Harbour Investment Chronometer

AUSTRALASIAN EQUITIES MONTHLY COMMENTARY

Information as at 30 June 2017

Overview for the Month

- The New Zealand S&P/NZX 50 index rose 2.6%, and the Australian S&P/ASX 200 index rose 0.2% (+0.1% in NZ Dollars) over June.

- The New Zealand market outperformed global equity markets over the month, led by a strong performance from Fisher & Paykel Healthcare (up 8.5% over the month), backed up by strong returns from mid-capitalisation stocks such as a2 Milk, Restaurant Brands, Air New Zealand and Tourism Holdings. Positive earnings guidance upgrades continued to support the NZ market, with a2 Milk, Air New Zealand and Summerset providing profit upgrades ahead of market expectations over June. The Fletcher Building stock price bounced despite monthly NZ residential building consents showing some volatility, partly reflecting capacity constraints and partly tighter credit conditions. Stock specific news contributed to negative returns from Sky City and Sky Television. Retirement village operators Summerset and Metlifecare were weak as investors anticipated slowing NZ residential activity. Film industry software provider Vista Group gave back some of its recent strong performance.

- NZ economic conditions remained solid. Both the ANZ business outlook survey and NZIER Quarterly Survey of Business Opinion (QSBO) showed business confidence remains strong. This sentiment bodes well for NZ GDP growth and the profitability of NZ facing businesses. It also provides a positive backdrop for the NZ profit reporting season for the June period (late July, early August), with the pre-result 'confession' season proving positive so far.

- The Australian market remained choppy. Healthcare was the best performing Australian sector over June led by a recovery in the Sirtex stock price on the announcement of a business restructuring, as well as CSL returning 6.8% over the month. Information technology and financials (ex-real estate) also outperformed. Resource stocks benefited from a recovery in iron ore prices. Energy was the worst performing sector, dragged by a 4.5% slide in the oil price over the month. The interest rate sensitive real estate and utility sectors came under pressure late in the month as Australian long term bond yields increased 0.2% following comments from key global central banks that the period of low interest rates may be ending. While overall Australian economic data points continue to beat expectations, underlying economic tailwinds remain inconsistent, and a spate of company earnings guidance downgrades during the month highlighted the challenge of industry structural change.

- The portfolio outperformed versus its benchmark over the month. Overweight positions in outperformers a2 Milk, Sirtex Medical, F&P Healthcare and CSL, and an underweight position in underperformer Sky City, boosted the portfolio's relative returns. Overweight positions in underperforming stocks Aveo, Oil Search, Vista Group and Summerset, and an underweight position in outperformer Z Energy detracted from the portfolio's relative returns.

Outlook – Expensive Goldilocks

Comments from key global central banks - led by US Federal Reserve action, but supported by recent statement by the European Central Bank, the Bank of England and the Bank of Canada -that the period of extraordinary easy monetary policy may be ending, may contribute to a period of sector performance rotation within equity markets.

In our view the move by central banks is gently 'tapping on the brakes' as inflation and employment hit target levels, rather than an aggressive tightening of policy settings in anticipation of higher inflation rates.

But what the modest move in central bank tone is doing is contributing to a rise in long term bond yields, and highlighting parts of the equity market as being expensive as a result of extremely low bond yields. Historically high price to earnings (PE) stocks (where earnings are skewed to the longer term) and stocks whose earnings don't react quickly to economic growth or higher inflation, such as telecommunications, infrastructure, utilities and real estate - sectors which dominate the New Zealand equity market by market capitalisation - tend to underperform in such periods of time.

Locally we have taken some profits in higher growth, higher PE stocks, not because of concerns around bond yield moves but because the stock prices of such companies are ahead of what our research indicates is reasonable in the near term. Real estate stocks have generally underperformed over the last six months, potentially anticipating higher bond yields. In our view, while real estate fundamentals are positive, growth potential will remain modest and structural change in the retail sector will cap returns for some real estate stocks. Locally, utilities are likely to benefit from a cyclically positive hydrology period (cold winter increasing demand, low lake levels reducing hydro generation capacity). But these stocks are fully priced, supported by investors chasing bond like returns as bond yields have fallen. Infrastructure stocks are similarly fully priced relative to their growth prospects on the basis of investors globally chasing low risk yield enhancement.

In summary, while we believe sound economic growth will support company earnings, and what remains relatively accommodative monetary conditions within a modest inflation environment will support valuation metrics, this 'goldilocks' scenario is expensive and some stock prices may give up some of their bond yield driven gains and overall equity market volatility is likely to increase from recent low levels by historic standards.

The portfolio is overweight versus its benchmark in higher growth healthcare, consumer staple, information technology and financial sectors as a result of individual bottom-up stock picking decisions. The portfolio is underweight versus its benchmark the consumer discretionary and telecommunications sectors, which in our opinion 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.

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