WILSONS

Inflation Beneficiaries: What is Currently Priced in?

Our weekly view on Australian equities.

23 February 2022

Positioning for the Prospect of Higher Inflation

The higher inflation narrative caught up with global markets in January this year. Australian 10-year bond yields climbed from 1.5% to 2.0% over the month, one of the fastest sell-offs seen in over three decades. Australian equities struggled against this regime change, with equities falling -6% in the month.

Inflation is driving a regime change, forcing central banks to quickly pivot from almost unlimited monetary accommodation to a faster pathway of rate normalisation. Complicating the task of assessing just how persistent higher inflation will be are the ongoing distortions from COVID-19.

For Australian equities, the prospect of higher inflation is mixed. Half of the market (in market cap terms) is likely to see improved earnings as a response to higher inflation - energy, materials, financials. For the remainder of the market, the earnings outcomes are less certain with the balance between higher revenues and costs often lagging and exposing earnings holes.

We look at some of the ways investors can position for the prospect of higher inflation (and interest rates). The energy, materials, and financials sectors have historically outperformed the broader market in periods of rising inflation.

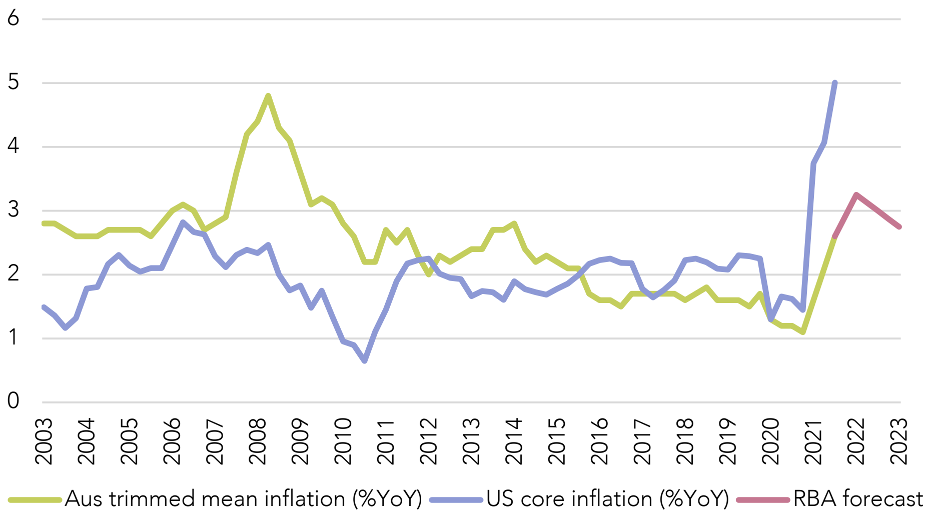
Both Computershare (CPU) and QBE Insurance (QBE) are often seen as 'go to' interest rate beneficiaries. We explore what the current share prices are implying in terms of earnings growth and future interest rates.

Rising Inflation... with Higher Interest Rates to Quickly Follow

After almost two decades of persistently low inflation reads, the COVID-19 recovery has pushed US inflation to a 40-year high. Australian inflation has also started to rise, although domestic inflation pressures are so far much more subdued than what is occurring in the US.

