Focus List Monthly – April 2022

Our monthly view on Australian equities.

04 May 2022

Narrative Beginning to Change

Since December, risk aversion in equity markets has shifted as inflationary pressures and higher bond yields have placed downside pressure on equity valuations.

The Ukraine crisis has added a further tailwind for inflation, increasing oil and food prices globally. As the risks of rapid tightening and the Ukrainian conflict play out, Australian equity markets will remain susceptible to volatility although Australian equities are proving relatively resilient compared to global equities.

Energy, utilities and materials have performed the best since the beginning of the year as investors have used commodities to hedge against inflation. Rising bond yields have largely been to blame for the worst-performing stocks, with high PE sectors like consumer discretionary and IT among the worst faring.

However, the narrative has changed slightly over the last month with defensives starting to outperform the market. Sectors like healthcare and consumer staples, along with utilities, have performed well against a backdrop of higher uncertainty around the US Feds and RBAs hiking expectations and the impact this will have on the economy. We think that US and Australian inflation will ease by the end of the year but remain cautious on the trajectory of rates and bond yields as the outlook remains murky.

We think that global economic growth will remain reasonably resilient and have therefore not positioned heavily towards defensives. More economic indicators like the global Purchasing Managers' Index (PMI) or Australian consumer confidence would have to flash red before we turn more bearish.

We believe that the next couple of months will continue to be an edgy period for markets as rates rise. We still think this could hit high PE sectors like IT even further.

Figure 1: YTD (as at end of April) ASX 300 price performance by sector

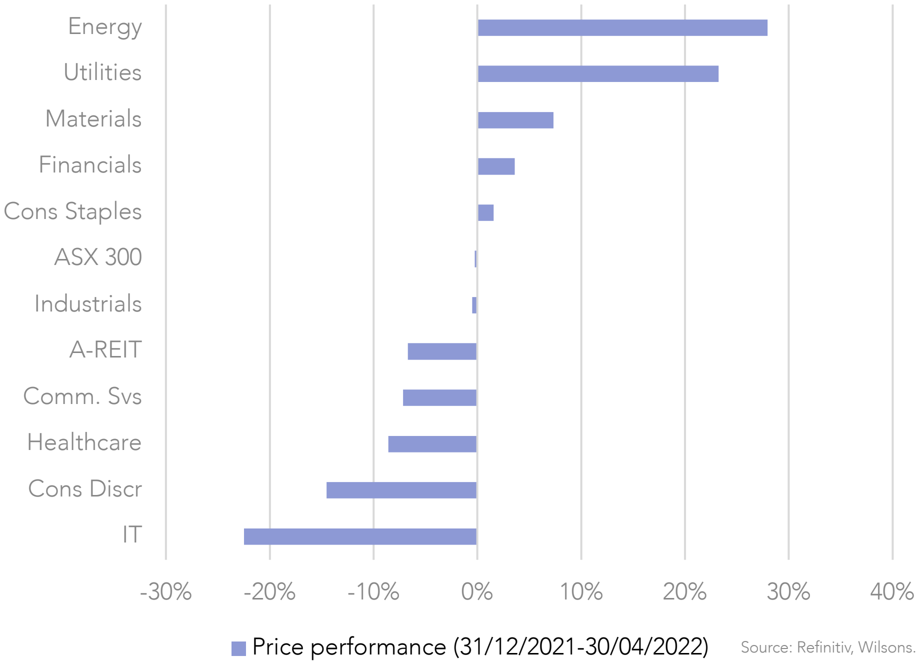
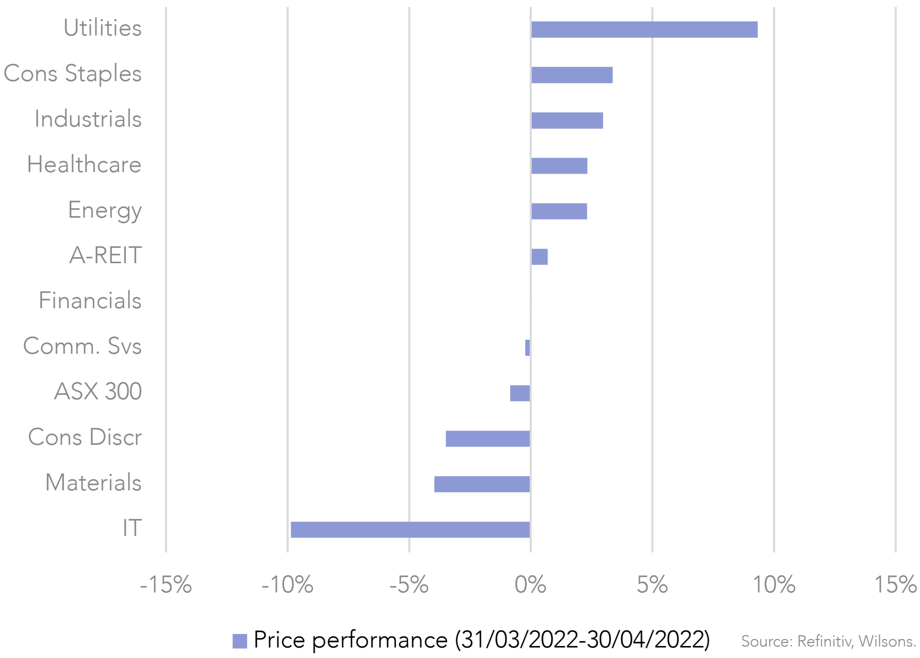


