Ausbil Investment Markets

Report

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Economic Review

During August the US Federal Reserve signalled it was getting closer to raising interest rates as Chair Yellen commented that: "In light of the continued solid performance of the labour markets and our outlook for economic activity, I believe the case for an increase in the federal funds rate has strengthened in recent months."

Days before her comments, Vice Chair Fischer highlighted that the economy was nearing the goals of price stability and he said "unemployment is close to most estimates of the natural rate," and then after Yellen's speech, Fischer emphasised the strong likelihood of a September rate hike and that there may be more than one rate increase in 2016.

This saw the market's implied probabilities for rate hikes spike for the upcoming meetings in September and December. The labour market remains tight as non-farm payrolls increased by 255,000 persons in July and the unemployment rate was unchanged at 4.9%. Annual wage growth accelerated to 2.6% and the broader employment cost index rose to 2.5% in the June quarter. Core measures of inflation were higher with consumer inflation elevated at 2.2% and the Federal Reserve's preferred private consumption measure rising to 1.6%. Real GDP in the June quarter grew at 1.1% with private consumption driving growth at a robust 3% pace, which was up from 1.1% in the previous quarter. The ISM surveys for the manufacturing and the services sector were consolidating in expansionary territory and the housing sector starts and sales were back above pre-GFC levels.

The Bank of England eased monetary policy through three channels: (1) cutting the cash rate by 25 basis points (bps); (2) boosting its quantitative easing programme by purchasing (a) GBP60 billion of government bonds and (b) GBP10 billion of corporate bonds; and (3) committing an extra GBP100 billion to the bank term funding programme. The aggressive easing move was a pre-emptive effort to counter the potential negative developments from the vote to leave the European Union. The sharp fall in the currency saw input prices surge by 4.1% in July.

The European Central Bank meeting minutes highlighted 'cautious optimism' regarding the outlook for growth in the Eurozone, while the fallout from Brexit was expected to generate headwinds and uncertainty. The ECB noted it was too early to implement further stimulus, but it remains ready to do so. Eurozone GDP for the June quarter expanded at an annual pace of 1.6% with Germany growing at 1.8%, France at 1.4% and Spain at 3.2%. The impact from Brexit to date is negligible, as seen in the PMI surveys for August and the rebound in the ZEW business expectations survey, with the German Ifo business confidence measure consolidating at elevated levels.

The Peoples Bank of China viewed the recent slowdown in credit growth as a distortion and it is expecting a rebound in the quarter ahead. Policy will remain prudent and flexible, but the scope for further easing was downplayed by the National Development and Reform Commission statement, which forecast consumer inflation would increase back to the 3% target this year. The official and private surveys on manufacturing are treading water around the key 50 point level, while services remain in expansionary territory. Industrial production slowed to 6% in July from 6.2% in June, retail sales were softer at 10.2% from 10.6% and fixed asset investment decelerated to 8.1% from 9%. House prices continued to grow at an annual rate of 7.9%.

Bank of Japan's Governor Kuroda said he would continue to examine the risks to activity and prices and that if required, he would take additional measures 'without hesitation'. GDP for the June quarter was flat, taking the annual pace to 0.6%. Growth in private consumption and residential investment was offset by the large drag from net exports. All measures of consumer prices turned negative in July, due to the deflationary pressure coming from lower energy input costs and the appreciating yen.

The Reserve Bank of Australia reduced the official cash rate by 25bps to a record low of 1.5%. The minutes revealed that this was aimed at a subdued low inflation outlook and stemming the currency appreciation. The economy is expected to grow above potential by mid-2017, with the unemployment rate to move lower to 5.5% from 5.8% currently. The RBA Governor, Glenn Stevens, conceded there was difficulty in halting the currency strength despite the recent round of interest rate cuts. He singled out the effect of foreign

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investors searching for yield and bidding up existing assets, instead of funding new business ventures. Stevens also stressed the limitations of monetary policy and acknowledged that undershooting the inflation target for a period, while achieving reasonable growth, could be the 'least bad option available'.

