view from the OUTER

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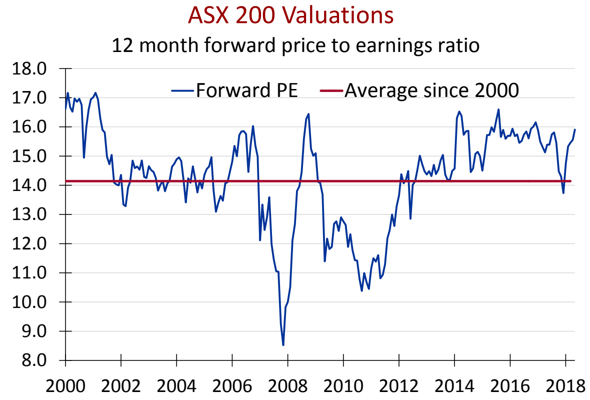
Australia: let's not get carried away

After the post-election rally, we are downgrading our recommendation on Australian equities to underweight.

There are a number of factors that are driving the downgrade:

- Market valuations are stretched. The forward price to earnings ratio (PE) of the Australian market has risen back to close to 16x, which has acted as an upper bound on valuations over the past 15 years.
- The recent deterioration in earnings is also a concern ahead of the reporting season in August. The weakness of the Australian economy suggests earnings will not be a driver of the Australian market in the period ahead.
- International risks are rising, given recent developments in the US-China trade war. This reminds us that the Trump administration is unpredictable, and it does not appear the market is pricing the risks from an extended dispute.
- The election result is a positive for several sectors but does not solve a number of other cyclical and structural problems.



Source: Thomson Reuters Datastream, Evans & Partners

Recommendations

We recommend investors consider lightening holdings in Australian equities and continue to see alternative assets as the preferred option to place these funds.

For now, we will retain our neutral position in global equities, although this has also become a closer call. In the US, valuations are not as stretched relative to history as they are domestically, and the recent reporting season suggests the corporate sector remains in good shape. The nascent recovery in the Chinese economy should also act as a tailwind and offset some of the downside from trade concerns.

Alternative assets offer a superior risk-reward trade off at present and we are particularly attracted to private credit funds. This sector is growing due to the regulatory and capital constraints facing banks both in Australia and globally. We recommend clients talk to their advisers about some of the opportunities in this space.

Australia: let's not get carried away

We are downgrading our recommendation on Australian equities to underweight after the post-election rally.

It is not that we disagree the election result was positive for a range of sectors. Instead, we believe market valuations are stretched and that the overall market was never priced for a significant amount of political risk. As a result, the election result does not solve a number of other cyclical and structural problems. The recent deterioration in earnings is also a concern ahead of the reporting season in August.

At the same time, international political risks are rising again. Recent developments in the US-China trade war have reminded us that the Trump administration is unpredictable, and it does not appear the market is pricing the risks from an extended dispute. We are, however, retaining global equities as neutral for now since valuations are not as stretched offshore.

Given the solid market gains this year, and rising uncertainties in some areas, we prefer to switch to less volatile investments. We see alternative assets, particularly private credit, as the stand out asset class and recommend investors consider pursuing opportunities in this sector.

The election result was good but….

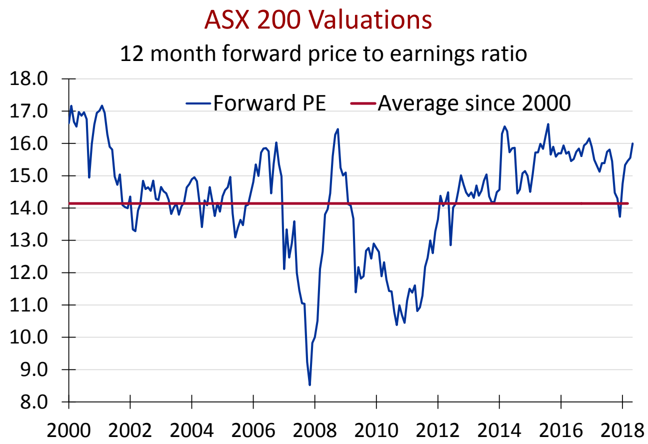
The election outcome was a positive result. It removes much uncertainty about the implications for a number of policies that could have had material macro and market effects – particularly in respect to franking credits and negative gearing.

There are also some particular positives for a number of sectors that investors have rushed to price in:

- Retailers will benefit from tax rebates and the second round of cuts to penalty rates.
- Healthcare stocks will be better off without the Australian Labor Party's premium cap. This will benefit insurance companies and private hospitals.
- Dividend stocks and hybrids will not suffer the loss of franking credit refunds for a number of investors.
- Financials have a little more clarity on regulatory change and the implementation of recommendations emanating from the Hayne royal commission.

