Spring 2022 Outlook

morgans

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Welcome

The global economy is headed for a likely recession, but most major central banks will press on with tightening monetary policy for some time yet as inflation remains uncomfortably high. Central banks have started what we expect to be the most aggressive cycle of interest rate increases since the late 1980s/early 1990s. The spectre of significantly higher interest rates has sent shockwaves through global markets as investor concerns grow that efforts to rein in inflation will end in recession.

We think the increase in government bond yields and the threat of slowing global economic growth will keep risk assets such as equities under pressure. However, we think Australian equities will fare better than global peers. We suspect markets will start to turn a corner later this year as tightening cycles near terminal levels. We update our asset allocation and tactical positioning maintaining a defensive tilt to portfolios. We prefer resources, agriculture, telecommunications and consumer staples at a sector level. However, we remain vigilant for buying opportunities amidst the noise.

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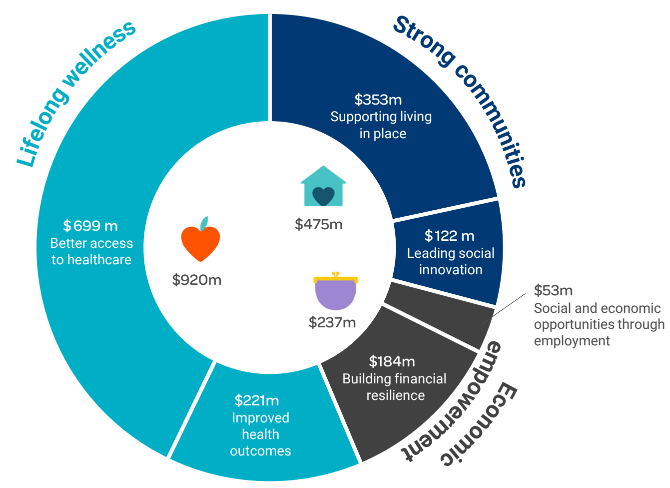
Feature
Australian Unity

Australian Unity is a mutual wellbeing company committed to its 380,000 members, 650,000 customers and the community through its health, wealth and care businesses. Australian Unity is well placed to benefit from the rising need for better-planned wealth accumulation, the opportunities presented by an ageing population, the changing regulatory landscape and increasing community expectations.

Australian Unity's purpose is to deliver value to members and the broader community through its targeted portfolio of products and services and has partnered with Social Ventures Australia (SVA) to report on its social impact as measured by the Community and Social Value framework. Australian Unity estimates, through their preliminary results, the company has contributed $1.6b of community and social value for FY2022 [(1)].

Read more

Community and Social Value FY2022



Source: Australian Unity Limited

(1) Australian Unity's Impact Report 2022, containing the final social impact value created and the basis of preparation, which details the CSV framework applied in estimating this value, is expected to be released in Mid-October 2022. This report will include PwC's limited assurance report and conclusion on the social impact value created for FY2022.

Economics

Australian recession appears extremely remote

The Australian economy in the June quarter was remarkably robust. GDP grew by 0.9% in the quarter while GDP per capita grew by 0.5% or 2% annualised. Real net national disposable income grew by 2.7% or 10.8% annualised.

On the other hand, productivity fell. GDP per hour worked fell by 1.9% for the quarter. This can be explained by a large number of people coming back to work.

What we have here is an economy growing rapidly because of a rapid increase in national income. This rapid increase in national income is caused by a major commodities boom.

The Governor of the Reserve Bank has said several times that the Australian terms of trade is currently the highest experienced since records began in the 1850s. It is higher now than the levels of the post-World War II boom.

This rapid increase in national income has caused a rapid decline in Australian unemployment. The level of Australian unemployment in August stood at 3.5%. This is a very slight rise from 3.4% unemployment seen in July. This increase in unemployment occurred because of an increase in the Australian participation rate from 66.4% to 66.6%. We must go back to the early 1970s to find similar periods of lower employment and labour demand as strong as this.

