Autumn 2022 Outlook

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Welcome

Global equity markets are down sharply year-to-date, as US bond yields, gold and oil rose and the Ukraine conflict escalated dramatically following Russian military action. This came as markets also priced a significant Fed hiking cycle in 2022 and some US economic growth indicators slowed. These factors have left markets at a critical juncture in the short term providing investors with a broad scope of potential outcomes. In this edition we explain our more cautious asset allocation and our preference for staying invested domestically. Our economist Michael Knox also explains why war risk is having an outsized impact on global oil and food prices.

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Recently published research

Equity strategy - Q2 2022 sector outlook and strategies	4 April
Equity strategy - Morgans Best Ideas	1 April
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Recent corporate offers

Commonwealth Bank

CommBank PERLS XIV Capital Notes

Morgans role: Joint Lead Manager

Offer size: $1.75 billion

ASX listing date: 1 April 2022

Morgans Financial Limited acted as Joint Lead Manager to the issue of CommBank PERLS XIV Capital Notes (ASX: CBAPK), raising $1.75 billion. The security is expected to pay quarterly distributions of 2.75% above the 3 Month Bank Bill Swap Rate. The security has a term to its first call date in 7.2 years (15 June 2029) and a Mandatory Exchange Date on 17 June 2032. The Offer included the Reinvestment Offer of the CommBank PERLS IX Capital Notes (ASX:CBAPF).

ANZ

ANZ Capital Notes 7

Morgans role: Joint Lead Manager

Offer size: $1.31 billion

ASX listing date: 25 March 2022

Morgans Financial Limited acted as Joint Lead Manager to the issue of ANZ Capital Notes 7 (ASX: ANZPJ), raising $1.31 billion. The security is expected to pay quarterly distributions of 2.70% above the 3 Month Bank Bill Swap Rate. The security has a term to its first call date in 7 years (20 March 2029) and a Mandatory Exchange Date on 20 September 2031. The Offer included the Reinvestment Offer of the ANZ Capital Notes 2 (ASX: ANZPE).

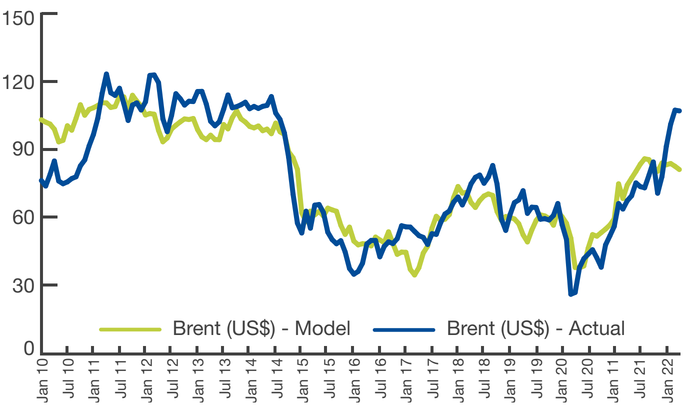
Economics

Food, oil and war risk

In this issue we focus on the effects on two essential markets, oil and wheat and how they've been affected by the conflict in Ukraine.

Saudi Arabia is the world's largest exporter of oil, but the second largest is Russia. How do we model Russia in terms of its impact upon markets? Shown below is our updated model of the Brent Price. Shown in that model is the equilibrium price of Brent based on the level of stocks of product plus currency effect. This explains 80% of monthly variation of the Brent Oil Price. It tells us the equilibrium Brent Oil Price should be US$81 a barrel. The price of Brent at time of print is US$107 per barrel.

Model of Brent Oil Price



Source: Morgans, Bloomberg

So how do we account for the difference between our oil price model based on fundamentals, stocks and currency effects, which explain most of what happens most of the time and why the price is so much higher than that? The difference between the two is war risk.

One of the time-honoured ways of running a naval campaign is blockade, making it impossible for ships to load at your opponent's ports and take away their exports. The Russians seem to have done this to themselves by generating a situation where the war risk in the northern Baltic Sea is so high that it's almost impossible for ships to get insurance to enter the northern Black Sea and load either wheat or oil at Russian ports. So that means that you cannot get cargos for Russian oil or Russian wheat loaded for export[1].

