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FROM THE AUSTRALIAN EQUITIES DESK

Market Commentary

The S&P/ASX 200 Accumulation Index returned -2.2% during November.

The Australian equities market remained weak in the month following the battering the markets experienced in October and was the worst performing major market over the period. In major global developed markets, Japan and the US led returns with Nikkei 225 and the US S&P 500 both returning 2.0%, followed by the Euro Stoxx 50 and the UK FTSE 100, which returned -0.7% and -1.6%, respectively.

During the month, the Reserve Bank of Australia (RBA) maintained the cash rate at 1.50%. The RBA has upgraded its view on the economy with forecasts for economic growth revised upwards for 2018 and 2019. Further reductions in unemployment and a return to target inflation are also expected.

Domestic economic data releases were mixed in November. Employment rose by 32,800 positions in October (mostly in full-time positions). Meanwhile, the unemployment rate held steady at 5.0%. The NAB Survey of Business Conditions eased 2 points to +12 in October and business confidence fell 2 points to +4. Retail sales were sluggish, up 0.2% in September, which was below expectations.

In stock specific news, Woolworths announced the sale of its petrol business to European and North American convenience and fuel retailer EG Group for AUD 1.725 billion.
Sector returns were mostly negative in November. The best performing sectors were Financials ex Real Estate (1.4%), which alongside Information Technology (1.0%,) were the only positive returns this month. Real Estate (-0.4%), Industrials (-0.6%) and Utilities (-1.8%) also outperformed the market. The worst performing sector for the month was Energy (-10.3%). Consumer Staples (-3.1%), Communications (-3.2%), Healthcare (-4.0%), Materials (-4.8%) and Consumer Discretionary (-5.1%) all underperformed.

Financials was the top performing sector during November. Three of the major banks reported broadly in-line results in the context of a challenging environment. Both ANZ Bank (6.5%) and Commonwealth Bank (2.9%) rallied following their reported results.

The Information Technology sector rebounded following last months' haemorrhaging. Afterpay (15.5%) and Wisetech Global (16.5%) were the key contributors within the sector.

The Energy sector continued its decline, continuing to be impacted by falls in crude oil prices with WTI crude oil falling 22% to USD 51/bbl. The fall was largely due to a supply spike from Saudi Arabia. Sector heavyweights Woodside Petroleum (-10.9%), Santos (-16.9%) and Origin Energy (-11.1%) were the key detractors over the month.

The Consumer Discretionary sector underperformed the market during November. Key detractors included Aristocrat Leisure (-10.7%) and Wesfarmers (-5.2%).

The Materials sector was one of the worst performing sectors this month off the back of falling iron ore, steel and alumina prices. Sector heavy weight BHP Billiton (-4.7%), South32 (-14.4%) and BlueScope Steel (-21.9%) were the major detractors within the 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 provides an attractive entry for rotation into extremely cheap economically-sensitive cyclicals.

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