Investment Watch

Winter 2021 Outlook

morgans

Welcome

We are at a challenging juncture for markets. Investors are grappling with interpreting solid economic data and the reaction of ultra-accommodative central bank monetary settings. We see the path out of the COVID-19 shock as a "restart" and not a typical business cycle "recovery". The broadening restart – coupled with our belief that this will not translate into rapidly higher interest rates – underpins our pro-risk stance. This quarter we look at what this means for asset allocation in 2021. We also look at what the economic restart means for the key industries in the ASX.

Recently published research

- **Equity strategy** – Winter 2021 equity sector strategies 30/6
- **Equity strategy** – Morgans best ideas 30/6
- **Investment strategy** – Asset allocation Q3 update 21/6
- **Economic strategy** – The US boom 22/6
- **Commodities** – Iron Ore – As good as it gets 17/6

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Recent corporate offers

Camplify Holdings Limited (ASX:CHL) - Initial Public Offer

Morgans role	Offer size	ASX listing date
Lead Manager & Underwriter	$11.5 million	28 June 2021

WAM Strategic Value Limited (ASX:WAR) - Initial Public Offer

Morgans role	Offer size	ASX listing date
Joint Lead Manager	$225 million	28 June 2021

BlueBet Holdings Limited (ASX:BBT) - Initial Public Offer

Morgans role	Offer size	ASX listing date
Joint Lead Manager & Underwriter	$80 million	2 July 2021

Silk Logistics Holdings Limited (ASX:SLH) - Initial Public Offer

Morgans role	Offer size	ASX listing date
Joint Lead Manager & Underwriter	$70 million	9 July 2021

Gefen International A.I. Limited (ASX:GFN)- Initial Public Offer

Morgans role	Offer size	ASX listing date
Joint Lead Manager	$25 million	Early July

Economics – solid growth set to continue

Threat of inflation

Alarm about the possibility of a blowout in inflation was provoked by the increase of the US consumer price index for the year to May by 5.0%. Close examination of the data tells us why this happened. All of these components point to an acceleration of transport prices. These resulted from the recovery of US transport from a dramatic stop in April 2020. For the year to May, US gasoline prices rose by 56.2%. Fuel oil prices rose by 50.8%.

Even transport items that were not part of food and energy rose rapidly. Used car and truck prices rose by 29.7%. Transportation services rose by 11.2%.

We think all of these price increases of transport - associated items in the US economy will begin to slow from this point. This means that the upward pressure they are putting on the CPI will start to ease in the second half and disappear as we move into 2022.

The Federal Reserve, in its Statement of Economic Projections released in June, believes that personal consumption expenditure inflation will be 3.4% in the 2021 calendar year. Still, it will drop to 2.1% in 2022 and 2.2% in 2023. This means that current inflation fears will be short-lived.

The RBA has a similar view of inflation in Australia. It believes the CPI will rise by 3.3% for the year to June 2021. Inflation will then ease to 1.8% for the year to December 2021. It expects Australian inflation to be 1.5% in 2022 and rise slightly to 2% in 2023. In both the US and Australia, a short-term surge in transport prices will ease and be replaced by lower inflation and lower inflation expectations.

Outlook for interest rates

The result of this more stable outlook for inflation in the US leads the Federal Reserve to believe that the Fed Funds rate will be unchanged at 0.1% at the end of 2021 and 0.1% at the end of 2022. The Summary of Economy Projections of 16 June 2021 suggests the possibility of a 50 basis point rise in the Fed Funds rate to 0.6% at the end of 2023. However, Jay Powell himself does not believe this is a highly reliable forecast.

In Australia, the RBA cash rate should be unchanged at 0.1% in 2021 and 0.1% in 2022. The RBA currently suggests that it will remain unchanged in 2023.

Outlook for AUD and the Australian economy

The simplest way to look at the Australian dollar is to look at what has happened to Australian commodity prices this year. We can discover this by looking at the RBA Index of Commodity Prices published on the first day of every month on the RBA website. The release in June tells us that "the index has increased by 39.7% in SDR terms" in the year to the end of May. In the same time, bulk commodity prices have increased by 51.7%. Our model, based on this index, suggests an equilibrium price for the Australian dollar rising above US85c in the second half of calendar 2021.

The improvement in the terms-of-trade boosted by higher commodity prices, will generate strong growth in the Australian economy, both in 2021 and 2022. The RBA Statement on Monetary Policy in May 2021 suggested full-year growth in 2021 of 5.3%, followed by full-year growth in 2022 of 4.0%.

Outlook for equity markets

Earnings per share for companies in the S&P 500 achieved an all-time high of record earnings of $US150.48 per share in the first quarter of 2021. We estimate these earnings will rise to a new all time record high of $US186.60 in the fourth quarter of 2021. Based on the first two quarters of earnings, we estimate a fair value of the S&P 500 of 3700 points. This is below the current level of the S&P 500. The market continues to rise ahead of strong fundamentals. We believe that we are looking at a moderately overvalued US market. This market can correct back to fair value but is currently supported by a strong US economy.

