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FINANCIAL *evaluator*

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Even more offshore

The Australian market hit record highs in terms of index points while valuations, using forward price to earnings ratio (PE) as a proxy, jumped above 17x for the first time since 2001. This is occurring at a time when earnings pressure is intensifying. FY20 earnings have now been revised down by around 6% since the financial year began.

The better news is that offshore equity markets are in superior shape in terms of both the economic prospects for 2020 and the current state of valuations. Europe and the emerging markets stand out. The UK market is also interesting given cheap valuations and the prospects of a Brexit resolution after the British general election.

Macroeconomic and market developments

We highlight macroeconomic and market developments from the month, including:

- The Reserve Bank of Australia (RBA) signalled further rate cuts were likely and it would consider quantitative easing only after the official cash rate was cut to 0.25%.
- Recent data has pointed towards a potential recovery in the manufacturing slump, improving the outlook for 2020 provided the current strength in labour markets and retail sales can be sustained.
- The S&P/ASX 200 continued its recent strong performance in November, gaining 3.3% over the month. The benchmark is up 27.8% year-to-date and is set to achieve its best year of performance since 2009.
- Australian major banks endured a difficult month as Westpac Banking Corporation (WBC) faces fines over its alleged "systematic non-compliance" with the Anti-Money Laundering and Counter-Terrorism Financing (AML/CTF) Act.

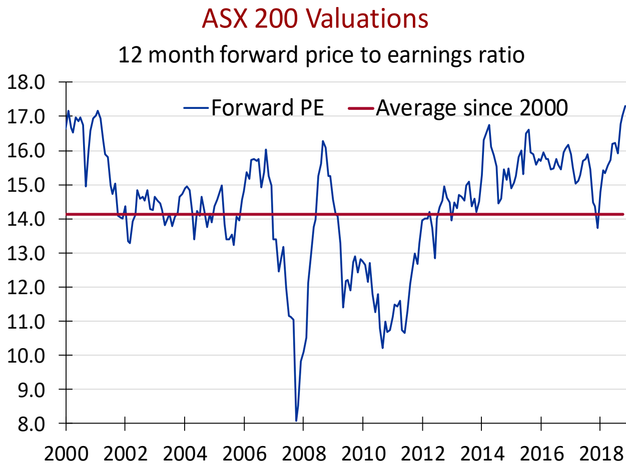
Equities Total Return

To period ended October 2019	Monthly (%)	Quarterly (%)	Annual (%)
ASX 300	3.2	4.8	26.0
ASX 300 Industrials	2.8	4.5	25.1
ASX 300 Resources	4.7	6.0	30.0
ASX 300 Financial Ex. A-REIT	-2.0	-0.8	11.8
ASX 300 A-REIT	2.3	0.8	27.0

Source: IRESS Market Technology

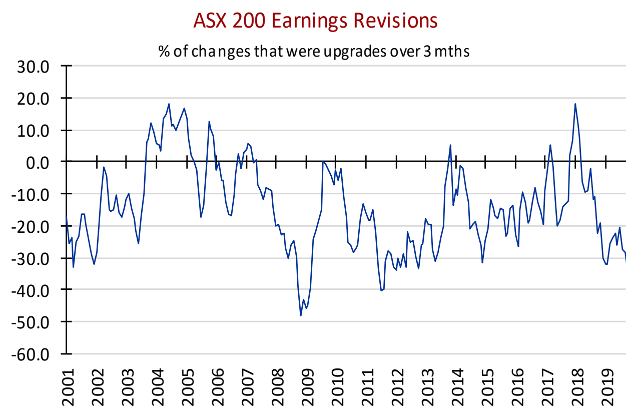
Even more offshore

The Australian market hit record highs in terms of index points while valuations, using forward price to earnings ratio (PE) as a proxy, jumped above 17x for the first time since 2001. As a result, we recommend trimming positions further in Australian stocks.



