WILSONS

Six Key Charts we are Watching Now

Our weekly view on Australian equities.

09 March 2022

Charting the Australian Equity Market

This week we share six charts we are watching right now on the Australian equity market.

The outlook for the Australian equity market in isolation remains quite encouraging, despite the current geopolitical tensions. Year to date, the Australian market is down -5% vs MSCI World index in A$ which has fallen -10%.

Read Solid Local Results Overshadowed by Global Events

The prospect of rising interest rates both offshore and domestically this year reflects the continuing cyclical recovery taking place in economies and corporate earnings. This should prove to be a reasonable backdrop for the market – especially given the large weighting of cyclical sectors like energy, resources, and financials.

Right now that outlook is being questioned, with the Russia Ukraine conflict raising numerous concerns. By itself, the conflict should have only a small impact on the Australian market which has very little direct exposure to Russian assets.

The impact of the current tensions on the Australian market will be primarily felt through the transmission mechanism of higher commodity prices and higher equity risk premiums (ERP). In prior global crises, higher ERPs have typically been associated with market bottoms, with rebounding markets delivering double-digit returns over the following 12 months.

Read Getting Over the Wall of Worry

1

Australian Equity Risk Premium

The ERP measures the level of risk being priced into equities by taking the difference between the earnings yield (inverse of the PER ratio) and the risk-free rate (10-year government bond). The higher the ERP the higher the level of implied equity risk being priced in relative to a risk-free asset like a government bond rate. A high ERP typically occurs when equity markets fear the worst in terms of outlook.

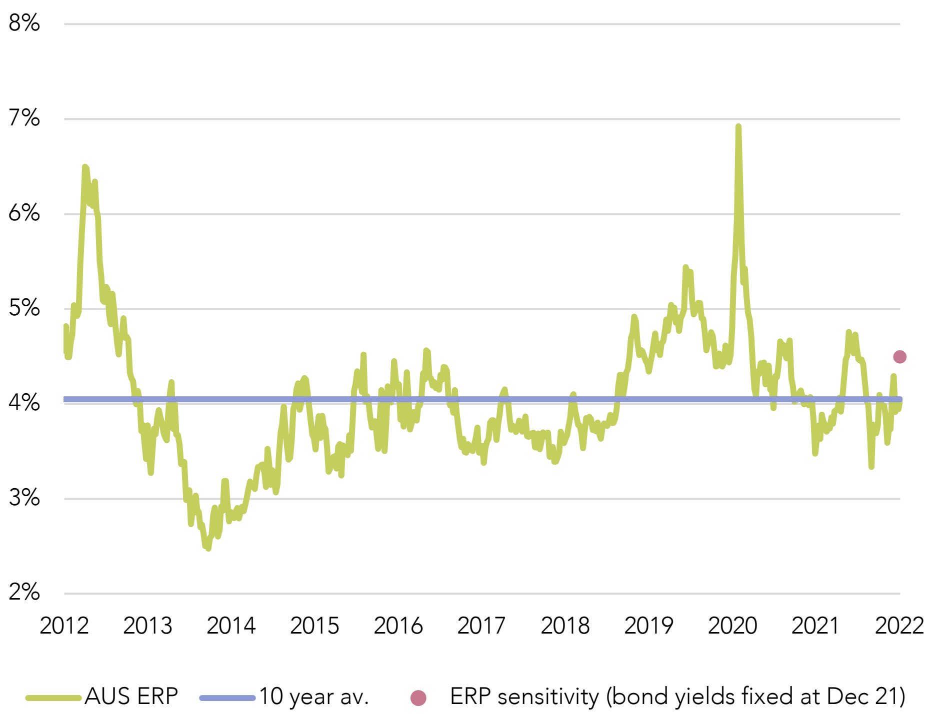
At present, the Australian ERP is only slightly elevated vs where it was in late 2021. This is unusual in a global risk-off event like we are currently witnessing. Both sides of the equation are currently working to depress the ERP, hovering around its long-term average.

If we hold the bond yield flat (vs the move from 1.7% to 2.2% since December), the adjusted ERP would jump from 4% to 4.5% – cheap vs history.

In reality, the nature of this risk-off event is likely to be beneficial for Australian market earnings, whilst the bond market suggests any potential global slowdown will not impact Australia as significantly as the rest of the world.

In a way, Australia has become a relatively safe haven in this risk-off event. Something to bear in mind when the conflict eventually deescalates.

Exhibit 1: Australian ERP has remained subdued so far during this risk-off event



Source: Refinitiv, Wilsons.

2

Resources Relative Performance

Resources sector has outperformed the broader market by 30% since November 2021. On a longer-term basis, resources have been on an uptrend relative to the market since 2015-16.