Federal Treasurer Scott Morrison repeated Governor Stevens' sentiments on the need for fiscal repair and reforms to support medium term growth. The factors that supported the economy's performance in the past decade were (1) the rise in household debt levels, which raised private consumption demand and (2) the increase in the participation rate in raising supply capacity. These are not viewed as repeatable. The solution lies with fiscal policy given gross public sector debt (Federal plus State) is at a low relative 40% share of nominal GDP versus gross household debt at 125% of GDP. Nominal wages rose by 0.5% for a third consecutive time in the June quarter, leaving the annual growth rate at 2.1%. Non-residential construction rose 2.1% in the June quarter reflecting increased infrastructure spending by Federal and State governments. In particular, public sector construction increased by 5.3% with the annual rate growing by a robust 15%.

Global Outlook

Global monetary policy divergence is in progress as the United States sets about normalising interest rates over a number of years. The concept of the 'neutral federal funds rate' (estimated to be at 0% real and 2% in nominal terms) will be an important guidepost for driving policy. The offset from lower oil and commodity prices is temporary and will fade, while the measures of core inflation are expected to return to the 2% target level. We expect the US Federal Reserve to hike rates by 25 to 50 basis points in 2016. Should activity and inflationary pressures re-accelerate, then the Federal Reserve would act more aggressively in 2017 and play catch up against a stable and less uncertain global environment. In Europe and Japan, negative deposit rates will continue as QE programmes are modified and extended beyond their originally intended time frames. Most advanced economies are oil importers, so the price fall is equivalent to a large permanent income tax cut.

Australian Economic Outlook

Australia is in a structural transition with the drivers of growth adjusting away from the previous resources boom. We expect real GDP growth at trend, which is estimated at 2.75%. The lower cash interest rate is providing ongoing support to aggregate demand and the lower Australian dollar is helping to drive domestic production, particularly in the services sector. Core inflation is undershooting the low end of the 2-3% target band, with benign wage inflation around 2%. Business confidence has trended higher and consumer confidence has become more favourable in the surveys. Employment growth, despite being moderate, would see the unemployment rate consolidate below 6%. The shift to the labour intensive services sector has more than offset the decline in the mining and manufacturing sectors. Lower wages and greater flexibility allows businesses to expand their workforces, prior to embarking on business investment.

Employment growth is supporting household income and in turn private consumption. Housing remains a key beneficiary in the near term. Construction, net exports and infrastructure spend are important drivers for growth in the year ahead. Given we believe oil prices have bottomed and commodity prices have based, we expect the fair value for the AUD/USD exchange rate to be 0.75 for the remainder of 2016 and average 0.78 for 2017 and average 0.80 for 2018. We expect the record low cash interest rate at 1.50% to stay unchanged for the next two years before gradual rate hikes commence in June 2018.

Fixed Interest

As measured by the Bloomberg AusBond Government Bond Index (0+ years), the debt market produced a return of 0.78% in the month of July and 6.90% for the year. The (0-5 years) Index returned 0.39% and 3.33% for the year.

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Fixed Interest

As measured by the Bloomberg AusBond Government Bond Index (0+ years), the debt market produced a return of 0.35% in the month of August and 6.58% for the year. The (0-5 years) Index returned 0.23% and 3.09% for the year.

2016	US	US	Aus	Aus
Month end	**Aug**	**Jul**	**Aug**	**Jul**
2yr	0.81%	0.66%	1.44%	1.51%
10yr	1.58%	1.45%	1.82%	1.87%
2/10 yield curve	0.77%	0.80%	0.39%	0.37%
10yr indexed	0.11%	-0.04%		
10yr spread to US			0.24%	0.42%

US bond yields rose as the US Fed raised hiking expectations. This saw US 2-years rise by 15 basis points and the 10-year rise by 13bps. The positive sloped 2/10 yield curve narrowed by 3bps. The inflation indexed US10-year real yield turned positive from negative at 0.11%. Australian 2-year bond yields fell by 7bps, 10-year yields fell by 5bps, and the 2/10 yield curve widened by 2bps. The 10-year spread to the US narrowed by 18bps.