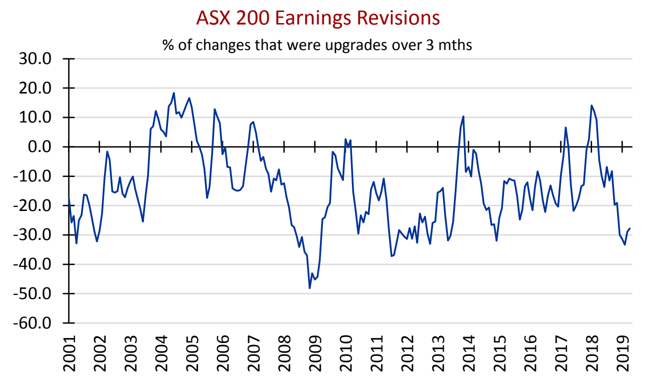
However, we do not expect the election result to trigger a sustained rally in the Australian market. Instead our view is that the election bounce is a one-off and the accumulation of other negatives and stretched valuations means it is now time to consider reducing equity positions.

Our main concern is valuations. The forward PE of the Australian market has risen back to close to 16x which has acted as the upper limit on valuations over the past 15 years.



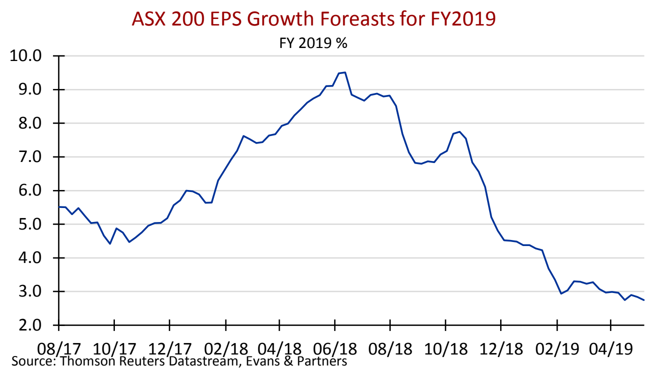
Source: Thomson Reuters Datastream, Evans & Partners

This suggests that further market upside would need to be driven by earnings improvements and this does not look likely. We are currently in the 'confession season' for FY19 earnings, where many companies are warning they will fall short of analysts' expectations. There have been 30% more downgrades than upgrades across the market, which historically is a poor result. This is shown in the earnings revisions chart below.



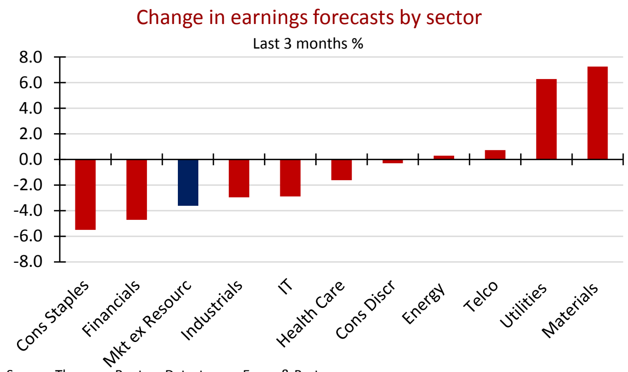
Source: Thomson Reuters Datastream, Evans & Partners

The extent of the bad news has been somewhat masked by the strength in commodity prices. Overall the ASX 200 FY19 forecasts are only down by a small amount – current forecasts are for 2.8% earnings growth, compared with around 3.2% a few months ago.



Source: Thomson Reuters Datastream, Evans & Partners

However, excluding resource companies, the recent downgrades would have been around 4% and earnings would be set for a 1% contraction in FY19.



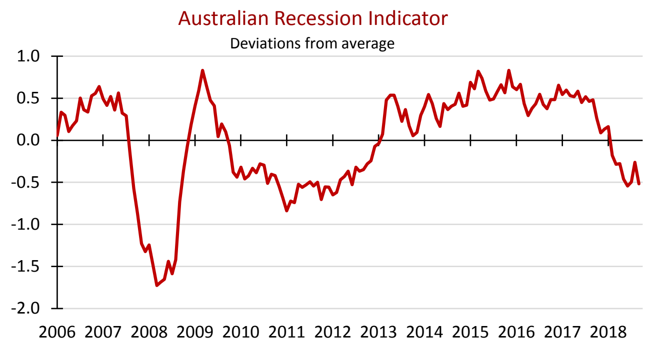
Source: Thomson Reuters Datastream, Evans & Partners

We also have limited confidence that earnings can improve as a major driver of returns in FY20 considering that the domestic economy is weak and resource sector earnings are unlikely to improve further from here.

