EVANS & PARTNERS

The Financial Engineer

Australian Equities Portfolio Strategy

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PREMATURE EXPECTATIONS

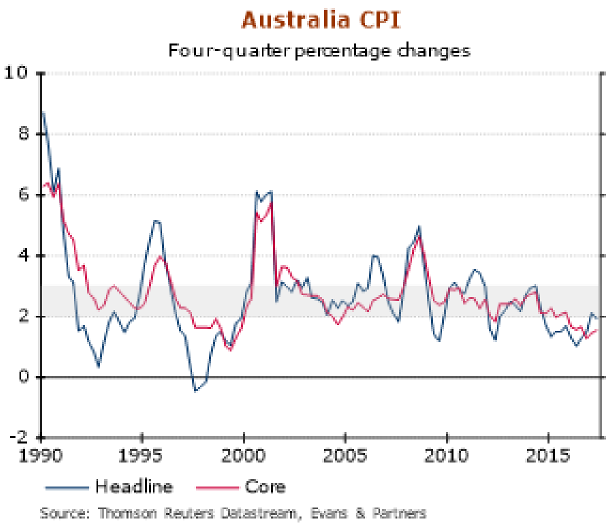
The market has positioned itself for rate rises by the RBA; bond rates and the $A have risen and interest-rate sensitive stocks have been hit. We see a rate rise from the RBA as unlikely this calendar year. The latest CPI data showed inflation below the RBA's target and the Australian economy faces more challenges from slowing housing construction and pressures on consumers from higher mortgage rates and electricity prices. We are more cautious on the Australian market given the challenged macro environment, elevated valuations and the risk of disappointments in reporting season but would revisit sold-down stocks in infrastructure and real estate.

PREMATURE EXPECTATIONS FOR RATE HIKES

Investors have been reassessing the outlook for RBA policy in recent months and have started to consider the possibility of the RBA raising rates over the next year. As a result the $A has jumped higher, interest rates have risen and yield stocks have been under pressure. We see these developments as premature given weak inflation data and some of the struggles ahead for the Australian economy.

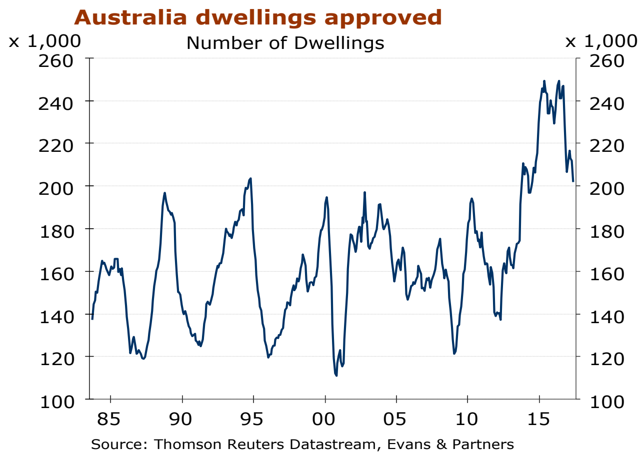
INFLATION IS WELL BELOW THE RBA'S TARGET

Weak inflation data suggests that the RBA is a long way from raising rates. The data for the second quarter showed that inflation is below 2% on both a headline and core basis. This is below the RBA's target of 2-3% and driven by structural factors that are likely to be persistent including technology change, over-capacity and ageing.



HOUSING AT A PEAK

On top of this, the Australian economy continues to struggle. Housing construction is now set to slow and consumers are facing new challenges. There are a number of pressures on housing mostly related to finance availability. The RBA introduced its second round of macro-prudential rules in March, lending to developers has been substantially curtailed, mortgage rates have increased and the banks have adopted more conservative living expense assumptions which will limit the borrowing capacity of some households. Foreign demand for housing will be affected by higher stamp duties and another crackdown on capital leakage in China. This should result in a softening in house prices and a fall in construction activity over the next year. Dwelling approvals have now fallen by more than 15% since late last year.



CONSUMER PRESSURE RISING

Consumer pressures will be more intense over the next year as higher rates and cut-backs on interest only loans will hurt disposable income. This is in addition to the pressures that the consumer is already feeling from anemic wage growth.

Looking at these pressures in more detail, mortgage rates have increased by different rates depending on the type of borrower. Rates on interest-only lows have increased the most, particularly for investors.

We believe high rates on interest only loans will cost households about $2.4 billion per year, which is about 0.5% of disposable income.

Effect of increase in rates on interest only loans

	Total loan outstanding (	% interest only	Increase in rate	Extra interest cost $b*
Owner Occupier	1092	23	0.52	1.3
Investor	581	63	0.76	1.1
				2.4

*after tax break for investors

Source: Westpac, RBA

There will also be substantial increases in electricity and gas prices in some states as shown in the table below. NSW and SA are most affected with regulated electricity price rises of more than 15%. Victoria will see price rises as well but these will not be announced until December. Price rises average about 10% across the country, and since total household spending on utilities was around $25 billion last year, the increases will take around $2.5 billion from disposable income.

