Harbour Investment Chronometer

AUSTRALASIAN EQUITIES MONTHLY COMMENTARY

Information as at 30 April 2017

Overview for the Month

- The New Zealand S&P/NZX 50 index rose 2.5%, and the Australian S&P/ASX 200 index increased 1.0% (+1.2% in NZ Dollars) over April.

- The MSCI World developed markets index increased 1.5% (in US Dollar terms) over the month, led by Europe and Asia (ex-Japan) equity market returns. In a month dominated by geopolitical news, markets initially traded weaker following softer US economic data, the impending French elections and the US taking action in Syria and talking tough on North Korea. A market-friendly French election outcome, the announcement of a snap election in the UK, and generally positive US earnings results (more than 70% beating earnings estimates) contributed to an improvement in investor sentiment and risk aversion over the second half of April. The mining sector underperformed globally over the month as commodity prices fell.

- The New Zealand market's performance was driven by large caps outperforming, with strength in energy, IT and telco's. The top performing stock once again was a2 Milk increasing 13% following on from the company further upgrading its earnings forecasts. Xero (+10%), Vital Healthcare (+7%) and Z Energy (+7%) were the other key outperformers. Comvita (-19%) provided a material profit downgrade citing poor weather conditions and softer sales. During the month Infratil placed its 19.9% stake in Metlifecare into to the market. New Zealand annual CPI inflation rose to 2.2% for the first quarter of 2017, ahead of the Reserve Bank of New Zealand (RBNZ)'s February projection of 1.5%, and through the RBNZ's 2% mid-point target. The market is pricing no chance of a change from the RBNZ until November, when the odds of an official cash rate (OCR) hike rise to 30%. A full hike is not priced for nearly 12 months.

- Telco's and consumer staples were the worst performing Australian sectors over April. Telstra dragged on the overall Australian market performance, with TPG Telecom announcing it had won a spectrum auction, and its intention to become the fourth player in the Australian mobile market. Commodities were weaker over the month, with iron ore, oil and industrial metals all down, dragging the Australian energy and materials sectors with them. Iron ore was particularly weak, down 23%, on the back of elevated inventory and signs that demand is peaking. Industrials, tech, healthcare and utilities were the best performing Australian sectors. Australian business confidence firmed in the month, to the highest level since the GFC. Employment was stronger than expected with strength in full time employment.

- The portfolio underperformed against its benchmark over the month. Investments in GTN, Sirtex, APN Outdoor, Mainfreight and Range, which underperformed versus the benchmark, detracted from the portfolio's returns. Overweight positions in positive performers a2 Milk, Gentrack, Metlifecare, CSL and Challenger boosted portfolio returns.

Outlook – Pause … before re-engaging

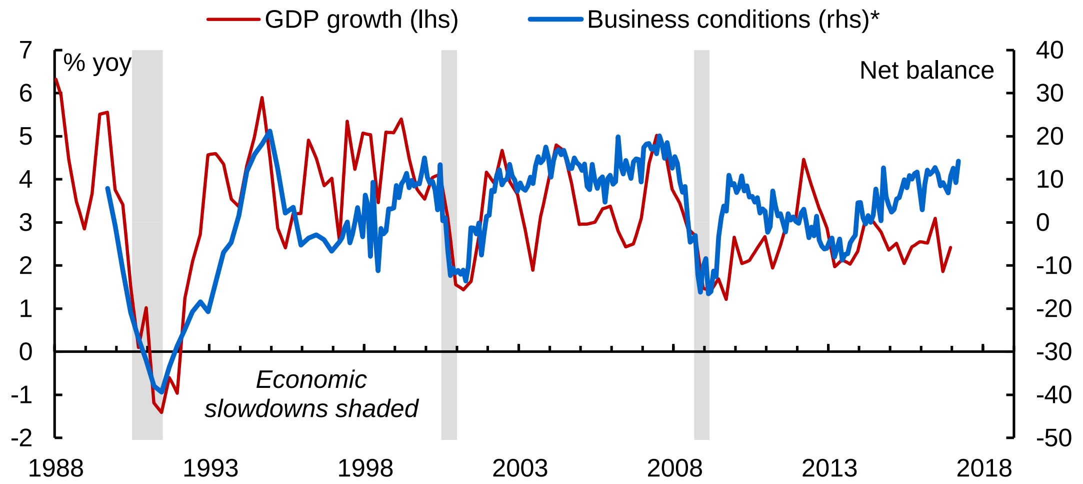
The global grind up in equity markets, led by positive global data surprises, has pushed equity market valuations to full levels, should earnings momentum not remain positive. Economic lead indicators suggest that the rate of economic growth may slow in the near term. Tighter Chinese credit conditions are slowing the Chinese economy, after easy monetary policy aggressively stimulated activity over the last two years. This may potentially impact, near term, on other economies which have benefited from the 'export' of Chinese capital. Medium term, solid business confidence and increased investment (both private and public sector) are likely to support economic activity. Company earnings growth may slow as cost growth (cyclical via weather events such as Cyclone Debbie and structural via pressure on labour costs) catches up with revenue growth.