Recent movements in the terms of trade since June 2022 have seen modest declines. The composition of Australian exports has changed. The strength of iron ore demand is easing as the Chinese economy is softer than anticipated. On the other hand, a very strong Indian economy growing at near 7% per annum and a growth rate supported by strong growth in the Indian labour market is generating an increased demand for Australian energy exports. Coal and liquified natural gas prices have been solid and have taken up the modest weakness in terms of trade. The result is that the Australian terms of trade is still higher than the peak levels seen during the resources boom earlier this century.

The Australian economy's challenge is that it is running up against a very tight labour market. From this point, growth in the labour force can come from modest increases in domestic population growth, plus immigration. The recent decision to increase the annual immigration rate of skilled immigrants in Australia to 195,000 gives extra room for continued growth in the Australian economy, but it will take time to achieve this migration rate.

Still, after growth of 3.3% in Australia in calendar 2022, we think growth will slow to 2.3% in 2023 and 1.8% in 2024. The possibility that Australia will fall into negative growth or recession appears extremely remote.

As growth slows in the Australian economy, we think inflation will fall from 7.8% in 2022, to 4.3% in 2023 and 3.0% in 2024. In response to this slowing GDP growth and falling inflation, we anticipate a very modest rise in unemployment.

The possibility that Australia will fall into negative growth or recession appears extremely remote.

The exchange rate

The Australian dollar is stable against major currencies represented in the International Monetary Fund (IMF) basket called the Special Drawing Right (SDR). Broadly speaking, the Australian dollar is trading sideways around a level of 0.52 SDR.

The same cannot be said about the US dollar. The US dollar has risen rapidly against the IMF basket of currencies throughout the past financial year. Two things have been happening to cause this.

1. **A dramatic decline in the US budget deficit** which has fallen from a level of 16.0% in 2020 to a 11.2% in 2021 and only 2.7% in 2022. This alone would generate significant strength in the US dollar.
2. **A dramatic rise in the Fed Funds rate.** So far in calendar 2022 the Fed Funds rate has risen by 300 basis points from eight basis points in February to 308 basis points in September. We believe the Fed Funds rate will continue to rise to a level of 460 basis points by February 2023.

This very rare combination of tightening US fiscal and monetary policy is driving up the level of the US dollar against all other currencies. We think that the Australian dollar will remain stable against the IMF basket but the level against the US dollar is difficult to forecast until this period of US fiscal and monetary tightening has come to an end.

Australia Economic Forecasts

	Morgans (CY22)	Consensus (CY22)
GDP Growth	3.3%	3.9%
Inflation	7.8%	6.3%
RBA Cash Rate	3.1%	3.2%
AUD	68c	67c
ASX 200	7,200	7,500

Source: Morgans, Bloomberg

For more economic coverage subscribe to our podcasts

Asset allocation

Q4 2022 update

Central bank tightening, the threat of energy shortages in Europe, and covid-related mobility restrictions in China all present headwinds to global growth. As a result, we favour tilting allocations toward parts of the market that should prove more resilient in the event of slowing economic activity.

We prefer assets with defensive characteristics, inflation protection and lower correlation to the economic cycle. However, the ongoing volatility and market dislocation will present tactical opportunities, so investors are advised to be nimble with their cash holdings.

As good as it gets

The global economy is headed for a likely recession, but most major central banks will press on with tightening monetary policy for some time yet as inflation remains uncomfortably high. The US economy will hold up relatively well, while much of Europe succumbs to recession as the terms of trade shock from higher energy prices bites. China's economy will continue to struggle with a property slump, fading export demand, only limited policy support and possibly intermittent lockdowns. Energy commodity prices will remain high amid supply disruption and non-energy commodities don't have much further to fall. This will make economies that are net exporters of raw materials, such as Australia, the relative winners in what is otherwise a relatively bleak economic outlook.

We think the rises in global government bond yields and falls in equity prices have further to run. Government bond yields have typically peaked shortly before the end of central bank tightening cycles and we expect most major central banks to continue hiking rates over the next six months. We think the increase in government bond yields and the threat of slowing global economic growth will keep risk assets such as equities under pressure. This environment may see some continued widening in credit spreads. We suspect markets will start to turn a corner later this year as tightening cycles near terminal levels.

