WILSONS

Plotting the Course of the Australian Equity Market

Our weekly macroeconomic view.

21 September 2020

Holding Pattern for Now

The Australian market now sits 12% below its 2020 starting level after what has been a tumultuous year.

A fast start for the local market was thrown violently off course with the dramatic COVID-19 induced 36% correction in the space of only 4 weeks, followed by a 35% rebound into early June.

After this rapid recovery, the Australian market has settled into a relatively tight range, as shown in exhibit 1.

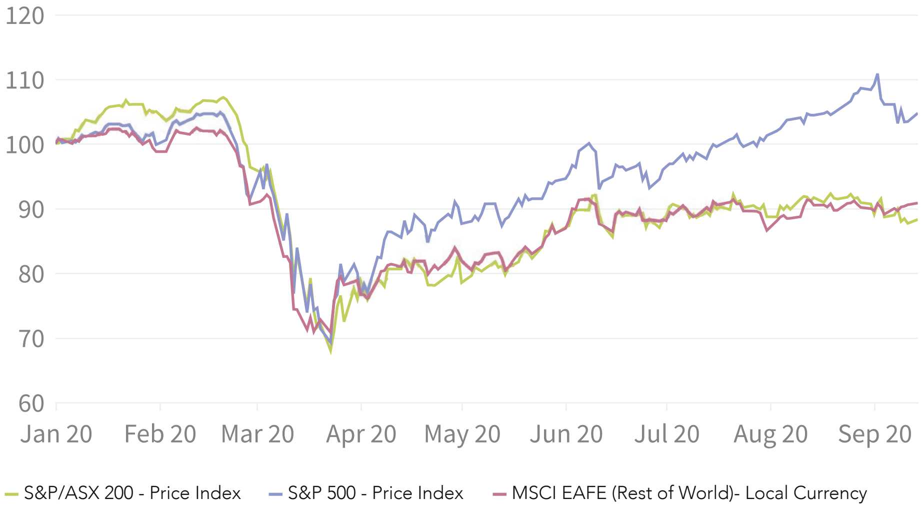
This recent range-bound performance has seen Australia underperform the tech-driven US market (although less so in common currency terms). Australia's performance has been remarkably similar to the performance of the developed world index, excluding the US.

While some commentators have suggested that undue hype around the US tech sector is giving the US market an unfair advantage, we see a reasonably strong relationship between earnings fundamentals and performance.

Australia and the rest of the world have arguably marked time in recent months because the earnings trends are relatively lacklustre and remain highly uncertain. The US, in contrast, has shown a clear return to positive earnings momentum.

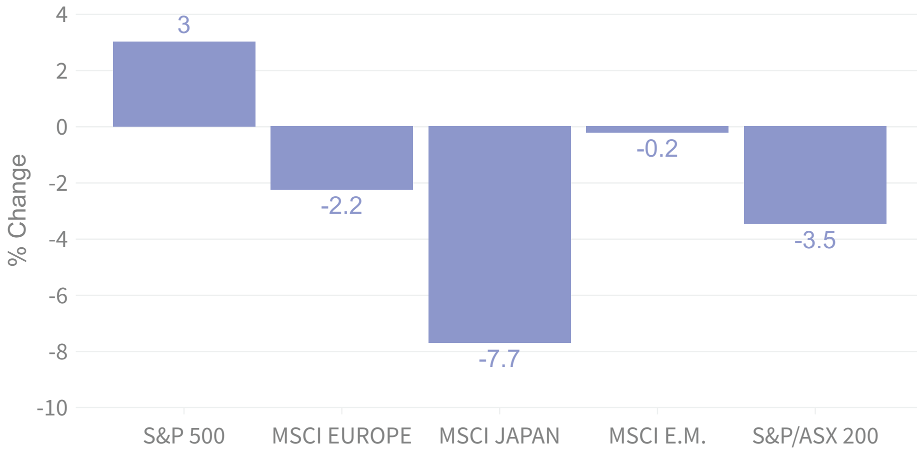
Read more about the US Tech Sell-Off.

Exhibit 1: Australian performance versus the world



Source: Refinitiv, Wilsons

Exhibit 2: Australian EPS revisions versus the world (last 3 months)



Source: Refinitiv, Wilsons

Lost Momentum

This lack of momentum is also evident in the performance of the Australian economy. The faltering of the domestic economic revival has likely contributed to the fact that the local market has been unable to break out of its 3-month trading range.

Australia had a less severe downturn than most other developed countries in the second quarter of this year due to a shorter and less extreme lockdown phase. Australia was also enjoying quite a rapid recovery in activity through late May and the month of June.

However, the dramatic shift back into lockdown in Victoria has had a significant impact on Australia's recovery profile with the recovery trend flattening out since early July. The Victorian lockdown is now considered to be close to the strictest in the world at present, meaning Australia's recovery is lagging.

We expect the early October Federal budget to provide further support ($30-50bn of additional stimulus); however, the critical JobKeeper support program is set to taper beyond September 30. The Australian economy will be relying on Victoria to reopen to see the next leg of recovery. With Victorian COVID-19 trends now improving quite rapidly, we expect reopening could ultimately proceed faster than currently planned, but there are still risks around that expectation.

Positive Catalysts

This stalled recovery raises risks to near term earnings as we move toward year-end. However, overall market sentiment is more likely to be influenced by the potential for good news in respect to global vaccine progress and the potential for a Victorian reopening. Good news on these 2 fronts is likely to overshadow some additional earnings downgrades in respect of dictating market direction.

What about Valuation?

