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Value Still Supported by Macro Tailwinds

Our weekly view on Australian equities.

20 April 2022

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Australian Value can Still Outperform

Similar to global value, Australian value has outperformed significantly since November last year, boosted by elevated commodity prices and rising global and local interest rates.

Even with a strong performance over the past quarter, we still think Australian value can outperform growth. With a positive view on the Australian economy, RBA hikes likely beginning this quarter and with a US bond yield that could still rise, we are still adding value to Australian equity portfolios. Due to this conclusion, we have made changes to the Focus List, adding to our banks weight while removing Block (SQ2).

We recently discussed our views on the global value vs growth debate.

Guided by History

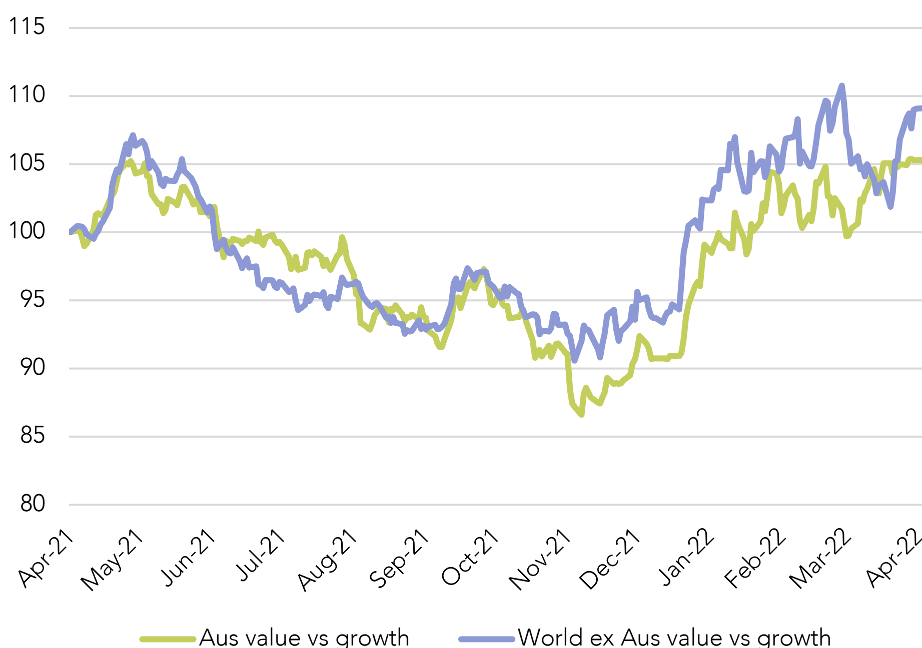
We still think US 10-year bond yields can edge upwards over the next 6 months. We believe this will be a headwind for US and Australian growth stocks as they are put under more valuation pressure.

We believe this cycle is more like the 2003-2007 period when the domestic economy was strong, rates were rising steadily and commodity prices were elevated. We believe this period may be the most appropriate guide for what lies ahead over the next 6-12 months.

In this period IT, materials and energy were the best-performing stocks. It is worth noting that the IT sector in 2003 was quite different to the sector today. In 2003, the majority of the IT sector's weighting was in Computershare (CPU), a stock highly leveraged to rising rates. The share price of CPU went from ~$1.50 to ~$11 in this period. Today, the IT sector has a significantly higher weighting to growth stocks like Wisetech (WTC), Xero (XRO) and Block (SQ2).

Over the past 3 periods, resources have consistently outperformed the market and we believe this time should be no different.

Figure 1: Australian value has outperformed growth, similar to its global peers



Source: Refinitiv, Wilsons.

Figure 2: Sector performance in rising rates environment

	Pre GFC (2003-2007)	Taper Tantrum	Synchronised Global Growth
Date	June 2003 - June 2007	May-Dec 2013	Jan-Dec 2016
Top Performing Sectors	IT (40%)	Healthcare (+9.5%)	Materials (+14.8%)
	Energy (38%)	Consumer Discr (+8.6%)	Financials (+11%)
	Materials (33%)	Materials (+7.5%)	Energy (+9.7%)
ASX 300 Performance	20%	2.80%	5%
Worst Performing Sectors	Comm. Services (3%)	A-REIT (-11.8%)	Healthcare (-10%)
	A-REIT (13%)	Utilities (-6.4%)	Comm Svs (-7.6%)
	Consumer Disc (14%)	Consumer Staples (-2.4%)	A-REIT (-6.9%)

Source: Refinitiv, Wilsons (performance annualised for Pre GFC).

Preference for Cyclical Sectors with Lower PE Multiples

Energy, financials and materials have lower valuations than the market. Due to the cyclical nature of these sectors they have higher earnings risk and therefore lower multiples. However, in a period of strong economic growth and rising rates, these sectors may experience less valuation compression than discount rate-sensitive growth stocks.

Banks Should Benefit from Higher Interest Rates

In light of the RBA's anticipated tightening cycle in the next 12-18 months banks should benefit from higher interest rates, alleviating some of the pressure on net interest margins the big 4 banks have experienced over the past decade.

