The Financial Engineer

Australian Equities Portfolio Strategy

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EVANS & PARTNERS

ASX200 Index Target December 2017 = 5500 – 5600

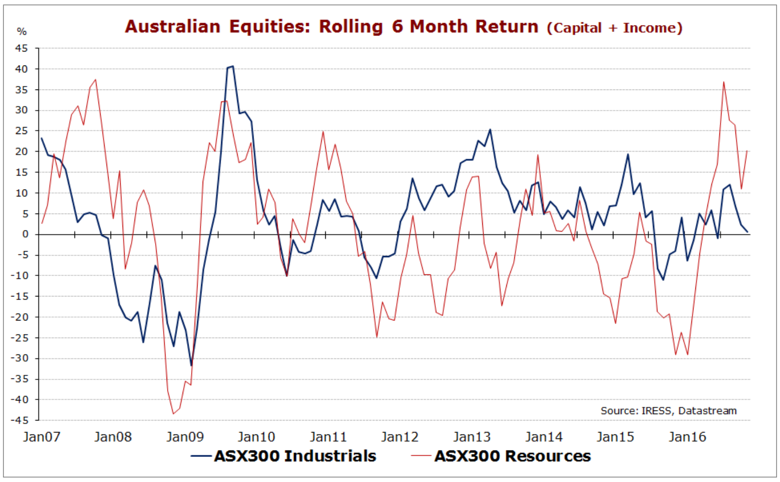
Synopsis: The ASX200 at 5440 at end November, provided a strong monthly return of 2.8% after the weakness evident from August to October. We see modest price appreciation prospects in the next 12 months as profit growth is delivered, partly offset by PE Ratio de-rating as bond yields move higher. Given US policy uncertainties (and the risks of a US policy mis-step), volatility risk is higher than normal, in our view. Inevitably, our market forecast reflects contemporary interpretations of a range of both positive and negative influences. We briefly note the following:

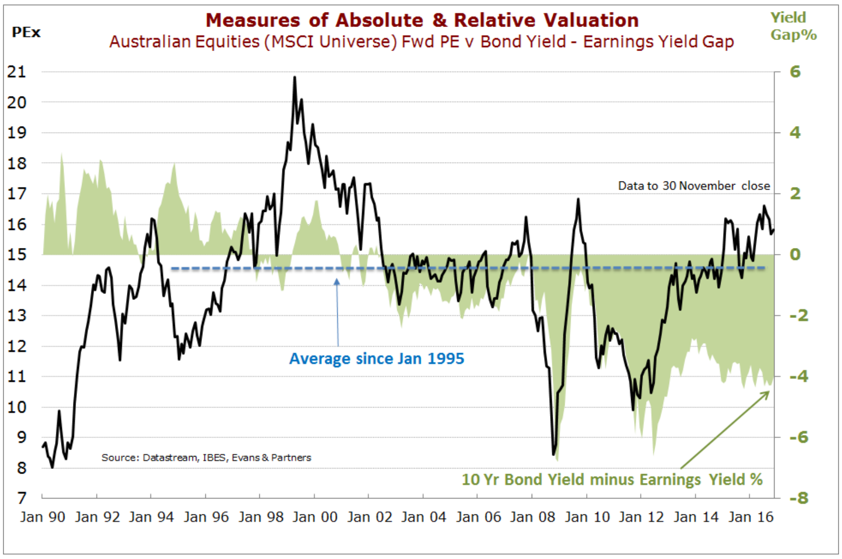
Positives

- Record low short term interest rates in Australia remain an ongoing positive. We assume the RBA holds official cash rates at 1.5% until at least end 2017. Fed tightening by 0.25% post the FOMC on 14 December 2016, looks well discounted and is unlikely to change this.
- The governments of the world's two major economies appears committed to fiscal stimulus to achieve their growth objectives. Higher than expected commodity prices and fiscally supported Chinese demand should support an improved domestic nominal growth environment and a less deflationary environment globally.
- While resource led, Australian EPS growth expectations have improved for FY17 and stabilized for FY18

