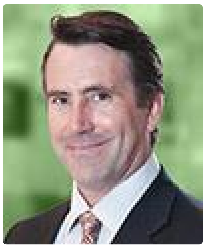
Outlook for Australian shares in the New Financial Year



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Focus on reliable dividend payers, offshore earners with stronger growth prospects.

Knowns and unknowns: it’s jargon that Donald Rumsfeld famously used, and it is finding its way into financial markets and investing. The term can be traced back to a 13th-century Persian poet, who said there are four types of men:

- One who knows and knows that he knows … his horse of wisdom will reach the skies.
- One who knows but doesn't know that he knows … he is fast asleep so you should wake him up.
- One who doesn't know but knows that he doesn't know … his limping mule will eventually get him home.
- One who doesn't know and doesn't know that he doesn't know … he will be eternally lost in his hopeless oblivion.

We can never ride the horse of wisdom for long, but we can own the mule to get us home.

The 2018 financial year has been a relatively good one for investors in Australian equities, particularly those that have stayed away from the large banks and Telstra. The total return for the financial year at the time of writing is plus 10.8 per cent, although energy and resource stocks, in particular, have enjoyed returns three or four times these levels.

This time of the year is notoriously known as confession session as companies often find that as they approach the end of June cut-off for their accounts, their guidance or even the consensus earnings estimates from the broking community will not be met.
Investment managers are already focusing on the next results season in August and beyond to 2019.

Outlook for 2018-19

As we look forward into the New Financial Year (FY19) we come back to the known knowns.

Domestically, the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry has dominated headlines since the second round of public hearings began. It has proved to be a turning point for the financial services industry, exposing more issues than most market participants expected.

The scope and fallout from the Royal Commission is much worse than we or the market may have been expecting, with major repercussions for executive management teams and boards, including those at AMP and Commonwealth Bank, and negative share price reactions have reflected this.

The current timetable is for a final report of recommendations in February, which is of importance to the Australian sharemarket because of the large proportion of the listed market the banking sector represents.

Neatly coinciding with these outcomes is the next known, a federal election in Australia due before 18 May 2019. The differing policies of the two major parties, including on issues such as franking credits, could have significant unintended consequences for investment markets.

At a recent conference that more than 100 Australian listed companies attended, the tone was cautiously optimistic on the domestic economy, highlighting that macro-economic indicators such as unemployment and population growth are continuing to remain supportive, with costs still a key focus for most management teams.

We are always looking for a balance between companies with domestic earnings that produce fully franked dividend streams we can pass on to our shareholders, and the companies that are investing and operating outside Australia.

This gives us greater diversification beyond the opportunities in the domestic economy and if they can succeed overseas (which is certainly not guaranteed), a sustainable growth pathway is developed in international markets, which are many multiples the size of Australia. One of the best examples is CSL, which is a world leader in a global market.

Focus on offshore earners

We believe that successful offshore earners will continue to do well.

International economies continue to perform well, with most economic indicators looking positive and the Donald Trump presidency delivering on US tax cuts, which are significantly boosting US company earnings.

While the US Federal Reserve is going to continue to lift interest rates throughout 2019, some of this expectation is already being seen in bond markets, with the US 10-year Treasury trading at 3.1 per cent, a level not seen since 2011. Debates about rates of inflation in the economy will persist and any acceleration in the pace of rate rises from the US Fed could be dangerous to assets.

Geopolitical noise between US, China, North Korea and Russia is likely to continue around trade and sanctions. However, it seems markets are becoming much less sensitive to these risks and events.

As always, no forward thinking is worth considering without China and its impact on the global economy. We remain optimistic on the overall outlook for China and, by default, commodity demand, including oil.

China is continuing to reform and is making progress in shifting its economy from one based on government spending, state-run companies and low-cost exports, towards private investment, entrepreneurial innovation and domestic consumption.

Additionally, China is undertaking what are sustainable supply-side reforms and a “war against pollution”. President Xi Jinping signalled in his speech to the 19th Party Congress in October that officials should take environmental issues seriously: “The damage that humanity does to nature will ultimately harm humanity itself – this is an unavoidable rule.” We have already seen tangible evidence of this policy with some of the more heavily polluted industries fined, and closures.

The other side of this is the Chinese efforts to lead in the development of electric vehicles and a focus on innovation, information technology and robotics. For example, the Chinese Government is targeting two million new electric vehicles on the road and annual sales approaching five million by 2020.

Battery demand, and the commodity demand required for them, is likely to remain a hot topic. Australia has several companies developing and exploring for lithium, cobalt and other battery-related commodities. These companies are seeing investment from further upstream, being the battery manufacturers as they look to lock in supply.

Of course, the biggest impact on the market in the next 12 months will be something we have not forecast or perhaps not even thought about. With markets trading at relatively high levels, consumer debt being high and wage growth low, there is not a lot of margin for error if we encounter one of the unknown unknowns.