Source: Refinitiv, Evans & Partners

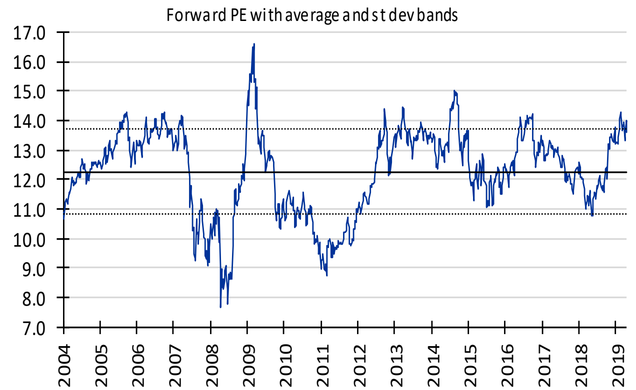
This is occurring at a time when earnings pressure is intensifying. FY20 earnings have now been revised down by around 6% since the financial year began as a result of weak results and recent downgrades to guidance during annual general meetings. The earnings revisions ratio has fallen back down close to post-crisis lows. The main culprit here is a lacklustre economy and the absence of any meaningful bounce in consumer spending after tax rebates and interest rate cuts.



Source: Thomson Reuters Datastream, Evans & Partners

The solid performance of Australian banks is particularly puzzling. Despite significant downgrades to earnings and dividends in recent months, and risks of further regulatory pressure in the wake of the latest Westpac scandal, valuations have drifted up to the high end of historical norms.

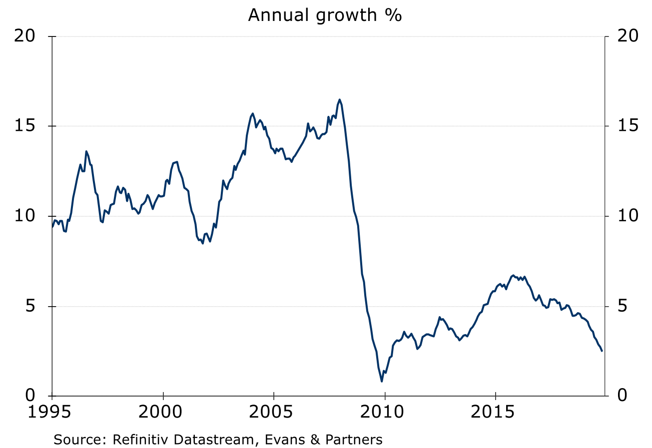
PE for Australian Major Banks



Source: Thomson Reuters Datastream, Evans & Partners

The ongoing slide in private credit growth raises the prospects that the next year will see both contractions in loan volumes and margins. Margins could face further pressure from additional interest rates cuts next year. Credit growth is clearly not responding to lower interest rates, with households much more focussed on paying down existing debt than borrowing further. The banks also appear to be losing market share in some key segments as new entrants seek to grab a foothold in mortgage and personal lending.

Australia Private Credit



Source: Refinitiv Datastream, Evans & Partners

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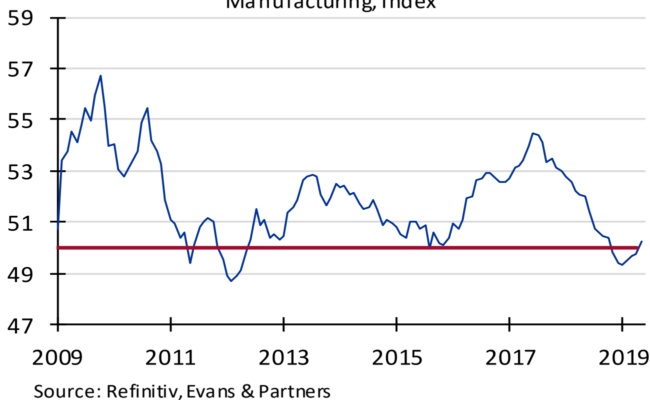
Looking offshore

The better news is that offshore equity markets are in superior shape in terms of both the economic prospects for 2020 and the current state of valuations.

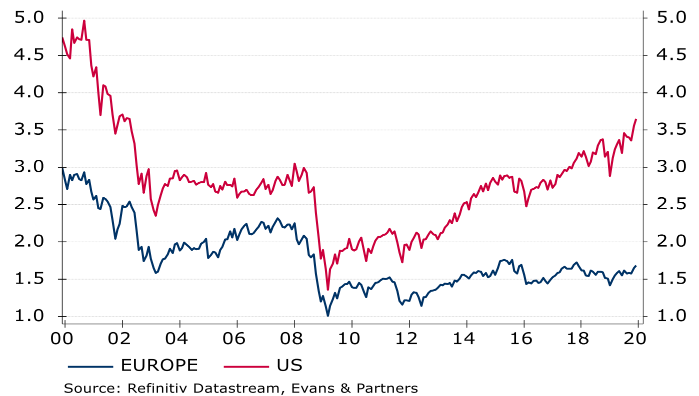
The best recent news is accumulating evidence that the sharp fall in manufacturing that has been in place since early 2018 may be starting to ease. Auto sector woes have played a large part in this but production levels have now been slashed to such levels in Europe and the US that excess inventories will begin to clear and conditions might improve. There will still be some lingering issues, particularly in China, related to the trade war but in our view conditions are more likely to improve than deteriorate in 2020.



