Harbour Investment Chronometer

AUSTRALASIAN EQUITIES MONTHLY COMMENTARY

Information as at 31 May 2017

Overview for the Month

- The New Zealand S&P/NZX 50 index rose 0.5%, and the Australian S&P/ASX 200 index fell -2.8% (-6.5% in NZ Dollars) over May.

- The MSCI World developed markets index increased 2.2% (in US Dollar terms) over the month, led by European and UK markets post the French presidential elections. But elevated political uncertainties (President Trump impeachment rumours, terrorist attacks), a downgrade of China's sovereign credit rating and OPEC's decision to extend output cuts (which markets concluded were insufficient) contributed to a choppy May for equity markets. Information technology was the best performing global sector over the month, while energy was the worst. US department store stocks fell 11% over the month reflecting structural shifts to online retailing. US 10 year bond yields fell on further unwinding of the 'trump reflation trade'. Daily market volatility increased from post-GFC lows, suggesting that capital markets may not be immune to central bank talk of winding back monetary policy support.

- The New Zealand market lagged global market returns over the month, with large capitalisation stocks Fletcher Building, Sky Television, Ryman and dual listed banks Westpac and ANZ dragging on performance. The announcement of solid profit results over May contributed to strong returns from F&P Healthcare, Xero, Air New Zealand and Z Energy. Lower bond yields supported demand for interest rate sensitive utility stocks including Meridian, Auckland Airport and Genesis.

- The Australian market was hit by weakness in the bank, retail and healthcare sectors. Industrial, telco and energy stocks provided some positive offset. Bank stocks fell following the announcement of a Bank Levy proposal in the Australian Federal Government Budget, the release of some mixed bank earnings results (subdued revenue growth) and as concerns grew that credit growth would slow further, and bad debts increase, should housing markets correct. Retail stocks, including retail mall owners, were hit by weaker than expected retail sales statistics. Retailers were also hit by concerns regarding Amazon's pending entry into Australia, and news of further Australian retailer voluntary administrations (Top Shop). Weakness in iron ore prices on high Chinese end user inventory stock piles, and a correction in coal prices from the previous month's weather-induced peak, weighed on the performance of resource stocks.

- The portfolio underperformed versus its benchmark over the month. Overweight positions in underperforming stocks APN Outdoors, Pacific Edge, Sirtex, CSL, and Challenger detracted from the portfolio's relative returns. Overweight positions in outperformers F&P Healthcare, Boral and Xero, and underweight positions in underperformers Fletcher Building, ANZ and Westpac enhanced the portfolio's relative returns.

Outlook – choppy weather but staying the course

Central bank liquidity and robust credit markets continue to provide a supportive backdrop for equity market returns.   In our view, markets will remain choppy near term, as cyclical and structural 'under currents' collide to challenge valuations in some parts of the equity market. Medium term we continue to expect a "Goldilocks" situation (not too hot or cold), low but positive growth, with modest inflation environment, which will continue to support equity market returns.

Yield curve flattening, with longer dated interest rates falling as core inflation measures come off a gentle simmer, Trump Government reflationary policy expectations unwinding, and a decline in global commodity prices, has supported the recent outperformance of bond sensitive stocks. Such stocks have also benefited from investors looking for a 'place to hide' in a market where valuations are full and uncertainty, whether political or economic, is perceived to be increasing. However, we would interpret the recent decline in bond yields as being a phase of correction in debt markets, rather than a return to a deflationary trend.

Global economic data, while mixed, continues to beat expectations. Markets have been supported by the highest levels of business confidence since 2008 in the major economies.

US real growth remains stable, and nominal growth is improving, supporting earnings and business confidence. While US politics are dramatic, non-legislative items are still proceeding, with potential for confidence boosting tax reform to emerge. US labour market strength and a modest increase in US wage inflation continues to support the US Federal Reserve gradually increasing official interest rates and tapering its balance sheet. We expect overall market volatility to remain relatively low during the transition in US monetary policy settings as the withdrawal of liquidity won't be quick. But there is potential for some parts of the market that have particularly benefited from easy US Federal Reserve monetary policy to be exposed and repriced by the changes.

