ASX 200 Accumulation Index posted a small gain (+1.53%) for the third quarter, most of it recorded in July
  - The monthly run of outperformance for Australian equities came to an end as the ASX declined in September.
- The Communication Services sector (+14.7%) was the best performing sector for the quarter, mainly from a contribution by telecommunication network companies
  - Information Technology (+12.2%) also performed well, predominantly through a few payment and software companies
  - The Utilities sector (-5.5%) was the worst performing sector for the quarter as it was pulled down by power and electricity firms
  - Other sectors that fell included Materials (-3.2%) and Consumer Staples (-2.7%).

## International Shares

- Global stocks rose over the September quarter, to mark their ninth gain in the past ten quarters after companies posted higher-than-expected earnings, the US economy expanded briskly, the Federal Reserve reaffirmed that monetary policy would only be tightened gradually, and Japan's economy rebounded
  - Gains were capped when the US escalated its trade war with China, US bond yields rose on inflationary pressures, a higher US dollar buffeted emerging markets and investors fretted about the impasse over the UK's departure from the EU
- US stocks reached unprecedented heights in September as companies reported strong earnings growth and the economy hummed
  - Financial research and data company FactSet said that 80% of S&P 500 companies announced earnings per share for the second quarter that beat estimates – a 'beat rate' that is the highest since FactSet began tracking this measure in 2008.
- European stocks rose after European companies posted higher-than-expected earnings, the US and European trade tensions eased, and Sweden's mainstream parties held off populists in elections
  - In July, US President Donald Trump and EC President Jean-Claude Juncker met and agreed to "work together toward zero tariffs, zero non-tariff barriers, and zero subsidies on non-auto industrial goods", a statement that boosted hopes the US and EU would avoid a trade war
  - Sweden's centrist parties did better than expected in the country's election to prevent the populist Sweden Democrats from holding a pivotal, rather than a nuisance, position in negotiations to form a government, even though the mainstream parties failed to win enough support to mould a coalition immediately
  - Gains were capped when the EU rejected the latest withdrawal agreement offered by the UK, and Italy's new populist government said it was aiming for a budget deficit of 2.4% in 2019, three times the shortfall of the previous government and in breach of EU budget requirements for indebted governments
  - Reports showed the eurozone and EU economies expanded 0.4% in the second quarter, the same rate as for the first quarter
- Japanese stocks rose as the economy bounced back to expand 1.9% in the June quarter, after contracting in the previous quarter, and pro-stimulus Prime Minister Shinzō Abe overcame a corruption scandal to win a third term as leader of the Liberal Democratic Party, which allows him to stay in office for three more years

# Market Overview

- In China, stocks struggled amid concerns about the trade war with the US and as signs emerged the economy is cooling
- Emerging markets fell as the collapse in Argentina's, and Turkey's currencies presaged financial crises in these countries, and Brazil's presidential election in October created uncertainty

## Australian Property

- A-REITs have benefited from a winding back of expectations about the likely rise in bond yields
  - For the quarter, the S&P/ASX200 A-REITs Index was up 1.86%, outperforming the broader share market
  - The sector has been animated by a pickup in M&A activity, with a bidding contest for the Investa Office Fund and a likely takeover of the Centuria Industrial REIT.

## Australian Cash and Fixed Interest

- Once again the RBA decided to hold the cash rate at 1.5%
  - Weak core inflation outcomes and tight financial conditions suggested that inflation would not recover to target within a reasonable timeframe
  - Though based on the most recent GDP data, the economy delivered above-trend growth
    - Labour market data showed the unemployment rate remained low at 5.3%, while domestic wage growth was still low at +2.1%
  - The central bank had less concern about housing or the recent rise in mortgage rates

## International Cash and Fixed Interest

- In September, the Fed raised the US cash rate by a quarter point to between 2% and 2.25% and, as expected, signalled another five rate increases into 2020
  - The Fed made its eighth post-crisis rate increases on signs that the US economy was growing at close to capacity
  - Over the three months, reports showed the US economy completed nine years of consecutive growth (June 2009 to June 2018) when it expanded an annualised 4.2% in the June quarter, its fastest pace in four years
  - The US jobless rate stayed close to the 18-year low of 3.8% set in May, and consumer confidence hit an 18-year high in September (as measured by the Conference Board)
  - 10-year US government bond yields rose 21 basis points over the three months to 3.06% on inflation concerns