In the Australian case, we think that fair value of the ASX 200 will be 6800 points but we do see some upside risk to our estimate if earnings data continues to surprise positively. Just as in the US case, we are looking at a moderately overvalued Australian market. This market can correct back to fair value but is currently supported by a strong Australian economy.

Economic forecasts

	Morgans (CY21)	Consensus (CY21)
GDP Growth	5.3%	5.1%
Inflation	1.8%	2.0%
RBA Cash Rate	0.1%	0.1%
AUD/USD	85c	79c
ASX200	6800	7100

Source: Morgans, Bloomberg

The improvement in the terms of trade boosted by higher commodity prices, will generate strong growth in the Australian economy, both in 2021 and 2022.

For more economic coverage subscribe to our podcasts

Asset allocation Q3 – global 'restart' taking shape

Economic data has been strong, and we expect more of the same as economies restart amid pent-up consumer demand and supply shortages. We advocate looking through near-term market volatility and remain pro-risk.

Tactically, we stay overweight equities as we expect the global economic restart to re-accelerate and short-term interest rates to be anchored near zero. We tilt toward cyclicality and maintain a bias for quality.

Pent-up demand powers restart

We are at a challenging juncture for markets. Investors are grappling with interpreting solid economic data and the reaction of ultra-accommodative central bank monetary settings.

Over the year, US activity looks set to restart strongly, powered by pent-up demand and historically high excess savings. However, unlike the GFC we think the magnitude of the restart may still be underappreciated.

US growth will likely peak over the northern hemisphere summer and the abnormally strong data will be transient; the more activity is restarted now, the less there will be to restart later. There is the potential for the rest of the world to pick up the slack by following the US course of reopening as vaccine rollouts pick up pace but strong growth 'surprises' are likely to fade into 2022.

Economic restart to be buffeted by inflation scares

We expect inflation to be volatile in the short term due to the impact of COVID-19 on the base comparison year. Bouts of elevated inflation will likely lead to a fall in the value of risk assets. Still, we see any significant pullback as an opportunity to reweight portfolios given our view that inflation concerns will prove transitory.

More importantly for portfolio positioning is the reaction function of central banks. Thus, any unanticipated changes to the current commitment to keep short-term interest rates anchored will be disruptive for markets. However, we think this risk is overstated as the US Federal Reserve is building credibility in its new framework and has set a high bar to change its easy policy stance, even in the face of higher realised inflation.

Staying pro-risk

The broadening restart, coupled with our belief that this will not translate into rapidly higher interest rates, underpins our pro-risk stance. As a result, we remain overweight equities favouring ex-US exposures, neutral property and infrastructure, and underweight fixed interest amid low rates and tight credit spreads.

Improving global growth and high structural US fiscal deficits will put downward pressure on the USD and thus a higher AUD (see our recent note). Therefore, to mitigate against short-term risks, we prefer hedged away currency risk.

Key changes to our asset allocation settings

We increase our underweight to cash. With global short interest rates anchored near zero we see the opportunity cost of holding elevated cash levels as a drag on returns. We use this to fund our overweight position in equities.

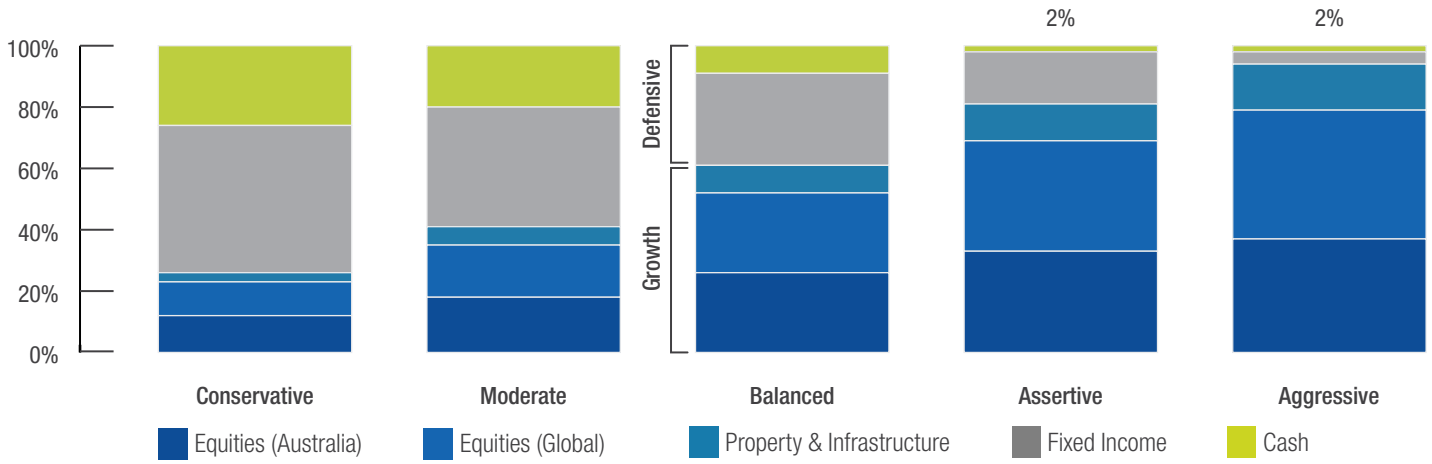
The Morgans Strategic Asset Allocation methodology takes a systematic approach in optimising exposure to the various asset classes at different stages of the economic cycle. Refer to our full publication Asset Allocation Update – Q3 2021 for product recommendations