Historically, the resources sector typically goes through extended periods of above/below market performance. In the last major commodity cycle materials outperformed by a factor of x3 over a 6-7 year period from 2003 to 2010. In the most recent cycle of 5 years between 2015-2020 the materials outperformed the market by a factor of 2x.

Our view is that the rally we have seen so far in 2022 across the commodity complex is an extension of the 2015-2020 cycle (which paused over the 2020/21 period). Prices for most commodities at the end of 2021 were well above the prior bottom of cycle levels. in many cases, prices were above both historical averages and consensus assumptions of long-term equilibrium prices.

That is not to say a potential de-escalation of the current conflict will not have a negative impact on the commodity complex in the short-term (it most likely will). Our fundamental view remains constructive over the medium-term given the prospects of further supply/demand imbalance given:

- Lack of capital spending across the materials sector
- Demand levels should continue to grow given global growth
- ESG agendas have slowed the deployment of capital into new supply

Exhibit 2: The current cycle of resource sectors outperformance is still dwarfed by prior 2003-2010 cycle

Source: Refinitiv, Wilsons.

3

Materials Share of Market Matching Post-2000 Highs

The share price rally in resources companies has coincided with BHP Group's (BHP) unification into the local index in early January. This has resulted in BHP's index weight lifting over 4% points from 6.5% to 10.7%.

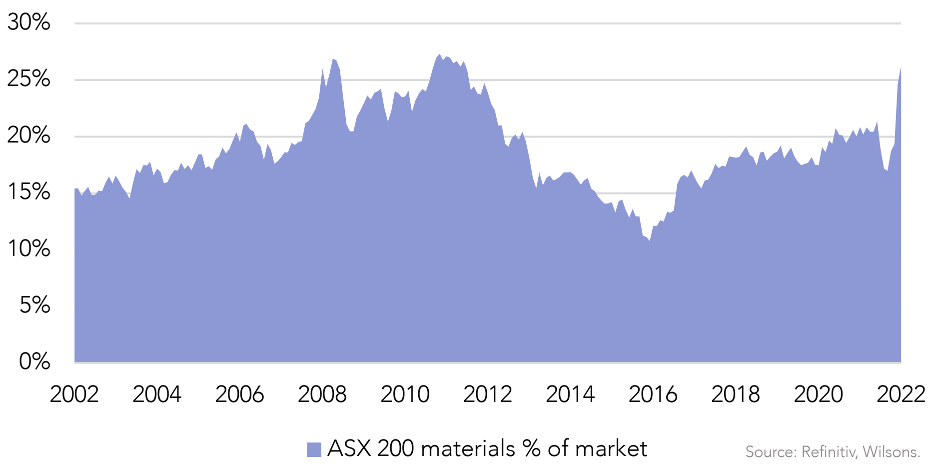
The upweighting of BHP is the largest compositional change to exit since News Corp was removed in the mid-2000s, which halved the size of the consumer discretionary sector at the time.

Read The Bigger Picture Behind BHP's Unification Plan

Combined, these two factors have lifted the materials sector through 25% of the market, up from 19% in late 2021. Since 2012, the materials sector has averaged ~17% of the market.

Our sense of looking at large active Australian equity managers' holdings is that many local managers remain underweight materials. Against a period of rapidly increasing prices and a seismic move in the index weighting of BHP, fund manager inertia is likely to have resulted in many active managers being underweight materials. It may take several months for this rebalance to play out, potentially supporting the share price.

Exhibit 3: Materials sector share of market still trails the post-GFC high



Source: Refinitiv, Wilsons.

4

Energy Sector Relative Performance

In this oil cycle, the Australian energy sector performance has materially lagged the experience in prior cycles. This is also the case when comparing against price moves in both European and North American energy sectors over the past 18 months. We have previously written about the Australian energy sector's lack of free cash flow (FCF) as being potentially explained by the apparent disconnect in the Australian market (versus offshore).