Figure 2: April 2022 ASX 300 price performance by sector



A more dovish narrative from the US Fed could reignite growth stocks, but we haven't reached that point yet, and don't expect to until at least the second half of this year. We think a barbell tilt towards both cyclical/value and defensives is sensible. We are looking for more clarity from central banks and a more benign outlook for bond yields to rotate back to growth.

Figure 3: Focus List positioning

Sectors	Weighting	Focus List Stocks	ISG View
Cyclical			
Resources	23%	BHP, STO, OZL, NST, AKE	The Focus List is underweight resources at a headline level, but this is predominantly due to our weighting in iron ore focused miners rather than our weighting to other sub sectors. We like resources as an inflation hedge and protection against a longer than expected Russia/Ukraine conflict. China's COVID lockdowns have added some risk to iron ore demand in the short term, but could lead to more Chinese stimulus in the next 12 months. Focus List is Overweight: Energy, Copper, EV minerals and gold. Underweight: Iron Ore.
Banks	21%	NAB, WBC, ANZ, JDO	The Focus List is neutral on the banks. We believe business lending bank NAB is better positioned to grow loans in the next phase of the cycle than home loans since there has been such intense competition in mortgages. Potential risks of NIM pressure exposed in HY results (this week) keep us neutral the sector, but would expect banks to perform well in a rising rate environment as NIM risks are alleviated and competition for mortgages eases.
Cyclical Value	7%	QAN, SVW	We have a preference for cyclical stocks with low PE multiples in a rising rates environment. Resources and banks provide us a large allocation to these sectors but we also hold QAN (as a recovery play) and SVW (as a proxy to the domestic economy) .
Quality Cyclical	10%	MQG, JHX	We believe that these quality cyclicals will continue to generate high returns on capital at this point in the cycle, even though higher bond yields are putting pressure on valuations. MQG and JHX remain core holdings of the Focus List. JHX has underperformed YTD as the market seems concerned on the US housing market. We think that the US housing supply is still in deficit to demand and this should be a tailwind for US homebuilders and US housing materials. Recent weakness in US housing stocks seems at odds with comments from US-facing companies such as Lowe's and Home Depot, which highlight that industry conditions are still favourable.
Growth			
Structural Growth	16%	ALL, GMG, SEK, SLA, PNI	The Focus List has a structural bias towards quality growth. We still hold these stocks as we believe they have a strong growth trajectory over the medium term, but higher bond yields have heightened valuation pressure over the last 3-6 months. In our opinion, the growth stocks in the Focus List have been oversold over the last few months. The average 12mth fwd PE of these stocks is 22x, below the ASX industrials PE and therefore look reasonable value.
High Growth	4%	XRO, TLX	We remain cautious on 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.
Defensives			
Defensive Growth	14%	CSL, IAG, TLS, HCW	We currently have a preference to defensives. With the market concern on global economic growth due to China's COVID lockdowns, the Russia/Ukraine conflict and a period of aggressive hiking from the US Fed, we think it is sensible to have an above-average allocation to defensives. Our picks are healthcare, insurance and telco.
Hidden Value			
Hidden Value	6%	NWS, TAH	We are always on the lookout for stocks with hidden value. We find this subset of the portfolio can provide above-market returns that are less correlated to the rest of the market. TAH and NWS should have catalysts to highlight value to the market over the next 12 months.

