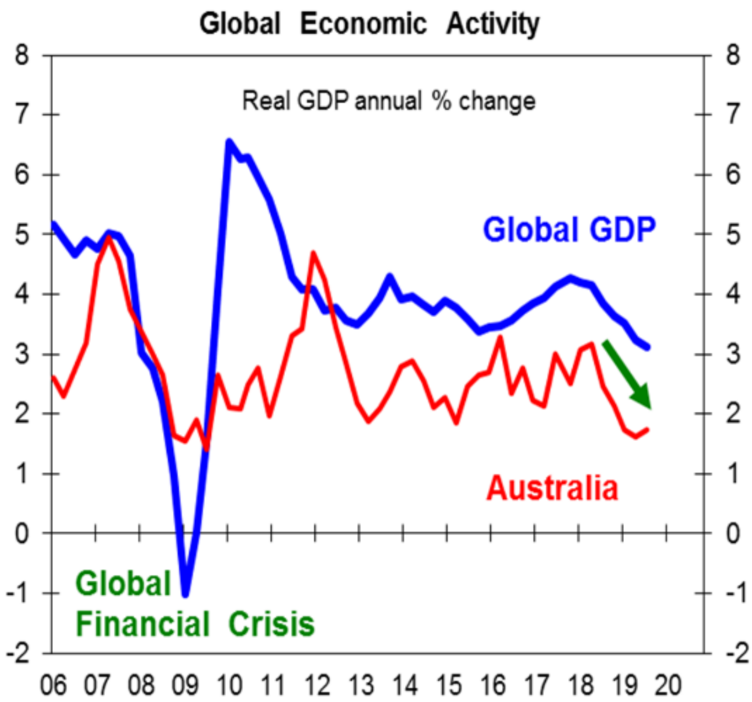
How good were Australian equity markets?

December 2019

Despite the slowdown in global growth in 2019 and numerous issues such as the ongoing US-China trade dispute and Brexit, markets delivered significant returns to investors. Share investors, in particular, were handsomely rewarded with most developed markets recording double digit returns, although these returns were measured off a low base as markets lost considerable ground in the December quarter 2018. Despite modest earnings growth, markets were underpinned by more monetary easing with very low interest rates (or negative rates as in Japan and Europe) plus widespread stimulus by central banks. Low inflation remains the norm across the developed world as central banks struggle to get inflation back up to their respective targets, leading to calls for more government spending to improve economic growth. The strength of investment returns in 2019 contrasted sharply with the considerable complexity in the global environment.



Source: MLC asset Management Services; January 2020

Another mixed report card for Australia's economy

Australia's economy remained in the 'slow lane' for much of the year, forcing the RBA to reduce the cash rate by 0.25% on three occasions to a record low of 0.75% by year's end. Australia's economic growth fell to an annual rate of just 1.4% for the year to 30 June, the slowest annual growth recorded since the GFC in 2009. The growth rate recovered to 1.7% for the year to 30 September but remains below the economy's growth potential. Inflation remained subdued and stubbornly below the RBA's preferred 2-3% band.

Comments by the RBA late in the year point to further interest rate cuts in the new year if sluggish economic conditions prevail. This is understandable as evidence of soft economic conditions has been widespread in both consumer and business segments of the economy. The NAB Monthly Business Survey saw business confidence and conditions weaken through the year. The deterioration was evident in most industry sectors with retail confidence being particularly weak. While there was a small improvement in business conditions and confidence late in the year both remain under average levels.

Consumer sentiment also deteriorated as evidenced by the Westpac-Melbourne Institute Consumer Sentiment survey which fell through much of the year. This was consistent with the weakness seen in other consumer oriented economic indicators. Traditional retailers continued to struggle as retail sales grew by only 2.1% in the year to 31 October and new car sales have fallen for twenty consecutive months. Consumers have been concerned about house price weakness and low income growth at a time of high household debt. The reluctance of consumers to spend occurred despite the benefit of income tax relief announced in the Federal Budget for low to middle income earners and the RBA cutting the cash rate to only 0.75%. The RBA has acknowledged this year's interest rate cuts may have increased consumer anxiety.