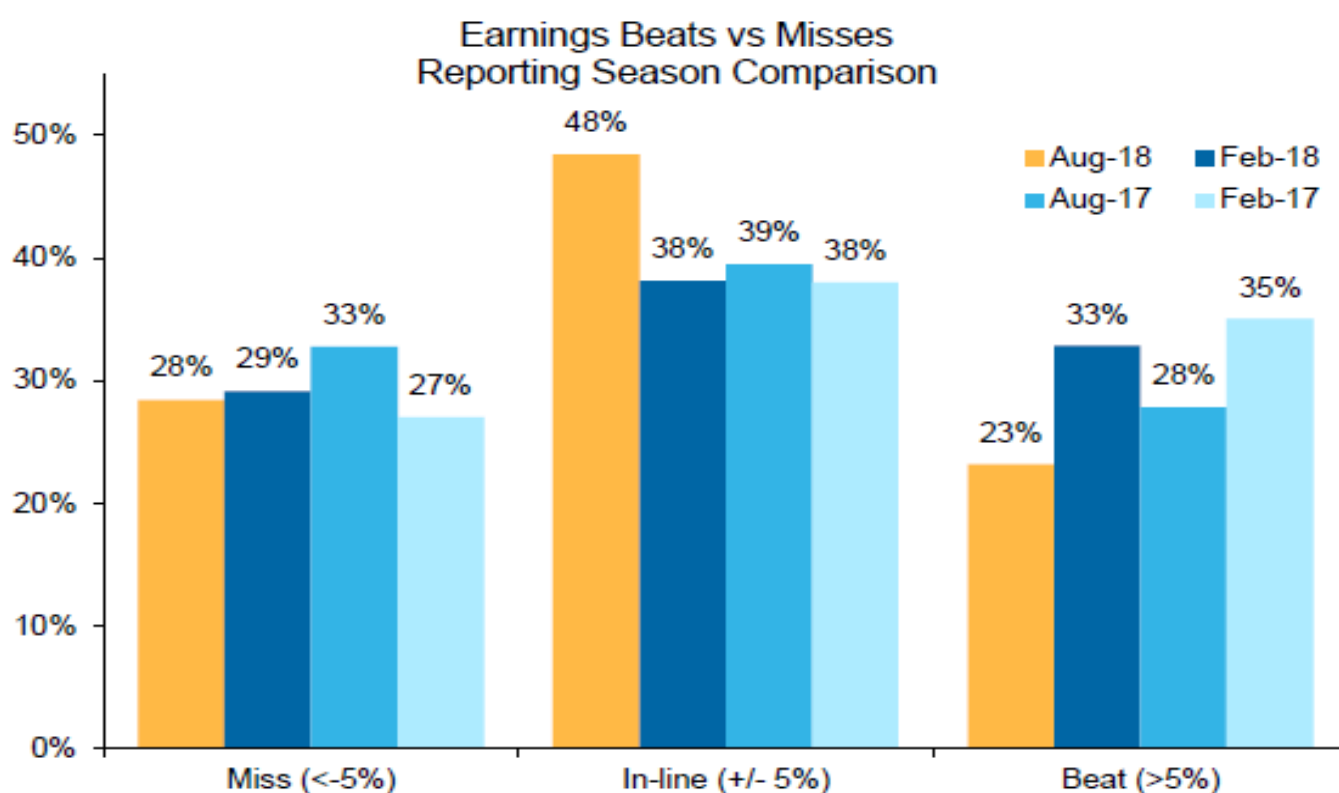
## Australian Dollar

- The Australian dollar fell heavily against most major currencies as it depreciated to a more than two-year low to US\$71.0c as fears over an escalation in the trade conflict between the United States and China dominated concerns.

# Reporting Season Wrap

Overall it was a solid reporting season for the 2017/18 Financial Year which resulted in gains for the S&P/ASX 200 Accumulation Index of 1.5% for the September quarter. But the reporting season did produce some significant share price moves at both ends of the spectrum, with the difference between the best and worst performing companies rather extreme. Companies continue to lift profits and remain keen to pay dividends. Almost 93% of full-year reporting companies produced a profit, well above the 87% long-term average.

