

Ausbil Investment Markets

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Report

April 2017

International economic review

Economic Review

United States (US) US President Trump launched a military strike on Syrian government targets in retaliation for their chemical weapons attack on civilians. Trump also ordered a carrier armada to the South Korean peninsula.

The International Monetary Fund's April 2017 World Economic Outlook raised global growth forecasts for 2017 to 3.5% (previously 3.4%) from 3.1% in 2016, while keeping its forecast for 2018 at 3.6%. The acceleration will be broad based across advanced, emerging and low-income economies, with the continuing expectation for higher growth in the United States.

The US Federal Reserve is preparing financial markets for "quantitative tightening", a phased balance sheet reduction likely to commence in Q4 2017. An overview of President Trump's proposed tax plan was unveiled, but it was light on detail. The corporate tax rate will fall to 15% from 35% and will collapse the seven individual tax brackets to three, with tax rates of 10%, 25% and 35%. There will be a one-time tax on repatriation of foreign earnings and no border adjusted tax. The aggressive corporate tax cut may boost the budget deficit by more than US\$2 trillion and Treasury Secretary Mnuchin stated that the proposal would "pay for itself" through economic growth. Separately Budget director Mulvaney proposed spending US\$200 billion in federal funds on an infrastructure and development plan and would also leverage private financing to bring the total to US\$1 trillion over the next ten-years.

United Kingdom (UK) Prime Minister Theresa May will hold an early general election on 8 June. In France, social liberal Emmanuel Macron and Far Right Marine Le Pen are through to the second round of the French presidential election to be held on 7 May.

The **European Central Bank (ECB)** left policy settings unchanged and maintained its forward guidance, stating rates would remain at present or lower levels for an extended period and they also said it could increase the size or duration of Quantitative Easing (QE) if needed. ECB President Draghi highlighted that the region's recovery is becoming "increasingly solid" and that the "the risks surrounding the euro area growth outlook, while moving towards a more balanced configuration (but) underlying inflation pressures continue to remain subdued and have yet to show a convincing upward trend."

Activity is accelerating and pushing GDP closer to 2% as the Eurozone composite PMI stands at a new six-year high. Price pressures remain elevated due to a rise in input prices amid firmer commodity prices, the weak euro and tighter supply chains.

The Summit between US President Trump and **Chinese** President Xi was better than expected as both agreed on a "100-day plan" to address the trade imbalance. In early April, China's Communist Party announced plans to establish the Xiongan New Area, a special economic zone 120 kilometres southwest of Beijing. The Xiongan area is set to become a new megacity in 10 years. Building a new megacity requires substantial investments in real estate and infrastructure, which will drive demand for steel and iron ore.

The **Bank of Japan** left policy unchanged and revised higher growth forecasts in its April outlook report. Core CPI forecasts were left unchanged and will reach the 2% target by "around FY18." Activity is seen to be accelerating into Q2 according to the latest PMI survey. The survey is showing an acceleration in output, new export orders and backlogs. This is associated with a broad based improvement in business sentiment as revealed in the Tankan quarterly business survey. All measures of consumer prices have turned positive and are inflating.

International economic review

The **Reserve Bank of Australia** (RBA) left the cash rate unchanged at 1.50% with a neutral bias. The statement highlighted a stronger global backdrop, but the focus was on the conclusion, developments in the labour and housing markets “the Board judged that developments in the labour and housing markets warranted careful monitoring over coming months.” The RBA expressed an overriding belief in the new macro-prudential measures to address the growing risk to the financial system from unsustainable house prices and accelerating household indebtedness. The consumer prices index in the March quarter saw the headline rate at 2.1%, back within the RBA’s target band. The trimmed mean core measure accelerated to 1.9%.

The Federal Government implemented a new policy called the Australian Domestic Gas Security Mechanism. The policy will allow the government to impose export controls on companies if there is a forecast shortfall of gas supply in the east coast domestic market and will be in place from 1 July 2017.

Global Outlook

Our investment outlook is based on the reflation trade, where global activity is accelerating, inflation is trending higher, bond yields are rising and nominal cash rates are normalising from emergency levels.

Global growth is in a synchronised upswing, which is accelerating in 2017. The US is expected to expand well beyond trend at a robust 2.3% pace, with the Eurozone at 1.8%, Japan at 0.9% and China at 6.5% or higher. We expect the US Federal Reserve to hike rates up to four times this year by a maximum total of 100 basis points.

