END OF QUARTER REVIEW.

Dec 2018

Market review

World equity markets in calendar 2018 have gone through various mini-cycles with periods of subdued investor confidence alternating with periods of renewed optimism. Over recent weeks, investors have primarily been focussing on two main concerns: the prospect of an economic disruption from an intensified tariff war between the U.S. and China, and the potential for the U.S. economy to slow down in 2019 as the fiscal boost from the Trump tax cuts fades away. There has also been a slew of other worries, including slower Eurozone growth and Brexit globally and the ongoing Banking Royal Commission in Australia.

As anticipated, the US Federal Reserve also raised its benchmark interest rate range a quarter of a percentage point to between 2.25%-2.5%—the move marked the fourth increase this year and the ninth since it began normalising rates in December 2015. Recently, the flattening US yield curve also has been receiving a lot of attention with the 10-year Treasury note yield only around 15 basis points above the 2-year note—triggering potential fears for a slowdown in global economies, particularly the USA. But it's worth noting that the US unemployment rate is currently at 3.7%, weekly jobless claims are at a 49-year low, and wages are growing at their fastest rate since 2009.

Over 2018, the MSCI World Index fell 11.2% to 456 points, the S&P 500 dropped 6.2% to 2,507 points, and the S&P/ASX 200 finished the year down 6.9% to 5,646 points. China's Shanghai Composite underperformed rest of the world, falling 24.6% to 2,494 points on the back of slowing growth in China with the authorities' easing monetary policy while continuing to pay close attention to the risks in the financial sector.

Domestically, the sharemarket has remained volatile in recent few weeks as on top of soft global equity sentiment, the financials have continued their weak run with further revelations from the Royal Commission along with an uncertain Australian political backdrop with Scott Morrison replacing Malcolm Turnbull as Australia's 30th Prime Minister on 24 August 2018.

The Communication Services sector was the weakest this year, down 21.4%—primarily on the back of a 21.5% decline in Telstra shares. The ongoing Royal Commission and its related findings weighed on the banks—driving the Financials sector 14.8% lower. The Healthcare sector set a rare example which was clearly ahead for the year— rising 17.3% driven by a 31.0% surge in the biotechnology giant CSL.

During the course of 2018, the Australian Dollar varied from a high of US81 cents to the current ~US70 cents, as the effects of an increasing global interest rate outlook and falling commodity prices played off against one another. In commodities, oil prices remained volatile on the back of wider global uncertainty and supply concerns. The quoted Brent oil price rose from US$67/barrel from end of calendar 2017 to a high of US$86/barrel on 3rd of October 2018 before falling sharply to finish the year at US$54/barrel.

On the political front, the next Federal Election is due to be held by May 2019 and there is an increasing chance that Labor is elected into Government based on current opinion polls. This has resulted in increasing scrutiny over the potential impact of various ALP policies such as the proposal to scrap the cash rebate when franking credits exceed tax paid, restrictions on negative gearing of property, and capping annual private health insurance premium increases at 2%.

Investment Environment

In the last meeting for the year, the Reserve Bank of Australia (RBA) has maintained its benchmark cash rate at an historic low of 1.5% on the back of below-trend economic growth and some signs of a slowdown in global trade, partly stemming from ongoing global trade tensions.

The Australian economic growth edged lower to 2.8% (down from 3.1% in the prior 12 months) largely due to softer construction and capital expenditure and a slowdown in the housing sector. The underlying inflation rate at 1.8% continues to sit below the bottom of the Reserve Bank of Australia (RBA) target range of between 2% and 3%—supporting RBA's decision to keep the cash rate steady at 1.5% (which has been the case since August 2016). The RBA last raised the official cash rate in November 2010 and the current yield curve indicates rates are likely to remain on hold for the next 12 months or so.

Nevertheless, the outlook remains encouraging and looking ahead, we are forecasting the Australian economy to grow by around 2.7% in both 2019 and 2020. Business conditions remain largely positive and non-mining business investment is expected to increase along with higher levels of public infrastructure investment which is likely to support the economy along with growth in resource exports.