There was a more significant proportion of 'in-line' results (48%) and a lower than average number of earnings beats (23%). Resources continue to support the broader market, posting 22% EPS growth in the 2017/18 Financial Year with Industrials (ex. Resources, listed property and banks) posting only a modest 1.4% EPS growth for the 2017/18 Financial Year, the second weakest year of growth since the 2010/11 Financial Year.



Source: Macquarie Research, September 2018

The key trends we saw materialise in the 2017/18 Financial Year reporting season were:

## Cost Pressures:

Although some companies reported robust revenue growth, cost pressures increased over the reporting period after years of cost cuts.

This was as a result of:

- Higher costs of production related to the increase in crude oil prices
- Higher input cost pressures for Internationally exposed companies, particularly in North America which is experiencing cyclical low unemployment
- Upside pressure to contractor and labour costs, particularly in the resources sector as the industry begins expansion into a capital base that has been whittled down during an extended period of capital restraint.

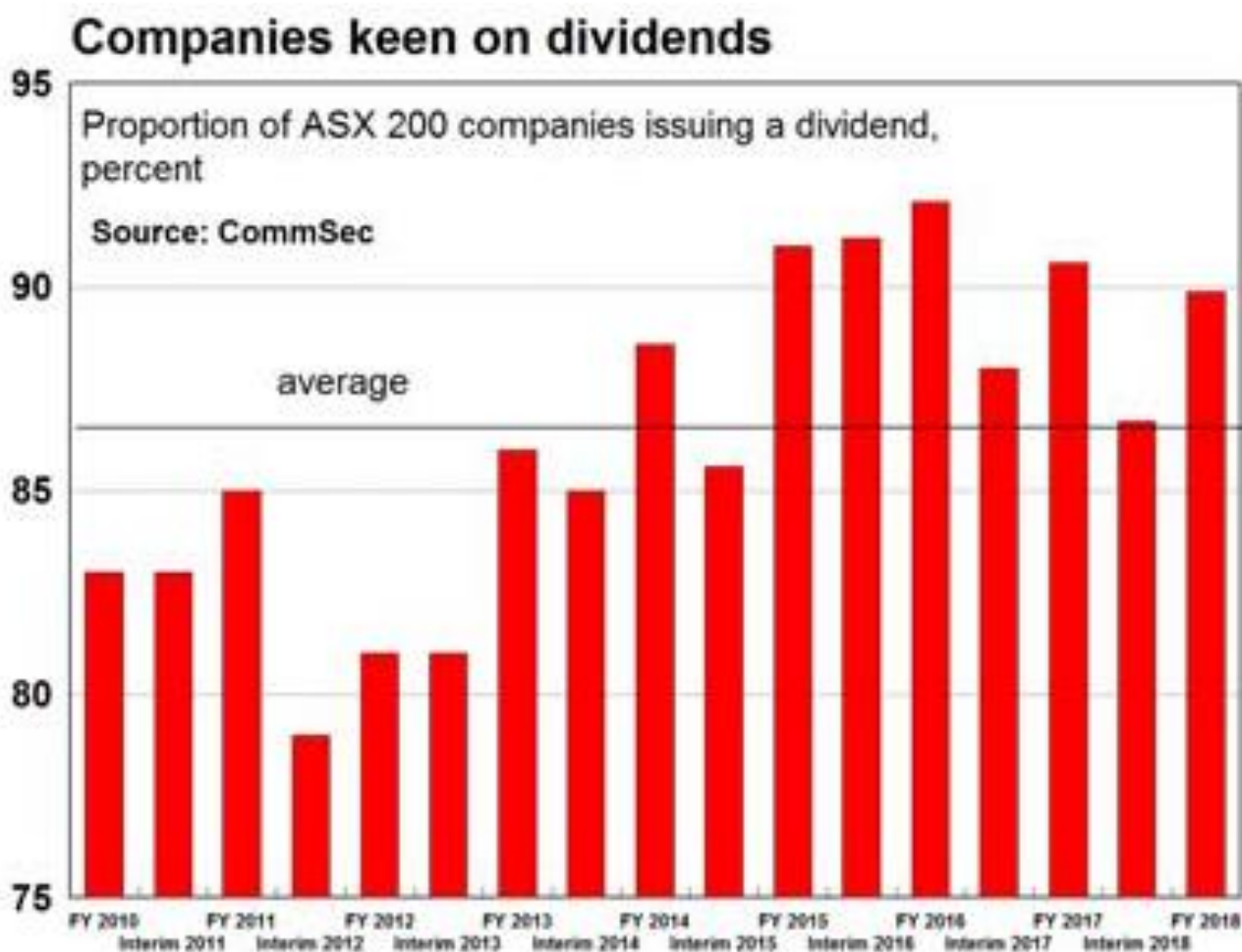
# Reporting Season Wrap

## Capital management

Capital management continued to feature with strong balance sheets giving many companies the option to deliver returns to shareholders through special dividends, share buybacks and capital returns.