In early May the US Federal Reserve signalled that it would continue to gradually increase their official Federal Funds rate. European and Asian central bankers continue to hold monetary policy settings at levels intended to stimulate activity. In the New Zealand and Australian economies, the balance of economic activity means that central bank monetary policy is likely to remain on hold for the foreseeable future. The increasingly desynchronised nature of central bank monetary policy is likely to contribute to increased dispersion of returns between stocks, as investors unwind the strong market driver of falling interest rates.

The Australian economy continues to surprise many, as does the improvement in earnings momentum in the Australian market. As shown in figure 1, Australian businesses believe business conditions are at their best levels since the Global Financial Crisis (GFC). This indicator is historically correlated with GDP growth, and **currently suggests that there is upside risk to Australian GDP**. The pending Australian Federal budget may see an increase in infrastructure fiscal stimulus, which if meshed with Australian State level investment, could provide a solid long term growth path for the Australian economy, offsetting measures aimed at stabilising the residential housing market.

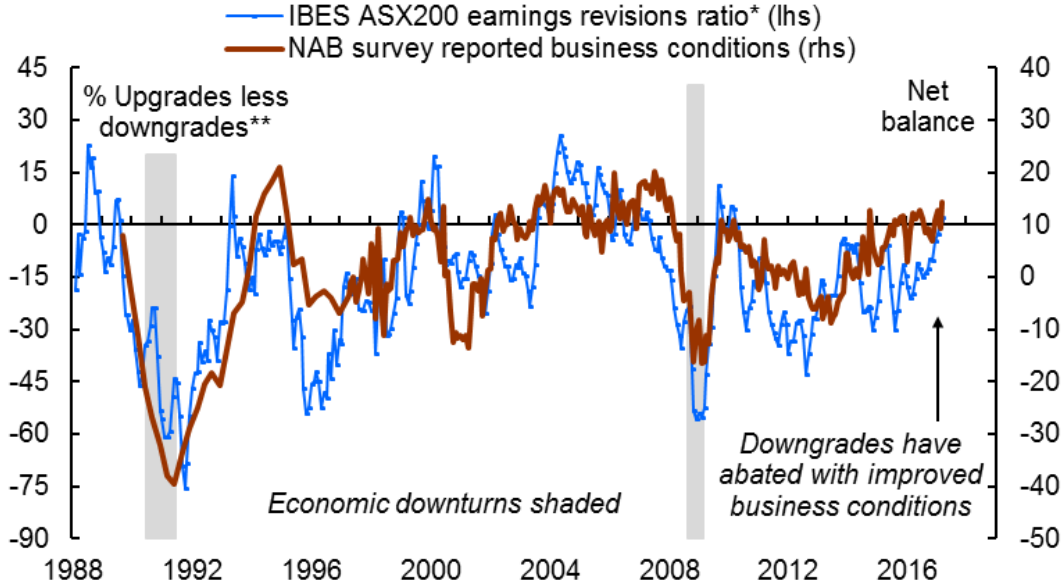
The improvement in Australian business conditions indicators is also associated with a recovery in Australian equity market earnings revisions. As illustrated in figure 2, the Australian market is now experiencing positive earnings revisions after a long period of negative revisions. While we expect this trend to continue, investors need to be selective when investing in the Australian equity market. Structural change in industries such telecommunications and retail mean that 'buying the market' may deliver some less than optimal investment outcomes. A number of New Zealand companies will benefit from the stronger Australian economy.

Figure 1. Australian Business Confidence suggests there is upside to Australian growth



Source: Citi Research, Harbour.

Figure 2. Australian Business Confidence leading to improved earnings revisions



Source: Citi Research, Harbour.

Investor cash balances remain high, with many awaiting a pullback in markets to increase exposure to growth assets. As we have previously noted, current investor asset allocation has a bias to secular deflation continuing. After experiencing two major equity market collapses in a decade (1998 and 2008) investors are paying a premium for perceived certainty. We expect the reluctant move of capital from assets that benefit from deflation and have low risk, to assets that benefit from inflation and growth such as equities (an inflection point higher for inflation and bond yields is better for stocks than bonds), will most likely continue to support the outperformance of growth assets in 2017. Company merger and acquisition activity may accelerate if equity markets experience a period of weakness, with companies acquiring each other to drive medium term growth.

In our view, should equity markets pull back, the portfolio's skew to higher quality stocks may provide some defence to returns. Given rapidly changing industry structures driven by technology and demographics, and a near term cyclical increase in cost pressure, we remain firmly focused on investing in companies with pricing power. Quality stocks tend to be able to grow cash flows in times when inflation is increasing.

Our expectation of an increasing spread of returns between individual stocks within the market supports the portfolios bias to stocks and sectors that tend to follow their own cycle (with a lower correlation to overall market moves). In our view, being selective and investing in stocks that benefit from structural growth and cyclical stocks with pricing power is likely to support future portfolio returns. **The portfolio is positively skewed towards selected stocks in the healthcare, financials, consumer staples and information technology sectors, where growth opportunities are not fully reflected in stock prices.** The portfolio has a low exposure to 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.

Equity markets may need to pause for growth to rebuild. But a positive re-engagement is likely, as economic and policy factors continue to support a medium term rotation to growth assets. While not cheap, the relatively high earnings certainty, relatively high income producing, relatively low risk characteristics of the New Zealand and Australian equity markets are likely to continue to attract investor capital flows.

Andrew Bascand, Shane Solly, Craig Stent

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