ATCHISON
CONSULTANTS

Market Review – October 2019

Australian Economy

In Australia, house prices rose strongly again in October +1.2% month-on-month to take the year-on-year decline to -2.3% after -3.9% in September. Strongest gains occurred in Sydney and Melbourne. Q3 CPI rose +0.5% over Q2 and +1.7% for the year, still below the RBA's +2%-3% target band.

The recent rebound in house prices removes the downside risk from a deep consumer deleveraging cycle.

Growth in retail sales of +0.2% in September was poor, not only half the consensus expectation, but the average monthly growth of +0.2% over the past six months shows little gain from low and middle income tax cuts and three interest rate reductions. Westpac CEO Brian Hartzer said consumers remain “cautious”, with flat wage growth constraining consumer spending. The September quarter retail sales data will feed into estimates for 3Q GDP. Markets continue to price in a 50-50 chance of a rate cut at the February 4 2020 meeting. Cash and bank deposits are likely to continue to provide poor returns.

NAB recently published their NAB Australian Wellbeing Report Q3 2019 (How Australians think and feel about their emotional and financial wellbeing). NAB’s Australian Wellbeing Index rose for the third straight quarter in Q3 2019 to 65.7 points ‐ the second highest reading since the survey began in 2013. Australians reported their highest levels of happiness and life satisfaction in the history of the survey, with life worth also at an equal survey high. Despite these positive trends, one of the four dimensions of the wellbeing index worsened ‐ anxiety. Highly anxious people also ranked their overall wellbeing much lower than those with low anxiety. Not only did overall anxiety rise, but anxiety specifically arising from our current financial position also increased.

The AUD/USD held steady at 69 cents. Gold rose slightly to US$1,515. Iron Ore slipped 5% and oil was flat at US$54.

Global Economy

Global markets rallied in October with strength broad-based in most sectors driven by optimism on the US-China trade war.

In the US markets eagerly await a US-China meeting on trade that is yet to be set aside. President Donald Trump announced a tentative agreement for a trade deal with the US suspending tariffs scheduled for October 15 in return for China buying up to $50bn in US farm products, indicating some lessening of trade tensions. The Federal Reserve cut interest rates by 0.25% at the third consecutive meeting with two members dissenting. The statement dropped the phrase “act as appropriate” and did not provide any forward guidance on the path of future rates – interpreted by most as a bias to remain on hold vs an easing bias from previous statements.

US: economic data was weak. The Institute for Supply Management’s factory index slipped to 47.8 in September, the lowest since June 2009. The figure missed all estimates in a Bloomberg survey that had called for an increase from August’s 49.1. Growth in orders and business activity slowed abruptly, while the employment gauge registered its weakest print in more than five years.

Non-farm payrolls missed, rising 136,000, vs expectations 145,000, although the unemployment rate fell to 3.5% from 3.7%. September core CPI was soft at 0.1% month-on-month while retail sales fell 0.3% (consensus +0.3%).

UK and Europe: Brexit headlines continued in the UK. Amongst the to and fro, MP's voted for an in-principle Brexit deal and EU ambassadors agreed to an Article 50 extension to 31 January. An early general election was called for 12 December.

China: 3Q GDP growth of 6.0% was the slowest since 1Q 1992, the earliest quarterly data on record. It was also at the bottom-end of the government's full-year target range of 6.0%- 6.5%. Industrial profits also remained weak in September, falling 5.3% over the prior year, following August's 2.0% decline. Taken together, industrial profits fell 2.1% over the first nine months of 2019.

Emerging Markets: Emerging market equities rallied in October, amid a pick-up in risk appetite. Signs of progress in US-China trade talks, further global central bank easing and US dollar weakness all proved supportive. The MSCI Emerging Markets Index increased in value and outperformed the MSCI World for the first month since January.

Russia recorded a strong gain as the central bank cut interest rates by more than expected. Hungary was the best-performing index market, supported by strong performance from OTP Bank.

In conclusion: Against a backdrop of uncertainty around an aging economic cycle, trade dislocation, and a collapse in real interest rates, investors have chased growth, certainty, and yield. There has been less interest in the growing equity risk premium on offer for the 'average' stock. This has pushed a favoured few companies to record levels and has supported a gaping valuation difference between those companies with lower perceived quality or certainty. Credit and money growth have now started to improve again. Other leading indicators have turned up and PMIs, which are more coincident, are beginning to stabilize.

