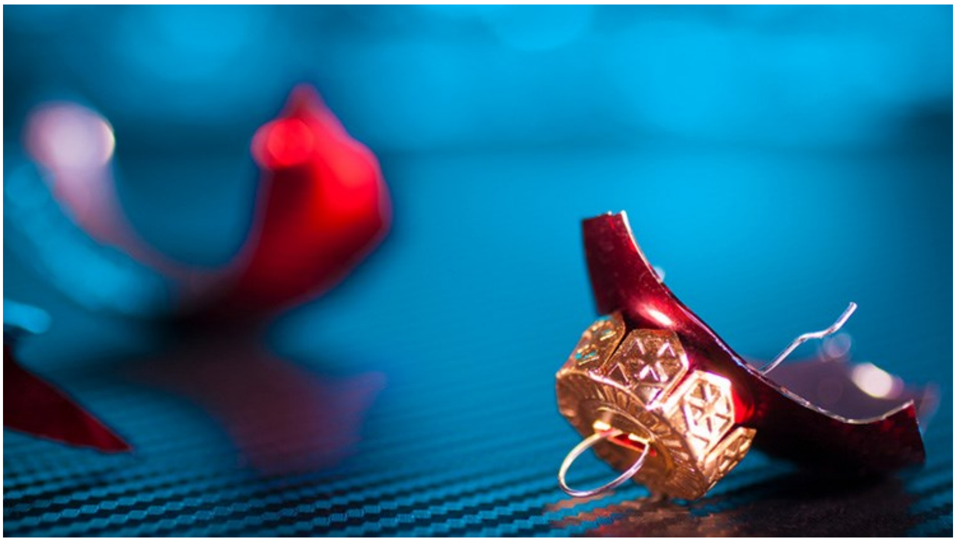
SANTA RALLY LOOKS UNLIKELY



PERPETUAL PRIVATE INSIGHTS
16/12/2018

Despite strong economic and corporate fundamentals, share investors are unlikely to enjoy a "Santa Rally" this year, but will markets rise when geopolitical risk fades? Here's the Perpetual Private Direct Equity team's view.

With the current geopolitical environment so fraught, investors are climbing a 'wall of worry' once again. From October, volatility has become more visible in daily market movements. Indeed, in the last two and half months, there have been 15 trading days with greater than a 1% move.

Traders, assuming the worst, sell first in these conditions. Long term investors tend to go on a "buyer's strike" as they wait for clarity.

Globally, political instability is rife and remains a primary source of uncertainty. The US-China trade war, Brexit and the looming Australian Federal election are key focal points.

Bad feedback

After a long, slow-burning equity market boom, market volatility is returning and starting to create a negative feedback loop. Recently investors have begun to worry that global economies are susceptible to recession. Paradoxically, whereas two months ago US bonds were selling off on the fear of rising inflation (seen as negative), now we see them rallying to reflect expectations of an emerging recession.

However, US inflation remains low and unemployment at 3.6% is the lowest it has been since 1969. Fundamental economic factors and corporate health simply do not point to an imminent recession, notwithstanding rising interest rates.

The US Federal Reserve Chairman, Jerome Powell, recently commented that monetary settings were nearing a neutral position, which indicates a willingness to slow the pace of rate rises if required. Nevertheless, investor sentiment seems to be unanimously incorporating the end of the current cycle with financials and cyclical businesses (e.g. banks, housing, consumer) being sold down indiscriminately. In our view, such actions appear premature and unwarranted.

In Australia, the market is now down around 13% from its August peak. To put that into context the market was up 33% since February 2016.

The prospect of a “Santa Rally” in the stock market is fading fast, the longer this major market correction continues. What is desperately lacking is a circuit-breaker that shifts investors’ myopic focus on political drama onto corporate and economic fundamentals which, to date, remain sound.

The timeframe for a reset now appears further, which could extend for up to 3-6 months. However, once this occurs, we continue to believe that the market can maintain growth, although at a more subdued pace.

Looking past the politics

In our view, despite an expected continuation of (normal) trading volatility, it is quite conceivable that Australian shares deliver total returns of 10% in 2019. That’s compared to -3% to date in 2018 and 7% per annum over the last 3 years. For this to occur however, it requires that consumer confidence (globally) holds up through the uncertainties that will continue into the first quarter. Ultimately, some more political stability is required one way or another.

While we acknowledge a higher level of risk, we do not believe that this is the beginning of a prolonged bear cycle. Where we find the opportunity, we will look to add more defensive exposures to our Perpetual Private Direct Equity portfolios. For example, we have recently added to our Coles holding following its demerger from Wesfarmers.

In uncertain times – more than any other time – you need to maintain investment discipline. Perpetual Private will stick with our rigorous screening process and employ our time-tested Protect and Grow investment philosophy which seeks quality companies at a reasonable valuation.

In volatile markets no company is immune to the effects of poor market sentiment. But it is the quality companies - with strong market positions, conservative levels of debt and solid management teams - that are first to bounce back. These companies are also more able to maintain the income paid to shareholders and sustain growth through the cycle. Investing in these types of companies - sticking to our knitting - has delivered above-market returns for Perpetual Private investors over the medium to long-term.