Negatives

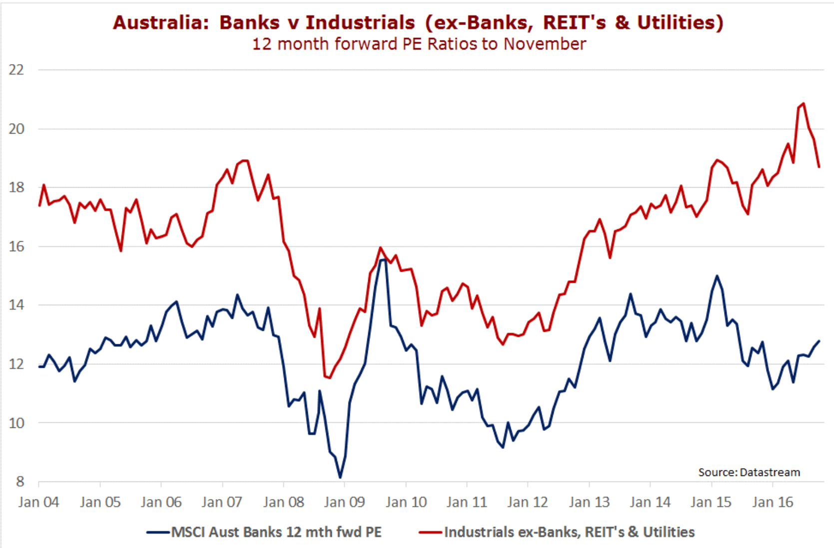
- The structural challenges confronting a significant proportion of Australia's largest listed companies remain substantial and an impediment to strong profit growth and improving ROCE.
- China's fiscal stimulus has certainly supported demand, but the coking coal price spike is overwhelmingly supply driven, while the outlook for additional low cost iron ore supply in 2017 remains daunting.
- If implemented, Donald Trump's proposed tax reductions / fiscal stimulus implies stronger US economic growth in 2017 and 2018. The risk of an ongoing sell-off at the long end of the US bond market, however, challenges valuation multiples; especially for low growth yield stocks but also high PER growth stocks.
- Equity markets responded favourably to the pro-growth and pro-business components of the Trump manifesto, but substantial uncertainty and risk potentially remains over his approach to trade policy.





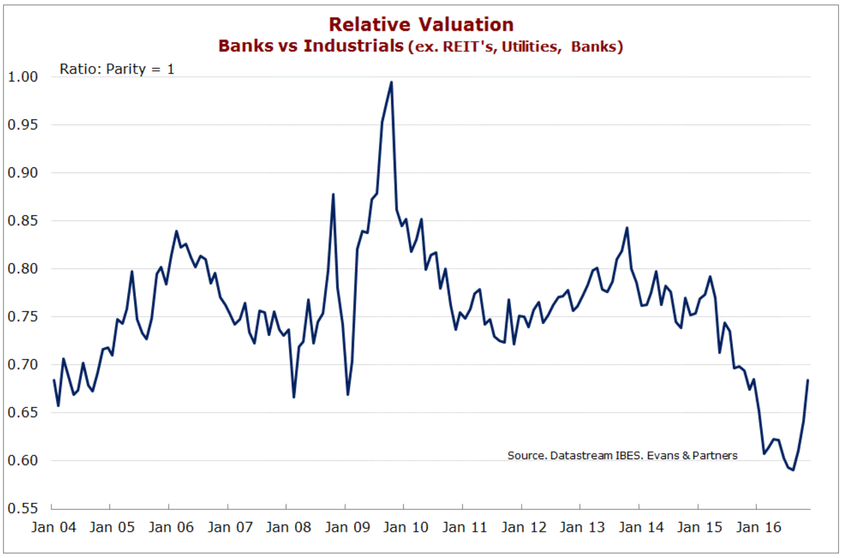
The 12 month forward PE Ratio of the broader market (based on consensus EPS estimates) is 15.8X. While not cheap in absolute terms it is supported by reasonable aggregate earnings growth expectations.

A continued rise in bond yields is likely to pressure equity valuations, but as the chart left implies, the equity market earnings yield has compressed far less than long bond yields. It is the long end of the bond market where the major relative overvaluation has resided.



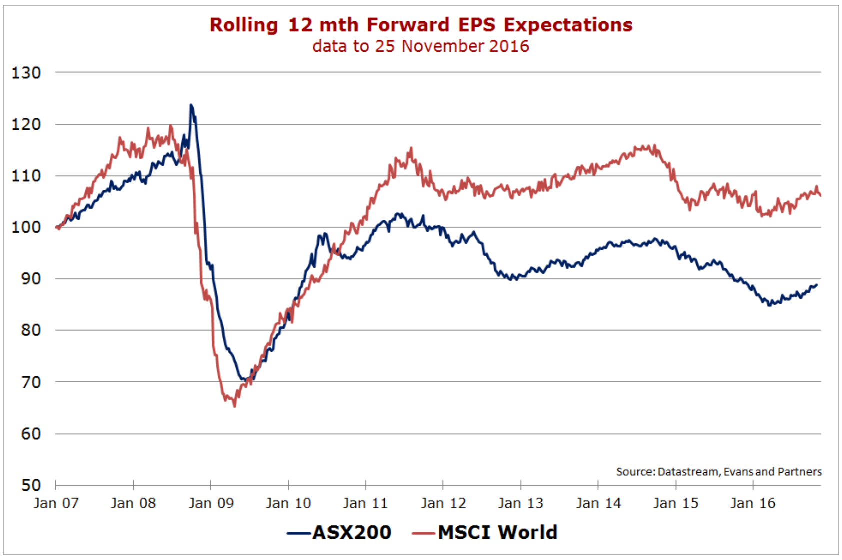
The consensus rolling 12 month forward PE Ratio of the Industrials excluding Banks, REIT's and Utilities has declined by ~2 PER points over the past 3 months. The sell-off in Australian ten year bond yields (from under 2% in July to 2.8%) has impacted high PER stocks as well as the more traditional yield plays (such as REIT's and Utilities). Rotation into cyclicals has exacerbated this trend.