Recession watch

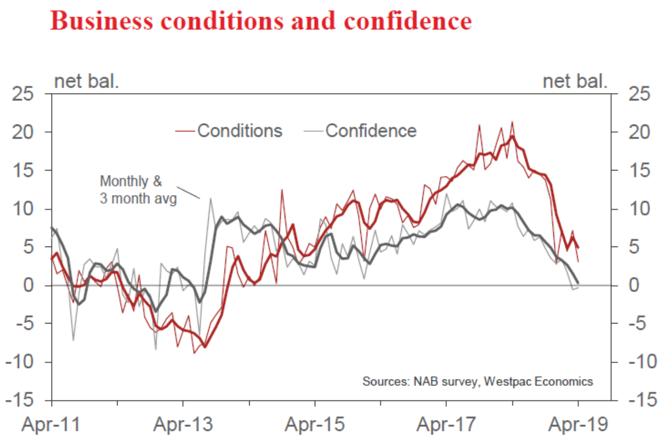
We continue to monitor domestic economic conditions closely to see whether the downturn in housing may cause a recession. We are certainly not in the clear yet.

The most recent newsflow has been negative on this point and our recession indicator has retraced. It still remains in the danger zone.

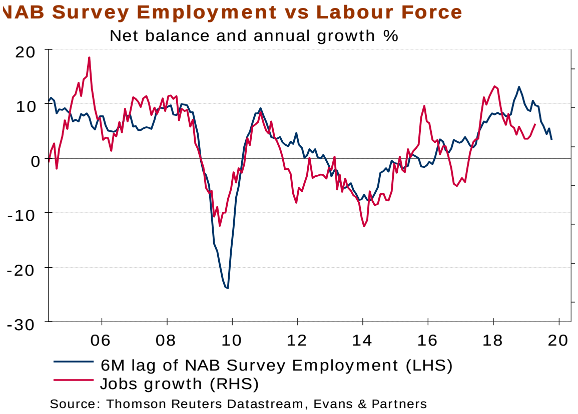


Source: Thomson Reuters Datastream, Evans & Partners

The bad news recently has been concentrated on business confidence and the labour market. These indicators may have been temporarily affected by election uncertainty, but they have definitely been weaker in recent readings. We will be watching closely to see if there is a sustained post-election bounce.



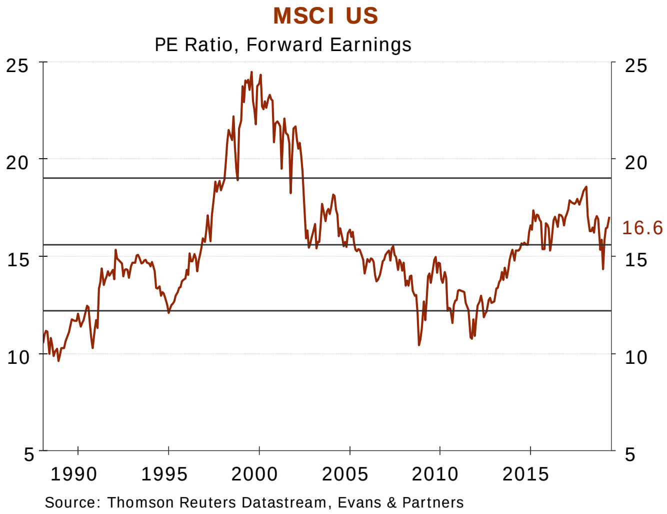
The Reserve Bank of Australia has emphasised that the labour market is critical to the outlook and weak readings on firms' employment intentions and job vacancies are a concern. While this does increase the chance of a near-term rate cut, which may be supportive of equities, it is an additional reason for caution in the short term.



What about global equities?

For now, we will retain our neutral position in global equities, although this has also become a closer call.

In the US, valuations are not as stretched relative to history as they are in Australia and the recent reporting season showed encouraging signs that the corporate sector there remains in good shape. More broadly, we also still expect the nascent recovery in the Chinese economy to gather pace through the year and could be of benefit to a range of regions, including emerging markets and Europe.



The biggest question now is whether the trade war will escalate from here and whether this will meaningfully change the outlook. Our view is that the downside from tariffs will be offset by additional policy stimulus in China and the US so that the aggregate macro effects will be negligible.

This balance of positives and negatives leaves us with a neutral recommendation, notwithstanding the increase in political risk — but we will continue to review this situation.

Recommendation

We recommend investors consider lightening holdings in Australian equities where appropriate and continue to see alternative assets as the preferred option to place these funds.

Alternative assets offer a superior risk-reward trade off at present and we are particularly attracted to private credit funds. This sector is growing due to regulatory and capital constraints facing banks both in Australia and globally. Around 70% of incremental corporate lending is now occurring outside traditional bank lending channels, which is creating a wave of opportunities. We recommend clients talk to their advisers about some of the opportunities in this space.

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