Table 1: Market Performance – Periods to 31 October 2019

Sector	1 Month %	3 Months %	1 Year %	3 Years % pa	5 Years % pa
Australian Shares	-0.4	-0.9	19.3	12.6	8.5
Australian Shares Small Cap	-0.5	-1.8	14.4	10.4	9.6
International Shares Ex-Aus (Unhedged)	0.4	2.7	15.8	15.7	13.1
International Shares Ex-Aus (Hedged)	1.9	2.3	12.3	11.8	8.5
Emerging Markets (Hedged)	3.0	1.9	11.4	8.5	5.8
Emerging Markets (Unhedged)	2.0	1.1	15.1	11.0	8.1
Australian Listed Property	1.2	-0.4	23.6	12.7	12.4
International Listed Property ($A)	0.3	7.6	20.2	11.8	11.4
Australian Direct Property	0.2	1.1	6.8	10.6	11.6
Australian Fixed Interest	-0.5	0.5	10.0	5.4	4.4
International Fixed Interest (Hedged)	-0.3	1.3	9.7	3.9	4.7
Cash (BAUBIL)	0.1	0.2	1.6	1.8	2.0
		Change over the month			
Australian Govt. 10 yr Bond Yield	1.03%	0 bps			
AUD/USD	$0.69	$0.01			

*as at 30 June 2019

Australian Shares (S&P/ASX 200 Accumulation Index)

The S&P/ASX 200 Accumulation Index slipped slightly by -0.4% in October with the gain over the calendar year still a very generous +19.3%.

The S&P/ASX 200 Accumulation Index has risen every month this calendar year except August an October. But our market has lagged the global market in recent months due to our index having a large skew to the Banks. The results delivered by the banks in early November reinforces that it is heavy going for this sector.

In terms of index performance, the Pharmaceuticals & Biotechnology sector (+9.6%) was the main sector contributor driven by CSL Limited which continues to deliver double-digit profit growth, while the Bank (-4.1%) sector was the main detractor as the sector starts to feel the impact of the low cash rate setting.

A lack of global growth has also dampened resource demand. BHP and RIO both eased back in October. A resolution of trade discussions would assist these stocks. October also saw some cracks appear in the super premium growth category. Wisetech fell -24% in October while Afterpay lost -19% and Costa another -17%.

The top three moves within the S&P/ASX 200 Accumulation Index included Clydesdale Bank (+24.5%) as the possibility of a "hard Brexit" was delayed until the end of January, Silver Lake Resources (+24.1%) after management announced gold production is expected to deliver in the upper range of guidance for the 2020 financial year and Clinuvel Pharmaceuticals (+23.7%) after the company received marketing approvals for a key product by the US Food & Drug Administration. The bottom three moves were Southern Cross Media (-33.6%) after management provided a soft earnings outlook for the 6 months to 31 December 2019 due to weak media markets, and Bega Cheese (-21.0%) after management downgraded the expected earnings in Financial Year 2020 due to increased competition in milk markets.

The index finished trading at a P/BV of 2.1x and a P/E Ratio of 18.0x and equity yield (dividend) of 4.1%.

The VIX was at 14.75 (the average since 01.10.2010 is 16.4) indicating below average level of market volatility.

Australian Shares Small Cap (S&P/ASX Small Ordinaries Index)

As a collective, Australian small caps (stocks 101-300 in the ASX) benefit from low interest rates, a low currency and availability of equity capital. Add a modest improvement in demand (high employment and some wage inflation) and there is reason to expect some growth.

The Small Ords Accumulation index fell -0.5% in October in-line with the broader index which returned – 0.4%.

Some of the strongest performers in the small cap space came from; QMS Media (+33.2%) was subject to a bid from private equity group, Quadrant. Adelaide electronics company, Codan (+11.9%) continued to perform exceptionally well, at the company's AGM, the board provided guidance well above consensus expectations.

Trailing P/E Ratio was at 19.8x at the end of the month, P/BV is at 2.1x and equity yield (dividend) of 3.1%.

International Shares (MSCI World ex Australia Index, Net AUD and the MSCI World ex Australia Index, Net LCL)

The MSCI World ex Australia Index (Unhedged) +0.4% for October whilst the MSCI World ex Australia Index (Hedged) returned +1.9%.

October was interesting in the distinct lack of volatility across almost all investment markets. In the US, the S&P500 was up +2.0% and the Nasdaq +3.6%. the UK FTSE was one of the few to fall – but only a modest +2.2%. Asian markets were a little firmer with China up 0.8%, HK up +3.1% and Korea +1.0%. Metals edged higher with gold up +2.5%, copper +1.6% better but nickel re-tracing +2.6%.

The uptrend in global equities so far this year continues to be led by P/E valuations rather than earnings, with the latter in turn supported by the decline in bond yields.

As at end-October, the global forward P/E ratio edged up to 15.3, from 15.1, compared with a 10-year average of 13.9.

Over recent years, the highest month-end P/E ratio reached by global equities has been around 16 to 16.5, or around 6% above current levels.

After solid gains from early 2016 to late 2018, global forward earnings peaked in November last year and declined by 4% by end-March 2019, reflecting sharp declines for earnings expectations in 2019 and 2020. That said, there are tentative signs that the downgrades to global earnings expectations for 2020 and 2021 are flattening out, which has so far resulted in a modest lift in forward earnings by around 2% since end-March. If current earnings expectations hold, forward earnings would rise by 9.6% over the coming 12 months.