Seek protection outside of the core

We expect volatility to remain higher for all asset classes. We are a few quarters away from being confident that central bank policy and inflation pressures are controlled. We stay underweight in global equities, with a focus on those resilient to an economic slowdown we continue to see ongoing risk in Asia and Europe. High fixed income volatility is expected to moderate in the near term, but significant challenges remain and we remain underweight.

While we see ongoing risk to core assets such as equity and fixed income, we see an allocation to alternative assets as a way to diversify portfolio risk. Due to the low correlation of returns against equity and bond indices, alternative assets have the potential to offer diversification benefits in a multi-asset portfolio of long-only funds in traditional assets. For more conservative portfolios, alternatives can play a valuable role in increasing the prospective return, without adding to equity market risks. See our full publication for preferred exposures.

Read more

Key changes to our asset allocation settings

We cut risk exposure this quarter, increasing our underweight to global equities. We don't believe the market has fully discounted higher interest rates and the risk to earnings from a global slowdown. We maintain our neutral position to Australian equities. In our view, the resilient earnings outlook assisted by higher commodity prices will see Australia outperform global peers. We overweight cash as we see the risk of heightened volatility over the next few months.

Global Equities

Recommendation

The global economy is headed for a likely recession, but most major central banks will press on with tightening monetary policy for some time yet as inflation remains uncomfortably high. We think the increase in government bond yields and the threat of slowing global economic growth will keep equities under pressure. We see risk that Europe succumbs to recession as the terms of trade shock from higher energy prices bites. China's economy will continue to struggle with a property slump, fading export demand, only limited policy support and possibly intermittent lockdowns. We prefer companies with pricing power and lower exposure to the economic cycle (healthcare, staples).

Australian Equities

Recommendation

We have a neutral view on Australian equities as we see ongoing volatility from higher interest rates and a moderating pace of economic growth challenge returns in the short term. As tailwinds from commodity prices fade, we think above-average earnings growth for the market will be harder to come by. Accordingly, we prefer a targeted portfolio approach favouring commodities and financials. Nevertheless, we think some tactical opportunities will emerge as uncertainty shakes investor confidence. In addition, quality industrials and consumer discretionary valuations are starting to look attractive.

Fixed Income

Recommendation

After the sharp move higher in global interest rates and credit spreads this year, the risk/return tradeoff in fixed income has become more favourable. With markets pricing in an aggressive central bank tightening cycle, we are seeing opportunities at the short end of the yield curve. Our preferred securities have an attractive yield and relatively short duration, which should help shield them from the risk of a further rise in yields. In our view, investors should focus on issuers that are robust enough to withstand a more challenging macroeconomic backdrop. We stay moderately underweight the long-end as we see investors demanding higher compensation for holding government bonds amid rising inflation and debt levels.

Property and Infrastructure

Recommendation

We believe that infrastructure assets, with their reliable earnings which are protected to a degree from inflation, are an attractive long-term investment proposition. But higher interest rates can be expected to lead to a higher cost of debt, and an increase in the rate at which investors value future earnings. We see the property market as being moderately expensive, especially on a yield gap basis. We are likely witnessing the tail end of positive revaluations and going forward we see some negative revaluations in future reporting periods if the higher level of bond rates persists and capitalisation rates begin to expand.

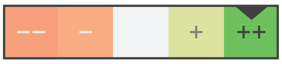
Alternatives

Recommendation

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.