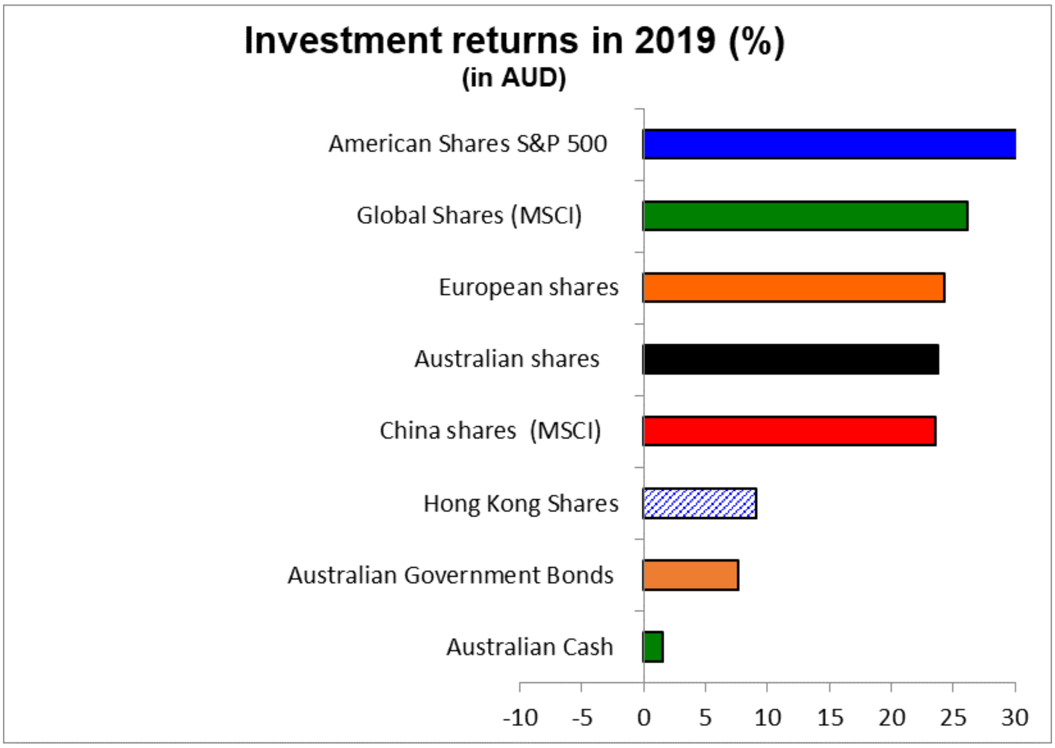
Spare capacity in the labour market remains elevated and continues to constrain wages growth, adding to the challenges facing many indebted Australian households. Wages growth was just 2.2% through the year (to 30 September) as the unemployment rate increased to 5.2% (November) and the underemployment rate, which measures part-time workers who want to work longer hours, remained high at 8.3%. The underutilisation rate of 13.5% (unemployment + underemployment rate) was 0.2% higher than last year. The serious drought affecting much of the country has adversely impacted farm income, cutting 0.2% from the economy's growth potential.

Residential property values rebounded in the second half of the year after a weak first half. The national median dwelling value was up 2.3% in the calendar year (as measured by the Core Logic survey) with both Sydney and Melbourne enjoying the highest annual gain of 5.3% over the year. However, prices continued to fall in Perth (-6.8%%) and Darwin (-9.7%). Despite the recovery in 2019, residential property prices in all state capitals except Hobart and Canberra remain below their 2017 peaks. The improvement in property indicators such as auction clearance rates and housing loan approvals point to further price recovery in the new year.

Despite the recovery in residential values, residential construction remained weak. Approvals for the construction of houses fell 15.1% in the year to 31 October 2019 while apartment construction approvals were down by 23.5%. The value of residential construction work done in the year to 30 September was down by 10.1%. The RBA expressed concern that further sizeable falls in housing prices could weaken retail conditions even further as consumers limit their spending.