Source: Refinitiv, Wilsons.

Focus on Resources – How Are We Positioned?

Although the Focus list is underweight resources at a headline level, this is predominately due to our weighting in iron ore miners rather than our weighting to other sub sectors.

We are underweight iron ore miners as we believe that iron ore prices will come back down to earth over the next 12 months. Iron ore is currently at $140/t - we think this could recede lower as Chinese demand eases modestly (even with a stimulus package), but primarily due to supply increasing as weather and COVID conditions in Brazil start to improve.

We have a more bullish outlook for copper, EV minerals and energy and therefore overweight these sub-sectors.

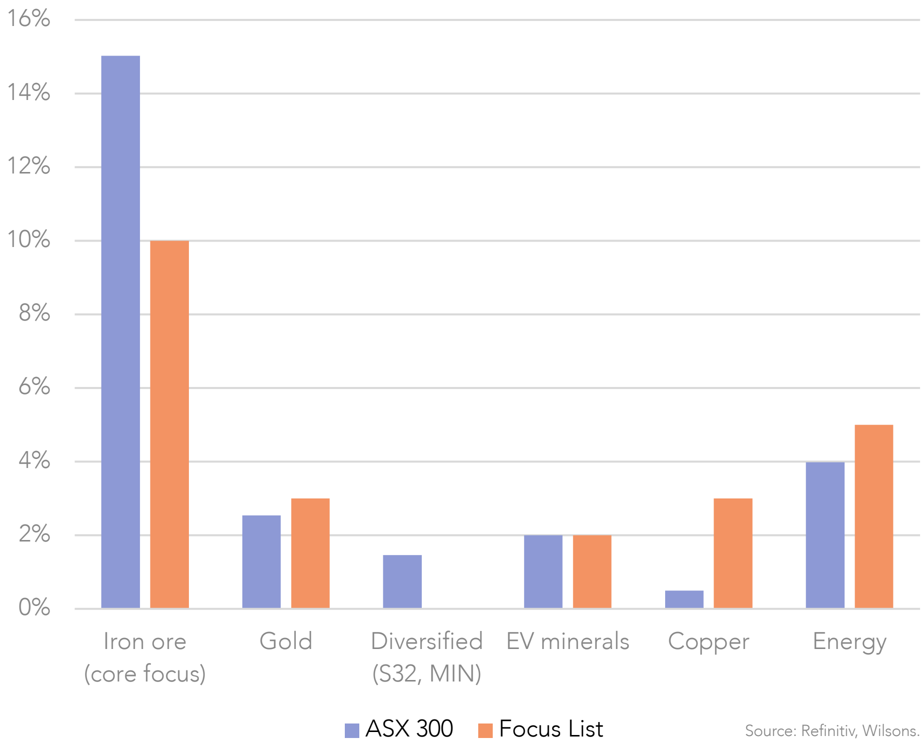
For copper and EV minerals (lithium), this is based on a view of demand outpacing supply over the medium term as the demand for EVs increases, potential exponentially, over the next decade and clean energy becomes a key thematic globally.

We are still overweight the energy sector, even after its phenomenal performance YTD. While the very long-term outlook for fossil fuel demand appears bleak, we still appear to be some way from peak oil demand, while the (in our view, unavoidable) role of gas as a transition fuel suggests demand is likely to accelerate in coming years, before plateauing and ultimately declining much further down the track.

These sticky demand patterns are playing out against a backdrop of very limited capital expenditure needed to deliver new supply to replace the inherent yearly decay in global production capacity. Solid medium-term demand with limited supply has for some time seemed to us a very bullish setup for the Australian oil and gas sector for the next few years.