There is a risk that the RBA will hike too quickly, potentially hurting the domestic economy and housing market. This would slow credit growth and could be a headwind for banks' earnings and sentiment. As of now, we believe the RBA will be relatively conservative rather than aggressive and the economy should be able to smoothly digest rate hikes, so we view this as a low risk.

Can Resources Push Higher?

Resources still have room to outperform over the next 6-12 months. This might not be a result of higher commodity prices, but from energy and broader commodities staying elevated for longer, with tight commodity markets persisting.

In this environment, there is a possibility that resources will continue to outperform as resources stocks continue to see earnings upgrades vs the market, which expects a mean reversion of commodity prices over the next 12 months (i.e. commodity prices fall back towards their long-term average).

Valuations are another reason to favour resources. Resources have a forward PE of roughly half that of the rest of the market, and if spot prices are used, the discount is even larger.

Figure 3: Cyclical sectors tend to have lower PE multiples and a lower sensitivity to higher bond yields

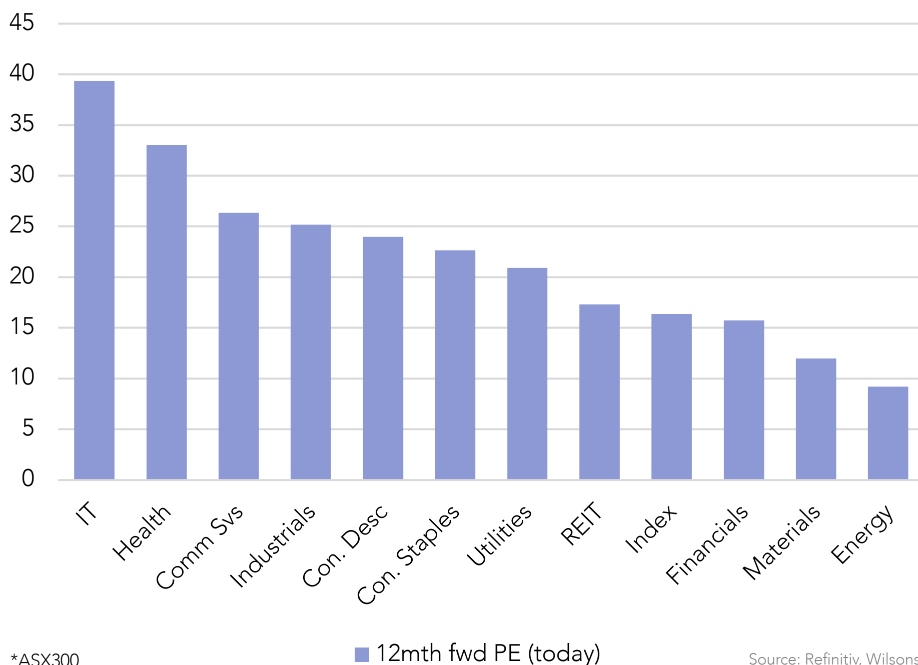


Figure 4: Elevated commodity prices could still drive long-term performance for resources

This sector is relatively insensitive to bond yield increases as the multiples are already on such low levels. However, it is important to note that resource stocks can have low PE's (based on elevated earnings) and may actually be overvalued just before a period where commodities prices fall significantly or more quickly than the market is expecting.

We believe, that at current spot prices there is still the potential for continued resources outperformance based on further earnings upgrades and low sensitivity to the bond yield relative to the market, leading to a further rotation into this sector.

Underweight Long Duration Stocks for Now

Growth stocks are highly sensitive to the discount rate which increases as US bond yields rise. In a rising rate environment, growth stocks are thus vulnerable to a recalibration of valuations. Although Australian growth stocks have already declined sharply since November, there is still a risk they could correct further if bond yields rise further.

There are still areas of the market where we see value in traditional growth stocks.

Read Three Oversold Structural Growers

However, we remain underweight high-growth stocks that are likely to be highly volatile as the market adjusts to the current risks. Even though we believe some of these high-growth companies are excellent companies, we remain underweight from a valuation perspective until we have greater clarity on inflation and interest rates.

If we get to a point where we believe US bond yields are starting to peak, we would get more constructive on growth names. There is a potential for this to happen over the next 6 months.

Where to Find Value?

We screened the ASX 300 for stocks with:

- PE multiples lower than the market (16x) for FY24
- Positive earnings growth over the next 3 years
- No significant (-10%) EPS downgrades over the last 90 days
- Market Cap above $5bn

We think this provides a screen of value companies that could be added to portfolios. Unsurprisingly, we found stocks from materials, financials, energy, real estate and utilities sectors.

We always prefer to consider stocks that have earnings growth over the medium-term. Some stocks may be cheap for a reason (eg: low PE but poor earnings prospects).

We hold Westpac (WBC), ANZ, NAB, Allkem (AKE), IAG, Qantas (QAN) and James Hardies (JHX) in the Focus List, which appear on this screen.