Source: Refinitiv, Evans & Partners

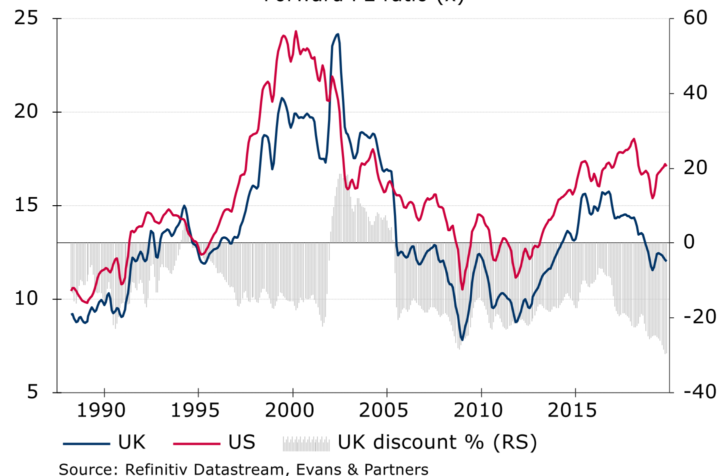
How positive an improving macroeconomic environment is for markets will depend on central bank actions. Markets have been much more sensitive to central bank developments than economics over the past five years, so the risk is that stronger activity means less central bank stimulus. Investors may become anxious about this if they start to fear the consequences of policy reversal.

Nevertheless, some areas will certainly benefit from a recovery, with Europe and the emerging markets the most likely areas given their indices have a greater proportion of companies with more cyclical earnings. Europe in particular has a large weighting to financials and industrials. There is also a widening valuation gap between the US and other regions. The chart below shows that on a price to book basis European markets are now trading at half the valuation of the US.



Source: Refinitiv Datastream, Evans & Partners

We also see the UK as particularly interesting. Equity valuations have drifted lower, the currency is around 25% below pre-referendum highs.

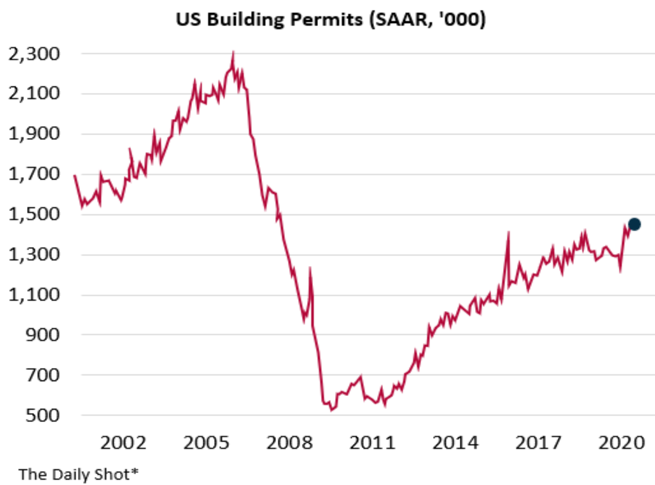


Source: Refinitiv Datastream, Evans & Partners

Based on these developments, we are cutting our Australian equity position further in our recommended portfolios and will be looking to put this money to work in offshore markets as opportunities arise.

Macroeconomic developments

There are some encouraging signs that the manufacturing downturn that has dominated the global economy through 2018 and 2019 may have reached its nadir. This has raised hopes of a better 2020, provided the current strength in labour markets and retail sales can be sustained. Easier monetary policy in a range of countries will also help in the recovery for 2020.