Additionally, financial institutions are refusing to back such transactions. What that means is suddenly one of the world's largest exporters in both of those markets disappears. That is how you define war risk and that is why that price is so much higher. This is something the Russians have done to themselves and it's this effective embargo on themselves that has driven the price up.

While the talking point has been about oil, we want to reflect upon the wheat market's impact. Russia is the world's largest exporter of wheat. It exports 37m tonnes every year. The Ukraine, very interestingly, is the fifth largest player exporting 18m tonnes and Australia is the sixth. We export 10m tonnes.

So how do we account for the difference between our oil price model based on fundamentals, stocks, and currency effects, and why the price is so much higher than that? The difference between the two is war risk.

Similar to our oil price model, the price of wheat sits significantly above our equilibrium price. That is because the ability to load Russian and Ukrainian grain is made impossible because of war risk, because ships can't insure themselves to load at those Black Sea ports to take to take those cargos[2].

In addition, we had a similar event to this in 2008. At that time, we had an overshoot in the price due to a global shortage in wheat. That overshoot generated food riots throughout the developing world. The riots were particularly bad in Egypt, Pakistan and other countries in the developing world.

Unfortunately, we see this problem repeating itself over the coming months. The wheat price will overshoot, stay high and that could generate shock waves and food riots across the developing world.

Conclusion

It is not standard fundamentals that are driving prices higher. Instead, it is war risk; the inability of ships to load cargos of either Russian oil or Russian wheat or Ukrainian wheat at Black Sea ports. Unfortunately, that problem will continue for as long as the war continues.

Economic Forecasts

	Morgans (CY22)	Consensus (CY22)
GDP Growth	5.5%	4.4%
Inflation	3.5%	3.3%
RBA Cash Rate	0.5%	1.25%
AUD	85c	75c
ASX 200	7600	7900

Source: Morgans, Bloomberg

For more economic coverage subscribe to our podcasts

Reference: Dallas Fed: Economics – The Russian Oil Supply Shock of 2022, Lutz Kilian and Michael D Plante, March 22, 2022

[1] The main reason Russian crude oil and refined product exports have been at risk since Russia's invasion has been the refusal of financial institutions to back such transactions. In addition, oil tanker rates for Russian destinations rose to record levels, reflecting public pressure on oil companies to avoid purchasing Russian oil, fear of official sanctions on Russian energy exports at a later date and attacks on vessels in the Black Sea.

[2] The effect of the Russian invasion is not limited to energy markets. Russia and Ukraine together account for 29% of global wheat exports. The disruption of exports from the Black Sea together with financial sanctions on Russia means that the supply of wheat and other grains is likely to be curtailed in 2022 and beyond.

Asset allocation
Q2 2022 update

A dramatic escalation of geopolitical risks, commodity prices, the Fed rate hike expectations and cautious market positioning provides investors with a broad scope of potential outcomes over the next few months.

Our tactical allocation favours equities and real assets, with a clear bias for quality. Short-term opportunistic risk hedges (currency, gold) are another option to navigate the uncertainty.

We like having some inflation protection with elevated pricing unlikely to unwind given the disruption from the war and supply chain constraints. We believe non-traditional return streams (alternatives), including private credit/equity, unlisted and real assets, have the potential to add value and diversification.

A foggy near-term outlook for risk assets

Global equity markets are down ~5.5% year-to-date, as US bond yields, gold and oil rose and the Ukraine conflict escalated dramatically following Russian military action. This came as markets also priced a significant Fed hiking cycle in 2022 and some US economic growth indicators slowed.

These factors have left markets at a critical juncture in the short term. On the positive side we could argue that: (1) markets are already pricing a significant Fed rate hiking cycle in 2022, (2) Russia and the US/Europe both have strong incentives not to disrupt key Russian commodity exports (energy or metals) despite the escalation of the Ukraine conflict, (3) investor surveys show equity market sentiment is already poor, (4) the S&P 500 is already over 10% off its recent peak and (5) there are few warning signals of any impending recession.

