A POCKET OF OPPORTUNITY AND THE BANKING BLUES - NOVEMBER 2016

A POCKET OF OPPORTUNITY

The S&P/ASX200 has fallen victim to historical probability, descending with conviction through the support level of the **Ascending Broadening Wedge Pattern** we identified in our October newsletter. The move confirms our expectation of further weakness materialising with two key events, the US Election (8th November) and the US Federal Open Market Committee (FOMC) Meeting (14th December) determining how deep the retracement will be. It's doubtful a Clinton victory will provide a boost to markets considering she may no longer be leading the polls, but given the medias portrayal of Donald Trump as America's Super Villain, if he does win, expect a far more despondent response from market participants immediately.

While the US elections have been a good source of entertainment in recent times, **we consider the FOMC meeting to be held on the 14th December far more important**. An increase in the Fed Rate, an outcome we believe is highly probable in December, will lead to a sell-off in US equities that will reverberate among Global markets as they succumb to the concurrent forces of capital outflows and a 'risk-off' market sentiment. How far this scenario will push the retracement is anyone's guess but Fibonacci Analysis on the S&P/ASX200 (XJO) points to a test of 5075 index points in the immediate future, a slightly more optimistic view compared to our October forecast of 4950 index points;

While a Fed Rate rise will initially be a negative for the Australian market, participants will gradually shift their focus to the performance and outlook of our economy as they seek to rationalise their decision to re-enter the market. **In our opinion this means the December quarter will present a short term pocket of buying opportunities to clients.** Recent forecasts from the RBA for GDP growth to average between 2.5 and 3.5 percent to June 2018 before accelerating thereafter, together with the good fortunes of seasonality that await us in the New Year, **will perch themselves patiently in the back of the minds of investors as the market continues its descent**. As pockets of value emerge we expect investor sentiment to gradually shift in line with the RBA's mildly positive outlook bringing with it a resurgence of common investment themes including the prevalent **'Hunt for Yield'**. While opportunities will be there for the taking, if you aren't prepared in advance to capitalise when the time comes, you may very well waste one of the more compelling buying opportunities we will have seen over the past 12 months.

THE BANKING BLUES

One of the longest-standing investment ideas among many Australian investors is that **no investment portfolio is ever complete without the inclusion of at least one banking stock**. The big four have reliably delivered investors with **consistent growth in dividend payments for over two decades**, a feat they have been able to achieve due to competitive advantages held in areas that have never looked under threat, **that is until today.**

Collectively the big four are estimated to control 85% of all residential mortgages in the market, a dominance that has generated significant profits as the housing market began to take off in the early 90's. In recent times we have seen growth in dividends stagnate as pressure mounts on the very areas that once served as key ingredients to their super profits and generated the much loved fully franked dividends. The risk factors thrown toward the banking sector in recent times has been relentless and we highly doubt they will be able to manage them without damage to their balance sheets;

- **Excessive Household Debt-to-Income ratios threatening serviceability of loan repayments.**
- **Regulatory pressure tightening lending procedures and restricting growth in loan books.**
- **Regulatory pressure to increase capital adequacy ratios, a key risk to dividends.**
- **Cyclical peak in residential construction.**
- **Rising bad debts.**

We certainly would avoid being drawn in by the attractiveness of the high yield being offered by the banks in the current environment. These yields are based on the past and they are certainly no indication of what's in store for the future. It's our view the long-established trend of consistent dividend growth has come to an end and **the market is due to price in risks presented to earnings and dividends**. While the **low interest rate environment is keeping the greatest risk of a public debt crisis in check at this time**, we believe APRA's directive to shore up the banks against a potential surge in mortgage losses, along with a gradual rise in bad debts, will force banks to raise more capital through either a reduction in dividend payout ratios (retain more earnings), an issue of capital or both. It's for this reason we believe the banks are at the greatest risk of underperforming the market during the December quarter. Taking a technical view of the S&P/ASX200 Financial Index (XFJ), which is weighted heavily toward the big four (makes up 73.37% of the Index), we're able to forecast potential retracement levels over the near-term.

A break of the long-established uptrend on the XFJ at the 5850 index point level suggests a descent toward 5600 index points over the immediate term. For the index to extend this move toward 5400 index points, market participants would have to be unnerved by a deeper fundamental catalyst such as adverse unemployment data, an emerging trend of rising bad debt levels or further regulatory pressures. If a deeper fundamental catalyst were to emerge as we progress through this quarter or beyond, it's possible the view held by many, that a portfolio can't be complete without holding one of the big four banks, will be swiftly abandoned.

Performance of Key Indices

Equities	*Close*	*Change (M)*	*Change % (M)*
All Ordinaries	**5402.44**	**-122.71**	**-2.22%**
S&P/ASX200	**5317.73**	**-118.19**	**-2.17%**
Dow Jones (US)	**18142.42**	**-165.73**	**-0.91%**
NASDAQ	**5189.14**	**-122.86**	**-2.31%**
S&P500	**2126.15**	**-42.12**	**-1.94%**
FTSE 100 Index	**6954.22**	**+54.89**	**+0.80%**
Nikkei 225 (Japan)	**17425.02**	**+975.18**	**+5.93%**
10-year bond rate (US)	**1.82%**	**+0.23%**	**+14.32%%**

ABS releases March

Building Approvals (August) – 2nd November
Retail Trade (September) – 4th November
Housing Finance (September) – 10th November
Lending Finance (September) – 14th November
Sales of New Motor Vehicles (October) – 16th November
Labour Force (October) – 17th November
Construction Work Done (September) – 23rd November

Upcoming US Economic Releases

FOMC Meeting Begins – 1st November
ISM Manufacturing Index – 1st November
PMI Manufacturing Index – 1st November
FOMC Meeting Announcement – 2nd November
Employment Situation – 4th November

International Trade – 4th November
Producer Price Index – 16th November
Consumer Price Index – 17th November
Existing Home Sales – 22nd November
Durable Goods Orders – 23rd November
New Home Sales - 23rd November
International Trade in Goods – 25th November
GDP – 29th November