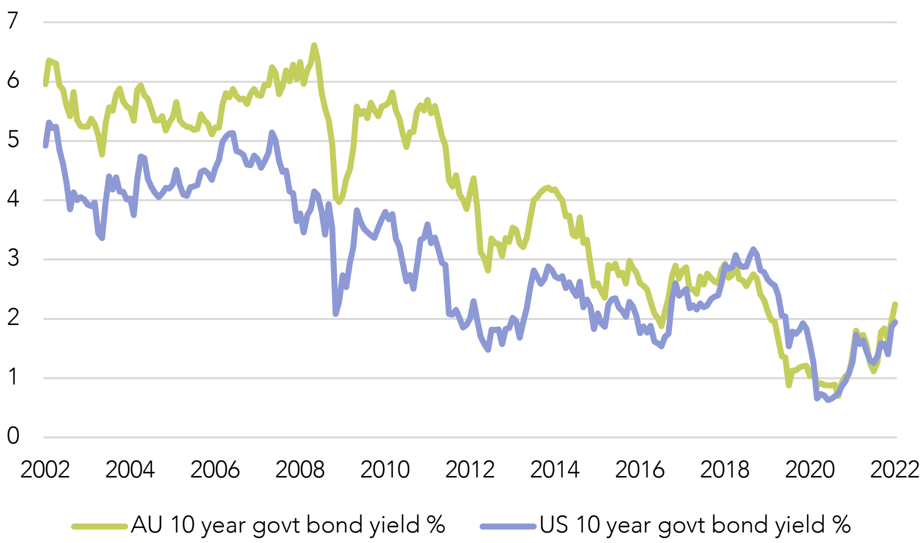
Forward-looking rate markets are now starting to factor in much higher rates. The pivot from the Federal Reserve in January 2022 and the RBA earlier this month has only heightened the markets' expectations of rate increases.

Exhibit 1: Australian core inflation has been much more subdued than in the US so far



Source: Refinitiv, Wilsons.

Exhibit 2: Australian bond yields rates rose from 1.5% to 2.0% in January



Source: Refinitiv, Wilsons.

Inflation Beneficiaries

Cyclical sectors typically outperform when inflation expectations are rising, a consequence of buoyant levels of economic activity and improved pricing power. The performance so far in this cycle looks very similar to what we have seen in prior cycles.

While the debate around inflation and interest rates continues, the equity market is likely to remain quite choppy, with no clear index direction emerging. The debate between cyclical earnings recovery (a positive for share prices) and higher interest rates or discount rates for valuations (a negative for share prices), will keep both a ceiling and floor under the index. At this stage, we continue to believe the earnings story will win out against a growth stifling tightening cycle from central banks.

The Wilsons Australian Equity Focus List is overweight energy, financials and market weight materials (adjusting for mining services company Seven Group (SVW)), as we are currently positioned for higher inflation and rising interest rates. Our overweight to communication services is two-thirds weighted to cyclical exposed News Corporation (NWS) and Seek (TLS), with Telstra Corporation (TLS) making up the balance.

Computershare (CPU)

Business processing specialist CPU is the most leveraged company to higher global interest rates in the S&P/ASX 100. CPU's management estimate that a 1% point lift in global rates will lift group profitability by ~40%.

Interest earning cash balances CPU holds across key business lines are expected to average ~$40bn this half. The recent acquisition of the Wells Fargo Corporate Trust has doubled CPU's exposure to interest rates.

We estimate half of CPU's earnings guidance upgrade at the 1H22 results is directly driven by higher rates. Guidance was upgraded from ~2% to ~9% EPS growth for FY22E, which was based on the forward rates curve in early February. The market is currently more ambitious, with +13% EPS growth currently forecast for FY22E. This accelerates to 30% EPSg in FY23E and 20% in FY24E.

Exhibit 3: Selected periods rising inflation and cyclical sector performance

	Outperformance to ASX All Ords		
	ASX All Ords Financials	ASX All Ords Energy	ASX All Ords Materials
Mar 1973-Dec 1979	1%	25%	33%
Mar 1981-June 1983	44%	21%	18%
Dec 1984-Dec 1990	6%	26%	49%
Dec 1999-Dec 2001	13%	-7%	1%
Mar 2020 - Now	22%	26%	56%