Although, negative factors could continue to weigh, such as Russian military action and the Western reaction, posing significant risk for a sharp jump in key energy and metal prices, disrupting the promising global recovery from COVID-19.

The war has changed the market's outlook

2022 is likely to have been a worse year for risky assets than we had previously forecast. After all, even if the war ends, the sanctions on Russia are unlikely to be fully unwound. One consequence of this, in our view, is that economic growth, and corporate earnings, will be a bit weaker than we had previously anticipated. This is especially the case in Europe, which is more economically exposed to the effects of the sanctions on Russia. The blow to the US economy, by contrast, will probably be much smaller.

This doesn't rule out further gains in risky assets, such as increases in equity between now and the end of the year. It also doesn't preclude equities in Europe outperforming the "growth" heavy US market over the remainder of the year as discount rates continue to rise. But all else equal, it is reasonable to think that year-end forecasts for major equity indices ought to be lower and forecasts for credit spreads perhaps a bit higher.

Second, commodity currencies and commodity-linked markets like Australia are unlikely to give up all their gains. So we suspect that even if de-escalation sees commodity prices ease back, the disruption the war and sanctions have caused to those markets will keep prices elevated.

Key changes to our asset allocation settings

We maintain an overweight position to risk assets but pare back our global equities exposure to neutral this quarter, we remain underweight traditional income assets. With global short rates edging higher and conditions in place for a return of volatility, we see the need to have some dry powder. See our asset class views below.

Global Equities

Recommendation

Comment

2022 is likely to have been a worse year for risky assets than we had previously forecast. After all, even if the war ends, the sanctions on Russia are unlikely to be fully unwound. One consequence of this, in our view, is that economic growth, and corporate earnings, will be a bit weaker than we had previously anticipated. This is especially the case in Europe, which is more economically exposed to the effects of the sanctions on Russia. The blow to the US economy, by contrast, will probably be much smaller. While the war will limit the upside potential of equities in the short term, the reflationary economic backdrop will continue to favour a modest overweight in global equities tilted toward commodities and quality franchises. The key risk to the outlook is a significant escalation in the Ukraine war, or a deterioration in Chinese growth as Omicron disrupts economic activity.

Australian Equities

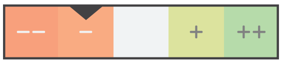
Recommendation

Comment

The ASX 200 is the top-performing market year-to-date, benefitting from higher commodity prices and strong underlying economic growth. Materials and Energy have benefitted from the strong gains in commodities but despite the recent easing in price, the ongoing sanctions on Russian supply should keep prices elevated. Meanwhile, household balance sheets are in great shape, which should continue to support the recovery in consumption. We also see upside risk to dividends as companies continue to normalise dividends as the fog over earnings clears, keeping payout ratios elevated. Accordingly, we prefer a targeted portfolio approach favouring reflation (financials, energy) and quality cyclicals with strong market positions that can absorb rising costs.

Fixed Income

Recommendation



Comment

We are underweight nominal government bonds as their ability to act as a portfolio defence is diminished with yields at current levels and inflation threatening to upend the low-rate regime. We prefer inflation-linked bonds as we see risks of persistently higher inflation over the next 6-12 months. We are underweight long-duration bonds on a tactical basis as we anticipate gradual increases in nominal yields supported by the economic restart. While underweight government bonds, we are more positive on corporate floating rates (hybrids) and sub-investment grade credit. On a tactical basis, the implicit solvency guarantee by the central banks will limit defaults and provide opportunities in the high yield credit space.

Property and Infrastructure

Recommendation

Comment

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 rates stay elevated without curtailing the economic recovery it would be positive for asset class returns. Accordingly, we remain neutral infrastructure with a preference for assets linked to economic activity such as tollroads, airports and data. We are neutral on the Australian property sector. While we continue to expect strong growth in housing and the industrial sub-sectors, we think macroprudential measures and the reopening of the economy will moderate the strong tailwinds powering the two sub-sectors.

