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Australian Market Outlook: A View into 2021

Asset allocation weekly.

7 December 2020

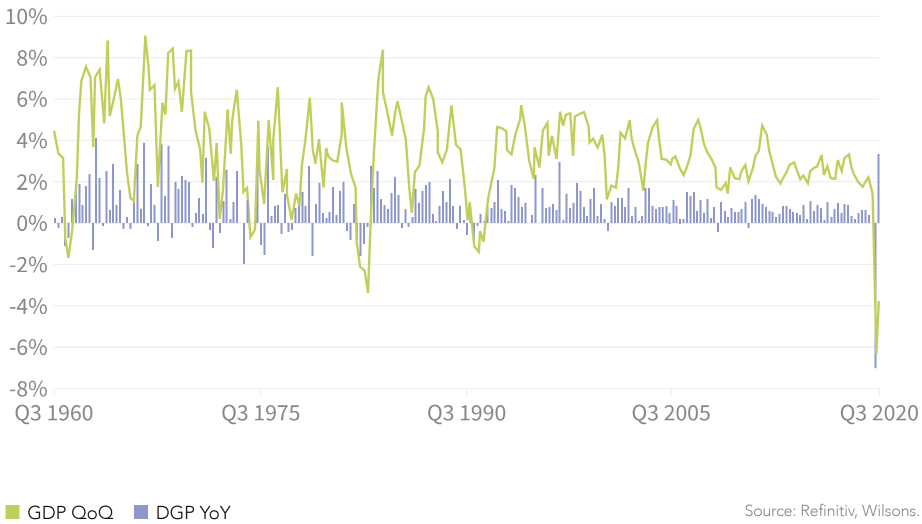
Our View Remains Constructive

The Australian equity market recovery accelerated in November as US election clarity and vaccine success buoyed equities markets globally.

We would not be surprised to see some near-term consolidation based on the pace of the recent bounce, the recent widespread capitulation amongst most investors to a positive view, and the market's stretched headline multiple, however, our 12-month view remains constructive.

We see 5-10% capital gains as a base case with risks skewed toward the potential for stronger returns due to the highly stimulatory monetary and fiscal backdrop.

Exhibit 1: Economic growth has begun to bounce back but remains negative in YoY terms



Source: Refinitiv, Wilsons.

Exhibit 2: Plenty of pent up demand in the economy as uncertainty wanes

Source: Refinitiv, Wilsons.

Domestic Economy Kicking into Recovery Gear

Australia's excellent management of the COVID-19 pandemic is beginning to show in superior economic performance which will have positive implications for corporate earnings.

September quarter GDP figures show 3Q growth of 3.3% quarter on quarter (QoQ) (a 44-year record for QoQ growth), albeit after an all-time record contraction of -7% in the June quarter.

Household consumption led the way with a 7.9% QoQ rebound as households begin to spend large savings reserves built up with the assistance of huge government transfers earlier in the year. The savings ratio dropped from a record 22% to a still massive 19% in Q3 suggesting plenty of consumer firepower.

While the bounce in growth is good news, Australia's GDP is still 3.8% lower year on year (YoY) and unemployment is at 7%, compared to a pre-COVID-19 level of 5.2%. The economy is still climbing out of a very sharp and very deep contraction. Nevertheless, the recovery is well and truly underway and should continue at an above-trend pace through CY21 (4-5% real GDP growth seems quite plausible) with bullish implications for corporate earnings with 20% earnings growth a prospect for CY21.

While political relations are decidedly strained, China's strong growth rebound alongside ongoing supply disappointment out of Brazil is buoying our largest commodity export iron ore ($136 per tonne is the high level since 2013) with positive implications for Australia's big major miners. In October, Australian exports hit a 4-month high of $12.7b despite the trade tensions. The broader global recovery is still struggling against a resurgent pandemic, but a vaccine roll-out in 2021 should see a synchronised global recovery emerge by the second half of 2021. This will further bolster the local market's earnings recovery.

We see prospects for a well above average 5% global GDP growth in 2021 compared to -4% in 2020. This should translate to a 20% plus global earnings recovery in 2021,which will extend into CY22.

Passing the Baton to Earnings in 2021

The increasingly positive outlook for earnings has not gone unnoticed of late, with November seeing the largest monthly rally in Australian equities since 1988. The market is up 46% from its March lows and is now only 8% from its February high.

Australian equities may be short-term overbought but 1 year (-1%), 5 year (+9%pa), and 10 year (+8%pa) returns do not convey a picture of a truly overheated market.

The market's headline 12-year forward price-to-earnings (PE) multiple at 20x is high, but we see 2 mitigating factors.