US market: The US equity market ended the month in positive territory after the US Federal Reserve (Fed) cut interest rates as expected and signalled that it was unlikely to move in either direction any time soon.

While not a uniformly positive picture, earnings season has helped ease concerns about the outlook for global economic growth. About 80% of companies in the S&P 500 index had topped expectations for profits by 24 October (source: Bloomberg), though Texas Instruments and Caterpillar both highlighted the uncertainty caused by trade tensions and global economic weakness.

The strongest performing sectors over the month were health care and technology, which retains its place as the top performing sector so far in 2019.

UK market: The UK equity market provided a negative return during October. The market fell sharply at the beginning of the month, with the FTSE 100 index posting its worst single day return in more than three years. The market was volatile due to renewed concerns around economic growth, supported by the release of worse-than-expected Purchasing Manager's Index (an indicator of economic activity) data for the UK's services sector.

European markets: Made modest gains in October as investor confidence was underpinned by alleviating US-China trade tensions, talk of increased government spending in Europe and faltering chances of a no-deal Brexit. Carrying on from September, markets continued to witness a style rotation away from 'defensive' parts of the market and into more 'cyclical' and economically sensitive equities.

Chinese market: Chinese equities ended the month higher on hopes of a preliminary trade deal with the US. On 11 October, US President Donald Trump announced that the US had agreed to suspend the tariffs schedule for 15 October, while China agreed to buy up to US$50bn in US farm products and accept more American financial services. Meanwhile, China's economic data was mixed. While China's third quarter 2019 GDP growth slowed to 6.0% from 6.2% in the second quarter and economic indicators disappointed, industrial production was ahead of expectations.

Emerging markets: Emerging market equities rallied in October, amid a pick-up in risk appetite. Signs of progress in US-China trade talks, further global central bank easing and US dollar weakness all proved supportive. The MSCI Emerging Markets Index increased in value and outperformed the MSCI World for the first month since January.

The broader index finished trading at a P/BV of 2.3x and a P/E Ratio of 18.8x and equity yield (dividend) 2.3%.

Emerging Markets Shares (MSCI Emerging Markets Index, Net AUD)

It was a strong month for emerging equity markets with all the regions recording gains. The MSCI Emerging Markets Index (Unhedged) +1.9% for October whilst the MSCI World Emerging Markets Index (Hedged) returned +3.0%.

Asia led the advance, followed closely by Latin America. In terms of country performance, Hungary, Taiwan and Russia came top. However, while most equity markets advanced higher there were some exceptions, most notably Turkey, Chile and Saudi Arabia. All sectors in emerging markets finished in positive territory, apart from communication services, with healthcare, technology and energy enjoying the best gains.

The index ended trading at a forward P/E Ratio of 12.7x and P/BV of 1.6x and equity yield (dividend) 3.0%.

Australian Listed Property (S&P/ASX 200 A-REIT Accumulation Index)

The ASX 200 AREIT index experienced a strong month in October +1.2% outperforming the market by +1.6%. S&P/ASX Diversified AREITS returned +1.8% in October, S&P/ASX Office AREITS returned +0.9% and S&P/ASX Retail AREITS returned +0.5%. Key outperformers were SGP (+7.5%), BWP (+5.1%) and MGR (+4.9%).

For the last 12 months, the top performers were CHC (+70.0%) and MGR (+54.4%). The worst performers over 12 months were SCG (1.8%) and URW (-6.2%).

At the end of October, the index was trading on a dividend yield of 4.3% with a P/BV 1.2x and a P/E Ratio 14.4x.

International Listed Property (FTSE EPRA/NAREIT Developed ex-Australia Index, AUD)

Globally, REITs were up +2.3% this month (USD terms) but +0.3% in AUD terms. United Kingdom was the top-performing region (+10.3%), US (+1.8%), Continental Europe (+3.4%). The worst-performing region over the month was the Japan (+1.1%).

At the end of October, the index was trading on a dividend yield of 3.7% with a P/B 1.8x and a P/E Ratio 21.4x.

Australian Direct Property (Atchison Consultants Unlisted Property Funds Index)

Australian direct property posted a return of +2.0% over the June 2019 quarter. Capitalisation rates across property sectors continued to trend downwards. Cap rates across office, industrial and retail properties range are 5.2%, 5.8% and 5.2% respectively.

Australian Fixed Interest (Bloomberg AusBond Composite Bond Index)

Australian fixed interest fell by 0.490% over the month. Australian government 10-year bond yields increased by 13bps to 1.14% while 3-year single A corporate credit spreads tightened from 0.855% to 0.829%.

International Fixed Interest (Barclays Global Aggregate TR Bond Index, Hedged to AUD)

International fixed interest returned -0.27% over the month (Bloomberg Barclays). The 10-year US government bond yield increased by 1bp to 1.69% while the US corporate investment-grade credit spread tightened from 1.560% to 1.500%.

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