Stocks that currently stand out as attractively priced to our analysts include **Brambles, CSL Limited, James Hardie Industries, Ramsay Health Care, ResMed Inc, Sydney Airports** and **Transurban.**



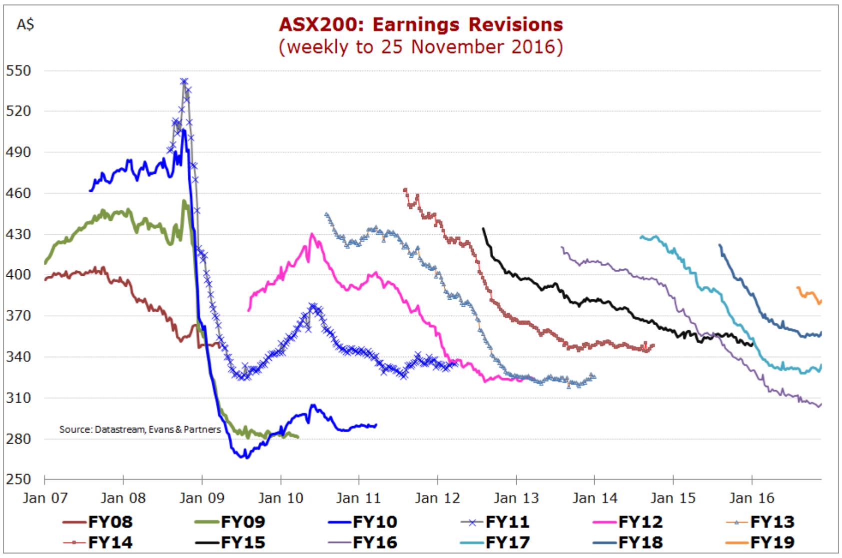
US Bank stocks rallied strongly post the US elections in response to optimism of a lighter regulatory approach from a Trump Administration and a steeper yield curve.

While the domestic earnings implications from a shift in the curve here are likely less than offshore, a steeper yield curve may still assist Net Interest Margins in FY17. Non-US banks have also rallied strongly on a relative valuation argument.



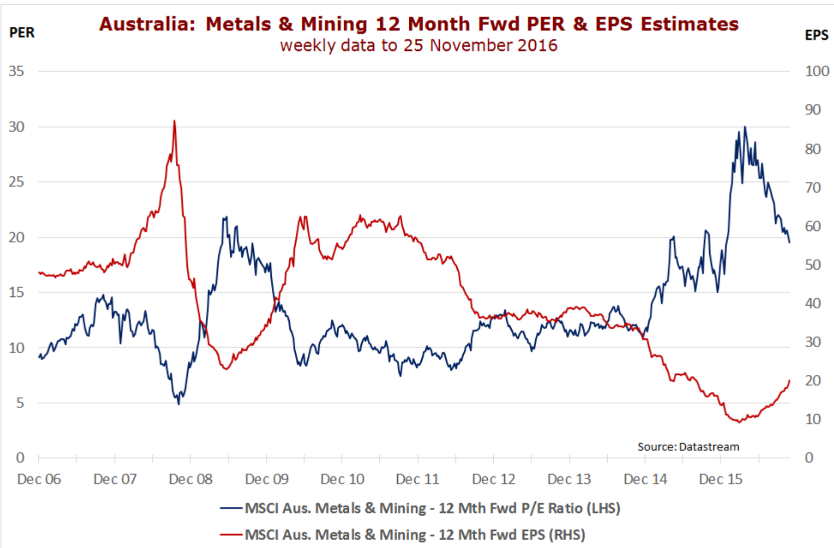
EPS growth expectations (both global and domestic) remain buoyant for 2017 and 2018. Absent significant downgrades, monthly roll forward implies a continuation of the more recent rising trend in rolling 12 month forward EPS expectations. See also chart below left.

Australian 12 month forward EPS expectations are still more than 10% below the level that was expected back in January 2007.



Analyst EPS downgrades to out-year forecasts have been an enduring feature of the post GFC environment.

The chart left shows the upgrade to FY17 market EPS growth estimates as analysts adjust for higher spot commodity prices. FY18 EPS have also stabilised in recent months.



China fiscal stimulus continues to support demand. The supply side remains a concern in 2017. Iron ore in particular has a strong growth pipeline of additional low cost supply, while the dramatic spike in the coking coal price largely reflects a confluence of supply factors.

The increase in 12 month forward EPS expectations since March reflect both higher than expected spot prices and monthly roll forward to a more favourable earnings year. We are cautious following the magnitude of sector outperformance this year.

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