Alternatives

Recommendation

Comment

We believe non-traditional return streams, including private credit/equity, unlisted infrastructure, venture capital and real assets have the potential to add value and diversification. Our neutral view is based on a starting allocation that is much larger than what most qualified investors hold. Many investors remain underinvested in alternatives as they overestimate liquidity risks. However, it is a complex asset class and may not be suitable for all investors.

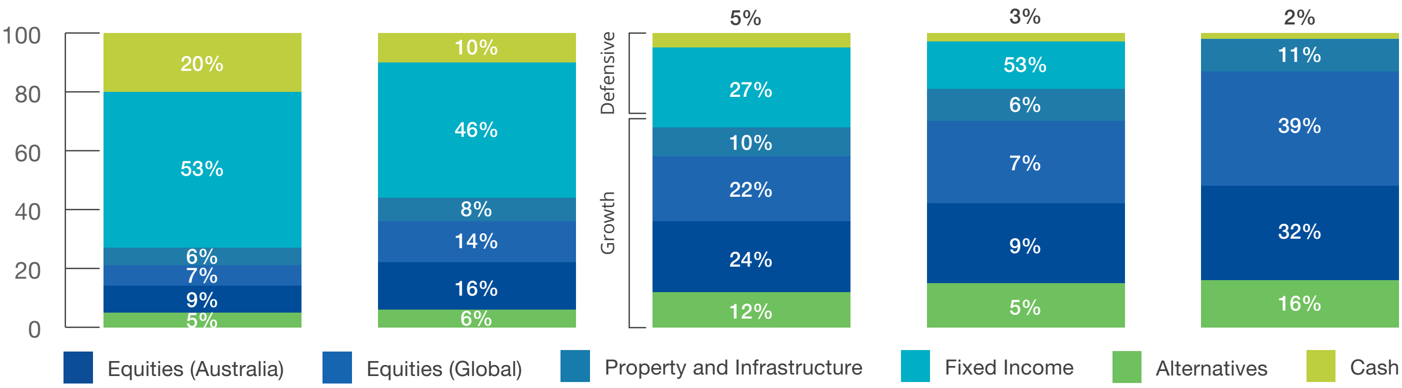
Cash

Recommendation

Comment

Our cash position moves back to benchmark this quarter. With global short interest rates trending higher and conditions in place for a return of pricing volatility, we see the need to build up some dry powder. Though current cash rates remain a drag on real returns, it does provide a necessary buffer against a period of elevated geopolitical risk.

Recommended asset allocation and tactical tilts



Benchmark long-term asset allocation and tactical tilts

	Defensive	Conservative	Balanced	Assertive	Aggressive	Tactical tilts (Aggresive*)
Equities (Australia)	7%	14%	22%	25%	32%	2% (0%)
Equities (Global)	7%	14%	22%	28%	39%	0% (0%)
Property and Infrastructure	6%	8%	10%	11%	11%	0% (0%)
Fixed Income	55%	48%	29%	18%	0%	-2% (0%)
Alternatives	5%	6%	12%	15%	16%	0%(0%)
Cash	20%	10%	5%	3%	2%	0% (0%)

*Implemented tactical tilts for the aggressive risk profile

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 – Q2 2022 for product recommendations.

Read publication

Equity strategy
A two-speed market

Morgans research analysts re-set their sector views, strategies and best ideas as markets adapt to new financial and geopolitical challenges. Solid opportunities reside among financials, materials/energy and industrials stocks, particularly those with pricing power to help combat cost inflation.

Equity portfolio construction

The ASX 200 is the top-performing market in 2022, benefitting from higher commodities and strong economic growth. Materials and energy have benefitted from the strong gains in commodities but despite the recent easing in price, the ongoing sanctions on Russian supply should keep prices elevated.

Meanwhile, household balance sheets are in great shape, which should continue to support the recovery in consumption. We also see upside risk to dividends as companies continue to normalise dividends as the fog over earnings clears, keeping payout ratios elevated.

We prefer a targeted portfolio approach favouring reflation (financials, energy) and quality cyclicals with strong market positions that can absorb rising costs. Read our Asset Allocation Update – Q2 2022 for more details.