Positive dividend surprises (23%) outnumbered negative dividend surprises (19%) again this reporting season, and 21% of companies exceeded payout expectations, which is modestly lower in comparison to the prior reporting season back in February.

Also, 90% of full-year reporting companies elected to pay a dividend, up from around 87% in the first half and well above the long-term average of 86%. Of those reporting a dividend, 70% lifted the dividend.



The market rewarded 59% of companies with positive dividend surprises on the day they reported, despite only 45% beating earnings forecast, which indicates that the market is still rewarding positive dividend outcomes.

We expect capital management to continue to be a significant focus post the reporting season, as many companies are thinking of ways to try and distribute excess franking credits to shareholders ahead of a possible change to legislation in this area.

# Reporting Season Wrap

## Corporate activity

There was also a surge in corporate activity during this reporting season.

Significant deals included Nine Entertainment acquiring Fairfax, Amcor acquiring US-based Bemis, and most recently TPG Telecom and Vodafone Hutchinson Australia announcing an agreement to a merger of equals.

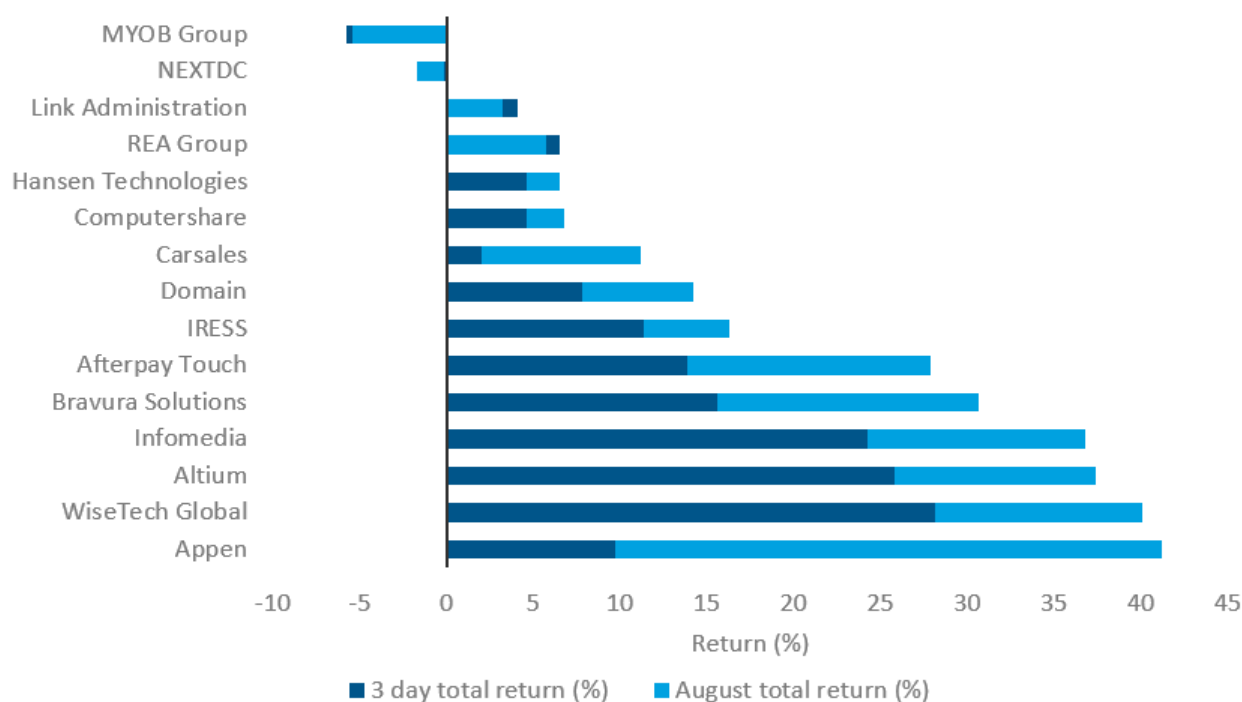
With balance sheets generally healthy and borrowing costs still relatively low, the environment remains supportive of M&A activity, notwithstanding the fact many segments of the market are currently priced at relatively high levels. On the flipside, a falling Australian dollar may increase the appeal of well-run Australian companies to foreign acquirers.