Global Equities	−− − + ++	Although we do not expect US bond yields to keep on climbing sharply, we think the recent "rotation" in global stock markets has further to run, given the upbeat prospects for the recovery in economies hardest hit by COVID-19. With governments more willing to deploy fiscal policy and central banks prepared to let inflation run hot, we think the reflationary economic backdrop will continue to favour being invested in global equities. The strengthening AUD will be a headwind for US exposure so tactically we prefer hedged exposures. Longer term as the effects of the pandemic fade, old problems will start to resurface. The biggest challenge facing advanced economies prior to the pandemic was the extremely weak rate of productivity growth across the developed world. This had several causes, including low rates of business investment and the failure of new digital technologies to feed through into broad-based rises in productivity.
Australian Equities	−− − + ++	Australian equities have not been immune to rising bond yields in the global reflationary backdrop. Resources, Energy and Financials have benefitted from the bounce back in economic activity. The progress of the vaccine rollout sees Australia achieving herd immunity by October which could lead to earlier than anticipated relaxation of border re-openings. Household balance sheets are in great shape which should continue to support the recovery in consumption. We also see upside risks to dividends as uncertainty from the virus clears keeping payout ratios elevated. We prefer a targeted portfolio approach favouring reflation (Banks, Energy, Resources) and COVID-19 reopening beneficiaries (Travel, Gaming, Traditional Retail).

For more, see our Equity sector strategies

Fixed Income	-- - + ++	We strategically underweight nominal government bonds as their ability to act as portfolio ballasts are diminished with yields near lower bounds and rising debt levels may eventually pose risks to the low-rate regime. This is part of why we underweight government debt strategically. We prefer inflation-linked bonds as we see risks of higher inflation in the medium term. We underweight long-term bonds on a tactical basis as we anticipate gradual increases in nominal yields supported by the economic restart. We also underweight credit on a strategic basis as valuations remain elevated and we prefer to take risk in equities. On a tactical basis, credit, especially investment grade, has come under pressure from tightening spreads, but we still like high yield for income.
Infrastructure	-- - + ++	A recovery in broader risk appetite should see infrastructure benefit relatively less than other assets. However, infrastructure is also an inflation-sensitive asset class with the opportunity for upside participation given the pass-through structure of many contracts. If inflation returns on better economic growth, it would be positive for asset class returns. We remain neutral on infrastructure with a preference for assets better linked to economic activity such as tollroads, energy and data.
Property	-- - + ++	We are neutral on the Australian property sector. While we are seeing some strength in housing and the industrial sub-sectors, the sector is a reopen area investors are shunning thus far. The uncertain environment for commercial real estate is justifiably the reason. Office buildings will likely suffer as companies allow work-from-home options and the population flees large cities. Likewise, the pandemic sped up the adoption of e-commerce, raising questions regarding the amount of needed retail real estate space. Additionally, with significant support measures rolling off in March (JobKeeper, repayment holidays) we could see a spike in bad and doubtful debts.
Cash	-- - + ++	We use cash to fund overweight in equities. Holding some cash makes sense, in our view, as a buffer against supply shocks driving both stocks and bonds lower.

Recommended asset allocation and tactical tilts



Benchmark long-term asset allocation and tactical tilts

	Conservative	Moderate	Balanced	Assertive	Aggressive	Tactical Tilts (Aggresive*)
Equities (Australia)	12%	18%	26%	33%	37%	7% (3%)
Equities (Global)	11%	17%	26%	36%	42%	4% (1%)
Property and Infrastructure	3%	6%	9%	12%	15%	0% (0%)
Fixed Income	48%	39%	30%	17%	4%	-9% (-4%)
Cash	26%	20%	9%	2%	2%	-2% (0%)

* Implemented tactical tilts for the aggressive risk profile

Equity strategy – cyclical rotation has further to run

Morgans research analysts re-set their equity sector views, strategies and best stock ideas as the 2021 economic recovery builds momentum.

As lockdown restrictions continue to ease in developed markets, we think the cyclical "rotation" in equities has further to run, driven by a strong economic recovery coupled with significant pent-up demand.