We still hold gold producer Northern Star (NST) as a hedge against inflation. We believe inflation will ease over the next 12 months but hold NST in case inflation stays elevated for longer than expected, which, while not in our base case, is still a distinct possibility.

Figure 4: Focus List resources weightings by sub sector



Source: Refinitiv, Wilsons.

Looking Ahead this Month

Banks reporting on the agenda this week

Results kick off for 3 of the banks in the Focus List today (4th May). We think that Net Interest Margin (NIM) pressures will be key for the predominantly home lending banks like ANZ and Westpac (WBC), while loan growth will be a key item for business bank NAB.

NIMs are likely to be under pressure for the home lending banks as competition has remained elevated over the last 12 months and customers have shifted towards fixed interest loans since the pandemic. We believe that this should still be evident in the 1H22 results for ANZ and WBC.

The cost out delivery of WBC will be closely watched, as WBC aims to deliver on its $8bn cost target by FY24. Reducing this cost-to-income ratio closer to peers could provide upgrades to consensus earnings. Costs will be important for the banks as wages have potentially increased across the board.

For NAB, business banking growth is critical in this result - it would offset any NIM pressure from the home lending side. We believe that NAB is the most likely to close the valuation gap on CBA over the medium term, with the turnaround proving successful to date.

Figure 5: Focus List banks to report this month

Bank	Portfolio Weight	ASX 300 Weight	Reporting Date	ISG View
NAB	8.5%	4.7%	5/05/2022	We do not expect to see the NIM pressure that should be evident in the home lending banks. Business banking to continue growing (and above market) as the economy has recovered after lockdowns in FY21. We are not expecting an announcement on capital return after the $2.5bn of buybacks announced in March, but a good result could improve market sentiment on the likelihood of further capital return.
Westpac (WBC)	5.0%	3.7%	9/05/2022	We are looking for good news on the cost out process after a good 1Q22 update in February. We expect NIM pressure will be significant in the 1H22. Further asset sales could be announced shortly, with BT Panorama the next on the chopping block, opening the door for further capital return to shareholders.
ANZ	4.0%	3.4%	4/05/2022	We expect NIM pressure will be significant in 1H22, especially for ANZ, as home lending competition has intensified over the last 12 months. Market volatility may have supported ANZ's institutional business, which is significantly larger than the other big 3. This has the potential to surprise the market and is typically 30% of cash earnings, so not immaterial.

Source: Refinitiv, Wilsons.

Confession season begins

"Confession Season" usually takes place in May or June of each year as companies become aware that they may not be able to meet profit expectations and then "confess" their sins. Either the management team made explicit forecasts during the previous financial year or at the post-financial-year annual general meeting, or consensus forecasts. We wait with bated breath for any news on Focus List stocks.

May Reporting Season

There are a number of Focus List companies reporting results in May. In addition to the banks, NWS, JHX, XRO, ALL and MQG report this month. Despite our relatively positive outlook on these businesses, we are wary that the market may punish an underwhelming result. As we saw in the US earnings season, stocks that have disappointed in terms of earnings have seen a substantial derating.