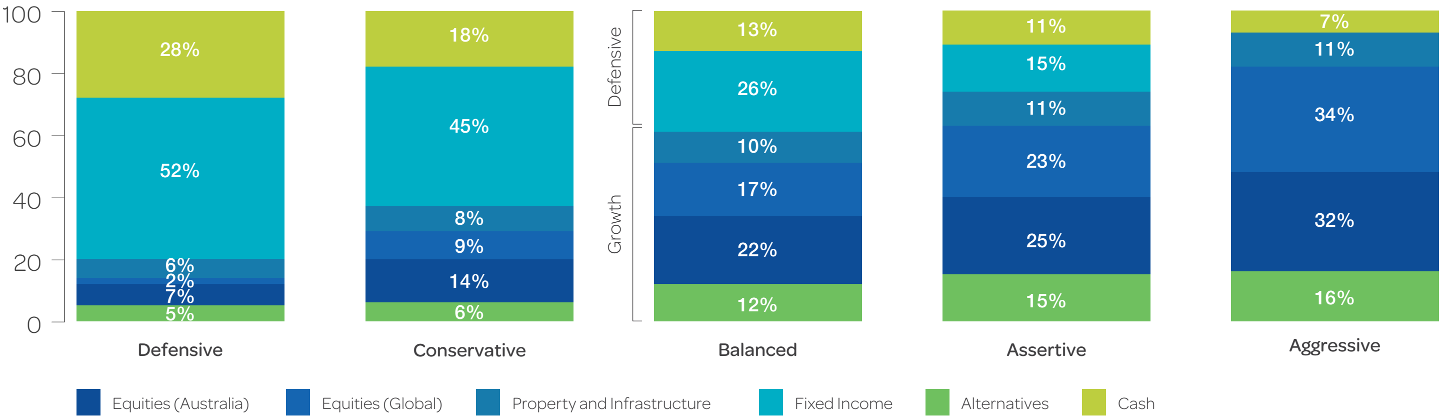
Cash

Recommendation



Our cash position increases again this quarter. With higher global short interest rates 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 market risk. We continue to look for tactical opportunities to deploy our cash position.

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%	0% (0%)
Equities (Global)	7%	14%	22%	28%	39%	-5% (-5%)
Property and Infrastructure	6%	8%	10%	11%	11%	0% (0%)
Fixed Income	55%	48%	29%	18%	0%	-3% (0%)
Alternatives	5%	6%	12%	15%	16%	0% (0%)
Cash	20%	10%	5%	3%	2%	8% (5%)

*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 – Q4 2022 for product recommendations.

Read publication

Equity strategy

Stick to the fundamentals

Morgans research analysts reset their sector views, strategies and best ideas as markets adapt to new financial and geopolitical challenges.

Equity portfolio construction

The short-term performance of Australian equities will likely see ongoing volatility from higher interest rates and a moderating pace of economic growth that will challenge returns. As tailwinds from commodity prices and the post-pandemic reopening start to ease, we think above average earnings growth for the market will be harder to come by.

We prefer a targeted portfolio approach favouring reflation (financials, energy) and quality cyclicals with strong market positions that can absorb rising costs. In this note, Morgans analysts see solid opportunities among **consumer staples, healthcare, financials** and **materials/energy**.

We continually seek to rebalance core equity portfolio exposure to all of yield, value, cyclical and growth factors. Ultimately we're looking for best-of-breed companies capable of thriving regardless of the macro-economic backdrop.

Key sector outlooks

Category	Sector	Rating	Best ideas	Overview
Financials	Banks		MQG	In the absence of material asset quality deterioration, we expect bank dividends to remain reasonably robust. However, bank dividend yields may become incrementally less attractive on a risk-adjusted basis relative to government bonds, bank hybrids and term deposits.
	Diversified Financials	+	QBE, GQG	We continue to see the relative appeal of diversified financials stocks. Our overall sector view is driven by: strong stock balance sheets, reasonable valuations, relatively defensive sector earnings streams and generally positive sector leverage to rising interest rates.
Defensives	Consumer Staples	+	WES, TWE	Food cost inflation looks likely to persist through FY23 and cost-of-living pressures are driving more value-conscious consumption. With interest rates set to rise further, we think the sector's defensive characteristics provide a solid anchor for diversified portfolios.
	Healthcare	+	RMD, HLS, M7T, PME	The healthcare sector has fared marginally better than the market post-COVID-19 but strong fundamentals (ageing population, medical innovation and government funding) support outperformance over the medium to longer term.
	Telco	+	TLS, NXT	Demand for secure digital infrastructure remains robust, with Telstra looking well placed given its legal restructure and peer challenges.
	Infra and Utilities		TCL, DBI	Essential service providers with regulated revenues, resilient demand, or long-term contracted earnings with low correlation to the economy remain in-demand. Scarcity of assets, takeover activity and the inflation hedge add to the appeal of the sector.
	A-REITs		DXI, HDN	While inflation can be positive for REITs, higher interest rates do create uncertainty on asset values. We expect any potential softening in asset prices to become evident in 2023, with some REITs flagging that growth in rent may help offset any cap rate expansion.
Cyclicals	Consumer Discretionary		ALL, LOV, DMP, JIN	Consumer confidence/expenditure will likely track lower in coming months due to pressure on household budgets. Sector valuations look more compelling on a medium term basis, although short-term volatility in pricing and sentiment.
	Industrials		CTD, WEB, ACF, IEL, PPE	We see evidence of supply-chain improvement but inflation remains stubbornly high. In a volatile operating environment, we see defensive companies exposed to food, beverages, healthcare, and repairs and maintenance activity being in the best position to benefit.
	Online	–	SEK	Valuations remain around historical average post the recent sell-off. We currently prefer a tilt towards higher quality, free cash flow generating businesses, but do acknowledge opportunities in some smaller caps with balance sheet capacity to fund near term growth.
	Technology	–	TNE	Selective exposure to technology stocks is likely to deliver value due to their ability to grow earnings faster than GDP, regardless of interest rate movements. We prefer high quality, cash generative technology companies with net cash balance sheets and pricing power.