Australian Economic Outlook

Australia is benefitting from the reflation theme as our terms of trade and national income are surging higher. We expect real GDP growth to be at 2.9% in 2017. Sustainably higher commodity prices would indicate that the fair value for the AUD/USD exchange rate averages US78c in 2017 and US80c in 2018. We expect the record low cash rate domestically to increase to 1.75% in November 2017.

Retail disruption set to escalate

The threat of Amazon's arrival has heightened the intensely competitive retail landscape in Australia and highlighted the laggard nature of some local online offerings.

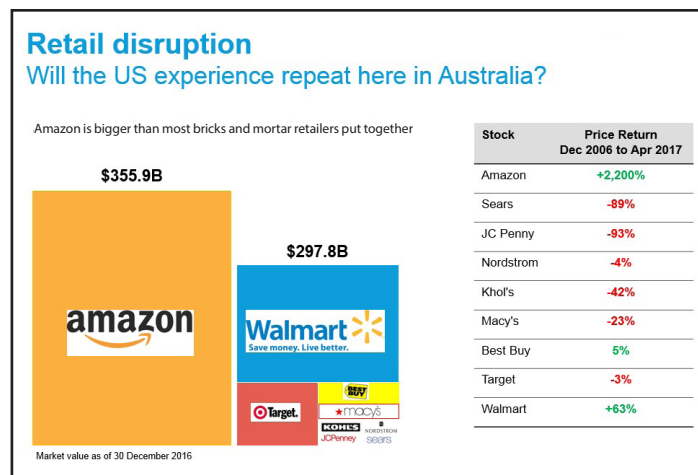
After months of speculation, Amazon recently placed an advertisement on its Australian website announcing it would bring Amazon Marketplace to Australia. Although Amazon has not confirmed the timing of its launch, using its entry into Spain as a guide, suggests the first expanded services could be available here within 12 months.

The looming threat of Amazon further heightens the already intensified competitive retail landscape in Australia which has been hit with a wave of global entrants over the last six years, including the likes of Zara, Uniqlo, H&M and Sephora. While most of these retailers have a predominantly bricks and mortar apparel offering, Amazon is a different beast altogether. It has a breadth and depth of retail offering unlike any other retailer globally and it is renowned for its competitive pricing and speedy delivery. Australian retailers in contrast have been slow to develop a competitive online offering with many still lagging sophistication on fulfilment and delivery capabilities.

For the financial year to date, the Australian discretionary retail sector has underperformed the broader share market (as measured by the S&P/ASX 200 index) by -11% and by -13% for the calendar year to date (CYTD), posting actual returns of 7% and -6.4% respectively. While retail conditions have been challenging, the underperformance CYTD has been driven more by price to earnings (PE) multiple compression than earnings disappointments. The PE compression largely reflects the market's concerns about Amazon's Australian entry. Multiples will stay largely compressed until Amazon is up and running and the market can more accurately assess the financial impact on sales and margins.

The rise and rise of Amazon

Amazon now has a market value of US\$450 billion, while its share price has risen from US\$200 in 2012 to more than US\$900 currently. Amazon says its focus is on customers rather than competitors and that it has no market share targets. A recent statement from Amazon said: "We are optimistic that by focusing on the things we believe customers value most - low prices, vast selection and fast delivery - over time we'll earn the business of Australian customers."



In the United States, Amazon accounts for almost 5% of total retail sales and 38% of online retail sales, while its share of UK retail spending is estimated to be around 3.5%, with its share of online sales at 24%. Macquarie Equities has estimated that Amazon's Australian sales could reach \$14.5 billion by 2025, representing about 25% of online sales.

According to Hitwise data, the most popular categories for Amazon shoppers in the US are Kindles, health and beauty, consumer electronics and groceries. For Australian shoppers viewing Amazon's US website, the top categories (excluding Kindle) are paperbacks and hardcover books, computers, electronics, toys, health and beauty and apparel. Amazon has the largest market share of online apparel revenue among shoppers aged 18-34 years on US retail sites.

Total annual retail sales in Australia are \$300 billion. JB Hi-Fi has \$3.9 billion in annual sales, Super Retail Group has \$2.5 billion and Harvey Norman \$1.8 billion. All three sell goods which are commonly available on Amazon's offshore websites.

What to expect

Amazon Web Services launched in Australia in 2012, followed by a Kindle Store on Amazon.com.au in 2013 and it currently has 1000 employees here. According to Amazon: "the next step is to bring a retail offering to Australia, and we are making those plans now."