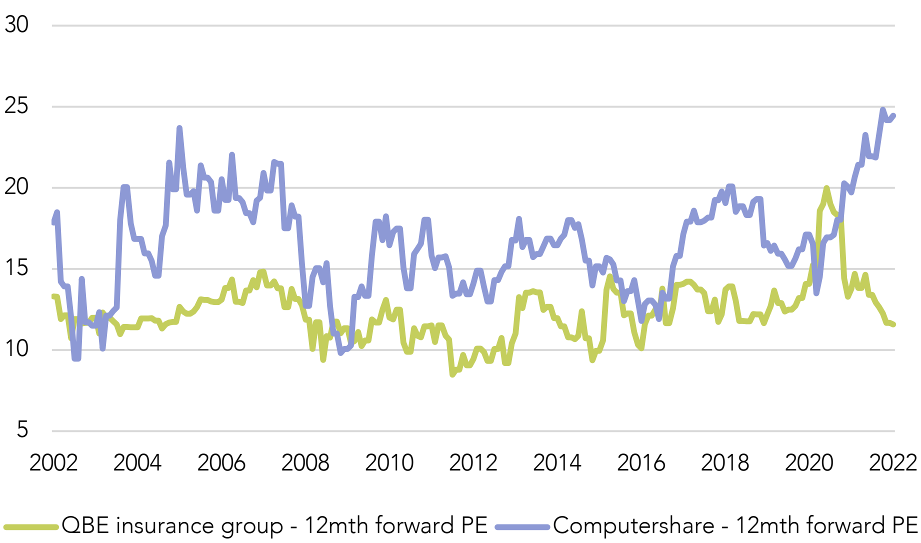
Source: Refinitiv, Wilsons

Exhibit 4: Focus List sector weights relative to market

	FL	ASX 300	Over/Under
Financials	28.5%	28.4%	1.0x
Materials	20.0%	24.9%	0.8x
Healthcare	10.0%	9.2%	1.1x
Energy	5.0%	3.6%	1.4x
Communication Services	9.0%	4.0%	2.3x
Information Technology	6.0%	3.6%	1.7x
Industrials	8.0%	5.8%	1.4x
Consumer Discretionary	6.5%	7.4%	0.9x
Real Estate	7.0%	7.2%	1.0x
Utilities	0.0%	1.2%	0.0x
Consumer Staples	0.0%	4.7%	0.0x

Source: Refinitiv, Wilsons

Exhibit 5: CPU's PER is now two standard deviations above vs long-term, QBE PER inline with long-term average



Source: Refinitiv, Wilsons.

CPU presently is trading on 12mth forward PER of 24x, two standard deviations more expensive than its long-term average. This puts CPU on its equal highest absolute and relative PE to the market since 2002.

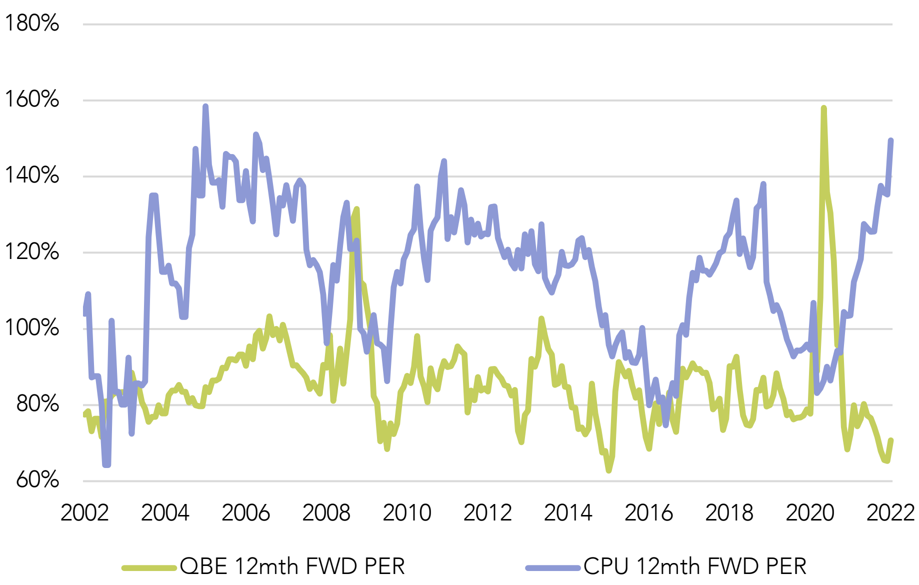
If we attribute half of that valuation stretch to the growth boost the Wells Fargo acquisition will provide over 2022-24E, then the remaining valuation stretch is likely to be explained by interest rate expectations. The current market forward curves blended for CPU exposure (US, UK, CAD, AU) imply bank bill swap rates of ~2.0% by mid-2024 (vs the current 0.2%). We believe this is already captured in market forecasts for CPU.