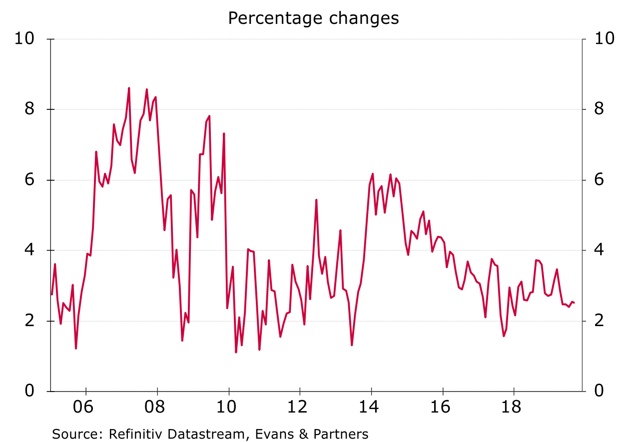
In the US, recent data have confirmed the prospects for a strong recovery in housing construction with a leap in building permits. This would broaden economic activity which has been heavily dependent on consumer spending in recent years. The corporate sector remains weak with soft business surveys and a reduction in investment intentions. The US Federal Reserve has been sending confusing messages on the future direction of rates – it appears likely that there will be one more rate cut in 2020.

The slide in Chinese economic data has continued. Data in the month showed another collapse in auto sales due to lower subsidies on electric vehicles and a renewed crackdown on the shadow financial system. As a result, there were further falls in industrial production and investment growth. The housing market has remained resilient and is now the healthiest part of the economy, but sales data has been a little weaker in recent readings. The People's Bank of China announced a small reduction in benchmark lending rates, but broader policy support remains absent.

European PMI

Source: tradingeconomics.com

News has become marginally brighter in Europe, with some evidence that the manufacturing downturn may be nearing an end. The auto sector has been a particular problem, but production has now been cut substantially. Elsewhere labour markets remain healthy and consumer spending has been robust. There was also further evidence of a strong bounce in French activity. Overall there is enough evidence to suggest better prospects for 2020.

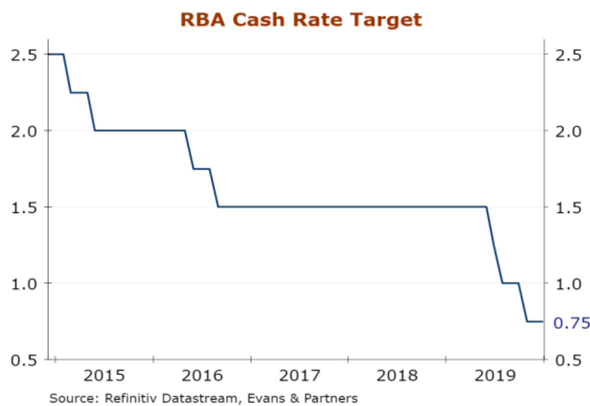


In Australia the RBA signalled that further rate cuts were likely and it was most focussed on developments in the retail sector. Spending has been very weak despite tax rebates and interest rate cuts. Elsewhere the positive news in property sales continued, although construction is likely to weaken further before it turns higher during 2020. Businesses continue to report a tough operating environment.

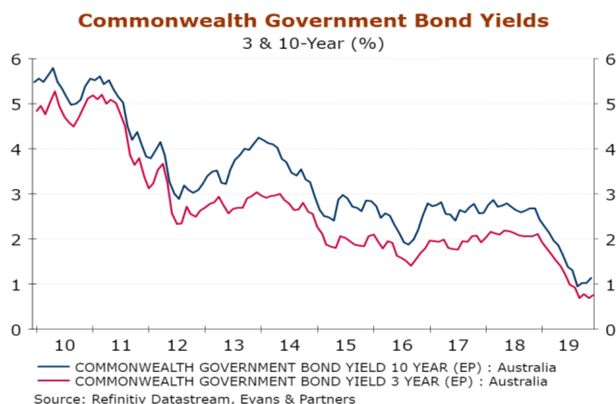
Market developments

Interest rate securities

Following three cuts to the cash rate in 2019, RBA held rates steady at 75 basis points in November. RBA Governor Philip Lowe noted the current low interest rate environment would persist into the foreseeable future, despite the domestic economy reaching “a gentle turning point”. From a global perspective, the RBA noted that risks were still tilted to the downside. While prospects of a partial trade deal between the US and China improved over the month, the likelihood of a comprehensive deal remained uncertain.

