Rates on the Move

Our weekly view on Australian equities.

11 May 2022

Cautiously Optimistic

Last week the RBA hiked rates for the first time in 12 years, raising the cash rate from an all-time low of 0.1% to 0.35%.

Several more rate hikes are likely in the next 12 months as the market expects aggressive action from the RBA.

Read Fed's biggest rate increase in 22 Years

The relationship between RBA hike cycles and Australian equities is quite nuanced. We have seen periods where rising rates have coincided with strong equity performance, like in the 2002-07 period, although shares eventually suffered in 2008. There are also times when rate hikes have led to poor performance from the outset, like in 1994 and 1973.

We believe that RBA rate hikes will not be a significant headwind for equities as the Australian economy should be relatively resilient to higher rates. However, a rate hike environment would likely result in prolonged volatility until the market gets more clarity on the end game.

Themes to Be Cautious on

While we are not bearish on the outlook for Australian equities, there are a few risks to consider when assessing portfolios.

- **Lower disposable income.** Households have less disposable income due to higher mortgage payments and high inflation.
- **Lower house prices.** House prices could decline as interest rates rise.
- **Corporate debt.** If interest rates continue to rise, highly leveraged companies may have a higher cost of capital.
- **RBA policy error.** The RBA may have started the hiking cycle too late and needs to be more aggressive in curbing inflation, contributing to an economic downturn.

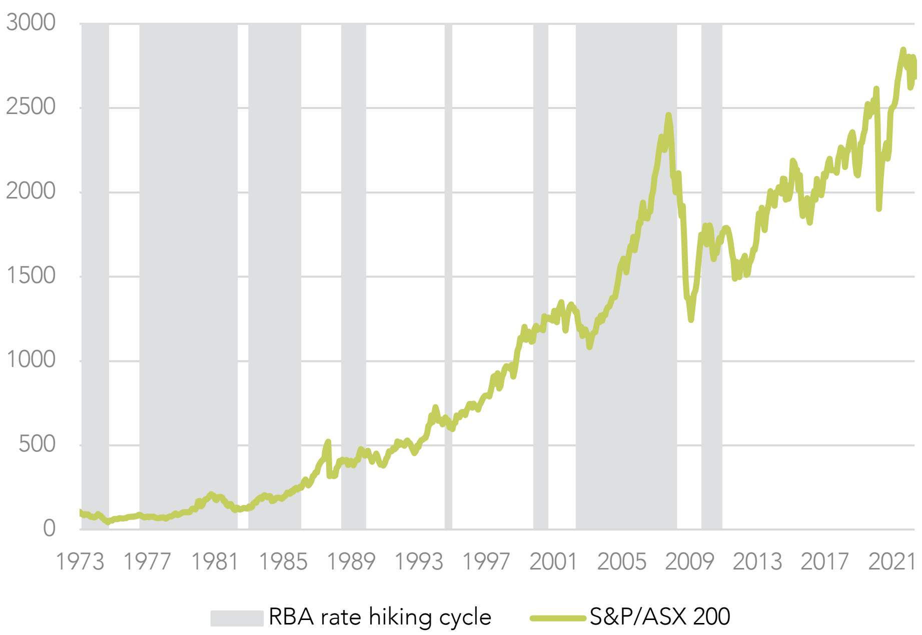
In this cycle, we believe that investors should remain underweight sectors such as retail and housing to avoid the risks cited above. We think this is sensible until there is more certainty around the quantum of rate hikes over the next year.

Rate hikes should also benefit certain sectors. In a rising rate environment, banks and insurance companies should see margin expansion.

The market has also heightened concern about the RBA's or the Fed's aggressiveness, putting a floor under defensives. This has been the case over the last month.

For some cyclicals, the Covid reopening may prove a more dominant driver than the impact of rate rises, for example, stocks like Qantas (QAN), Silk Laser (SLA) and Tabcorps (TAH) wagering arm will likely benefit from a consistent period of zero mobility restrictions in FY23.

Figure 1: Australian equity performance has been nuanced during previous rate hike cycles



Source: Refinitiv, Wilsons.