## Small-cap tech companies

The clear winner from this reporting season was the Information Technology sector, as quite some companies in this sector exceeded earnings expectations. This was the highest across all sectors, which translated into volatile daily share price moves.

High profile small-cap tech stocks led the gains with their performance likely aided by strong market support for high price-to-earnings (PE) names in general throughout this reporting season.

### Return profile of ASX200 Information Technology Sector



Source: Macquarie Research, September 2018

On a cautionary note, the expansion in the PE multiple of many of these companies has now far outstripped the increase in underlying earnings. As such, for many names in this sector, the focus remains on top-line revenue growth rather than profits.

From this point, extreme caution will be required investing in small-cap tech sector stocks.

# Reporting Season Wrap

The performance of key sectors in the market:

## *Banking Sector – Majors continue to shed market share*

Retail banking conditions continued to deteriorate in the second half of the 2017/18 financial year. Increased competition, higher funding costs and slowing credit growth have impacted heavily on the banks' retail division performance to such an extent that revenue growth was negative in the recent reporting season.

The medium-term outlook for revenue growth appears challenging should banks continue to chase slowing mortgage growth aggressively. However, mortgage re-pricing should provide a near-term reprieve to elevated funding costs, with the majors following smaller lenders in re-pricing existing mortgage books.

We remain cautious about the short-term outlook for the banks.

## *Resources Sector – Cost pressures increasing*

Resources had a solid reporting season with 70% of energy companies and 66% of materials companies beating or meeting earnings expectations. This helped earnings growth for the Resources sector post a substantial 22% increase. Good results were in many cases supported by better than expected margins, cost performance and cash flow.

However, cost pressures are increasing, and labour is getting tighter. Also, cap-ex costs are also starting to rise across some projects.

The sector and commodity prices will most likely continue to be supported by above-average global growth, rising inflation, and China's materials-intensive growth cycle which continues to be supported by the government, despite deleveraging efforts.

There remains upside risk to earnings forecasts with spot commodity prices staying ahead of previous estimates. This could translate into earnings upgrades for the most profitable companies in the sector. However, the sector has run hard, with resource and energy stocks appearing fully priced.

## *Healthcare – International exposed companies better placed*

Results from the healthcare sector were mostly in line with expectations, but the results were mixed. Offshore companies like CSL that are leveraged to global growth significantly outperformed their domestic peers such as Ramsay Health Care (RHC).

A significant reduction in medical procedures, combined with the lower affordability of private health care premiums, which have come under pressure, has placed downward pressure on domestic healthcare operators. They will now need to focus on cost management to offset declining revenue growth over the short to medium term.

We remain attracted to pockets of the Health Care sector.

# Reporting Season Wrap

## *Listed Property Sector – Retail getting harder*

Retail landlords continue to find it tough. The modest improvement in specialty retail sales growth across the sector was dwarfed by the challenges in leasing conditions for landlords and retailers, which remain difficult. On the other hand, the office sector remains strong as portfolio metrics have generally improved and office conditions are expected to remain supportive in the medium term.

Increasing debt costs over the next few years may well become a drag on the 2018/19 Financial Year earnings of the sector. Also, rising bond yields may lead to a further rotation out of interest rate sensitive sectors like listed property. However, sectors that are tilted to growth areas like commercial property should be able to adapt, but the retail space will remain challenging due to structural headwinds compounded with cyclical headwinds such as rising rates and political uncertainty.

### **Summary:**

Corporate Australia remains in healthy shape. Despite a period of stronger growth in expenses, underlying profitability remains solid.

The August reporting season saw the emergence of some interesting themes in the Australian equity market. The persistence and duration of these trends will be significant in determining the best sectors going forward.

At this stage, it would appear that the Australian market is reasonably priced, with Global trends likely to have the most significant impact in the direction of our market over the coming 12 months.