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Australian Equities: Underappreciated in a Global Context

Our weekly macroeconomic view.

9 November 2020

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Growing Support for the Local Market

The backdrop for the Australian equity market is getting incrementally more positive as the market attempts to break out of its range trading pattern of the past 5 months.

We upgraded Australia to overweight versus global equities in mid-October, and support for the local market looks to have built over the past few weeks.

Read our Fourth Quarter Asset Allocation Strategy.

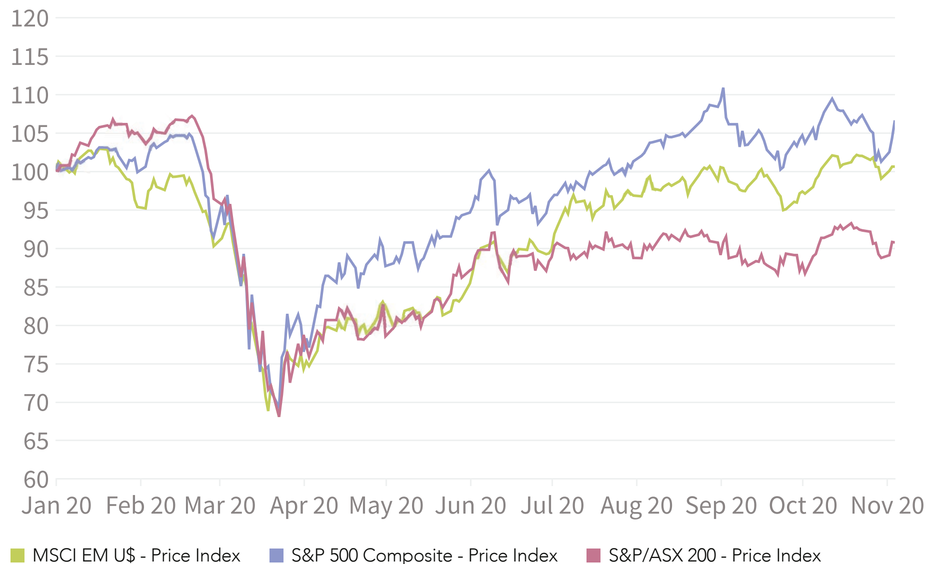
In the past month we have seen:

1. A very supportive Federal Budget (11% of GDP in support).
2. Further monetary stimulus from the RBA, including a move to a full-scale quantitative easing (QE) program.
3. Improving local COVID-19 containment trends (Victoria) at the same time as US and European infection rates have accelerated.
4. AGM season is showing some rays of light in terms of better than feared earnings performance.

The Australian market's performance has improved versus the global MSCI index; however, outperformance is very much in its early infancy when assessed against Australia's longer-term (10 year) underperformance history.

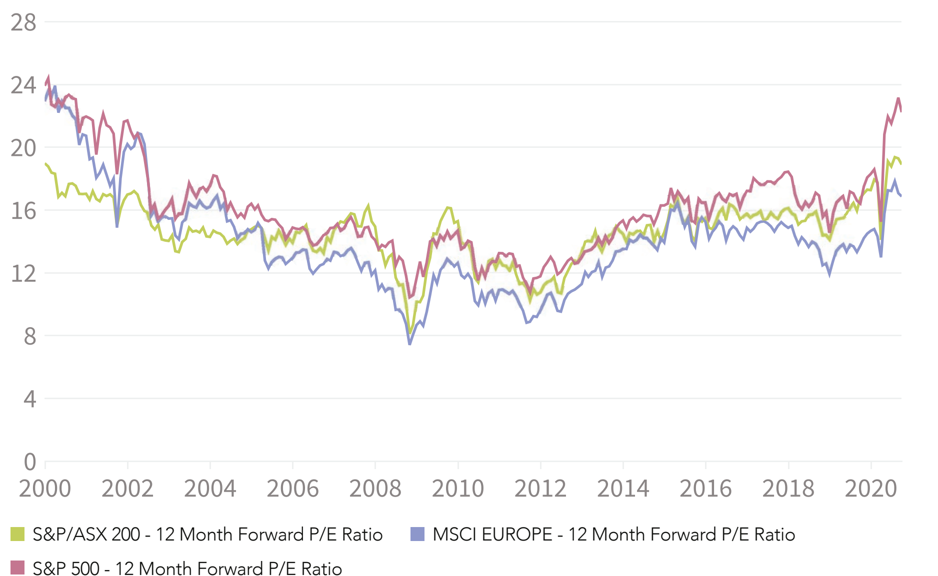
The US equity market juggernaut has been a phenomenon, and the likelihood of a Biden presidential victory (with a Republican senate) seems to be providing fresh impetus to the US market on the assumption of a less dramatic policy agenda. This is also providing support to equities outside the US, although the rally in US bonds is giving the (long duration) US tech trade yet another turbo boost.

Exhibit 1: EM equities have gained ground since mid-year. Can Australia build as fundamentals improve?



Source: Refinitiv, Wilsons.

Exhibit 2: US Equities close to 2000 price-to-earnings (P/E) ratio highs



Source: Refinitiv, Wilsons.