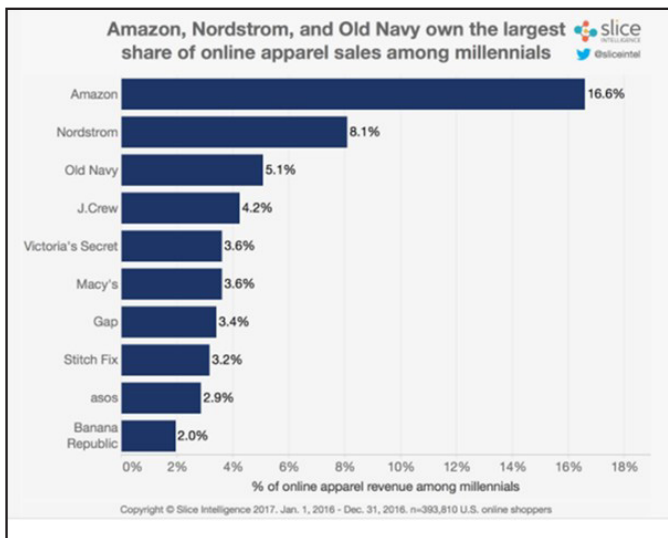
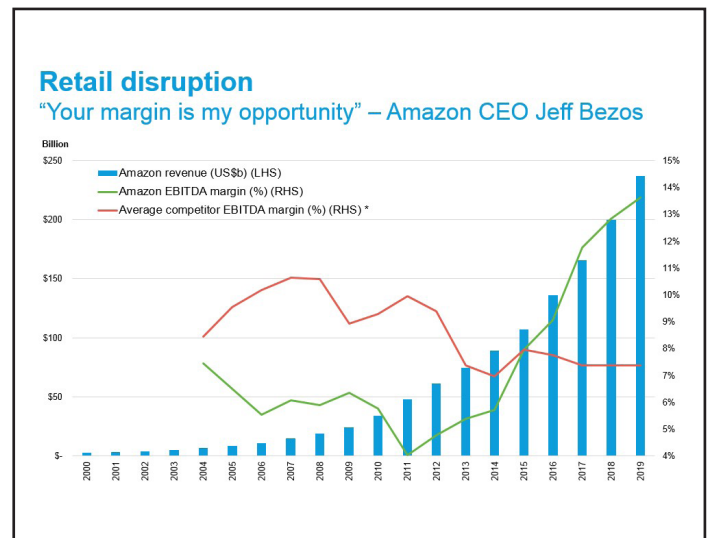


Chart 2 reference - Slice Intelligence's online shopping ranking - Slice Intelligence



We understand that Amazon is actively looking for a warehouse to become a fulfilment centre (the first of many in Australia), with floor space of up to 93,000 square metres, or the equivalent of about five MCG's. Analysts estimate that Australian consumers already spend between \$700 million and \$1 billion per annum on Amazon.com.au and Amazon's overseas sites. Given Amazon's strengths in books, consumer electronics, clothing and sporting goods, the bricks and mortar retailers that are most exposed will include JB Hi-Fi, Harvey Norman, Myer, Dymocks, Super Retail, BIG W, Kmart and Target.

Looking at Amazon's entry into Spain provides some interesting insights. Amazon announced its entry into the Spanish market in September 2011 and then opened a 28,000 square metre distribution centre five kilometres from Madrid's Barajas airport 14 months later, offering two and three day shipping through subscription service, Amazon Prime. Amazon initially sold Spanish consumers products such as books, CDs, DVDs and consumer electronics. It now sells about 175 million products, including clothing, toys, homewares and hardware and employs more than 1000 people.

Retail outlook

Australian retailers have been through turbulent times in recent years. The threat of online retailing was accentuated by the AUD trading above parity against the USD in 2012 creating significant investor anxiety. The PE multiples of mature discretionary retailers substantially de-rated between 50% and 100%, with material EPS downgrades driving a significant increase in short interest.

This time around the difference is that an online offer to varying degrees has been adopted by all Australian retailers, while Amazon's domestic presence will remove the exchange rate arbitrage that Australian consumers were playing when our currency was previously significantly higher than it is today.

News flow about Amazon's entry plans will gather pace over the coming twelve months and will continue to weaken the market's appetite for retail exposure despite the fact that valuations are starting to look enticing. In addition, there is risk of a general slowdown in consumer spending given the weak outlook for wages growth and a potential fall in consumer confidence driven by rising interest rates and the possible stagnating or contracting of housing prices.

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