Tough Period for Retailers?

Consumer spending is likely to be affected directly by higher interest rates via two channels. With a higher savings rate, households are incentivised to save more and spend less. Another factor more relevant to Australia, is that mortgage repayments increase. Australia is particularly at risk since most loans are pegged to the RBA cash rate, rather than fixed rates.

There is a risk that more households will be under pressure to pay their bills and put food on the table if mortgage repayments and inflation rise. Households with lower incomes will be less likely to spend money on clothes and electronics.

This could be a very challenging period for retailers.

Consumer confidence has already been impacted by expectations of higher interest rates and higher inflation; further declines could lead to a substantial slowdown in consumer spending.

Looking at the initial period of rising rates in 2002, retail stocks struggled relative to the ASX 200.

However, it is not all bad news for retailers this time around. Households are still sitting on high levels of cash, with $200bn in excess cash saved over the pandemic. This excess cash should be used to offset cost of living pressures. Even with this elevated savings rate, we still believe that the risks for retailers outweigh the rewards in a period of rising rates.

In our view, consumer services will be less impacted by rising rates than retailers. The consumer services sector has more defensive products, such as gaming and fast food. We also believe that a normalising of spending habits from goods to services (e.g., sofas to travel), will provide a tailwind for services over the next 12 months.

ASX 100 retailers where risks remain elevated:

Harvey Norman (HVN), JB Hi-Fi (JBH)

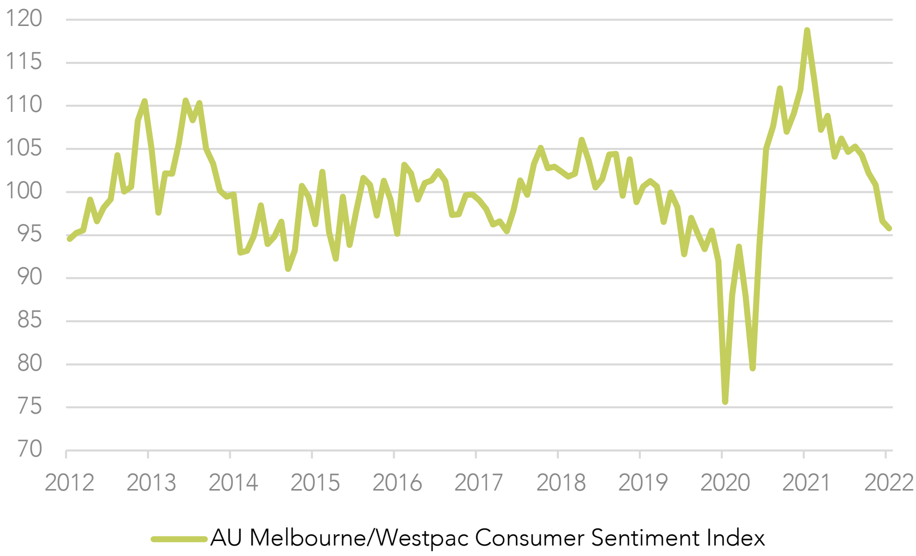
COVID has been an exceptional trading period for these stocks. They will likely face additional headwinds if the cost of living keeps rising.

Housing Sector at Risk

As a result of very high prices and high levels of household debt, the Australian property market is highly sensitive to the monetary cycle. In 2009-10, rate hikes were quickly followed by a period of weaker prices. We believe that the housing market is likely to come under pressure as rates rise, especially after a period of such strong returns.

For Australian equities, risks remain elevated on sectors and companies associated with housing activity.