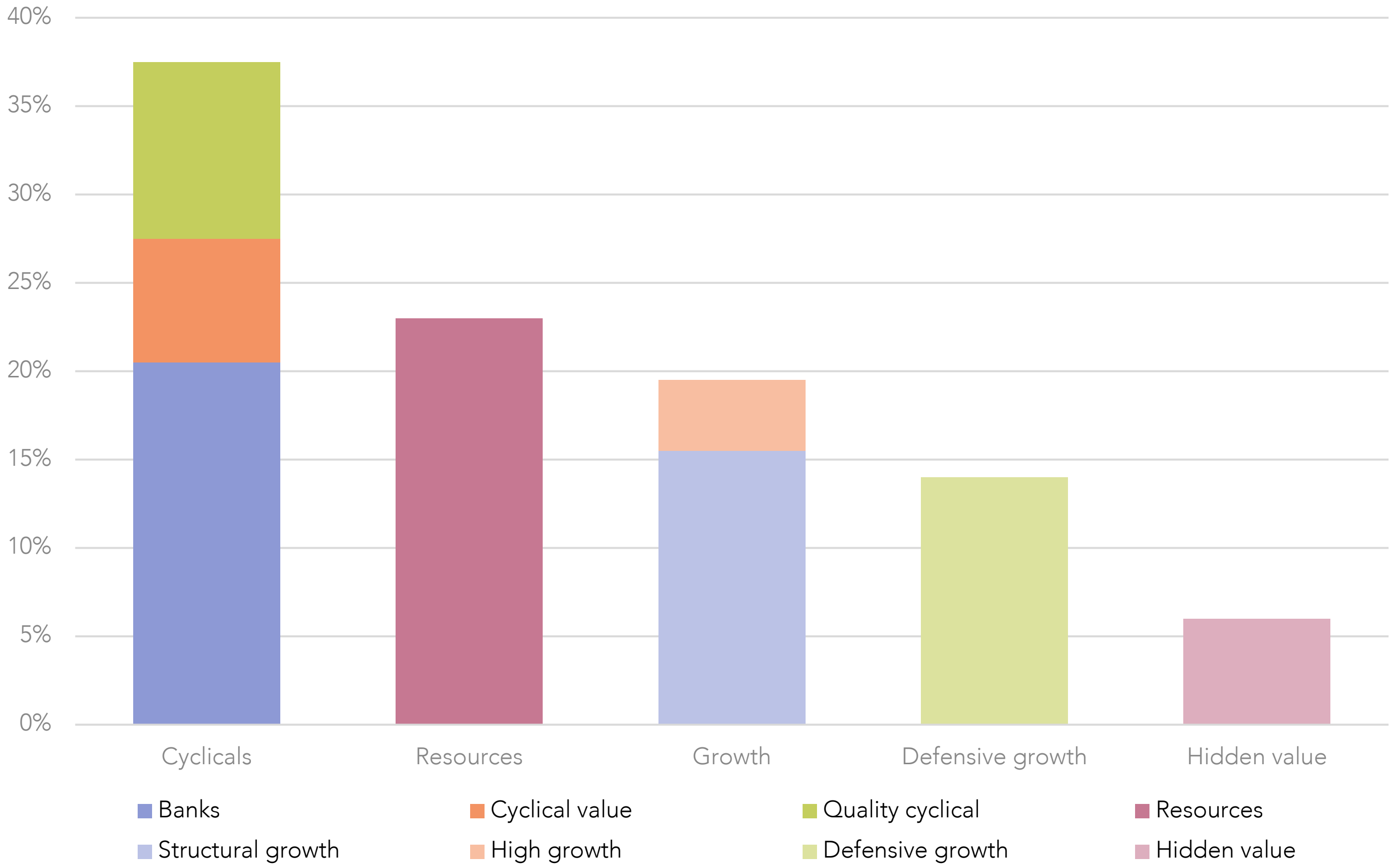
This is certainly the case for growth stocks where PE multiples may be elevated. Netflix is a prime example of a stock decimated by a poor result. Most stocks reporting (outside of the banks) could be classified as growth or high PE (quality) cyclicals. This is something we will monitor closely over the next few weeks.