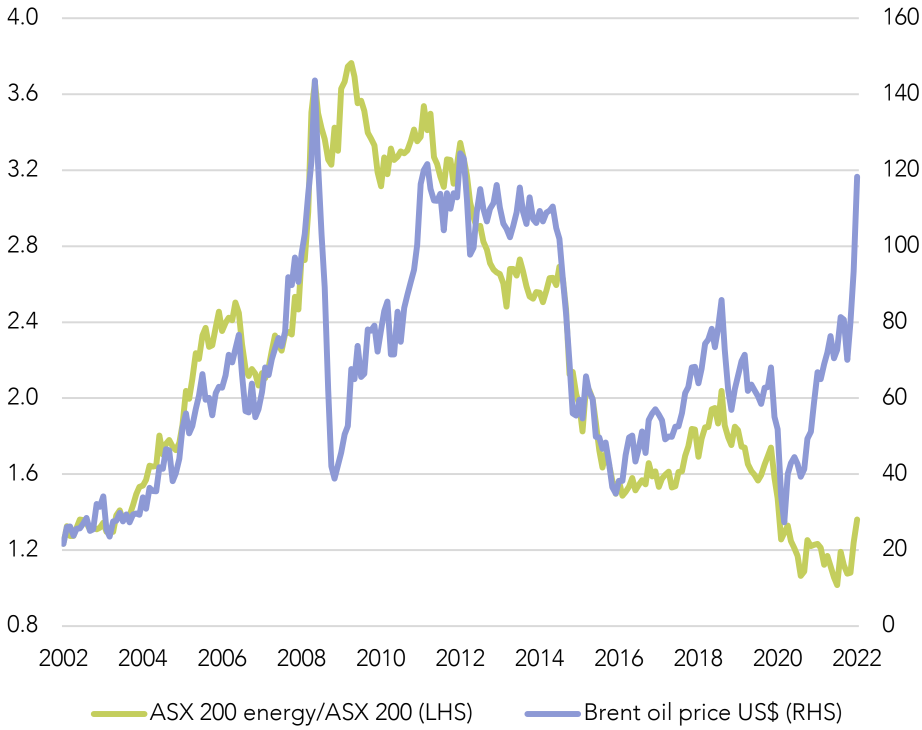
Read Australian Energy Sector: Streamline to Rerate

In the last energy crisis, oil rose just over 4x, reaching $US140 in 2008. Over the same period, the Australian energy sector outperformed the broader market by almost 3x. In the current period, oil is at US$130, up to 3-4x (discounting the period when oil went negative in 2020), yet the Australian energy sector has outperformed by just ~40% since the low in 2Q20.

Can oil keep running? The short answer is yes. An inflation-adjusted spot price of >US$180/bbl would match the prior highs of US$140 in 2008. With global GDP today less reliant on oil vs 2008, oil would need to move substantially from current levels to have the same negative impact on global activity.

Australian oil stocks are discounting the current price of oil. Whilst Brent oil futures currently imply $US110/bbl over the next 12 months – the share price of Santos (STO) implies an oil price of ~$62.00. For Woodside (WPL) the implied oil price is ~$73.00.

Exhibit 4: Energy sector relative performance vs the oil price



Source: Refinitiv, Wilsons.

Exhibit 5: Australia vs global sector performance since the Russian invasion of Ukraine

Sector	ASX 200	MSCI World	Outperformance/ Underperformance
Industrials	-5.2%	-5.5%	0.3%
Cons Discr	-9.4%	-12.7%	3.3%
Cons Staples	0.3%	-5.2%	5.4%
Energy	14.5%	6.4%	8.1%
Financials	-8.1%	-12.0%	3.8%
Healthcare	-8.3%	-0.9%	-7.4%
IT	-8.4%	-7.3%	-1.1%
Materials	4.0%	-3.6%	7.6%
A-REIT	-6.8%	-1.4%	-5.4%
Comm. Svs	-3.7%	-6.5%	2.7%
Utilities	-1.7%	1.7%	-3.4%
Index Level	-3.5%	-6.3%	2.8%

*Price performance 17/02/22 to 07/03/22.

Source: Refinitiv, Wilsons.

5

Sector Performance Since the Russian Invasion of Ukraine

Since the start of the invasion of Ukraine, consumer discretionary, financials, and technology sectors have fallen the most.

Energy has been the star outperformer boosted by the oil price, followed by materials on concerns around raw materials supply. Classic defensive sectors like utilities and consumer staples has outperformed.

Value indices have dropped, given a heavy tilt towards financials. Growth indices have been more resilient, partially reversing some of the gains value made over the past 6 months.

6

Areas of Dividend Appeal

Banks continue to stand out relative to other traditional dividend yield areas of the market, offering ~4.5% unfranked yield for close to 6.5% when grossed up. REITs look around fair value relative to bond yields at ~2% premium (in line with the sector's long-term average). The utilities sector at face value looks attractive, but dividend certainty is lower than usual with the ongoing strategic review at AGL currently underway.

Whilst not a traditional area of dividend appeal, Resources currently offer a prospective 7.7% dividend yield, despite the rally in share prices this year. Upside earnings scenarios to current commodity prices imply close double the earnings in FY23E, which could potentially see significantly upgraded.

Finally, term deposit pricing from the major banks has not changed over the past 12 months at 20-30bps.

Exhibit 6: Resources continue to standout from a yield perspective, followed by the banks

Asset	Yield %
ASX 200 Resources	7.4
ASX 200 Banks	4.4
ASX 200	4.3
ASX 200 Utilities	4.1
ASX 200 A-REIT	3.5
ASX 200 Cons Staples	3.1
ASX 200 Telecom	2.9
Aus 10 Year Government Bond %	2.2
Term Deposit	0.3

Source: Refinitiv, Wilsons.

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Recommendation structure and other definitions

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

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