Australian equities have not been immune to rising bond yields in the global reflationary backdrop. Resources, Energy and Financials have benefitted from the bounce back in economic activity. Household balance sheets are in great shape which should continue to support the recovery in consumption. We also see upside risks to dividends as uncertainty from the virus clears, keeping payout ratios elevated.

Equity portfolio construction

Recent adjustments to the Morgans Equity Model Portfolios reflect shifts in our sector preferences.

Recent Equity Model Portfolio changes include: up-weighting Banks exposure (over-provisioning releases, dividend/capital management upside), adding Suncorp and Computershare (leverage to rising rates), and adding ALS Limited (commodities reflation). Concurrently, we have moderated our exposure to the beneficiaries of lower interest rates (Utilities & Infra), HUB24 and Reliance.

The Model Portfolios are not constructed to position for the risks of excessive inflation nor the lack of it (ultra-low rates). The Morgans Investment Committee debates the macro-economic outlook frequently, but does not risk portfolio capital by selecting all-in bets on the inflation outlook. We think a "barbell" approach to managing macro-driven risk is prudent, incrementally adjusting exposure to Yield, Cyclicals and Growth as events unfold. Ultimately we seek out quality companies capable of thriving regardless of monetary policy settings.

Refer to updated Winter 2021 equity sector strategies for more coverage

Refer to our **Morgans Best Ideas** for more www.morgans.com.au/stockpicks

Key sector outlooks

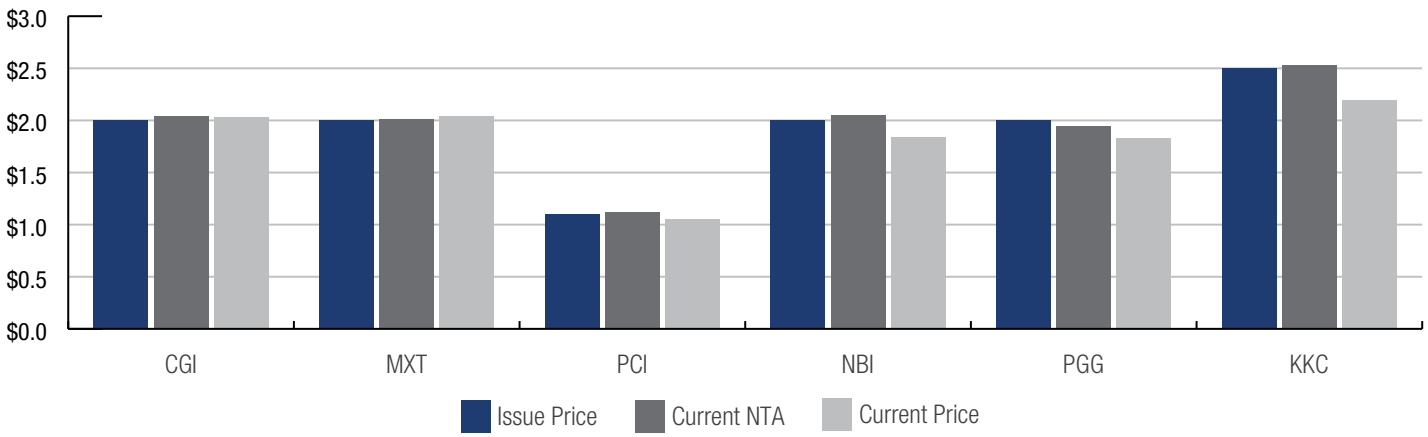
Category	Sector	Rating	Best ideas	Overview
Financials	Banks	−− − + ++	ANZ, MQG	Their increasingly robust dividend outlook and potential for capital management supports ongoing rotation into the Banks. While balance sheet strength and dividend yield are the key attractions, improvement in system home loan growth is supportive of earnings growth.
	Diversified Financials	−− − + ++	MFG, TYR, QBE, KSL	The operating backdrop for Financials has progressively improved with stronger markets, upward pressure on interest rates and improved sentiment. A gradual lift in bond yields reflecting steadily improving economic activity would be broadly positive for the sector.
Defensives	Consumer Staples	−− − + ++	COL, ING, BGA	Demand should remain solid but near term sales growth will be under pressure after cycling unprecedented growth from last year. While we remain positive longer term given solid industry dynamics, the slowdown in sales could limit sector gains in the short term.
	Healthcare	−− − + ++	RMD, SHL, M7T, VHT	Appetite for the defensive attributes of Healthcare stocks has fluctuated with the appetite for risk through the pandemic; however, long-term exposure is justified by the re-assertion of strong underlying structural fundamentals driving organic growth in the sector.
	Telco	−− − + ++	TPG, NXT	Sentiment has turned the corner now that the NBN is practically complete, helping to settle down customer migration. Telcos also see an improving outlook in mobile as competitive activity becomes more rational.

