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Media Update
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Martin Currie Midyear Market Outlook: Focus on Australia, Global and Emerging Equity Markets

Australian equities supported by rate cuts, with income opportunities still in focus.

Emerging markets equities have potential for improvement, despite bumps from tariff concerns short-term.

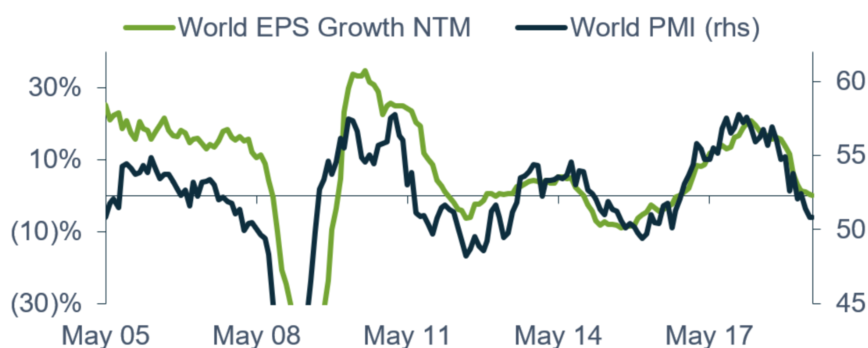
Martin Currie, an investment affiliate of Legg Mason, notes that Australian equities will continue to be impacted by global themes.

More:

The global Purchasing Managers' Index (PMI) has been in decline since 2017. Combined with the heightened risk of a prolonged US-China trade war; this has caused global interest rates to decline and for the US Federal Reserve to halt any further tightening of monetary policy. This has resulted in a significantly more dovish outlook for global economic growth and policy settings.

Related to this trend is a continued reduction in the rate of growth in global earnings per share (EPS). By the end of 2019, the current trend in global earnings may result in negative EPS growth, supporting the very low level of interest rates.

World EPS growth and PMI



Source: Martin Currie Australia, Factset; as of 31 May 2019.

Against this backdrop, central banks, including the Reserve Bank of Australia (RBA), have had no choice but to adopt an easing bias with interest rates, and the RBA has recently started to ease policy again, cutting the cash rate to an historic low of 1.25% in early June.

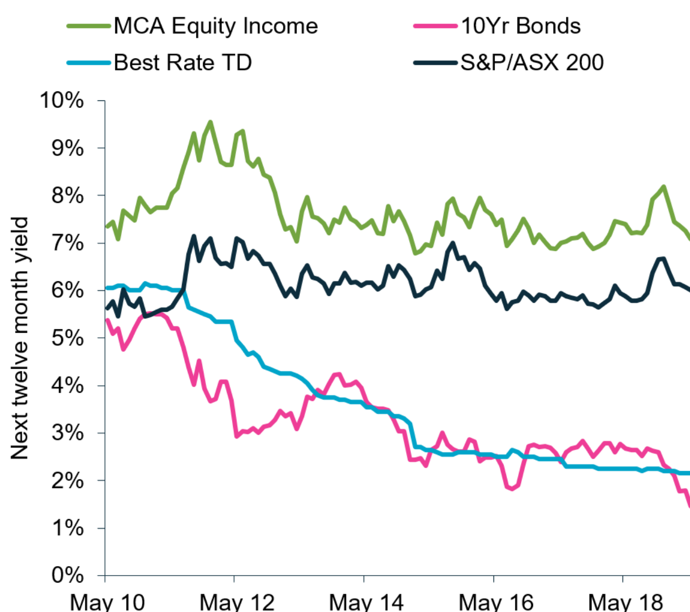
A stabilisation in the global PMI (as compared to further deterioration) is now a critical point. Improved trade negotiations between the US and China that have recently been reported will be positive for equities and the global PMI. For Australia, the stimulus from tax cuts, interest rate cuts, an easing in financial conditions for residential lending and improved consumer and business sentiment, coupled with an improved PMI, should be very supportive for equities.

Australian Equities supported by Lower Interest Rates

The reduction in the Australian cash rate to a record low of 1.25% is positive for investment in the Australian equity market. Given that the yield spread for Australia equities to the best rate term deposit or the 10-year bond is now at a post-GFC high, we expect investors to continue to favour assets such as Australian equities that will help deliver required income with the appropriate level of risk.

The following graph illustrates the expected franked yield for the Martin Currie Australia Equity Income strategy. At 7.1%, it also well above the broader equity market due to its focus on high quality businesses, with solid track records of paying sustainable dividends throughout the business cycle.

Yield comparison – Equity Income Fund



Past performance is not guide to future returns. Source: Martin Currie Australia, FactSet; as of 31 May 2019. Data calculated for the representative Martin Currie Australia Equity Income account. Next 12 Months (NTM) Income yield is calculated using the weighted average of broker consensus forecasts of each portfolio holding – because of this, the returns quoted are estimated figures and are therefore not guaranteed. Assumes zero percent tax rate and full franking benefits realised in tax return.