Fiscal and Monetary Policy in Place for "Extended" Economic Support

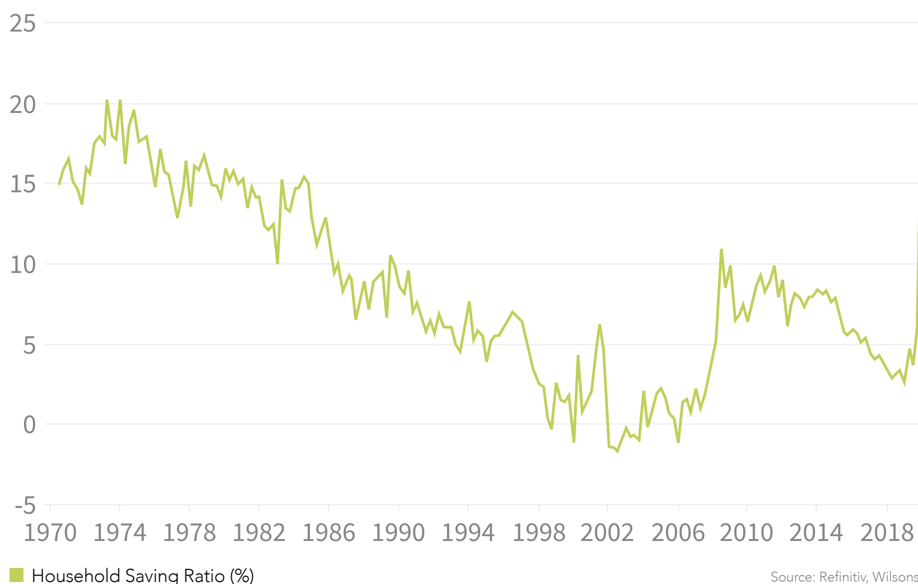
Early October saw the Federal Government announce a deficit of $214 billion for 2020-21 or 11% of GDP. The largest since the end of WW2, by comparison, the highest budget deficit following the GFC was just over 4% of GDP. The Government has stated it will not attempt to shift the focus to budget repair until the unemployment rate is comfortably below 6%. While we have likely passed the maximum fiscal impetus from a quarterly dollar flow perspective, the large build-up in household savings suggests the potential for a significant release of precautionary savings over the coming year.

In addition to fiscal support, the RBA has added some extra weight to the policy support task with a largely well-flagged suite of measures. The RBA reduced the cash rate target, the 3-year yield target and the interest rate on bank (term funding facility - TFF) borrowings from 0.25 to 0.1%.

The RBA also announced it will purchase A$100bn of government bonds with maturities of between 5 and 10 years over the next 6 months – a faster pace of buying than consensus was looking for. The consensus had expected this level of buying to occur over 12 months rather than a 6 month window. The RBA also flagged it was leaving the door open for more bond buying support if needed.

The RBA has also set a high bar for the eventual lifting of interest rates, guiding not to expect a rate hike for at least 3 years. Specifically, interest rates will not be increased until actual inflation is sustainably within the 2-3% target, which will require the return to a tight labour market (less than 5% unemployment). The RBA is clearly trying to reassure households and businesses that it is not about to move the goalposts any time soon.

Exhibit 3: Australia's household savings ratio back at record highs



Source: Refinitiv, Wilsons.

Exhibit 4: A$ jumped in the past few days despite RBA QE

Source: Refinitiv, Wilsons.

At the same time as it eased policy the RBA's central economic forecasts were actually revised upward. GDP growth to June 2021 is expected to be +6% (+2pp from the August forecast). The unemployment rate is expected to peak around 8%, not 10% as previously thought, and is then expected to fall to 6% in 2022 (-1pp from the previous forecast).

It is interesting that the A$ has moved from 70.4 to 72.8 since the RBA's confirmation it would commence full-scale QE. This underlines the difficulty the RBA faces in controlling the currency via QE in the context of the global spectrum of influences on the exchange rate. We do think the RBA can lean against the A$ and at least act to cap a sharp appreciation, but we see upside in the A$ on the basis of global and local economic recovery. Investors should retain a partial hedge to overseas equities in our view.

Read more about The RBA's Last Cut as it Moves into New QE Territory.

Australia an Attractive Low Risk Reopening Play

While policy support is important, reopening is the key to the path of the economy over the coming months and quarters.

With lockdown fears increasing in the Northern Hemisphere, Australia looks relatively attractive as a lower risk reopening play. Victorian metro reopening targets firm up Australia's path to a more normal operating economy. State borders are also beginning to open up with NSW flagging November 23 as the date for free movement between NSW and Victoria. We see significant scope for improvement in economic momentum and business confidence over the next few months as reopening gathers momentum, though the economy will still not be firing on all cylinders in 2021. The ongoing frictions in Australia's trade relationship with China are a source of risk, though the notable absence of key export markets iron ore and LNG are at least a source of some comfort.

Global vaccine success is still the game-changer in terms of a full-scale embrace of the recovery or reopening trade. Global equities at present remain wedged between hopes of vaccine and the reality of rising case-loads in the US and Europe. With 11 vaccines in stage 3 trials, the odds are firming for news on some of these trials before the end of the year.