	Infra & Utilities	−− − + ++	SYD, DBI, SKI	Providers of critical services with regulated revenues (AST, SKI), resilient demand (AZJ), or long-term take-or-pay contracts (APA) should remain in-demand. Ultimately, ultra-low interest rates can plausibly intensify the appeal of strong cash generators (SYD, TCL) once their volumes recover.
	A-REITs	−− − + ++	AQR, AVN, HDN, WPR	Capital performance will fluctuate with bond rate expectations but REITs continue to offer attractive distribution yields for investors with the sector average around 5%.
Cyclicals	Consumer Discretionary	−− − + ++	CTD, LOV, APE	We think the next 6 months will offer some attractive entry points into quality retailers with much stronger businesses in the wake of the pandemic, but which may get treated harshly in the near term as earnings step down from unsustainable peaks.
	Industrials	−− − + ++	ANN, RWC, AQZ, ACF	Despite higher supply chain and raw material costs, many industrials are net beneficiaries of the strong global economic recovery. We are biased towards ongoing momentum in the packaging, housing and civil infrastructure segments.
	Online	−− − + ++	FDV, BKG	Buoyant end markets have supported upgrades to the major classified players' earnings and is expected to remain a near-term feature. This, however, looks well captured by the market with near-record share prices and trading multiples for these players and we continue to prefer smaller cap exposures in the space which have not run as hard.
	Technology	−− − + ++	TNE	Overall, the tech sector has fallen out of favour over the past 12 months as investors rotated from growth into reopening trades. We think this trade will reverse over the next 12 months. Investors are likely to realise that earnings growth in the reopening trade has played out and many of these non-tech stocks will revert to subdued growth trajectories. We believe this should reignite interest in the tech sector. The substantial variation in individual stock price performance will remain a feature of the tech sector as earnings, particularly in the B2B software space, can be volatile.
	Agriculture	−− − + ++	IPL, GNC, NUF	Following successive years of drought, robust seasonal conditions combined with strengthening soft commodity prices (economic reflation, USD weakness) offer strong sector tailwinds in 2021.
Resources	Metals & Mining	−− − + ++	BHP, WHC, RMS	An overweight exposure to Commodities/Resources is supported by: improving demand in-line with the post-pandemic recovery; a highly resilient Chinese economy; genuine supply-side constraints influenced by capital discipline; emerging inflationary forces and US dollar weakness.
	Energy	−− − + ++	STO, KAR, SXY	Our conviction in a sustainable oil market recovery is growing helped by steadily improving demand (global growth), declining inventories, US shale issues and a weakening US dollar. This paints a bullish 1-2 year outlook.

Listed Investment Trusts (LITs) – finding income

The asset backing (NTA) for all LITs have moved back to or currently exceed their issue price as the outlook for credit markets has improved. This means that the institutional market valuation of the underlying assets (e.g. loans and bonds) held by these trusts have recovered back to pre-COVID-19 levels. However, the ASX unit price of some LITs continue to trade at discounts to their NTA. This means that if an investor buys units in a LIT which is currently trading at a discount, it would cost less than buying the underlying assets directly and therefore represents an excellent opportunity for investors seeking attractive yields.

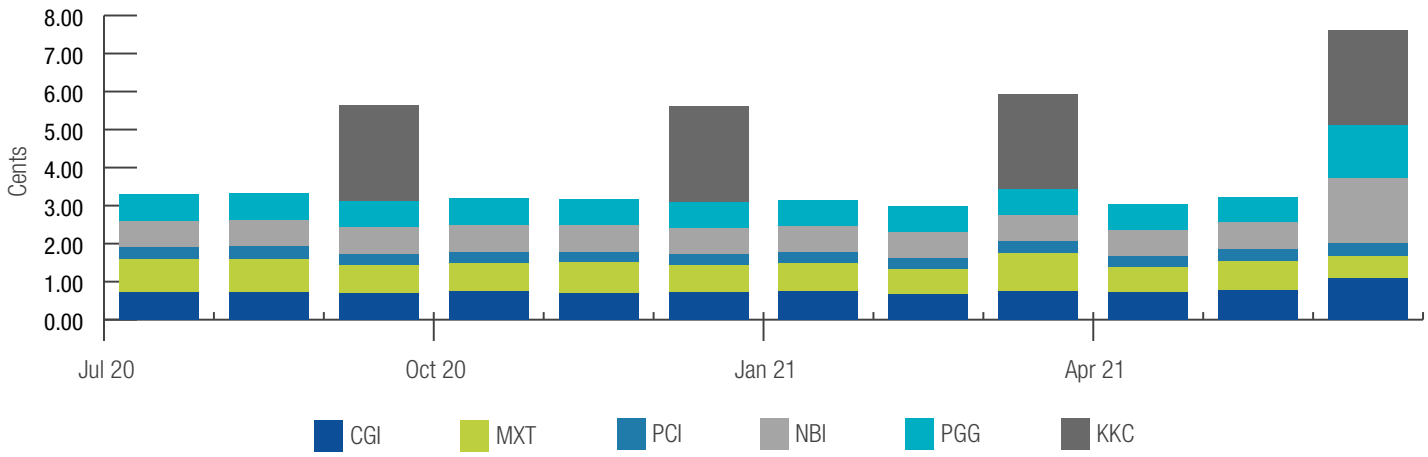
Listed Investment Trusts - Price snapshot



