2019 outlook: Australian equities

Despite dire predictions, I believe 2019 will be a stronger year for the Australian equity market as much of the uncertainty we've experienced this year will have played out. Interest rates remain low, balance sheets are strong, earnings growth is still mid-single digits, valuations have improved and dividend yields are attractive. I would expect to see earnings growth combined with valuation expansion in 2019 driving solid investment returns for the calendar year.

To date the Australian Equity Market (ASX 200) has delivered a negative 2.5% return for the year following strong returns in both 2016 and 2017. [1] Market concerns around higher interest rates, a US/China trade war and declines in the residential property market consumed positive returns from the first half of 2018.

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Australian equities outlook

In 2019 I believe we'll see a returned focus to high quality businesses with strong cash flows and high certainty of earnings. Over the last few years low quality businesses have been pushed up by the stock market on higher inflation and growth expectations. I think this is unlikely to continue in 2019 as fundamentals re-exert their dominance.

Personally, I always love these periods in investments markets as it gives me the opportunity to buy the businesses I've always wanted to own at much more attractive valuations. Warren Buffet once said that as an investor, it is wise to be "Fearful when others are greedy and greedy when others are fearful". It certainly feels like a lot of people are fearful right now. Is it time to get greedy?

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2019 is also looking like another important year for the banks and financial services with the Royal Commission releasing their findings on 1 February. While the report is unlikely to be pleasant reading it could also, interestingly, bring more certainty to the sector as companies start to put poor behaviour and bad press behind them. With more attractive valuations, low expectations and high dividend yields, banks could end up having a much improved 2019.

The resource sector looks to have more mixed prospects ahead. In general, balance sheets are strong and management teams are taking a disciplined approach to the cycle. In the past, the majority of blow-ups were caused by poor balance sheets so the sector's disciplined approach to capital is certainly positive. On the negative side, China is slowing with the potential US/China trade war further subduing demand and weakening commodity prices. So, strong balance sheets but vulnerable commodity prices translate to more mixed prospects for the sector and the need for investors to have a more selective approach. I remain focused on quality, strong cash flow businesses that have greater certainty in their earnings outlook.

The sectors I believe to be best positioned in 2019 are consumer staples and healthcare. Strong cash flows and greater certainty around earnings are attributes that will be in demand as the market's higher expectations on interest rates and inflation begins to moderate. In addition, companies and sectors that can deliver growth in this environment are also likely to be chased by the market as earnings growth is proving a rare attribute in these market conditions. I firmly believe that in strong economic conditions a rising tide is likely to lift all ships, in tougher conditions you really need to back the best management teams to deliver a strong strategy and execution.

The residential property market is also likely to continue its soft landing in 2019. Residential property prices in Sydney and Melbourne are fundamentally over-valued however there isn't a catalyst for major declines but rather a soft deflating of prices. I would expect residential property prices in Sydney and Melbourne to be flat to slightly down in 2019 which points to a more subdued year for residential property services and construction related companies.

The other key event for markets in 2019 will be the Federal election. While there are concerns around some possible policy changes like Capital Gains Tax (CGT) discount, negative gearing and franking credit refunds, it is likely that the election results will bring more certainty. Australia has had considerable political instability over the last decade and the 2019 Federal election result has the potential to bring more stability. Political stability allows companies to make decisions and better invest for the future.

2019 is shaping up as a better year for investment returns in the Australian share market. More attractive valuations, solid dividend yields, strong balance sheets and a returned focus to quality, cash flows and fundamentals should provide investors the potential to reap good rewards.

Finally, I would like to take this opportunity to wish you all a wonderful holiday season and a fantastic 2019.

[1] As at 7 December 2018

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