Markets are very curious at the moment. The economy is weak, and earnings growth is almost non-existent, but stock market prices keep going up. In the following Q&A, Paul Taylor, Portfolio Manager, Fidelity Australian Equities Fund, talks about how the market seems to be having an internal battle between weak earnings growth and higher valuations, with higher valuations, at least for now, winning out.

What's been happening in Australian equities?

Yes, the market's been really interesting the first half of 2019. The economy's been weak, earnings growth is pretty flat to maybe a little bit up, but the stock market has been going up very strongly, and there seems to be this internal battle between the sort of weak economy and earnings growth and much higher valuations, and at the moment much higher valuations are winning.

The valuations are being created because of the cost of capital readjustment, so as interest rates have come down, cost of capital has come right down. A lower cost of capital is what future earnings get discounted back at, the lower the discount rate, the higher the valuations. So at the moment anyway, that's winning out.

Will interest rates stay low?

Yeah, I think markets are now assuming that interest rates are going to remain low for a prolonged period of time, and I think there's a few key underpinnings to that. One is first of all the economy is weaker, earnings growth is going nowhere, but also central banks have focused on NAIRU, which is the non-accelerating inflation rate of unemployment, and because of technological shifts and changes in the workforce, the view is that that rate is now much lower.

So, even as unemployment comes down, it needs to come down much more before you get inflation entering into the economy, which means that there has to be more stimulus before you get that inflation, which means it's unlikely that interest rates are going to rise.

Now, with a whole range of technological innovation, employment replacement happening that could potentially impact middle Australia, the likelihood is that interest rates are not going to be moving up for any … anything in the short term. So, interest rates remaining low means cost of capital remains low, which means a permanent cost of capital is getting factored into stock markets.

So, in this type of environment, I think there are a couple of groupings of stocks that do tend to perform quite well. So we're in a low growth world, a high volatility world, and a low cost of capital world, and in that environment what does work well is sustainable yield, so companies that have got strong cash flows, good businesses, great moats around those businesses, excellent management teams, strong industry structure, that have that sustainable yield, they perform very well and that's the foundation of the portfolio, and in fact I look at those two types of companies forming a barbell-type structure for the portfolio.

One end are these sustainable yield-type companies, which are the biggest, the foundation, the biggest part of the portfolio, at the other end are growth companies. So in a low growth world, growth is a rare asset, and that's going to be bid up by the market, and those sorts of companies, I think, are going to do incredibly well in this environment. Maybe they're a little bit more volatile because we are in a high volatility world, but the performance is going to be good over the long term.

Cash or equities?

Investors are holding high levels of cash at the moment, but to me that makes it really interesting from an equity market perspective. Cash is earning you less and less, the equity markets are still relatively attractive, so you're still getting 4% or 5% fully franked dividend yield in the Australian equity market. I also think as the cash rate continues to come down, people can't earn a return on the cash market. Cost of capital is coming down on equity, so that's pumping up valuations, but even just from an income return, the markets are looking so much more attractive.

I think we're moving from a fear of losing money to a fear of missing out as equity markets continue to rise, so I think equity markets are not only good value from an absolute perspective, but probably even more so from a relative perspective. So equity markets against cash or fixed income or property, against a range of other asset classes, I think is really the standout asset class.

Australian equities outlook

I still have a fairly positive outlook for the next financial year. Now, when we started 2019 I was actually really surprised how positive I was on the outlook for the calendar year 2019, and that wasn't because the world looked rosy, or things looked great, or earnings growth was coming through strongly, it was really based on expectations, expectations were so weak. You know, the outlook was so weak, I just thought, well, the market doesn't have to do much to actually deliver quite good returns.

Now we've had a lot of that movement in the first half of 2019, but I still remain relatively buoyant for the coming financial year, which comes back to that cost of capital. Cost of capital is the key issue for the equity markets, I think, over the next 12 months, as that more permanent structural low level of cost of capital gets factored into equity market prices.

Now that doesn't mean we're still not going to get volatility over the next 12 months, because as I said, we are in a low growth world, we're in a high volatility world, and we're in a low cost of capital world. To me that all means a better outlook for 2019-20, but it does also mean volatility, and it does mean, as I've spoken about, that barbell-type structure within the portfolio.