We continually adjust Balanced equity portfolio exposure around quality, yield and value factors with a tilt to cyclical exposure. Ultimately we seek best-of-breed companies capable of thriving regardless of the economic backdrop. Morgans analysts current see solid opportunities among financials, materials/energy and select cyclical industrial stocks.

Key sector outlooks

Category	Sector	Rating	Best ideas	Overview
Financials	Banks	–– – + ++	MQG, BOQ	Their robust dividend outlook and potential for capital management supports market interest in the banks. We expect a rising rate environment, in the absence of material asset quality deterioration, to generally be supportive of bank earnings.
	Diversified Financials	–– – + ++	QBE, CGF, GQG, HUB, MME	The operating backdrop has progressively improved with stronger markets, upward pressure on interest rates, sector M&A and improved sentiment. A gradual lift in bond yields reflecting steadily improving economic activity would be broadly positive for the sector.
Defensives	Consumer Staples	–– – + ++	EDV, TWE	Higher supply chain costs have been a headwind, but are beginning to ease on relaxed pandemic restrictions. We see modest sector upside reflecting relatively full valuations, but we also don't see excessive downside risk due to defensive characteristics.
	Healthcare	–– – + ++	RMD, COH, HLS, M7T, PME, VHT	The sector has recently underperformed on a rotation away from growth. The result is attractive pricing across several quality names underpinned by strong underlying structural fundamentals (aging population, medical innovation and government/insurance funding).
	Telco	–– – + ++	NXT	Events of the last 18 months have only fast-tracked digitisation of everyday life. Digital infrastructure providers like NEXTDC are key suppliers into this theme and will continue to benefit.
	Infra and Utilities	–– – + ++	TCL, ALX, DBI	Essential service providers with regulated revenues, resilient demand, or long-term contracted earnings with low correlation to the economy remain in-demand. A low interest rate environment can further intensify the appeal of these scarce income-generative assets.
	A-REITs	–– – + ++	HCW, HDN, DXC, HPI, WPR	Capital performance will fluctuate with bond rate expectations, but REITs continue to offer attractive distribution yields to investors with the sector average around 5%.
Cyclicals	Consumer Discretionary	–– – + ++	WES, LOV, APE, UNI, SUL, BBN	Rising inflation and the rebalancing of consumer spending back towards services may see a slowing in retail sales growth. We prefer retailers offering a growth strategy independent on consumer spending patterns.
	Industrials	–– – + ++	CTD, WEB, RWC, ACF, IEL	Industrials enjoyed a solid reporting season with price increases helping to offset cost inflation and supply disruption. While elevated uncertainty persists, companies with pricing power in industries with strong underlying demand should continue to perform well.

Sector	Sub-sector	Stocks	Outlook
Cyclicals	Online	SEK	Recent volatility has seen sector valuations mean revert to more historical levels. This provides an opportunity for those looking to enter higher-quality names both on the larger side as well as the smaller caps with large growth pathways ahead of them.
	Technology	TNE, AMS	Selective exposure to technology stocks is likely to deliver customer and shareholder value regardless of interest rate movements. We prefer high quality, profitable technology companies with net cash balance sheets and pricing power.
	Agriculture	IPL, NUF, NAM	Very strong seasonal conditions combined with strengthening soft commodity prices (economic reflation, USD weakness) combine to offer strong sector tailwinds through 2022. We do caution though that a sector sell-off may follow the roll-off of record seasonal conditions.
Resources	Metals and Mining	BHP, S32, WHC, RED, RMS, PAN	Sector momentum is now benefitting from upweighting by generalist investors recognising that inflationary forces and current geopolitics are powerful tailwinds. Our sector strategy preferences oil and gas, aluminium, gold and coal.
	Energy	STO, WPL, KAR	We think broad sector underperformance has been driven by local energy stocks' large exposure to upstream, which requires greater conviction in prices. We expect that strengthening oil/gas prices will drive a gradual re-rating in Australian energy stocks.

Refer to updated Q2 2022 Sector Outlooks for more coverage.