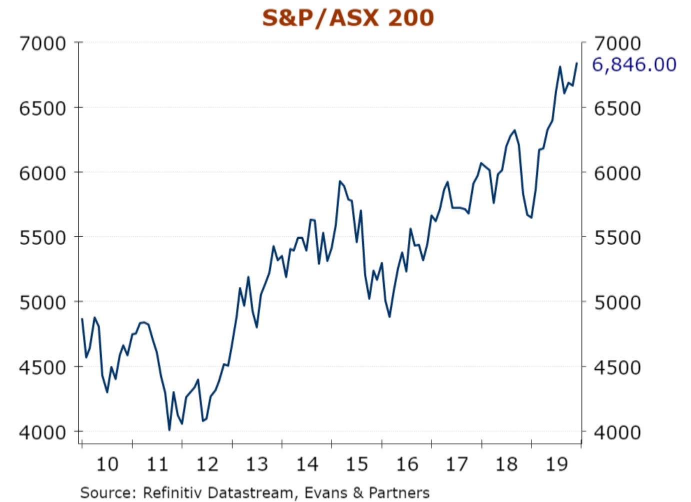


Earlier in the month, Lowe gave a speech outlining that a scenario of negative rates in Australia was "extraordinarily unlikely" as the economy is in a very different situation to some developed counterparts in parts of Europe and Japan that have employed unconventional forms of monetary policy, such as negative interest rates. Lowe however did not rule out the possibility of employing other forms of unconventional policy such as the purchase of government bonds in an attempt to flatten the yield curve and lower the risk-free rate. Lowe commented: "Our current thinking is that QE (quantitative easing) becomes an option to be considered at a cash rate of 0.25%, but not before that. " Markets were quick to assume this as the "base case" scenario, sending government bond yields lower to 0.65% and 1.03% for 3 and 10-year maturities respectively.

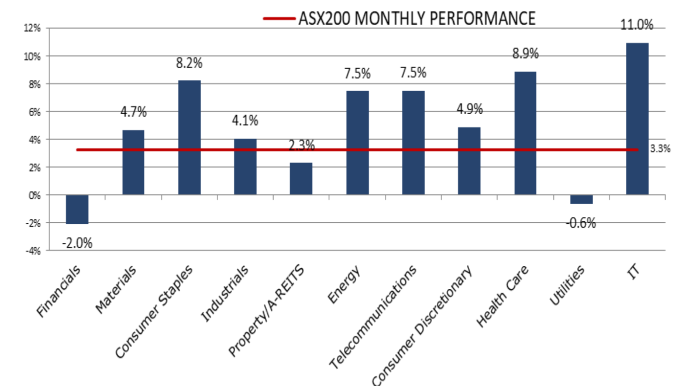


Australian equities

The S&P/ASX 200 continued its recent strong performance in November, gaining 3.3% over the month. The benchmark is up 27.8% year-to-date and is set to achieve its best year of performance since 2009. The information technology (+11.0%), healthcare (+8.9%) and consumer staples (+8.2%) sectors led gains over the month, while financials (-2.0%) and utilities (-0.6%) were the only detractors.



Strong performers included A2 Milk Company (+22.7%), Xero Limited (+17.8%), Telstra Corporation Limited (+10.6%) and CSL Limited (+10.7%). Conversely, continued industry scrutiny surrounding the financial sector weighed heavily on most of the banks’ share prices with WBC (-10.2%), NAB (-6.6%) and ANZ (-4.1%) all declining over November.



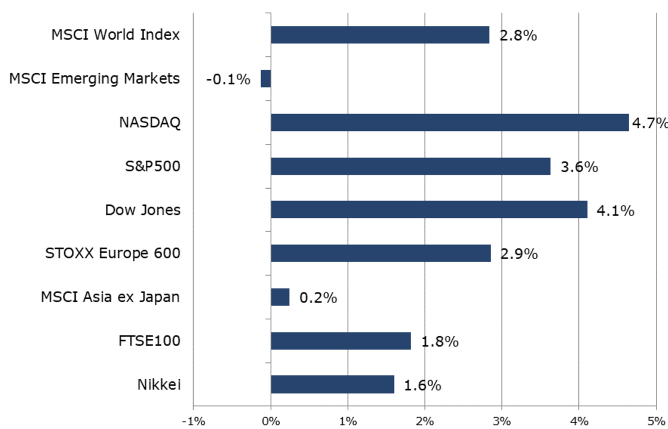
Source: IRESS

WBC shares were sent tumbling after financial intelligence agency AUSTRAC launched legal action against the bank, alleging “systemic non-compliance” with the Anti-Money Laundering and Counter-Terrorism Financing (AML/CTF) Act. In response to the fallout, Chief Executive Officer (CEO) Brian Hartzer stepped down from his position with Chief Financial Officer Peter King taking over as acting CEO with immediate effect. Prior to AUSTRAC’s investigation, WBC initiated a $500 million capital raising process through a

share purchase plan offer. However, in light of the AUSTRAC scandal and following discussions with ASIC, WBC announced that it will provide some investors with the opportunity to withdraw from the share purchase plan.