Figure 2: Consumer confidence is fading

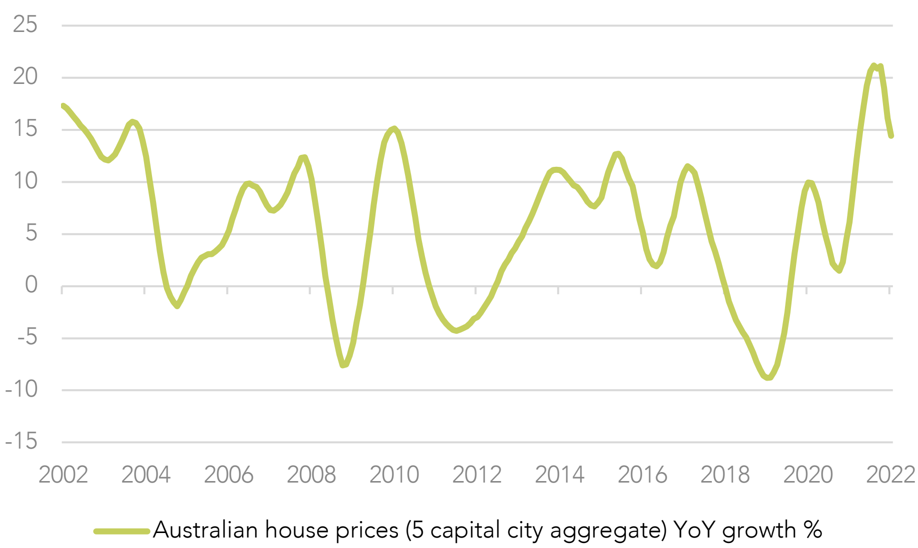


Source: Refinitiv, Wilsons.

Figure 3: Retail underperformed in the last significant hiking cycle

Source: Refinitiv, Wilsons.

Figure 4: Australian house prices have grown rapidly in recent years



Source: Refinitiv, Wilsons.

Companies and sectors in the ASX 100 where housing may put pressure on earnings include:

Online house listings: REA Group (REA) and Domain (DHG)

Listings may fall as homeowners and buyers get more concerned about the outlook for mortgage rates and house prices. REA already guided to lower listings in this quarter in its most recent update. We prefer to use New Corp (NWS) as a cheaper method of buying REA, which we think represents value relative to the REA valuation.

Bunnings: Wesfarmers (WES)

Households spend more on renovations and DIY when house prices increase. A tighter household budget and higher mortgage repayments could also burden customers. However, Bunnings has a strong market position and has proven resilient to moderate slowdowns over the last 10 to 20 years.

Housing REITs: Mirvac (MGR) and Stockland (SGP)

The housing development sector should be weaker from lower demand for housing (if prices fall). Elevated timber and steel prices could add to build costs; these companies are unlikely to be able to pass these costs onto buyers.

Corporate Debt Levels Acceptable

Stocks that are typically highly geared like utilities, toll road operators, REITs and supermarkets have a capacity to carry these levels of debt, usually due to defensive earning profiles.

Additionally, the majority of these stocks are sensitive to the long end of the bond curve, which we believe is closer to peaking than the cash rate.

For these reasons, we are not too concerned about corporate debt in a rising rate environment.

Financials Should Provide Protection, Banks and Insurance Should Benefit

We have recently discussed at length the benefit of rising rates for banks, but just to reiterate, we expect an expansion in net interest margins (NIM) as interest rates rise.

This might not only be a NIM story. Over the 2002-2008 period, banks earnings increased as credit growth was booming. We don't expect credit growth to be as stark as the pre-GFC period, but we do not think that rising rates will be a drag on credit growth, as some market commentators are suggesting.

As interest rates rise, insurance stocks can thrive. Interest rates and insurance companies typically have a linear relationship, which means that the higher the rate, the greater the growth. As a result of their underlying portfolios of bonds, insurers do not perform well in low-rate environments.

Figure 5: Banks' earnings increased significantly over the pre-GFC period

Source: Refinitiv, Wilsons.

Dependable Defensives

In the event that investors become more concerned about the outlook for economic growth as high inflation and high interest rates put downward pressure on household incomes and wealth, then defensives may outperform.

We think that global economic growth will remain reasonably resilient and have therefore not positioned heavily towards defensives at the time but think a barbell tilt towards cyclical/value and defensives is sensible, given the murky economic backdrop.

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Recommendation structure and other definitions

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

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