Read publication

Banks

Strong capital and dividend outlook

Increasing prospects of the Reserve Bank of Australia (RBA) raising interest rates is providing support to the net interest margin (NIM) outlook for the banking sector. We expect every 25 basis point rise in the official cash rate to benefit major bank NIMs by 2-4bps with all else constant. Additionally, we expect the NIMs going forward to benefit from waning demand for fixed interest home loans (which are generally lower margin) relative to variable rate home loans.

While we expect a rise in the average cost of funds particularly as banks replace Term Funding Facility (TFF) funding with senior unsecured bond issuance and other conventional sources of funding, we expect the banks to mitigate the impact of this on NIMs through asset repricing, particularly repricing of fixed rate home loans. We also expect the banks to be better poised to win back home loan market share from the non-bank lenders in a rising interest rate environment.

On the non-interest income front, we expect a rising interest rate environment to be supportive of the Markets and Treasury revenue generated by the major banks. Longer term, we will be closely watching the impact of rising interest rates on credit quality. At this stage, we do not anticipate material asset quality deterioration with the official cash rate rising from 10bps to 150bps.

In the absence of material asset quality deterioration, we expect bank dividend yields to remain robust and we continue to see robustness of dividend yields as the key attraction for the sector. We also expect dividend yields over the medium term to be supported by the major banks focusing on absolute cost reduction.

Recent publications

Westpac
ADD TP A$29.50
Trading update points to over-pessimism in price

Read publication

CBA
REDUCE TP A$77.00
High quality but remains overpriced

Read publication

Ranking	Stock	Recommendation	Share price	Target price	Dividend yield	Gross yield	12m forecast TSR
1	WBC	ADD	$24.24	$29.50	4.9%	7.0%	29%
2	ANZ	ADD	$27.60	$30.00	5.1%	7.3%	16%
3	NAB	HOLD	$32.35	$30.50	3.9%	5.6%	0%
4	CBA	REDUCE	$105.77	$77.00	3.3%	4.7%	-22%

Source: IRESS, MORGANS. Data at 4 April 2022.

Diversified financials

Opportunity in a lagging segment

The operating environment for the insurance/diversified financials sector continues to look favourable heading into FY23, even after acknowledging there has been significant recent flooding and weather related damage for the insurers.

Positive forces include: (1) strong price increases for insurers following recent large claims events, (2) expected benefits to flow from rising interest rates and (3) an improving macro-economic environment overall. Several corporates also stand to benefit from significant cost out plans as we head into FY23.

We think investors should maintain an overweight exposure to the insurance/diversified financials in the current environment. We think the sector has further to run in its post-COVID-19 recovery, particularly as it has lagged other parts of the market.

We like the sector tailwinds from price increases and interest rate rises and also the defensive nature of the sector amid a market more vulnerable to volatility overall. Of the stocks offering the best leverage to rising interest rates we see Computershare and QBE as the stand outs, while from a long-term quality bias Macquarie is our preferred exposure. This reflects its tilt towards structural growth areas in areas including renewables and infrastructure.

Recent publications

MACQUARIE

Macquarie
HOLD TP A$209.62
A very strong
3Q22 performance

Read publication

QBE

QBE
ADD TP A$13.50
Best result in a long time

Read publication

Resources and Energy

Momentum as an inflation hedge

Generalist investors are increasingly rotating exposure into energy/commodities in recognition that global inflation and geopolitical risks are powerful tailwinds. The reorganisation of trade flows due to Russian sanctions is spiking energy pricing (oil, gas, coal) and lifting met coal, aluminium and grain prices. These offer material upside to Australia's export revenues, trade balance and current account.

We expect prices for oil and LNG, aluminium, gold and coal in particular to keep surprising market expectations to the upside. As such we remain bullish on the sector, believing the accelerating upcycle across major commodities has further to go. We also see commodities (physical assets) as offering a great inflation hedge, in particular energy which is also a key source of inflation.

Our sector strategy is focused on oil and gas, aluminium, gold and coal, while also seeing alternative energy and uranium as ultimately benefitting from current developments. Resource investors for the most part have already benefitted from the upcycle so far, creating the opportunity for profit taking, but we continue to recommend core exposures are held given current market fundamentals.