1. The earnings recovery is likely to be substantial over the next 2 years

Market estimates will likely prove too low for key cyclically leveraged sectors such as banks and energy alongside a long tail of stock-specific COVID-19 impacted recovery companies. Indeed more than 60% of the ASX 100 is set to benefit from a 2-year recovery tailwind of varying degrees after the hit to earnings this year.

Read our report
Energy - Ready for Take-Off?

The overall market should deliver in excess of 20% earnings per share (EPS) growth in CY21 with strong double-digit growth also a prospect for CY22. While the market is already factoring in a solid double-digit revival in earnings in CY21, 1-year forward estimates are 16% below the pre-COVID-19 estimate, so there is plenty of upside across 2021 and 2022.

2. Extremely low interest rates support high valuations

Low interest rates will tend to support high valuations if the financial system is relatively free of stress, as it currently is. Even before we factor in the potential for a big earnings recovery, stocks could still be considered cheap in the context of the prevailing interest rate regime.

We assume the market multiple will edge down over the coming year closer to pre-COVID-19 levels as the earnings recovery comes through. It is normal

Exhibit 3: Market PE is high but earnings estimates are depressed and interest rates are low

MSCI Australia - 12 MTH FWD PE Ratio

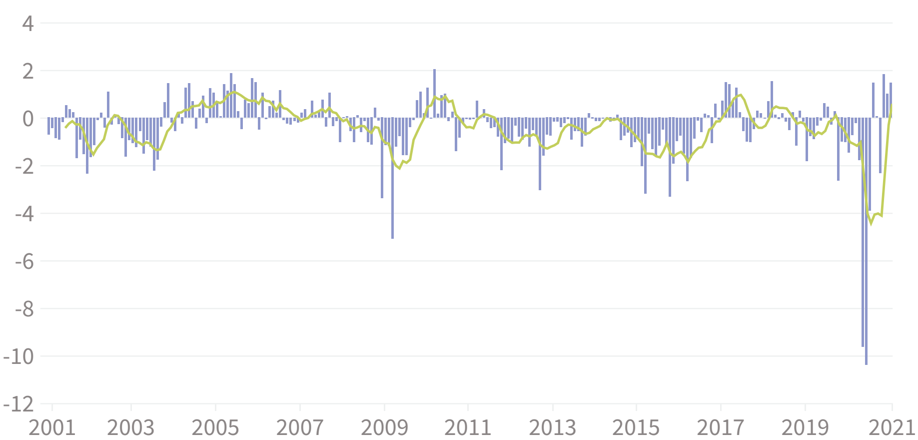
Source: MSCI.

Exhibit 4: The 1-year forward market EPS estimate is still 16% below the pre-COVID-19 level

MSCI Australia - 12 MTH FWD WTD EPS

Source: MSCI.

Exhibit 5: Consensus earnings revisions are now turning positive



S&P/ASX 200 - 12MTH FWD 1MTH %CH
6 per. Mov. Avg.(S&P/ASX 200 - 12MTH FWD 1MTH %CH)

Source: Refinitiv, Wilsons.

for the market multiple to reduce as an earnings recovery progresses.

However, ultra-low rates, ample liquidity and building optimism around the economic backdrop could see multiples hold at current levels, suggesting close to 20% capital gains over our base case of 5-10%.

The view that valuations stay elevated versus long-term averages rests on the assumption that earnings growth revives at the same time as interest rates stay very low. We do expect the Australian 10-year bond to track higher over the coming 12 months led by a lift in the US 10-year yield. However, we expect any rise in long bonds in the coming year to be relatively moderate for a number of reasons:

1. Central banks remain committed to keeping the official cash rate at essential zero
2. Central banks also remain committed to significant QE (bond-buying programs)
3. There is too much spare capacity (particularly in the labour market) to expect a significant rise in inflation

A moderate rise in the long bond in the order of 50-100 bp is unlikely to short circuit the equity market rally, though the bond market may prove more troublesome for the equity market later in the cycle.

A Sweet Spot for Stocks

While the market has rallied hard and sentiment has shifted to be reasonably bullish (which is somewhat of a negative) we believe the relatively early-stage nature of the earnings recovery cycle and the very supportive interest/liquidity backdrop suggests more upside for the local market in 2021. The recent rally in value/recovery areas likely has further to run, but the prospect for a relatively broad-based bull market in 2021 looks reasonably promising

Exhibit 6: Market earnings yield has not re-rated anywhere near the extent of the bond yield drop

Source: Refinitiv, Wilsons.

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Recommendation structure and other definitions

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

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