The manager sees investment opportunities in Income and Cyclicals

"We believe that the best opportunities are currently income generating assets with strong free cash flows and reasonable return on invested capital. These tend to be real assets such as utilities, infrastructure and retail shopping centres. Real assets are defensive, generally provide essential services and often are very dominant in their respective markets. This industry structure is typical in Australia and New Zealand.

"Companies in the consumer staples and discretionary sectors should also benefit from the combined stimulus from the RBA's rate cuts, the government's tax cuts and measures to stimulate housing demand. This also extends to building material companies which are leveraged to growing

infrastructure spend and an expected recovery in housing construction once the current housing market stabilises and the easing of credit flows through to first and new home buyers."

Global Equities

Geopolitical risk will undoubtedly be an important and ongoing focus for the market in the months ahead. This will, in our view, centre around two key areas: first, U.S.-China trade tensions, and second, Brexit visibility (and the ongoing uncertainty of its outcome). The former will feed into the longer-term outlook for Chinese and U.S. economic momentum, and by extension, drivers of global economic growth. Although Chinese authorities have continued to take action this year to avoid a hard landing for their economy, there is the ongoing risk of a weakening of momentum at this stage.

This will in turn lead to a secondary focus for the market on the macro front, namely the need to assess monetary policy actions across the regions. The U.S. Federal Reserve has been more vocal about the potential need for interest rate cuts, as has the European Central Bank, so a more accommodative monetary stance is likely to be a theme for the rest of the year and beyond.

On the economic growth front, leading indicators are weak across all regions, which highlights downside risk to GDP estimates and earnings forecasts. In our view, equity valuations are relatively more supportive in Asia and Europe than they are in the U.S., although the backdrop of weakening economic momentum means that monetary policy assessment has become an important aspect to consider when assessing both direction and style leadership in the market.
Impact of Tariffs

We believe that the current impasse over tariffs has minimal potential to affect the long-term outlook for equity markets. Our view on the long term has not changed – we continue to see a lack of inflationary pressures, and in fact, strong underlying deflationary currents brought by technological disruptions. In this environment, we continue to focus our fundamental research work on finding undervalued companies with attractive, sustainable returns, good growth profiles, and strong balance sheets, as well as those that offer good compounding characteristics over the long term.

The Emerging market opportunity

On a 10-year view, looking at current basic price-to-book (P/B) value versus history, emerging markets in aggregate (as measured by the MSCI EM Index) are at a wide valuation discount compared with world equities as a whole (as measured by the MSCI World Index. This is despite the fact that the EM equities offer very similar profitability and better aggregate profit growth potential. In our mind, this presents a compelling opportunity for long-term investors. What's more, the EM market opportunity (as measured by the EM index) has also undergone a powerful shift in nature, becoming materially less weighted to resources and more weighted to the information technology and consumer sectors over the last 10 years.

MSCI EM vs MSCI World P/B Ratio from 30 Jun 2009 to 30 Jun 2019

Source: Bloomberg, as of 6/30/19. **Past performance is no guarantee of future results.** Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.
Focus on Asia

Looking regionally, there is reason to be positive about China. Valuations are reflecting much of the uncertainty about the trade situation, and longer-term secular growth opportunities are now being mispriced. Indonesia should benefit from more accommodative monetary policy globally; consumer sectors are cycling through the difficult growth environment and the outlook is improving.

Meanwhile, in Hong Kong, while the local economy is more sensitive than most to problems in the overall trade environment, we believe the stock market includes companies with really attractive long-term secular growth characteristics. Apart from the obvious impact of money flows that will be needed to avoid unwanted deviations from benchmarks, we see the inclusion of A shares in major indexes as likely to drive the Chinese equity market forward in terms of corporate governance and a greater focus on ESG factors. We also see further inclusion as likely to drive a further reform and liberalisation of capital markets.

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About Martin Currie
Martin Currie is an independent investment affiliate of Legg Mason, a global asset management firm. Martin Currie is an active equity specialist, driven by investment expertise and focused on managing money for a wide range of global clients. Its approach to investing is simple: it focuses on companies. The integrated investment floor seeks out those companies it believes have the fundamentals to deliver material outperformance on a medium to long-term basis. Once identified, these ideas are moulded into well-balanced portfolios. The firm's approach to portfolio construction reduces and controls macro-factor sensitivity, aiming for client portfolios to derive maximum value from stock insights and for returns to be delivered in a predictable and sustainable fashion.

- Established 1881
- Head office Edinburgh, Scotland
- Martin Currie Australia team has 35+ years of experience managing Australian equities
- Total funds managed as at 30 September 2018: AUD$23 billion

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