As strong as the oil price has already been, we see no easy answers and expect further upside in the short term. We base this on the ~1mb/d supply deficit prior to the Russia-Ukraine war and media reports of widespread boycotting of Russian crude since. If reports are accurate, as much as ~7.5mb/d of Russian oil could be displaced; a quantum of supply that cannot be replaced by an investment-starved global oil industry. An easing of Iranian oil sanctions (on a new nuclear agreement) could see as much as +1.6mb/d of supply although this may not offset Russia.

The uptrend in oil prices has gone almost vertical, with a ~70% increase Brent oil so far in 2022. The current Brent price is double the long-term consensus average, dragging earnings from oil & gas producers into an aggressive upgrade cycle. We recently upgraded the targets of our top picks in oil and gas being Santos, and Karoon Energy.

Recent publications

BHP

BHP
ADD TP A$51.80
Fundamentals absorbing
iron ore headwinds

Read publication

Industrials

Rolling with the punches

The industrials sector enjoyed a solid reporting season overall with most companies reporting results that were either in line or above market expectations. Even the few companies that missed expectations didn't disappoint by much (2% at most), which was a good effort considering how tricky the operating environment has been over the past two years. Labour shortages, supply chain disruptions and higher raw materials costs remain key challenges faced by all businesses. This is pushing up costs and putting pressure on margins.

While there's plenty to watch out for, the good news is that many companies are dealing with the uncertainty well and controlling what they can. Almost all are increasing prices to offset the impact of cost inflation and despite products being more expensive, this has not had a noticeable impact on demand. A key trend has been higher inventory holdings with many businesses adopting a 'just-in-case' approach over the previous 'just-in-time' philosophy. While this has affected working capital, we see this as prudent business practice while supply chains remain tight. As one CEO often says, "it's better to be looking at it than for it".

Looking forward, we expect uncertainty to persist for the foreseeable future with the key unknowns being COVID-19 and the conflict in Ukraine. Despite this, we still see plenty of opportunities for sector outperformance and it will be the businesses that have the most desirable products, strongest pricing power and most capable management teams that will best navigate through these challenging times and use this environment as an opportunity to increase efficiency and gain market share.

Recent publications

amcor

Amcor
ADD TP A$18.35
Toughing it out

Read publication

RWC

Reliance Worldwide
ADD TP A$6.35
Demand remains positive

Read publication

Telco

Critical digital infrastructure

The telco sector has the positive attributes of earnings defensiveness, growth and yield. We have an overweight sector view due to a significant improvement in overall macro trends (which is flowing through to earnings growth), reasonable valuations and in some cases positive catalysts which should release value.

Exposure to the telco sector via incumbents broadly suits balanced investors targeting a yield and some capital growth. Whereas those seeking capital growth are better suited to the data centre operators who are benefiting from very strong structural growth of cloud computing and digitisation.

With the NBN complete and 5G mobile rollout gathering steam, companies are behaving more rationally on pricing. Consumer price rises are here to stay and it's much easier to grow earnings with the benefit of price rises.

The digital economy including securing Critical National Industries and the broader digital infrastructure that supports Australia will only continue to grow in importance. Select telcos and data centre operators remain well positioned to benefit from these strong medium-term structural trends.

Recent publications

TELSTRA

Telstra
ADD TP A$4.56
Under the hood it's looking good

Read publication

NEXTDC

NEXTDC
ADD TP $14.64
These NEXTDC's build competitive advantage

Read publication

Agriculture and Food

The bumper crops keep rolling in

Soft commodities broadly benefit from the same forces supporting metals and energy commodities (economic growth, lower USD and supply/demand dynamics). Exposure to agricultural companies offers diversification and a partial de-coupling from the broader market as performance is driven more by seasonal conditions in domestic/global markets, and less by general economic conditions. We still need to eat!