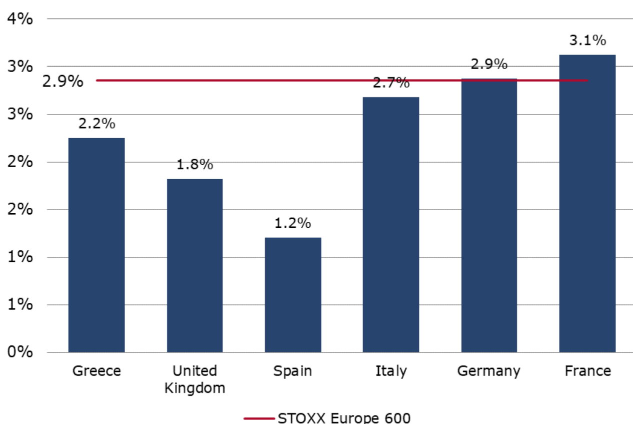
International equities

Global equity markets advanced in November, with the MSCI All Country World Index gaining 2.5%. The biggest gains came in the US, with the tech-heavy NASDAQ delivering a strong return of 4.7%. The MSCI Emerging Markets Index and MSCI Asia ex Japan Index were the worst performing indices, delivering returns of -0.1% and 0.2% respectively.



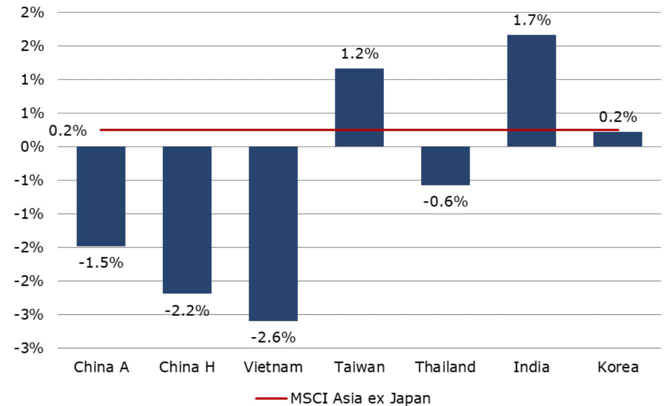
Source: Bloomberg Professional

European equity markets performed well over the month, buoyed by marginally better economic data. As previously mentioned, there is some evidence emerging that the manufacturing downturn may be nearing and the equity markets of manufacturing powerhouses, Germany (+2.9%), France (+3.1%) and Spain (+1.2%) all responded positively.



Source: Bloomberg Professional

Asian market performance varied across the region, with the MSCI Asia ex Japan Index advancing 0.2% in November. The Indian SENSEX and the Taiwanese TWSE indices were the top performers, in the region rising 1.7% and 1.2% respectively. China A and H shares underperformed, returning -1.5% and -2.2% over the period. The broader MSCI Emerging Markets Index fell 0.1%.



Source: Bloomberg Professional

Tourism activity in Hong Kong has decreased significantly according to data from the Hong Kong Tourism Board, with just 3.31 million arrivals in October this year, a decline of 43.7 per cent from the same month in 2018. More than five months of anti-government protests have affected Hong Kong's economy, with tourism among the hardest-hit industries. The value of Hong Kong goods and services exports — which includes tourism spending — is nearly double that of its gross domestic product, making the economy particularly vulnerable to a slowdown in visitors.

Real assets

Domestic residential property prices increased by 1.7% over the month, according to the CoreLogic Hedonic Home Value Index. Once again, the gains were primarily driven by strong performances in Sydney and Melbourne, with the two major cities posting 2.7% and 2.2% increases respectively. Sydney has now returned 6.2% for the quarter and 1.6% annually, while Melbourne has returned 6.4% for the quarter and 2.2% annually.

The federal government announced plans to bring forward A$3.8 billion worth of infrastructure projects in order to help stimulate the struggling domestic economy. The federal government had previously asked state Treasurers to nominate projects with start dates that could be brought forward. In the end, upgrades to the Gold Coast Light Rail, M1 highway in Queensland, Tonkin highway in Western Australia, Princes highway in New South Wales and the Monash highway in Victoria were all approved. The federal government had been facing pressure to stimulate the economy given record low interest rates, stagnant wages and rising unemployment.

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