Average price increases from July 1, 2017

	Electricity	Gas
NSW	17%	7%
SA	16%	9%
Queensland	5%	2%

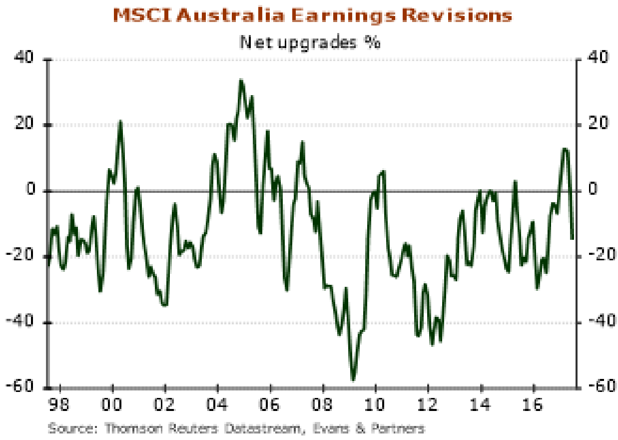
*VIC prices rises will be announced in December

Source: Origin Energy and AGL

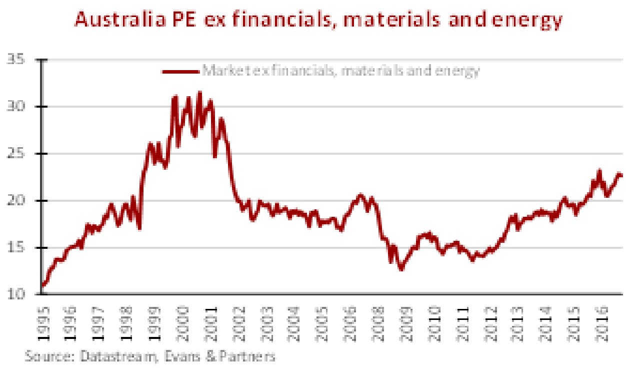
The total cut to spending from these two effects is around $5 billion, or about 1% of total disposable income of around $600 billion. Given these pressures and since core inflation remains well below target, we believe there is unlikely to be any increase in interest rates any time soon; the next move on rates is just as likely to be down.

WAITING FOR REPORTING SEASON

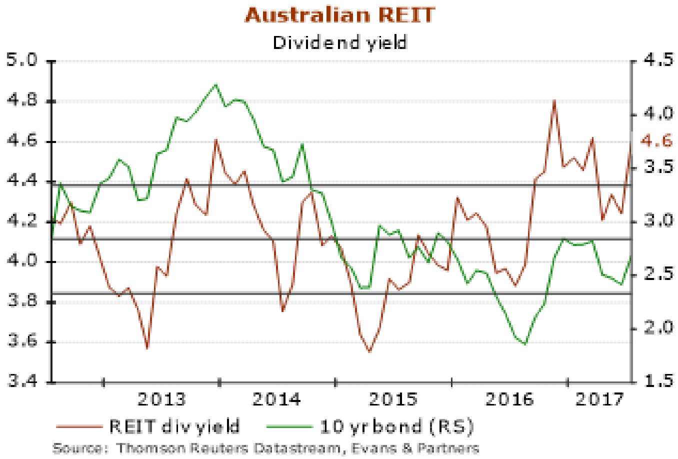
The extent of some of these pressures may become clearer during the next company reporting season. There have been some warning signs of late from an increase in the number of earnings downgrades during the traditional "confession season". This has seen around 15 downgrades from companies in the ASX 200 dominated by the consumer sector (Ardent Leisure, Automotive Holdings, Retail Food Group, Myer). There had actually been more earnings upgrades than downgrades earlier in the year, resulting in the earnings revisions ratio rising to its highest level since 2007, but this has not been sustained as commodity prices have softened and the domestic economy has continued to struggle.



We remain cautious on the Australian market given the challenged macro-economic environment and elevated valuations. The forward PE of the industrial sector remains close to the highest it has been in 15 years. Our index target for June 2018 is 5900 around 3% above current levels and consistent with total returns of around 8% (including franking).



Two sectors where value is emerging are REITs and Infrastructure. These have suffered from the recent increase in bond yields that has occurred as investors have reassessed the outlook for monetary policy around the globe. We believe this has been an over-reaction. Given the recent falls in inflation around the world, and the structural forces of demographics and technology that are contributing to this, we do not expect substantial further rises in rates. Our preferred picks in the REITS and Infrastructure Sectors currently are Stockland (SGP), Scentre Group (SCG) and Transurban (TCL).



RESEARCH RECOMMENDATION DEFINITIONS

Positive	Stock is expected to outperform the S&P/ASX 200 over the coming 24 months
Neutral	Stock expected to perform in line with the S&P/ASX 200 over the coming 24 months
Negative	Stock is expected to underperform the S&P/ASX 200 over the coming 24 months
Speculative Buy	Stock has limited history from which to derive a fundamental investment view or its prospects are highly dependent on event risk, eg. Successful exploration, scientific breakthrough, high commodity prices, regulatory change, etc.
Suspended	Stock is temporarily suspended due to compliance with applicable regulatory and/or Evans & Partners policies in circumstances where Evans & Partners is acting in an advisory capacity.
Not Rated	Stock is not included in our investment research universe.

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Valuation	Composite of Rolling 12 month prospective multiples and discounted cash flow (DCF), or DCF for resource stocks.
Earnings Outlook	Forecast 2 year EPS growth.
Earnings Momentum	Percentage change in the current consensus EPS estimate for the stock (rolling 1 year forward basis) over the consensus EPS estimate for the stock 3 months ago.
Shareholder Returns	Composite of forecast ROE (rolling 1 year forward basis) and the percentage change in ROE over 2 years.
Debt Servicing Capacity	Rolling 12 month EBIT Interest Cover ratio.
Cyclical Risk	Qualitative assessment of the 2 year outlook for a stock/industry's profit cycle.
Industry Quality	Qualitative assessment of an industry's growth/returns potential and company specific management capability.
Financial Transparency	If we don't understand it, we won't recommend it.

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