Specialist debt LIT managers have constructed large and diversified portfolios to mitigate against potential defaults and to continue to provide reliable monthly income. This was best demonstrated during the COVID-19 sell-off in global and domestic markets. Despite this volatility, the sector has experienced no defaults and distributions have continued to be paid in line with, or exceeding target levels.

We also note that KKC will begin paying monthly distributions following a restructure of the Trust and will continue to target a distribution yield of 4% - 6% p.a., while NBI has increased its target distribution for FY22 to 4.75% p.a. (net of fees and expenses) from 4.50% p.a.

Listed Investment Trusts - Past 12 month distribution payments



One of the benefits of the trust structure is that LITs must distribute all income and realised capital gains to investors over a financial year which may result in additional returns as seen by the latest declared distributions in June 2021. While LITs are not cash deposits and do have additional risk, at current prices some LITs are delivering running yields of up to 5.50%. This is supported by a number of risk mitigants including the ranking of debt over equity, bond and loan protections and the very high level of diversification in underlying portfolios. These layers of protection, combined with monthly income and the attractive yields on offer, build a compelling case for investors.

Banks – strong capital and dividend outlook

The earnings outlook for the major banks has continued to improve with improvement in the outlook for asset quality, most notably with a further reduction in the unemployment rate and further house price strength.

We continue to see potential for further credit loss provision releases. If the major banks keep clinging onto conservative collective provision coverages, then while there may be no provision releases, we would not expect the cost of risk (the credit impairment charge as a percentage of the loan book) to exceed 5bps per annum. Either way, we believe consensus credit impairment charge forecasts for the sector are too pessimistic.

With asset quality holding up well following the end of JobKeeper and the end of loan repayment deferral periods in March 2021, we believe capital management will be increasingly front of mind for bank boards, particularly with each major bank having large surplus CET1 capital positions. We see capital management potential for all four major banks in FY22 and FY23. Having said this, with NAB potentially facing enforcement action from AUSTRAC, we do not expect NAB to announce capital management initiatives until the AUSTRAC issue is resolved.

The improving asset quality outlook, together with balance sheet strength, is making the outlook for ordinary dividends look increasingly robust. Over the medium term, we expect ROEs and dividends to be supported by a focus on absolute cost reduction. We believe the absolute cost reduction potential for the sector is real, and this thesis has been supplemented with WBC and ANZ recently setting explicit absolute cost reduction targets by FY23F.

Recent publications

NAB
HOLD TP A$27.50
Increased probability of AUSTRAC penalty

CBA
REDUCE TP A$73.00
Further confirmation of positive themes

Ranking	Stock	Recommendation	Share price	Target price	Dividend yield	Gross yield	12m Forecast TSR
1	ANZ	ADD	$28.28	$34.50	5.1%	7.3%	29%
2	WBC	ADD	$25.89	$29.50	4.4%	6.3%	20%
3	NAB	HOLD	$26.18	$27.50	4.9%	7.0%	12%
4	CBA	REDUCE	$99.26	$73.00	3.6%	5.1%	-21%

Source: IRESS, MORGANS. Data at 30 June 2021.

Diversified financials – a solid operating backdrop

The operating backdrop for Diversified Financials has progressively improved with stronger markets, upward pressure on interest rates and improved sentiment. Further tailwinds include the improving economic outlook; lower bad debt risks (banking); strong balance sheets and a pick-up in M&A. Broad sector valuations currently look reasonable, and at a modest discount to historical averages.

Financials stocks offer some protection from the prospect of rising global inflation and interest rates. They typically benefit by making higher asset spreads on both client balances and their own shareholder capital. Indeed, the collapse in rates since the GFC created a significant earnings headwind that many business models were not designed to endure, but this trend may now be starting to reverse. The earnings of Computershare and QBE are among the most exposed to rising interest rates.

Weather remains an issue for the insurers, which are struggling to enjoy a respite from large natural hazard events. Despite this, their valuations support our view that the insurers deserve to catch-up up some underperformance relative to the very strong run in the banks, particularly as the global insurance pricing has responded to the pandemic with double-digit premium rate increases.

The wealth managers have enjoyed improved sentiment driving very strong net fund inflows for both managers and investment platforms. This looks set to continue in the near term; however, volatility amid very strong market performance does look inevitable, which would lead to a period of lower inflows as markets normalise. Structural change and consolidation within this segment looks likely to feature for several years, with the specialist investment platforms the biggest beneficiaries via growth in market share.