Multispeed Australia

A Bloomberg survey of 31 economists expects the Australian economy to grow by 2.5% in 2017 and 2.7% in 2018 and 2019 respectively[1] – which compares with the Reserve Bank of Australia (RBA)'s forecasts of a little above 3%. While these forecasts are a useful start point, there remains some anomalies in the Australian economy. Business conditions and capacity utilisation in non-mining states continues to improve. But despite relatively full employment levels, Australian consumers remain wary with retail sales growth remaining soft and housing starts slowing. Expectations of higher energy costs, mortgage rates and risks around tax policy and a slowdown in the residential property market (short term risk, medium term positive) may continue to see Australian consumers keep their hands in their pockets, potentially dampening what is a robust level of business confidence (with strong employment and equipment purchase intentions). This is now a consensus market view, with Australian retail stocks having significantly underperformed the wider market over the last three months.

After holding its cash rate at 1.5% in its June board meeting it is likely that the RBA will keep the cash rate at this level for some time and assess the impact of recent macro prudential policy tightening. The RBA noted *"holding the stance of monetary policy unchanged at this meeting would be consistent with sustainable growth in the economy and achieving the inflation target over time"*.[2] While headline inflation returned to RBA's 2%-3% target in 1Q for first time since 2014, core consumer prices that central bank closely monitors are still advancing at below-target pace. The RBA expects the Australian Dollar to fall against the US Dollar as the US Fed increases official rates, and improving global activity will support the domestic Australian market.

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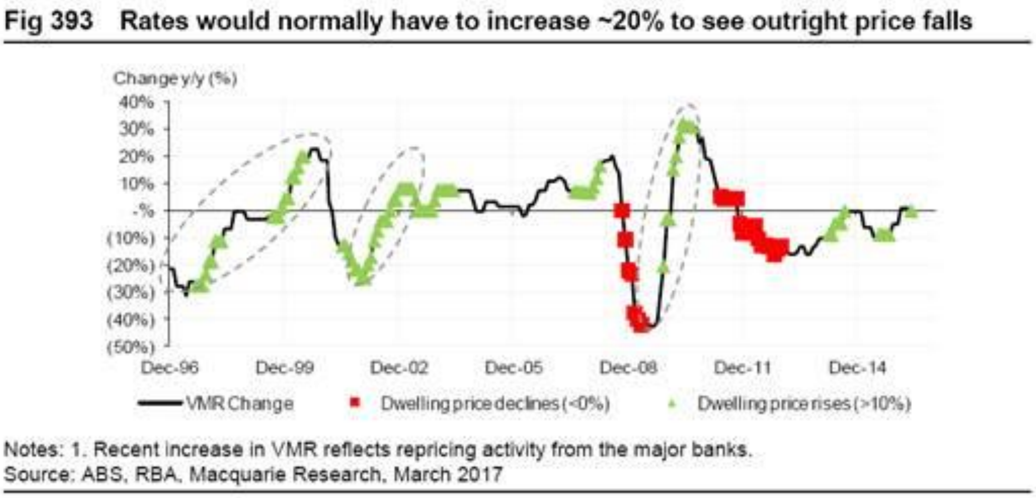
1 Bloomberg, Australian Economy Seen Expanding 2.5% in 2017, 24/5/17

