



# A Challenging Market Environment Despite the Rebound

We expect concerns over trade and global economic slowdown to dominate markets in the short term.

June 2019

- A strong Australian equity market combined with signs of global weakness and a sluggish domestic economy saw us turn more cautious near term.
- Consequently, we increased cash and reduced portfolio beta. The market has an attractive dividend yield, inexpensive valuations, and a domestic economy that can still deliver profits to investors.
- We continue to see good opportunities in stocks with Chinese consumer exposure and select multinational structural growth stocks.



**Randal Jenneke**  
*Head of Australian Equities,  
T. Rowe Price Australian  
Equity Strategy*

Macro forces have been the dominant feature of the Australian equity market over the past nine months, as we bounced from U.S.-China trade/tariff tensions, to local political drivers (Scott Morrison's surprise election victory), through to central bank policy changes (a dovish pivot from the Reserve Bank of Australia (RBA) and the Fed). This has resulted in a challenging period for active Australian equity managers, particularly high-conviction stock pickers like us, who look to stock selection as the predominant source of alpha rather than top-down macro factors.

The Australian equity market has been surprisingly strong in 2019, up 19.6% total return year-to-date and one of only three markets to post positive returns in May, after the surprise LNP Coalition election victory midmonth. Despite this, a combination of strong performance year-to-date and rising external risks has made us turn more

cautious near term. We increased cash and reduced exposure to high-beta, economy-sensitive stocks and added to more high-quality, defensive, lower-beta stocks. The net impact had been to increase the quality of our "quality growth" portfolio to its highest level ever.

These changes were intended to protect against another sell-off while maintaining our positions in high-quality companies that we expect to drive alpha over the medium term. We still see good opportunities in stocks with exposure to the Chinese consumer and select structural growers with significant offshore earnings.

## **Trade and Tariffs Remain the Key Threat for Australia**

The breakdown in U.S.-China trade talks remains the biggest threat to global markets. We expect concerns over trade and a global economic slowdown to continue to dominate markets in the short term. The recent

# 19.6%

Total return  
year-to-date for  
Australian equities,  
one of the world's  
best-performing  
markets.

collapse in yields only reinforces these fears. The risk is that the longer the current impasse continues, the more collateral damage there is likely to be to the global economy. History shows that spikes in policy uncertainty can weigh on consumer and business sentiment. Companies respond by reducing inventories and capex plans, with adverse consequences for gross domestic product (GDP) growth and employment. The global economy is considerably less robust today than 12 months ago. So any negative spillovers from U.S.-China trade fears are coming at a very inopportune moment.

### A Difficult Time for Quality Growth

Our portfolio delivered solid absolute performance over the past six months, but in relative terms, it lagged behind the strong Australian equity market. The market rally in 2019 has largely been driven by a rerating of previous large-cap laggards (the big four banks and Telstra), iron ore commodity names, a basket of deflation trade beneficiaries (notably bond proxies), and aggressive growth tech names. Many high-quality businesses have been left behind in this rally. The reelection of the LNP Coalition government and coordinated policy easing by the RBA and the Australian Prudential Regulation Authority (APRA) may have removed some of the tail risks

from the housing market, but growth is still expected to continue to be subdued for some time.

Not surprisingly, the stocks that rebounded the most after the election were the ones that were previously expected to be the main losers under a Labor government. This included the banks, building materials, discretionary retailers, and property-related stocks now that the uncertainty created by Labor's proposed negative gearing policy has been removed. We also expect this will diffuse the standoff that has persisted between buyers and sellers in the housing market seeking clarity on capital gains tax changes and negative gearing.

We believe the recent bounce is a temporary reaction and are comfortable to stay underweight the banks and domestic cyclicals given our long-held concerns over the housing market, which, despite the intervention by the RBA and APRA, is likely to stay weak. We also remain concerned about growth prospects for the domestic economy following a weak set of first-quarter GDP numbers.

Wide swings in macro and market drivers have seen autocorrelation in style leadership turn sharply negative in recent periods. In layman's terms, investment

## (Fig. 1) Global Equities: Style Performance Has Been Volatile Recently

MSCI World Index monthly style correlation has turned negative

As of March 31, 2019



Sources: Macquarie Research and MSCI (see Additional Disclosures). The above chart looks at 10 Macquarie styles each month, ranks them by their information coefficient, and compares this with the prior period ranks. The plot is a 12-month average of this correlation.

“Wide swings in macro and market drivers are reflected in investment styles that have struggled to outperform on a consistent basis. History suggests such periods don’t last too long.

— Randal Jenneke  
Head of Australian Equities,  
T. Rowe Price Australian  
Equity Strategy

styles have struggled to outperform on a consistent basis. The violent rotation and sell-off in the fourth quarter of 2018 is the best example, when almost all investment styles underperformed.

### **Markets Respond Favorably to LNP Election Win**

The Morrison administration’s surprise victory on May 18 shows that Australians voted to continue to “grow the pie, rather than cut it differently.” The Australian public voted for growth and jobs over a more radical policy agenda offered by the Labor Party. This message came across loud and clear, particularly from the outer suburbs of our capital cities and regional and rural areas. In particular, the proposed franking credit change seems to have been a key factor in many electoral districts. The clear election outcome rewarded investors with a short-term bounce across most sectors. As the excitement fades, the market’s focus is expected to return to more fundamental factors, such as the ongoing trade and tariff tensions between the U.S. and China and domestic housing weakness.