Soft commodity prices are at their highest level since the global food crisis in 2008 on growing fears of a global shortage as the Russia/Ukraine war cuts off exports of wheat, corn, sunflower and other commodity staples. Fertiliser prices have also soared given Russia and China (major global exporters) have halted exports and the European gas price (key input for fertiliser) is at record highs. Australia just planted the largest summer crop in recent years and there should be another big winter plant in April-June given the rainfall outlook and recent seed, ag-chem and fertiliser sales.

Record prices and bumper crops should see earnings across the listed agricultural and chemical companies peak in FY22. ABARES is forecasting the value of Australian crop production to fall 6% to A$76bn in FY23 (still the second highest on record). An expected return to more average seasonal conditions in FY23 will mean lower crop production. When the war ends, we would also expect that soft commodity prices will decline.

Recent publications

GrainCorp

GrainCorp
HOLD TP A$8.06
The perfect storm

Read publication

Incitec Pivot

Incitec Pivot
ADD TP $3.98
Now taking advantage of the commodity upcycle

Read publication

Recent initiations

GQG Partners **ADD PT A$2.15**	GQG is a global asset management boutique, managing over US$87bn in funds across four primary equity strategies.
Atturra **ADD PT A$0.78**	ATA is an Australian owned, IT services company that designs, implements, and maintains predominantly niche IT solutions for many of Australia's largest private and public organisations.
Step One Clothing **ADD PT A$2.40**	STP is a pure play, direct-to-consumer online business that has brought much-needed innovation to the men's underwear market.
Veem **ADD PT A$1.15**	VEE designs and manufactures stabilisation and propulsion technology and provides products and services to the marine, defence and mining industries.

Property
State of play

Year-to-date the property sector has under-performed the market largely due to fears of interest rates increasing, however the underlying fundamentals for most sub-sectors are strong and demand and pricing for real assets also remains strong. We remain focussed on the niche sectors which are delivering good underlying cash flows underpinned by strong tenant covenants, growth opportunities, trading around or at a discount to NTA and offer an attractive distribution yield. This includes REITs exposed to pubs, social infrastructure, convenience retail, as well as industrial/logistics. Many REITs still offer attractive total returns and we expect the sector to remain in focus given its defensive attributes, particularly in the context of the current geo-political environment. However, we acknowledge that sentiment will swing around depending on bond yields which currently sit around 2.8% (+100 basis points year to date).

Overall, the recent reporting season saw most REITs reiterate FY22 guidance. Some groups upgraded guidance including Centuria Industrial REIT, National Storage REIT and HomeCo Daily Needs REIT. Groups focussed on funds management have also been upgrading FY22 earnings expectations (including Charter Hall Group, HomeCo and Goodman Group). The favourable tailwinds for industrial/logistics assets remain in place with significant demand for the asset class given the growing shift to e-commerce and increased focus on supply-chain resilience.

Many REITs continue to trade around or at a discount to NTA (although the gap has narrowed for some groups following the exit of lockdowns in NSW and VIC with retail landlords performing better). Year-to-date, M&A activity has been focussed on the finalisation of the merger between HomeCo Daily Needs REIT (HDN) and Aventus Group (AVN) which now creates a portfolio of Large Format Retail, convenience and health services assets across Australia valued at +$4 billion. Several groups are also undertaking on-market buy-backs (Waypoint REIT, Dexus Industria REIT, Dexus Convenience REIT, Growthpoint).

While there is acknowledgement that interest rates are heading higher, balance sheets remain sound ensuring most REITs also have options to expand portfolios and/or commit to new developments. We note that the REIT sector has also historically been a good hedge for higher inflation given rising income/rent.

Near term unknowns and risks include: (1) movement in bond yields, (2) the general economic environment/recovery coming out of COVID-19, (3) impacts on leasing/rental markets, particularly for office and (4) increasing costs.

Our preferred REITs under coverage are:

- Specialised – HealthCo Healthcare and Wellness REIT (HCW); Waypoint REIT (WPR); Hotel Property Investments (HPI)
- Retail - HomeCo Daily Needs REIT (HDN)
- Industrial – Dexus Industria REIT (DXI)

Recent publications

HomeCo Daily Needs REIT
ADD TP A$1.73
A new chapter

Read publication

HealthCo REIT
ADD TP A$2.48
A solid maiden result

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