2 Statement by Philip Lowe, Governor: Monetary Policy Decision 6/6/17

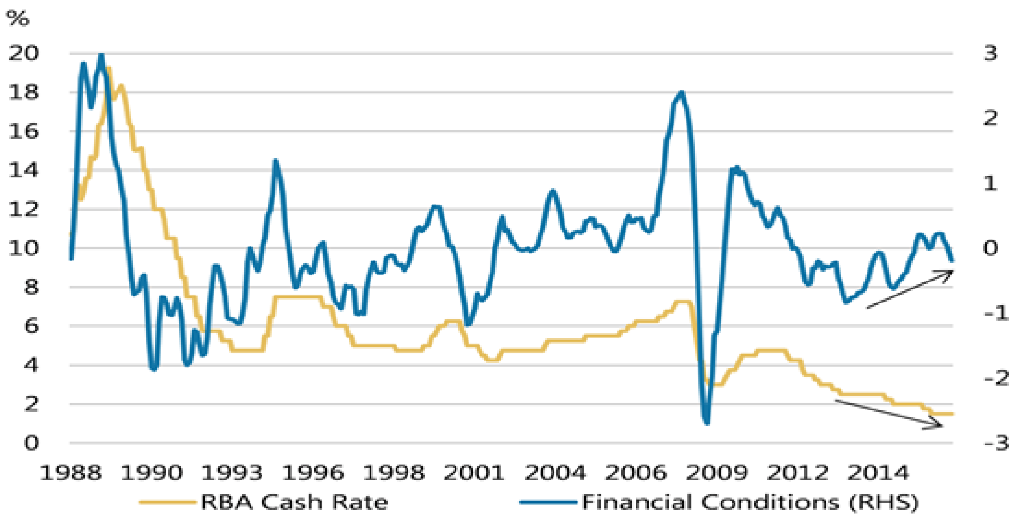
The state of the Australian residential housing market remains a hot topic for many stock market investors. On housing the RBA noted “*Conditions in the housing market vary considerably around the country. Prices have been rising briskly in some markets, although there are some signs that these conditions are starting to ease. In other markets, prices are declining.*”[2] In the RBA's Financial Stability Review it showed more concern on housing, noting "*Growth in housing debt has outpaced the slow growth in household incomes*".[3] However, the RBA implied they had 'already responded' as "*recent supervisory measures should help address the risks associated with high and rising levels of indebtedness*". Indeed, the RBA added *"Lenders have also announced increases in mortgage rates, particularly those paid by investors and on interest-only loans*". Australian residential price growth remains net positive. While there is some risk around the rate of future appreciation, with corrections likely in some markets, the RBA notes that price declines typically only occur when a there a is a greater than 20% increase in borrowing rates.

Figure1: Markets are wary of an Australian residential market collapse, but will mortgage rates increase by more than 20%?



Undoubtedly Australian financial conditions are tighter post the recent out of cycle interest rate hikes by Australian banks. Figure 1 compares Morgan Stanley’s Australian Financial Conditions index against the RBA’s official cash rate. Financial conditions are clearly tighter in the real world – but they are not significantly out of step with historic averages.

Figure 2: Australian Financial conditions are tighter than the RBA cash rate suggest – but not unusually so.



Source: Morgan Stanley

[3] Reserve Bank of Australia, Financial Stability review 12/4/17

Given this background we continue to tread carefully in the Australian market, focusing on stock selection, investing in companies with compelling growth.

The more volatile nature of the Australian economy and market continues to highlight the more predictable New Zealand market. A solid March reporting season from New Zealand companies contributed to the recent out performance by the New Zealand market, and provides medium term support for New Zealand market returns. But pricing of parts of the New Zealand equity market are becoming stretched.

Staying the course: Growth & Quality

Return dispersion between stocks has increased in recent months, and is likely to increase further from recent low levels. Accelerating industry change and altering economic settings are exposing some businesses that have benefited from strong liquidity flows, as investors have moved up the risk curve to boost returns as interest rates have fallen. This acceleration in change is increasing the risk of earnings disappointments and valuation compression for some stocks. We believe our focus on quality companies, which can grow cash flows ahead of the broader economy, is likely to contribute to solid medium term portfolio performance.

We remain selective, maintaining overweight exposure to higher growth healthcare, information technology, financial and consumer staple sectors as a result of individual bottom-up stock picking decisions. We also remain selectively overweight with cyclical sectors such as the materials sector reflecting stock specific investments. The portfolio remains underweight the consumer discretionary and telecommunications sectors, which remain exposed to negative industry change, and underweight the utilities and real estate sectors that are priced for interest rates to remain at low levels.

While we expect local equity markets to produce a positive medium term return, near term market choppiness may create some volatility – which in turn may be an opportunity for patient investors.

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