Finally, the high growth BNPL sector darlings do struggle with volatility in response to speculation about inflation, but their underlying business momentum does look sound.

Recent publications

Link Administration
HOLD TP A$5.57
Going down the IPO path

Challenger
ADD TP A$6.26
Investor day wrap up

WH Soul Pattinson & Co
HOLD TP A$28.84
Merger makes strategic sense

Resources and energy – reflation tailwinds

Remaining overweight Metals and Mining has proven an effective strategy since the start of the cycle in 2016. However, after such a strong run up we do not expect it to be all smooth sailing, and now see potential for there to be 'cycles within cycles'. While fundamentals remain strong and supportive of a continuing resources cycle, we also note that several metals (iron ore, copper, gold, aluminium, and zinc) are trading ahead of their marginal cost of production, which is essentially the level we view as the long-term sustainable price for a metal with few exceptions. This dynamic leaves potential for some increased volatility in some metals in the near term even if the underlying supportive fundamentals remain intact and the upcycle subsequently resumes.

Major commodity-consumer China, whose economy has now fully recovered from the 2020 COVID-19 fallout, looks set to ease the stimulus measures it has effectively used to support its economy. This paves the way for China's economy to switch gears away from infrastructure/property growth and back towards domestic consumption. We see this as a risk for high-flying raw material iron ore, particularly given global supply is also recovering. This is an important consideration given iron ore is a core business segment for Australia's largest miners. Over the medium and longer term, we continue to expect physical assets like metals to outperform supported by a global recovery (ex-China) from COVID-19, continued synchronised stimulus, and volatile US dollar.

In terms of medium-to-long-term portfolio construction, we are still confident on major long-term fundamentals for resources that leaves us recommending core positions maintained in the diversified miners, while also favouring copper, nickel, and lithium exposures for long-term supportive thematics in battery markets. However, given the general strength in share prices across the sector, we recommend investors remain patient and wait for potential better buying opportunities.

Recent publications

Fortescue Metals
REDUCE TP A$18.80
Iron Ore – as good as it gets

South32
HOLD TP A$3.25
SAEC off the books

Infrastructure – balancing defensives with recovery plays

While conveniently grouped into a single 'infrastructure' investment category, ASX-listed infrastructure covers a broad group of economic, regulatory and contractual exposures with different balance sheet and risk management settings. This ranges from energy haulage and storage networks (regulated and contracted growth from investment), airports (travel growth and commercial earnings), toll roads (population growth and regional development), and coal-related infrastructure (Asia-driven demand growth for power generation and steel making). Balance sheets are typically investment grade quality, allowing competitive access to debt markets. Outside of core infrastructure, we also consider waste management (waste generation, government policy) and logistics (trade flows, economic growth).

In a normal environment, the core infrastructure sector boasts a mix of defensive qualities, structural growth drivers and appealing distribution yields. This translates into sector returns that historically have been less volatile than the broader market. Within the sector itself, the market risk of patronage-driven assets (toll roads, airports) is typically higher than regulated and/or long-term contracted businesses because they have greater linkage to economic conditions.

Applying these characteristics to our economic outlook (cyclical uptick, rising rates), we would typically recommend a higher portfolio weighting to GDP-linked assets. However, COVID-19 continues to impact these businesses (particularly airports). As such, stock selection needs to be framed on a multi-year recovery basis (eg. SYD). Furthermore, we think portfolios need to be balanced with lower risk regulated/contracted assets, given their structural growth drivers, earnings upside from rising rates and dependable yields.

During the following quarter, we will be watching for release of volume data, M&A activity (eg. TCL's consortium bidding for the remaining 49% of WestConnex), regulatory resets and contracting events that could have non-systematic impacts on the sector's stocks.

Recent publications

APA Group
ADD TP A$10.53
2021 Investor Day

Spark Infrastructure
ADD TP A$2.34
Project EnergyConnect

Atlas Arteria
HOLD TP A$6.35
Downgrade to HOLD on share price strength

Recent initiations

Peter Warren Automotive – ADD
PT A$4.05
PWR is a dealership group with 17 dealerships (27 OEM brands) across Sydney, Northern NSW and Southern QLD.

Airtasker – ADD
PT A$1.29
ART is Australia's leading e-commerce platform for the provision of local services. The Airtasker platform is all-encompassing, facilitating the entire task (ie the physical act) on the platform.

Tyro Payments – ADD
PT A$4.29
TYR is a technology-driven company offering payment solutions (debit/credit card acquiring), together with complementary business banking products to Australian businesses.

MLG Oz – HOLD
PT A$1.08
MLG is an integrated mining services provider, which enjoys long-term relationships with clients across the WA and NT gold, iron ore and nickel sectors.

Online media and technology – the haves and the have nots

The online media and technology space is driven by cyclical economic forces, but also provide access to compelling structural trends such as the shift to digital consumption and online transactions. Sector exposure suits growth-oriented investors who desire exposure to these cyclical trends which generally take time to manifest.

