Harbour Investment Chronometer

AUSTRALASIAN EQUITIES MONTHLY COMMENTARY

Prepared on 7th March 2017

Overview for the Month

- The New Zealand S&P/NZX 50 index rose 1.7%, and the Australian S&P/ASX 200 index added 2.3% (+5.1% in NZ Dollars) over February.

- The MSCI World developed markets index expanded 2.8% (in US Dollar terms) over the month, led by US and Asia (ex-Japan) equity market returns. Equity markets rallied to new highs even as the 'Trump reflation' trade paused as President Trump's economic policy came under increased scrutiny. The earnings season for the US market was largely positive. Economic indicators globally continued to positively surprise, triggering increased investor asset allocation towards growth sensitive equities. Despite positive economic data, defensive sectors outperformed cyclical sectors globally.

- The New Zealand market's performance was driven by positive returns from Auckland Airport, Fisher & Paykel Healthcare, Sky City and Contact Energy, offsetting weakness in Fletcher Building, Sky Television, Metro Performance Glass and Genesis. The profit announcement season for the December period saw defensive stocks (particularly electricity generation/retailers, excluding Genesis) deliver slightly better profit results than expected, while results for cyclical stocks were at the lower end of expectations. Subsequent to the profit announcement period, consensus NZ market earnings forecasts were trimmed slightly for the 2017 and 2018 periods. The Commerce Commission's rejection of Sky TV's proposed merger with Vodafone NZ surprised some investors, particularly those based offshore. Trailing NZ economic data remains firm, with net migration breaking record highs, residential values rising and services sector activity at near record highs for January.

- Defensive and bond yield sensitive sectors including consumer staples, healthcare and real estate were the best performing Australian sectors over the month, reflecting the waning 'Trump Reflation' trade and lower long term bond yields. The mining sector was the worst performing sub-sector despite generally higher commodity prices over the month. Telco's were also weak. The Australian earnings reporting season was better than expected, allowing for rebasing of expectations during the pre-result season earnings 'confessions'. Subsequent trimming of consensus market earnings forecasts was lower than has historically been the case. Australian economic data released over the month was mixed, with strong business condition surveys and employment growth contrasting with retail sales and private capital expenditure coming in below expectations.

- The portfolio outperformed its benchmark over the month. Overweight positions in positive returning Westpac, CSL, a2 Milk, APN Outdoor and Sirtex, and an underweight position in poor performer Sky TV, enhanced portfolio returns. Overweight positions in CBL and Metro Performance Glass which produced negative returns, and underweight positions in positive performers Sky City and Auckland Airport, detracted from portfolio returns.

Outlook – Transition to profit tailwinds dominating

While equity market valuation multiples are running above long run average levels reflecting a period of ultra-low interest rates, earnings growth is re-emerging to improve apparent values for some stocks.

Investors have increased overall equity exposure recently from below long run levels. Investors are still, on average, modestly invested in equities relative to normal long run asset allocation levels. In some cases investors have increased equity investment via increasing exposure to bond like sectors with low sensitivity to activity levels, rather than investing in balanced portfolio of stocks.