Share Market Outlook

All up, we see this year's market performance as a reset to slowing economic growth and earnings expectations globally as markets expect US fiscal fade in late 2019 along with lagged monetary tightening in some major economies. All recent events indicate there is a potential for market rebound following correction at some stage during the course of 2019 although volatility is expected to remain high.

The Australian share market is currently valued on a forward consensus price earnings ratio of 13.8x, which is 6.1% below the long term average of 14.7x. The forward consensus dividend yield for the Australian share market is an attractive 5.0% (80% franked) and this also continues to attract investors searching for yield, particularly given the very low interest rates that currently prevail.

With strong market earnings growth forecast in FY19, and undemanding market valuation, we continue to see scope for the Australian share market to deliver a reasonable return over the next 12 months as measured by the S&P/ASX 200, to reach our target of 6,350 in mid-2019, which is ~13% above the 31 December 2018 close of 5,646 (excluding dividends).

The 2019 Favoured Stocks

Our preferred stocks for calendar 2019 (in alphabetical order):

A global company providing analytical testing services for the environmental, food, pharmaceutical and electronic sectors; asset care and tribology testing services for the energy, resources and infrastructure sectors; and analytical testing services for the mining and coal sectors.

The company should benefit from a continuing recovery in the overall resources sector and ongoing growth in the food safety and pharmaceutical testing sectors.

A refiner, importer and marketer of transport fuels and lubricants — it owns the Lytton crude oil refinery in Brisbane and the Kurnell import terminal in Sydney and has a network of around 2,000 company owned, franchised or affiliated service station sites.

The group is also a major player in convenience retail stores, which are located at its service station sites, and management believes that there is "a significantly untapped opportunity" in this sector.

A financial group comprising a Life Company, which specialises in retirement income products and annuities and accounts for most of the group's earnings, and a funds management business.

As baby boomers continue to move into retirement, it is inevitable that annuities will become a major and rapidly growing product.

A leading global company in the development, manufacture, and distribution of plasma therapies as well as non-plasma biotherapeutic products.

The global growth in plasma volumes is expected to be around a solid 8% per annum for the foreseeable future and, in addition, the group is planning to launch new products from its very extensive Research and Development portfolio.

One of the world's largest integrated industrial property groups with operations centred around development, management and ownership throughout Australia, New Zealand, Asia, Europe, United Kingdom, North America, and Brazil.

The long term outlook for industrial and logistics properties is favourable given the continuing growth in ecommerce (or on-line retail sales) and the growing middle class in developing countries.

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A global financial group providing clients with five key services across asset management, corporate and asset finance, banking and financial services, commodities and global markets, and capital advisory and raising services.

The group is well positioned with its very diversified operations to adapt to changing economic and financial market conditions.

A specialist investment platform technology provider in Australia that offers investment management solutions to financial intermediaries, who provide financial advice on superannuation and other investments, and self-directed individuals who have chosen not to seek advice.

In recent years, the group has been taking market share from the institutional platform providers such as the major banks and other large diversified financial companies. Looking forward, a structural shift within the wealth management sector from large vertically integrated players towards the more independent players should further boost the group's growth outlook.

The group has a 29% interest in the PNG LNG Project, which is currently producing at a rate of 8.9 mtpa from two trains, and is in active discussions to participate in the proposed development of three new LNG trains with a total capacity of 8 mtpa at the existing PNG LNG plant site.

The group also has an interest in some Alaskan (North Slope) oil fields with material upside potential from exploration and appraisal drilling.

The world's third largest pathology provider with significant operations in the USA, United Kingdom, Germany, Switzerland, Belgium, Australia and New Zealand.

Against the backdrop of continuing growth in the demand for pathology services over the longer term, the group has further international expansion opportunities in both existing and new geographical markets.

The group operates supermarkets, liquor stores, discount department stores, and hotels. It is Australia's largest grocery retailer and accounts for around 38% of the food and liquor retailing market.

Management has recently sold the petrol business for $1.725 billion and capital management initiatives are being considered.

Note: refer to our latest company research and contact your adviser for more information.

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