The majority of the major online classified players continue to test all-time highs as buoyant conditions in their end markets and the continued structural move of the consumer online see earnings upgrades permeate the market. Whilst this market environment remains (and the outlook for the real estate, employment and auto markets continues to look promising), these stocks are likely to remain well supported.

M&A has been a constant feature during the past 6 months: REA (Elara, Mortgage Choice, Property Guru), Seek (sale of Zhaopin stake), CAR (Trader Interactive) and DHG (bid for PEXA stake). With the cashflow generation capabilities of these companies, and balance sheets still looking in reasonable shape, we would expect portfolio optimisation to remain a feature of the sector as these companies look to establish the next leg of growth post current end-market strength.

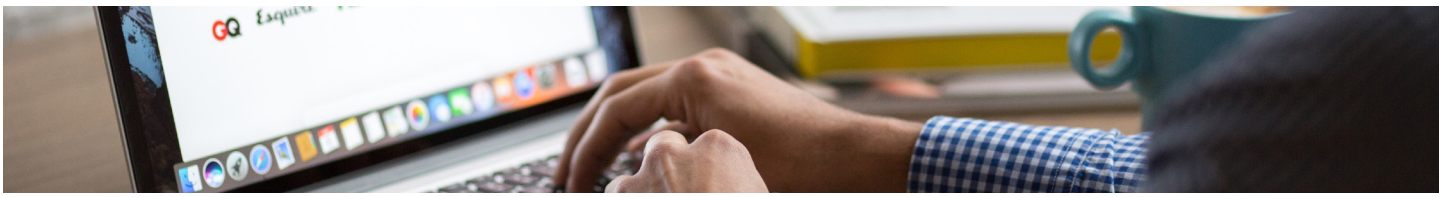
At the smaller end, e-commerce players have either seen marked declines in share prices or stagnated as the need to cycle the COVID-19-induced bounce to the topline whilst re-investing back into the business comes at the same time as general cost inflation (marketing, operating , discounting etc). This has seen the market re-appraise near-term earnings estimates. The recent share price weakness in some of these names has seen them now looking increasingly attractive for the long-term investor, with the move to e-commerce likely to prove enduring. In the near term it is hard to see material outperformance in these names until they prove up an ability to cycle the COVID-19 tailwinds of 2020.

Recent publications

Airtasker
ADD TP A$1.29
Getting some chicken, need some egg

Carsales
ADD TP A$20.82
Adding another cylinder to the engine

REA Group
HOLD TP $139.40
Setting up more growth angles than pricing



Property – performance propelled higher over last quarter

Year to date, the sector (on a total return basis) is up around 8.4% vs the market up around 13.5%, although the sector has performed strongly over the past quarter relative to the market, with bond yields stabilising after steadily increasing earlier in the year with a strong economic environment and bond yields stabilising. Year to date the sector has delivered a total return of +25%.

REITs continue to offer attractive distribution yields to investors with the sector average around 5%.

Looking towards the upcoming reporting season most groups now have guidance in place given the better clarity on impacts from the Code of Conduct/COVID-19 on earnings. While NTAs were largely stable over the February reporting season, with retail valuation falls not as significant as previous periods and office valuations largely stable, REITs exposed to these sub-sectors continue to trade at discounts to NTA. We expect that industrial/logistics as well as large format retail, convenience retail, pubs and self-storage will likely see some asset appreciation with several REITs exposed to industrial assets already announcing significant cap rate compression. The favourable tailwinds for industrial/logistics assets remain with huge demand for the asset class given the growing shift to e-commerce and increased focus on supply chain resilience.

While there are ongoing structural headwinds for retail mall operators, we will get some better insights into office metrics including the leasing environment with trading updates in August. There has been concern over impacts to office demand from the working from home thematic which has accelerated over the past year; however, we are yet to see any clear impacts. While many businesses have adopted a hybrid model (home and office), other industry commentary suggests a hub and spoke model may also be a compromise in the future. Tenants will also likely be seeking high-quality, technology enabled and wellness focused buildings. We expect a successful vaccine rollout will continue to improve sentiment around returning to the office environment as well as increased confidence in economic growth which would be positive for office markets.

There has been some increase in M&A activity over the past quarter with some of the listed property fund managers (CNI has announced a proposed merger with Primewest and Dexus announced a proposed acquisition of APN Property Group).

Overall, balance sheet gearing remains sound with debt costs low. Liquidity also remains high for most REITs with several undertaking capital raisings or asset sales over the past 12 months. Several groups have taken the opportunity to acquire assets/value-add existing assets and grow earnings and some are using capacity for buybacks.

Near-term unknowns and risks include: 1) movement in bond yields; 2) the general economic environment/recovery coming out of COVID-19; and 3) impacts on leasing/rental markets.

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