Reporting Season Wrap

At Ausbil Investment Management we believe the latest reporting season represented an inflection point whereby the earnings base of the share market showed considerable dispersion as a greater number of value stocks beat consensus earnings expectations than their higher P/E counterparts.

Based on a variety of sources, 43% of value names did better than expected, versus just 16% of high P/E stocks. Given these value stocks were generally trading at lower price points, they tended to outperform during the period.

The higher P/E stocks have enjoyed a strong period of outperformance this year and were arguably vulnerable to price corrections, especially if the forward earnings expectations they issued were less than exciting.

Cost cutting was an ongoing theme across the market and another prevalent item was the lack of forward guidance, with only 19% of companies issuing an upgrade to FY2017 consensus earnings expectations. Overall 28% of companies beat consensus EPS expectations, while more than 30% of the top 200 companies missed earnings expectations. This represented a fairly substantial reduction from the level of outperformers in the first half of the past financial year when 40% of companies beat expectations.
About 70% of firms recorded a reduction in the pace of sales growth, while dividend payout ratios tended to be slightly lower across the market.

Generally speaking, the best results were achieved among the Mid Cap stocks as most of the Top 20 stocks struggled for earnings growth. While Small Cap stocks fared better than the Top 20 overall, their individual results were very mixed in nature.

Within the Banking sector, consensus estimates continued to move slightly lower as further net interest margin pressure was felt across the industry. Bad and doubtful debt charges also moved higher during the period. Investors are keenly waiting to see if further additional capital needs to be raised by the Banks in FY2017.
Companies with foreign earnings recorded fairly mixed results, but investors continued to support those stocks which exhibited improving underlying operating momentum, while the relative strength of the domestic economy supported solid performances among the housing sector stocks.

The Resource sector results reflected the volatility in commodity prices, which were characterised by a difficult phase in 2015 followed by quite a substantial rally (in most cases) since January this year. Pleasingly, most management teams were focussed on increasing cashflow rather than volumes.

Capital management was a highlight of the reporting season with Nick Scali Furniture, Genworth Mortgage Insurance Australia and Fantastic Holdings increasing their payout ratios or announcing a special dividend, while Insurance Australia Group, CSL and Seven Group all announced buybacks.

Payout ratios among the Industrials rose more than five percent to 73.6%, including the first dividend from Qantas in seven years. The Banks lifted their payout ratios by 1% to 79.9%, while the payout ratio among the Resources stocks slipped 3.5% to 69.4% despite a higher than expected payout from Fortescue Metals Group. Payout ratios are forecast to ease slightly this financial year, but remain healthy among the Banking and Resources sectors. Overall, almost 80% of dividends declared were equal to, or better than, expected.

Two stocks that disappointed with regard to capital management included AGL and Telstra. AGL failed to announce any capital management plans or to change its dividend policy, which left investors underwhelmed, while Telstra's $1.5 billion in capital management was in line with expectations, but the additional $4 billion capital program, which saw capex lifted from 15% of sales to 18% of sales, surprised market participants.

Resource stocks were generally the best performers with regard to upward EPS revisions with Whitehaven Coal, Galaxy Resources, MMG, Mineral Resources, Newcrest Mining and Fortescue leading the way. Conversely AWE, Origin Energy, Aconex and Virgin Australia declared the some of the biggest negative earnings revisions.

The Resource sector fell sharply in FY2016, but the outlook has improved considerably. Rising commodity prices, tight capex control and ongoing cost cutting underpins the brighter outlook.

Elsewhere, the housing sector showed few signs of weakening as consumer spending remained strong and supported retail spending, while the Banking and General Insurance sectors remained under heavy competitive and pricing pressure.

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