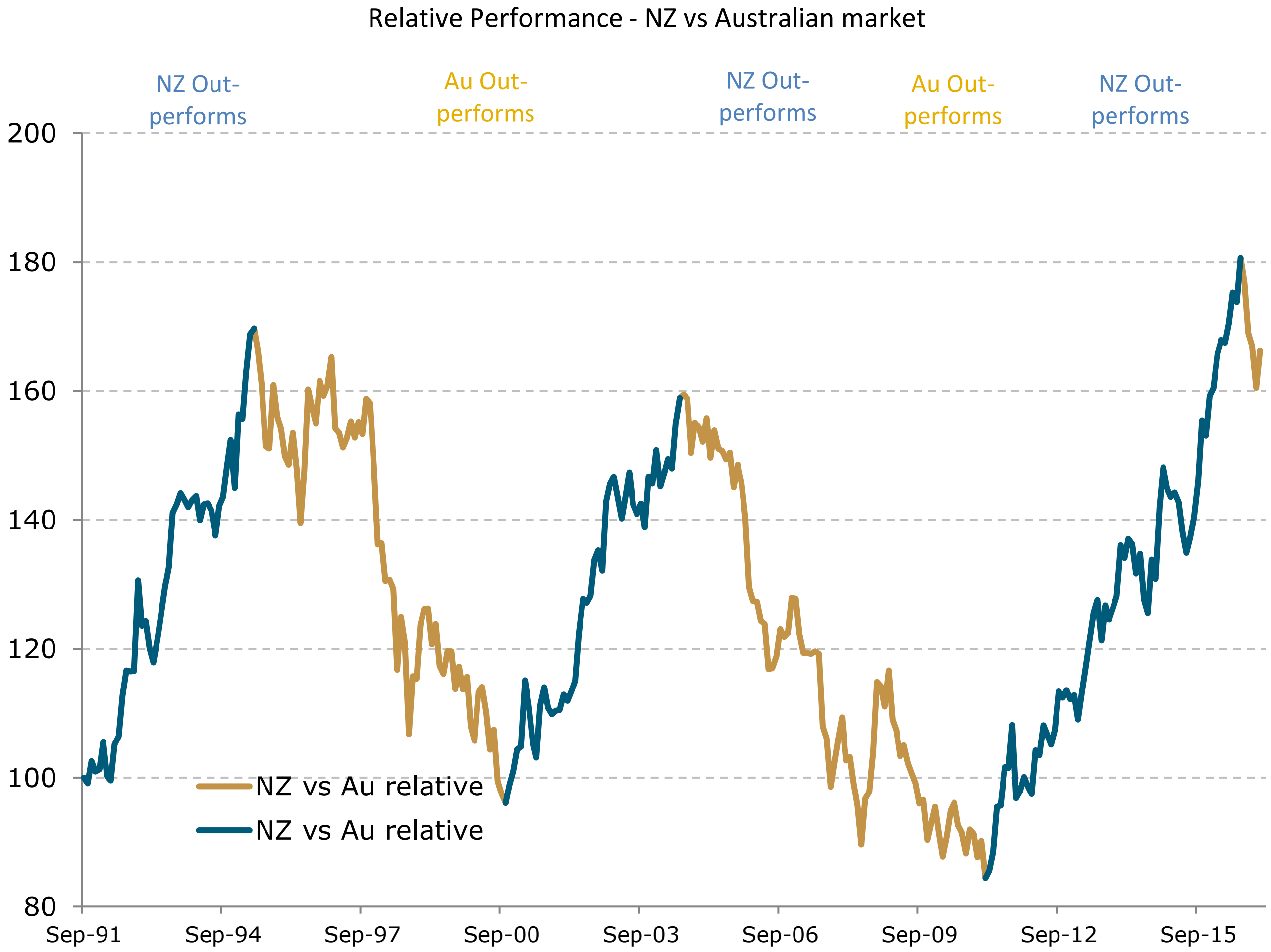
In our view equity markets remain in a transition period, from being driven by low interest rates increasing the price earnings multiples for bond like equity sectors, to a period where stock specific earnings and cash flow 'tailwinds' will have a greater influence on portfolio returns. This may be a 'choppy' period for overall market performance, favouring an active approach to portfolio management.

Structural growth key to positive medium term returns

We expect companies with structural growth pipelines, such as F&P Healthcare and a2 Milk, to continue to outperform. One theme that emerged from the recent New Zealand profit results season was that the operating leverage of some cyclical companies may have peaked. While revenue may be growing relatively quickly, cost growth is accelerating faster in some cases, putting pressure on profit margins. While defensive stocks have rallied recently we expect the head wind of higher interest rates (as monetary policy is moved from ultra-loose settings) on the valuations of low earnings growth stocks will hold their returns back. New Zealand real estate stocks produced a poor return over February despite lower long term bond yields. This may reflect the view that the commercial property valuation cycle may have peaked, or it may reflect investors rotating into other higher growth sectors.

In our view we are moving to a more normal situation where earnings do matter, and stock returns will reflect differential earnings prospects. A key out take from the Australian profit reporting season was that earnings upgrades were not just about resource companies benefiting from commodity prices – the profit 'beats' against expectations and earnings upgrades were wide spread. While this earnings strength reflects 'self-help' programmes implemented by Australian businesses over the last few years, it also reflects a stronger leverage to the 'rising tide' of global activity that the Australian market has when compared with the more bond sensitive NZ equity market. We see potential for this trend to continue with Australian market earnings growth now outpacing New Zealand earnings growth, and the Australian equity market potentially outpacing the New Zealand equity market.

Figure 1. Five year cycles of relative performance? New Zealand versus Australian equity market returns



Source: Bloomberg, Harbour. Data to 31 Jan 2017

In our view, being selective and investing in stocks that benefit from structural growth and cyclical stocks with pricing power, is likely to be key to positive medium term returns.

Structural growth companies such as F&P Healthcare, Mainfreight, Auckland Airport, a2 Milk, Summerset and CSL, that earn relatively high or growing margins, with strong balance sheets, are at the core of the portfolio. We remain pragmatic , taking advantage of short term volatility to increase exposure to stocks with long term quality growth paths, and quality growing dividend streams (where supported by sustainable and growing earnings) that markets may be underestimating.

The portfolio is overweight versus benchmark weights in selected stocks in the healthcare, financials, consumer staples, material and information technology sectors, where growth pipelines are not fully reflected in stock prices. The portfolio is underweight versus benchmark weights in consumer discretionary stocks, where industry risk remains high, and the utilities, real estate and telecommunications sectors, where valuations are high due to investors seeking a yield pick up over low yielding bonds rather than valuing stocks in these sectors based on medium term cash flow growth potential.

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