Exhibit 5: Consensus % EPS Revision over the past month

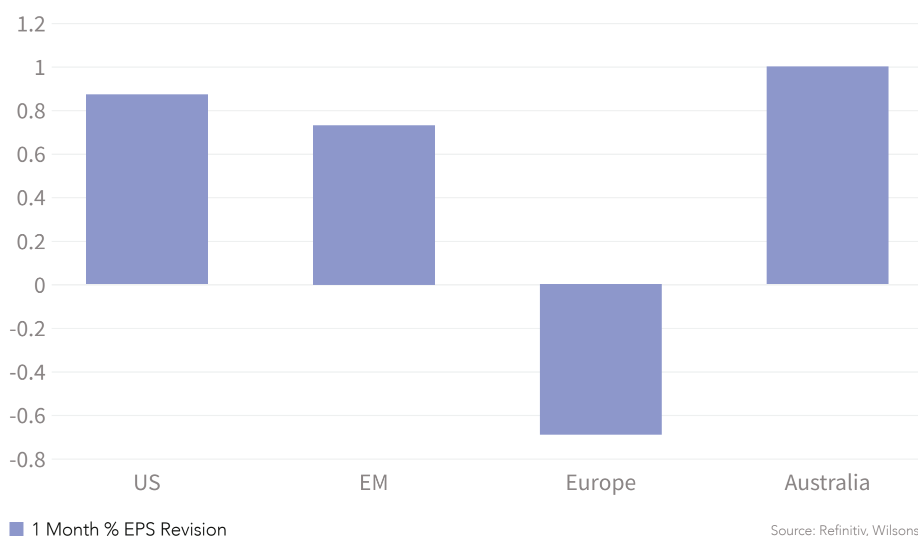
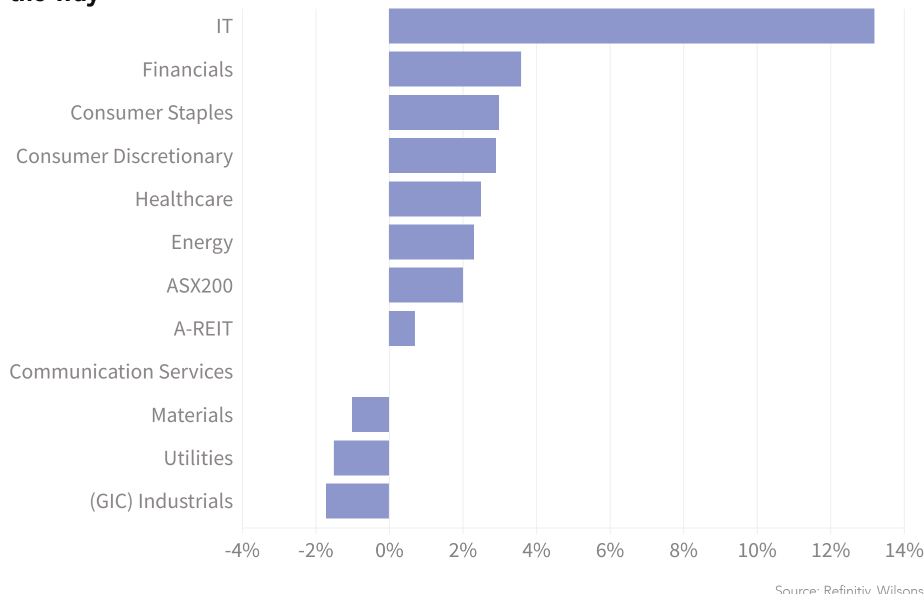


Exhibit 6: Financial performance (past mth) has improved but IT still leads the way



Rotational Trends Still Mixed

We see Australia as a lower risk play on recovery (alongside EM) compared to the very cheap but somewhat binominal risk/return trade offered by Europe.

The local AGM season has assuaged fears with several companies flagging better than expected trading. The broader earnings revision trends for Australia look better than global averages on a 1 and 3-month basis, helped by the China-driven mining sector. We see scope for this trend to build with substantial medium-term upside for earnings per share (EPS) and dividends. We believe a 30-35% EPS and dividend recovery is plausible across CY21 and CY22 assuming a progressive return to the previous trend line. Dividends are likely to have more upside than earnings given the payout ratio has dipped this year.

> Read our report on why The AGM Season Points to an Earnings Upgrade Cycle.

A Vaccine Still the Most Powerful Catalyst

Sector performance action is still mixed, but signs of life in the value/recovery trade is seemingly confirming a better macro environment, with key value/ recovery sectors like banks displaying better recent performance. While there are signs of life in the recovery trade, the IT sector is still leading recent market performance with US tailwinds undoubtedly a support. We are reluctant to chase the local IT sector currently and have been adding to the domestic recovery trade largely through up-weighting the banks. A vaccine is the most powerful catalyst for a full-scale tilt at global recovery/mobility trades. We see reasonably good prospects for a positive announcement on some of the current stage 3 trials before year-end.

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Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

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