### **Coordinated Policy Easing to Support Housing Sector**

While we have been worried about the tightening of credit conditions, one thing which is interesting is that straight after the election, we have seen coordinated policy easing from the RBA and APRA. APRA said they were looking to ease the rate that banks use for stress testing mortgages from the current level of 7.25% to 250bps above the mortgage rate, which is currently less than 7.25%. In May, Governor Phil Lowe had strongly hinted that the central bank was considering lowering interest rates. A 25bp cut in the cash rate to 1.25%, a record low, duly followed at the June meeting. Why are the monetary authorities doing this? We believe they are trying to put a floor under growth, and to succeed in that, you first have to put a floor under housing. A subpar first-quarter GDP report released on

June 5 suggests one should not place too much hope in an early rebound as the Australian economy remains sluggish.

### **Market Sell-Offs Provide Opportunities to Stock Pickers**

Market performance from here on is expected to be driven primarily by earnings rather than multiple expansion. Our base-case scenario for Australia remains one where economic growth remains subdued in the second half of the year, and this in turn flows through to corporate earnings. Markets will be watching earnings revisions very closely. Much like the end of last year, a volatile environment is likely to create some good opportunities for longer-term investors like ourselves. The panic fourth-quarter sell-off and divergent trends in the first-quarter rebound had indeed provided opportunities to add to positions in a number of quality growth stocks that appeared oversold while also bringing some new names to the portfolio at attractive valuations. This enabled us to significantly increase the highest-quality component of our portfolio.

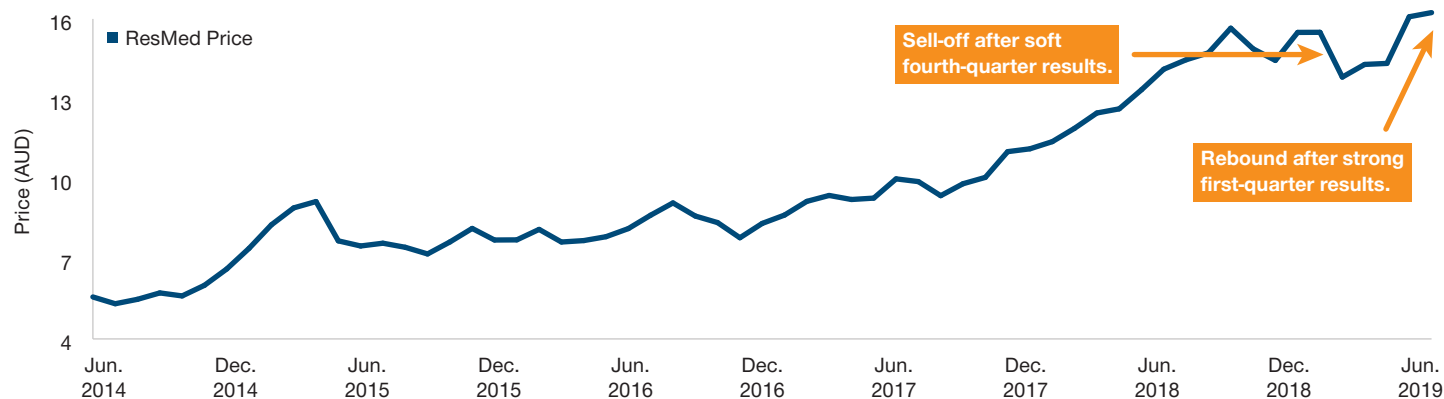
Leaning into controversy and market uncertainty has kept us busy over the last six months, where we have been taking advantage of the market volatility. We believe that through increasing our cash levels, tilting the portfolio to include select high-quality defensive names, and increasing our holdings in some of our high-conviction, quality growth names in weak markets, we are setting the portfolio up for stronger performance over the longer term and providing some downside protection if we see another market sell-off.

This is best reflected in the recent sell-off and rebound in ResMed, the highest-conviction name in our portfolio. We added substantially to our position, doubling our overweight in ResMed following an overreaction in late January to a weaker-than-expected profit announcement. This stance has been vindicated by the solid set of results

## (Fig. 2) Taking Advantage of Volatility—ResMed

ResMed share price

As of June 5, 2019



Source: ASX.

“We believe RBA easing removes the tail risks from the housing market and expect to see property stabilise in the second half of the year, with some limited improvement in domestic growth.

— Randal Jenneke  
Head of Australia Equities,  
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posted by ResMed in May, which saw the share price significantly outperform.

### Conclusion

The combination of very strong Australian equity market performance year-to-date and rising risks, particularly the deterioration in U.S.-China trade negotiations and emerging signs of global economic weakness, has seen us turn more cautious on equity markets in the near term. Consequently, we increased the cash position in the strategy; reduced our weighting to higher-beta, more economy-sensitive exposures; and increased our weighting in select, more defensive, high-quality, lower-beta names. These actions, combined with topping up existing positions, had seen the highest-quality component of the portfolio reach an

all-time high and raised the overall quality of the portfolio.

On the positive side, the Australian equity market continues to draw support from a number of features, including an attractive dividend yield of 4%–5%, valuations that are not historically expensive, and a services-oriented domestic economy that, housing apart, is in good shape that can continue to deliver profits to investors. We continue to see good opportunities in stocks with exposure to the Chinese consumer and select multinational structural growers with big offshore operations. We maintain our overweight positions in health care, industrials and business services, and consumer staples. Our fundamental approach remains unchanged, and we continue to favor high-quality structural growth stocks.

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