For CPU's PER valuation to fall back to the long-term average (adjusted for Wells Fargo acquisition), CPU would need to see earnings upgraded by ~10-15% (leaving other parts of the business unchanged). That equates to an upward shift in CPU's blended swap curve to 2.2-2.3%. That's not unreasonable if (US) inflation remains elevated over the next few months.

It does leave the CPU share price vulnerable if inflation turns out to be more transitory than what the market is currently forecasting.

Read The Australian Economy, the RBA and Interest Rates

Exhibit 6: PER relative to market: CPU approaching 20-year high, QBE still looks cheap vs the market



Source: Refinitiv, Wilsons.

QBE Insurance (QBE)

Insurance companies typically provide outperformance opportunities in periods of rising inflation/interest rates. They benefit from higher premiums due to the rising inflation environment and higher interest income on policy holders' funds. There is some offset as claims inflation can eat into premium growth. Insurance companies typically use inflationary periods to exercise their market power and lift premiums over underlying inflation. In the last quarter, QBE lifted premiums by almost 10% and has had 8% plus premium growth since 2019.

Estimating QBE's leverage to higher interest rates is more nuanced than for CPU. There are a range of factors that could interfere with headline benefit – and a number of them are outside of management's control. This dilutes the overall capture of the higher interest rates into the share price.

QBE has not guided to direct interest rate sensitivity. We estimate QBE would see a benefit of 10-20% to earnings if rates were to rise by 1.0%. This assumes that higher premiums are not offset by higher claims inflation; the capital base is unchanged while profit margins expand marginally.

Market consensus currently implies 20% EPS CGAR for QBE over FY21-24E. Over ¾ of growth is derived from margin expansion, not premium growth, which looks to have peaked in this cycle in 1H21. Being an insurance company, the benefit of further lift in market interest rates will be more nuanced than for business processing companies like CPU.

QBE's PER multiples both in an absolute sense and relative to the market don't appear to contain much, or any additional expectation of higher interest rates. PERs are around the long-term average, despite a favourable rates outlook and a period of earnings growth likely to be 4-5x higher than QBE's long-term average. Relative to CPU, QBE looks like the value play for interest rate exposure.

Exhibit 7: Selected company sensitivity to +100bps move higher in interest rates

Stock	Company Guidance	Earnings Change	Wilsons Comment
CPU	Yes	40%	Significant leveage to higher rates across US and UK. Skew is overnight and three month rates.
QBE	No	10-20%	Primarily based on uplift from high premiums and small contribution from policy holders funds. We assume a small expansion in profit margin and no additional change in the capital base.
IAG	No	5-10%	Benefit depends on IAG ability to offset claims inflation with premium increases.
EML	Yes	18%	14-15m EBITDA benefit from rates. If US rates were to move up through 2%, the benefit would improve further still.

Source: Refinitiv, Wilsons

Focus List Beneficiaries of Higher Rates

Focus List

Insurance Australia Group (IAG) | 3% weight

We see IAG as offering mild positive exposure to higher inflation/interest rates. Premium growth of 6.2% in 1H22 reflects IAG pricing power in a duopoly market. So far, higher claim costs are not enough to detract from the premium benefits. We are watchful that lower $A (unusual given commodity prices and rising inflation expectations) may soak up some of the pricing benefit given potentially higher claim costs (think auto parts, specialist building products). Overall, IAG is a story of many moving parts at present. We see near-term catalysts around the favourable court ruling on business interruption insurance opening the pathway for capital return.

Focus List

EML Payments (EML) | 2% weight

Buried in the noisy investment case of EML at present is its interest rate leverage. As a payments business, EML earns a return on client funds held in its accounts. The guidance provided by EML equates to a 15-20% uplift in earnings for a +1.0% move in rates. This is not captured in FY23E market estimates. If rates move through 2%, the leverage becomes even greater given EML's rate structures in the US. With rate rises already in place in the UK, and all but given in the US, higher rates should assist in EML meeting guidance.

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Recommendation structure and other definitions

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

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