Australia's terms of trade (the ratio of export prices to import prices) improved through the year, due in part to higher prices for key Australian exports. The iron ore price was up by 32.2% over the year after the tailings dam collapse in Brazil curtailed global supply.

But our share market performed exceptionally well
Australian shares returned 23.4% in the year to 31 December 2019. This was a pleasing outcome compared to the -2.8% return in 2018. However, this year's return is abnormally high because it is measured off a low base as the December quarter 2018 was one of the worst quarters for markets since the GFC.



Source: Bloomberg, MSCI; January 2020

Our market began the year with seven consecutive monthly gains through to July. Further evidence of challenging conditions in the Australian economy raised expectations the Reserve Bank of Australia (RBA) would need to reduce interest rates, which it subsequently did on three occasions (June, July, October). This was particularly favourable for the Australian share market. The market also responded positively to the re-election of the Coalition

LNP Government as Labor's proposed capital gains, franking credit and negative gearing changes would not be implemented. Prior to the election in May, share investors benefitted from many companies deciding to clear undistributed franking credits via special dividends or share buybacks ahead of a possible change of government.

The performance of the market in the second half of the calendar year was less consistent with falls in August (-2.4%), October (-0.4%) and December (-2.2%), partly diluting very positive returns in July (2.9%), September (1.8%) and November (3.3%). The lacklustre profit reporting period in August/September plus ongoing uncertainty about the US-China trade dispute and its impact on the global economy contributed to this volatility.

All industry sectors recorded positive returns but there were notable highlights and lowlights. Healthcare (43.5%) was by far the best sector performer for the year as investors were attracted to companies such as CSL (48.9%) for their superior earnings performance and growth potential. Consumer Discretionary (32.4%) outperformed despite the weak retail environment as retailers such as JB Hi-Fi (70.1%) and Harvey Norman (32.1%) were expected to benefit from the Federal Government's income tax cuts. Aristocrat Leisure (54.2%) also contributed to the sector's superior performance. Telecommunications Services performed well (27.3%) as Telstra's share price improved by 24.2% amid signs of a more benign competitive environment following the decision of the Australian Competition and Consumer Commission to block the proposed merger of two rival companies. The low interest rate environment raised the attractiveness of sectors such as Australian Real Estate Investment Trusts (REITs, 19.4%) because many REITs have provided growing income and a distribution yield higher than government bonds and term deposits.

Resource based sectors also performed well. The 27.2% return of the Materials sector reflected good performances by iron ore miners who benefitted from higher iron ore prices after a tragic tailings dam collapse at a major Brazilian mine cut global supply at a time of elevated demand. Fortescue Metals Group was a standout performer with a rise of 173.4% compared to the more modest returns of BHP Group (13.7%) and Rio Tinto (27.9%). The performance strength of gold producer Newcrest Mining (38.8%) as the gold price increased by 18.9% also contributed to the Materials sector return. The Energy sector returned 22.9% as the oil price was higher by 22.7% (Brent Crude) due to concerns growing tensions in the Middle East could disrupt supply.

The Financials ex-AREITs index returned 13.5%, underperforming the market's return by a significant margin. The four major banks and AMP had to contend with a multitude of issues that had both reputational and financial implications. The Banking, Superannuation and Financial Services Royal Commission released its final report in February, with criticism resulting in the resignation of National Australia Bank's Chairman and CEO. Fears that banks' and AMP's earnings and dividends could be impacted by substantial remediation and compliance costs as well as the weaker economy and housing sector also contributed to their underperformance. Late in the year, Westpac's CEO resigned following the launch of civil proceedings by AUSTRAC in relation to multiple transactions that are alleged to contravene the Anti-Money Laundering and Counter-Terrorism Financing Act. Commonwealth Bank (10.4%) was the best performer of the four major banks while AMP shares (-21.6%) reached a historic low during the year.

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