

# Monthly Market Update

September edition 2016  
By Ofer Karliner



**Royston Capital**

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As reporting season draws to a close, it has largely been a forgettable financial year for Australian listed companies with earnings down around 8% driven by resources (weighed on by weak Chinese demand), and to a lesser extent, the banks. It was less the performance this year however that has dragged the market down 2.8% in August, but more the dour outlook statements that have highlighted the weak state of the underlying economy in Australia, that was confirmed this week with 0.5% Q2 Gross Domestic Product (GDP) growth, coming in behind expectations, in part by worse than expected terms of trade as export prices were weak.

The RBA decided to cut its cash rate at its early August policy meeting by 0.25% to a record low 1.50% on the back of the low Q2 inflation readings. According to the RBA, annual inflation is forecast to stay below its 2-3% target band all the way out to its most distant forecast for December 2018, which represents, along with the strong Australian dollar, the main reasons that the RBA is expected to cut again this year, most likely in November post the Q3 inflation number.

The US continues to be the standout amongst the major developed economies, with Q2 GDP up to 1.1% annualised from 0.8% in Q1. The underling result may be even better, with consumer spending growing at a strong 4.4% annualised pace, while a rundown of business inventories detracted 1.3% from GDP growth in the quarter. It is now likely strong consumer spending and business restocking will promote much stronger GDP growth in Q3. While we still expect a rate rise in the US this year, weaker than expected non-farm payrolls in August means this may occur later rather than soon.

Despite a number of articles ringing the alarm bell for a China/HK crash and the impact this would have on the Australian Economy, we believe the risk of an imminent collapse seemed to have receded somewhat compared to the beginning of this year, albeit none of the major issues in China have gone away. The base case scenario for most people today is that China will follow the path of Japan over the last twenty years. There will be no obvious market crash (beyond the mini one last year), but China's growth will continue to weaken. The growth drop will be accelerated by a continued decline in people of working age, which peaked in 2012, and as overall population contraction begins, which is expected to start as early as 2018.

We believe the Chinese currency (RMB) in particular is not defensible at current levels. While in the minority, we have seen economists who are suggesting that the currency should be trading at a fair value of USD 1 = RMB 9 or 12 vs the current rate of 6.6. Perhaps as a result of this, the Chinese government has decided to shut down currency reform this year. Our base case is that the Chinese government will allow inflation to creep in - which works for their numbers because the nominal GDP will be higher, and if they underestimate the official inflation rate it will automatically make their real GDP numbers appear more impressive. However, this will hurt middle-class Chinese citizens that have their life's savings in RMB, and this perhaps helps to explain why liquidity keeps finding new ways to leak through the system.

We see the risk to Hong Kong itself is not that large, and indeed has been receding since 2014. For example, the stock market trades Chinese names at a much lower multiples than local names across most sectors and Hong Kong has incrementally lowered its food imports from China (only about 20% of food now comes from China), shielding them to some degree from any runaway inflation in China that may occur.

Other industries that are overexposed to China are starting to see a shift away. At one point luxury retail and jewellery were the growth drivers for Hong Kong, because that's what the Chinese tourists wanted, but tourist arrivals from China peaked in 2014, and those two sectors have experienced a consolidation in the last eighteen months. In February, Disneyland HK fired the last CEO for being too pro-China and hired a Hong Kong American as the new head, who has since then created specific programs to attract Japanese and Southeast Asian customers. July was the first month since 2014 that the city-state's overall tourist arrival recorded positive growth, even though arrivals from China continued to drop.

This shift is being replicated in other industries too. Anecdotally, some of the next generation of fund management leaders (mostly in their late 40s and 50s) are quite publicly lobbying the removal of the pro-China managers on the grounds that these pro-China managers spent their entire career in China and do not understand the rest of Asia. Thus there appears to be a changing of the guard to refocus HK companies back to Asia. The longer we stay in this

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Sources: Alexander Funds Management, BCA Research

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"will-it-crash-will-it-not" limbo, the more of Hong Kong's economy will be retooled away from China, and the less it will suffer when problems begin to emerge on the mainland.

While a no-crash scenario will be beneficial to Australia in the short to medium term overall, we think this is now priced in and, despite the small pullback in stock prices over the last month, we still see overly optimistic earning expectations built into prices which will likely lead to further downgrades as the year unfolds. As a consequence we continue see risks as to the downside in equity markets as markets adjust their earnings outlook and, at least in the US, start to price in interest rate increases.

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