Figure 6: Fundamental table for the Focus List

Company Name	Ticker	Weighting	Share Price	Market Cap (A$b)	Forecast Multiples 12mth fwd PE	Forecast Multiples 12mth fwd EV/EBITDA	EPS FY1	EPS FY2	EPS FY3	EPS CAGR % (FY1-FY3)	Dividend Yield % 12mth fwd	ROE (FY1)	Net Debt/ EBITDA (FY1)	Consensus Recommendation Mean (5 = Strong Sell, 1 = Strong Buy)
Communication Services		**8.0%**												
Telstra Corporation	TLS	2.0%	3.99	46.6	24.1	8.0	0.14	0.17	0.19	14%	4%	11%	1.6	2.2
News Corp	NWS	3.0%	28.54	16.9	19.9	7.1	0.92	1.02	1.19	14%	1%	7%	0.2	2.0
Seek	SEK	3.0%	26.93	9.6	34.7	21.0	0.69	0.78	0.89	14%	2%	14%	2.4	2.4
Consumer Discretionary		**9.5%**												
Aristocrat Leisure	ALL	4.5%	33.16	22.3	19.4	12.1	1.56	1.78	1.98	13%	2%	21%	-0.1	2.1
Silk Laser Australia	SLA	2.0%	2.81	0.1	12.4	6.5	0.15	0.23	0.27	33%	0%	9%	1.2	1.3
Tabcorp Holdings	TAH	3.0%	5.34	11.9	26.0	11.9	0.17	0.21	0.23	15%	3%	6%	1.8	2.1
Energy		**5.0%**												
Santos	STO	5.0%	8.01	27.2	7.2	4.3	0.84	0.69	0.58	-17%	4%	19%	0.6	2.0
Financials		**31.5%**												
Westpac Banking Corp	WBC	5.0%	23.88	83.8	13.8		1.51	1.84	2.07	17%	5%	8%		2.8
National Australia Bank	NAB	8.5%	32.32	104.3	14.2		2.04	2.40	2.39	8%	5%	11%		2.1
Insurance Australia Group	IAG	3.0%	4.53	11.2	15.1	10.5	0.19	0.31	0.33	31%	5%	8%		2.4
Macquarie Group	MQG	6.0%	203.18	78.1	18.7		11.53	10.74	11.37	-1%	3%	17%		2.0
Australia and New Zealand Banking Group	ANZ	4.0%	27.30	76.5	12.5		2.05	2.25	2.46	10%	6%	9%		2.3
Judo Capital Holdings	JDO	3.0%	1.65	1.8	29.0		0.01	0.06	0.11	251%	0%	1%		2.2
Pinnacle Investment Management Group	PNI	2.0%	9.06	1.8		18.2	0.42	0.48	0.56	16%	4%	24%	-0.4	2.0
Healthcare		**9.0%**												
CSL	CSL	7.0%	270.45	130.6	32.9	20.6	4.95	5.87	6.83	17%	1%	20%	2.3	1.8
Telix Pharmaceuticals	TLX	2.0%	4.30	1.3			-0.17	0.07	0.28		0%	-70%	2.9	1.6
Industrials		**7.0%**												
Qantas Airways	QAN	4.0%	5.76	10.9	20.4	5.8	-0.72	0.37	0.68		2%	-332%		2.2
Seven Group Holdings	SVW	3.0%	19.66	7.2	10.6	8.3	1.59	1.87	2.09	15%	2%	17%	2.7	2.0
Information Technology		**2.0%**												
Xero	XRO	2.0%	90.00	13.5	185.2	52.0	0.05	0.46	0.81	304%	0%	2%	-0.8	2.3
Materials		**22.0%**												
BHP Group	BHP	10.0%	47.98	243.5	8.9	4.7	4.38	3.73	2.74	-21%	8%	42%	0.1	2.3
Allkem	AKE	2.0%	11.91	7.6	8.8	5.2	0.50	0.99	0.93	37%	0%	17%	-0.4	1.9
James Hardie Industries	JHX	4.0%	40.66	18.2	16.1	10.8	1.40	1.75	1.90	17%	4%	47%	0.7	2.2
OZ Minerals	OZL	3.0%	24.35	8.2	14.7	7.3	1.68	1.63	1.44	-7%	1%	14%	0.5	2.6
Northern Star Resources	NST	3.0%	9.61	11.2	19.2	5.7	0.30	0.52	0.63	45%	3%	4%	-0.1	1.7
Real Estate		**6.0%**												
Healthco Healthcare and Wellness Reit	HCW	2.0%	1.94	0.6	21.7	16.2	0.06	0.09	0.11	32%	5%	4%	7.9	2.0
Goodman Group	GMG	4.0%	22.26	41.7	24.4	23.0	0.81	0.92	1.03	13%	1%	11%	0.8	1.9

Source: Refinitiv, Wilsons.

Figure 7: Focus List weighting by factor



Source: Refinitiv, Wilsons.

Disclaimer and Disclosures

Recommendation structure and other definitions

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

Disclaimer

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