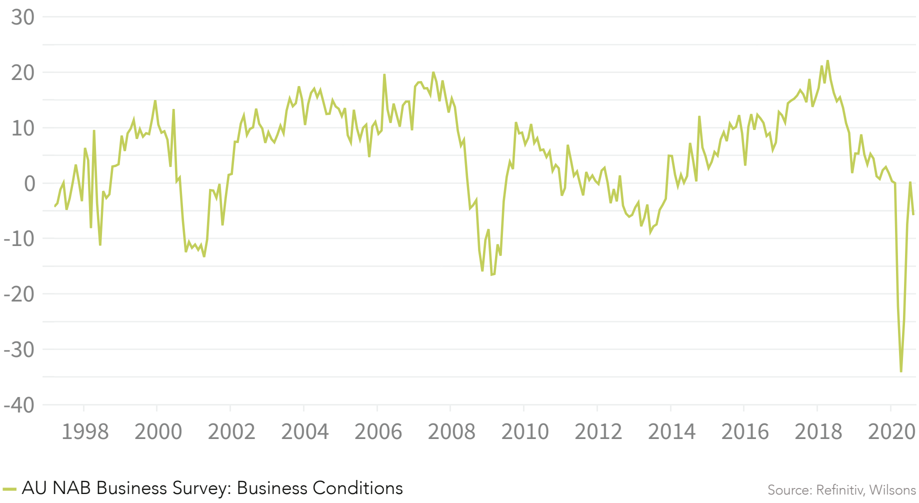
The market does not look particularly cheap at present with the market price earnings ratio (P/E) well above the long-term average.

We are not overly concerned around local valuations (on average). We have argued consistently that the current earnings base implicit in the market P/E is depressed even though the consensus is factoring in a recovery over FY21 and FY22.

The market's 1 year forward earnings per share (EPS) estimate has moved off the bottom but is still way below pre-COVID levels (23% below pre-COVID estimates). When looked at on a financial year basis, the market's FY22 estimate is well below FY19 and it is quite reasonable to expect a return to trend earnings on a 2-year view. FY19 was not a particularly strong year, being well below the long-term trend line, so we see the prospect for a multi-year recovery cycle as the world and Australian economy normalises. Monetary and fiscal policy support will be unprecedented, so ultimately we think growth can surprise to the upside despite our short-term concerns about the current lacklustre backdrop.

While near term risks, particularly the first half of FY21, is to the downside, FY22 and FY23 estimates could potentially prove too conservative. We believe this supports a positive medium-term view on Australian equities.

Exhibit 3: NAB business conditions



Source: Refinitiv, Wilsons

Exhibit 4: P/E and 1 year forward EPS

Source: Refinitiv, Wilsons

Of course, low interest rates are the other consideration. Even on a depressed earnings base, equities look attractive versus cash rates and long-term bond yields. The attraction of equities will continue to be strong over the medium-term with the RBA unlikely to consider a rate hike for multiple years in line with the sentiment expressed by the US Fed this week.

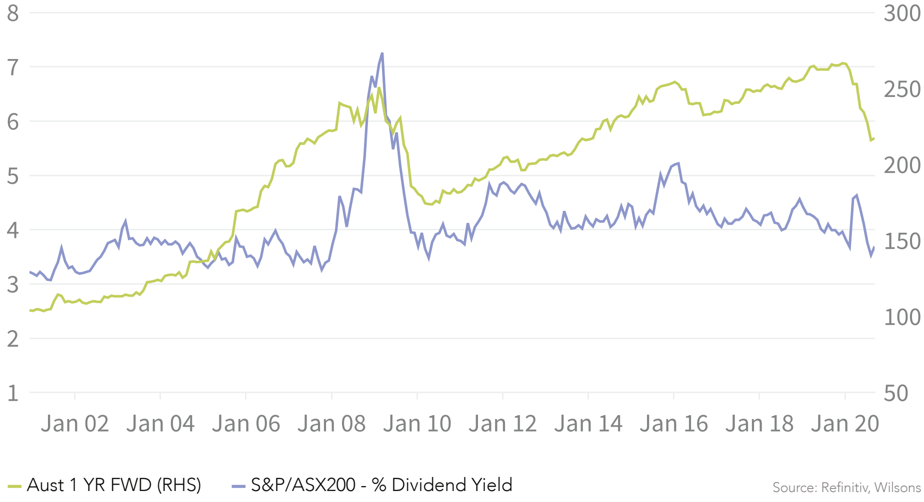
Read more about The US Fed's Experimental Policy, Inflation Risk and Investment markets.

This is of course a dilemma for savers, especially when dividends have been hit even harder than earnings this year (see exhibit 5). We do expect a strong recovery in dividends over the next 2-3 years, although we believe the payout ratio will not regain pre-COVID levels, particularly for the banks. Nonetheless, we still expect a strong recovery from current depressed levels of dividends. The combination of yield plus yield growth against a backdrop of near-zero rates will likely support the market over the medium-term.

Holding out for a Break

In the short-term, we think the prevailing range-trading environment could extend with the risk of near term earnings downgrades. Ultimately we believe the next major break will more than likely be to the upside. While probable but not certain, good news on a global vaccine would lift business and consumer confidence, as would the potential of a fresh re-acceleration in economic activity as Victoria reopens and state borders begin opening up. In the medium-term, the prospect of a multi-year earnings and dividend recovery against a backdrop of near-zero rates should provide significant support for the market.

Exhibit 5: Market Expected Dividend Yield and 1 year forward DPS



Source: Refinitiv, Wilsons

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Recommendation structure and other definitions

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