For stocks outside of the Focus List, the EV metals sector looks relatively appealing on a valuation basis but also on an earnings growth perspective. Stocks like IGO, Pilbara (PLS) and Mineral Resources (MIN) all look interesting propositions at current prices.

Origin Energy (ORG) and Lendlease (LLC) are turnaround stories that we believe could offer significant upside if changes are implemented by management. These stocks also look interesting to increase value weightings in portfolios.

Figure 5: Value screen

Company Name	Ticker	Price Change % YTD	PE FY24	EPS CAGR % (FY1-FY3)	12mth fwd EPS (90 day change %)	12mth fwd Dividend Yield %
Energy						
Ampol	ALD	8%	12.3	12%	8.3	4%
Washington H Soul Pattinson and Company	SOL	-3%	12.5	3%	-5.1	2%
Financials						
IAG	IAG	2%	13.4	29%	5.1	5%
QBE	QBE	5%	9.2	23%	-3.9	4%
Suncorp	SUN	0%	11.8	18%	8.1	6%
Westpac	WBC	13%	11.5	17%	4.3	5%
ANZ	ANZ	0%	11.0	10%	-0.1	6%
NAB	NAB	14%	13.7	9%	7.9	5%
Bendigo	BEN	13%	11.9	3%	4.9	5%
Janus Henderson	JHG	-22%	8.6	2%	-9.5	5%
BOQ	BOQ	-1%	10.2	2%	4.6	6%
Industrials						
Seven Group Holdings	SVW	-4%	9.9	15%	-4.5	2%
Atlas Arteria Group	ALX	-4%	13.3	8%	3.5	6%
Brambles	BXB	-5%	15.8	8%	3.1	3%
CIMIC Group	CIM	30%	13.8	6%	-6.3	4%
Aurizon Holdings	AZJ	10%	13.1	3%	3.8	6%
Qantas Airways	QAN	9%	8.1	>100%	284.5	2%
Materials						
Mineral Resources	MIN	11%	11.9	60%	64.6	4%
IGO	IGO	22%	11.6	48%	82.7	3%
Pilbara Minerals	PLS	-8%	7.2	42%	119.2	0%
Allkem	AKE	30%	11.3	36%	137.4	0%
Evolution Mining	EVN	15%	14.3	24%	9.6	2%
James Hardie Industries	JHX	-26%	15.8	17%	10.8	4%
Lynas Rare Earths	LYC	-8%	13.6	13%	30.4	0%
Amcor	AMC	-4%	13.7	4%	-1.0	4%
Real Estate						
LendLease Group	LLC	6%	11.2	65%	-5.3	2%
Mirvac Group	MGR	-15%	14.3	9%	-2.8	4%
Vicinity Centres	VCX	10%	13.4	7%	8.2	6%
Stockland Corporation	SGP	-2%	11.1	6%	4.3	7%
GPT Group	GPT	-6%	14.7	5%	-3.5	5%
Scentre Group	SCG	-6%	13.2	3%	6.2	5%
Utilities						
AGL Energy	AGL	41%	9.3	40%	37.1	5%
Origin Energy	ORG	25%	12.8	26%	20.1	5%

Source: Refinitiv, Wilsons.

Removing Block (-2% SQ2)

After a volatile period, we have removed Block (SQ2) from the Focus List.

Duration risk – we are removing some of the duration risk we have in the portfolio. With a PE multiple of 80x, we are concerned that higher US bond yields could put further pressure on US fintech's with high PE multiples, like Block.

Competition - Block is facing competition from a number of different competitors, including Apple, which plans to expand its payments business.

PayPal, Shopify, Lightspeed and Clover are companies have all rolled out or are planning to launch point of sale (POS) systems. The market is becoming more saturated and this does not seem to be appreciated.

Afterpay - Afterpay's latest results (owned by Block) showed a worrying trend in the buy now pay later (BNPL) sector. Losses increased in the half to December, potentially indicating a concern that Afterpay and BNPL companies are struggling to scale effectively.

During the December half, Afterpay's revenue increased by 54% to $644.99 million. The gains in revenue were offset by higher operating costs, including a more-than-doubling of expenses ($176.7m) related to bad debts during the December half.

We continue to prefer the SAAS-driven Xero (XRO) over Block (SQ2) and have removed Block from the Focus List.

Adding bank exposure (+1% NAB, +0.5% ANZ, WBC)

Over the past quarter banks have outperformed the market, and due to the static nature of the Focus List we have increased our weighting to close out any disparity relative to the benchmark.

We still believe recession risks are low, and in a period of rising rates we do not want to be underweight the banks. In the next 12 months we believe net interest margins (NIM) pressure will begin to ease as the RBA starts raising rates.

Due to the current competition in mortgage lending we believe there will be a little less NIM pressure on NAB than the home lending banks (ANZ and WBC), although we believe this is a short-term issue.

Disclaimer and Disclosures

Recommendation structure and other definitions

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

Disclaimer

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Wilsons contact

david.cassidy@wilsonsadvisory.com.au | +61 2 8247 3149

rob.crookston@wilsonsadvisory.com.au | +61 2 8247 3101

www.wilsonsadvisory.com.au