Cyclicals	Agriculture	+	NUF, IPL	Soft commodities broadly benefit from the lower USD and tight supply/demand dynamics. Exposure to agriculture companies offers diversification and a partial decoupling from the broader market as performance is driven more by seasonal conditions in domestic/global markets.
Resources	Metals and Mining	+	BHP, S32	Risks to demand have risen materially and share prices are capable of dislocating below fundamentals. Investors require a strong stomach but can take comfort from strong sector balance sheets, cost competitiveness, strong AUD buffer and leverage to compelling medium term fundamentals.
	Energy	++	STO, KAR	The European energy crisis supports pricing into the Pacific market to benefit Australian producers (LNG/Coal). That said, energy volatility also poses macro risks, affecting equity risk premiums, requiring strong stomachs among investors.

Refer to updated Q4 2022 Sector Outlooks for more coverage.

Read publication

Banks

Robust yield expectations

Net interest income generally accounts for c.80% of bank revenues. Increases in the RBA cash rate support the outlook for net interest margins (NIM), through interest rate-insensitive deposits and free funds. Furthermore, NIMs will benefit from waning demand for fixed rate home loans (which are generally lower margin) relative to variable rate home loans, as fixed rates on offer have normalised.

Offsetting these NIM tailwinds is the likely rise in the average cost of funds, as a result of refinancing drawings on the RBA's ultra-cheap Term Funding Facility with far more expensive wholesale debt, rising costs of wholesale debt (both bank bills rates and credit spreads), increases in term deposit rates, a reversion of funds from at-call deposits to term deposits and a reduction of deposits on bank balance sheets. Furthermore, intense competition sees margins on new loans below those on loans outstanding.

While recent reported credit growth (both home loans and business) has been strong, higher interest rates may slow credit growth. However, we 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.

Fears of significantly higher interest rates have put downward pressure on asset prices and increased risk of rising unemployment (albeit from very low levels). It also puts pressure on household budgets that have already been impacted by higher grocery and fuel costs. As such, bank asset quality, which has been around all-time highs, should be expected to deteriorate to more normal levels.

Banks continue to focus on cost efficiencies, albeit labour shortages and rising wage inflation make this task difficult.

In the absence of material asset quality deterioration, we expect bank dividends to remain reasonably robust. However, dividend yields may become less attractive on a risk-adjusted basis relative to interest rates on government bonds, bank hybrids, corporate debt and term deposits. Given regulatory capital levels are relatively close to APRA requirements, future buyback activity seems predicated on further asset sales.

Recent publications

Commonwealth Bank

ANZ

BOQ

Banks
Major Banks:
Compare and contrast.

Read publication

Industrials

Tricky operating environment

Inflation remains stubbornly high in many countries despite central banks' efforts to moderate the rate of growth through pushing interest rates aggressively higher. While there is anecdotal evidence that supply chains are improving, the war in Ukraine and labour shortages remain risks with prices for key business inputs such as raw materials, energy and logistics likely to be elevated for some time. Going into the Northern Hemisphere winter, the energy crisis in Europe is another factor that investors need to keep an eye on and could have negative implications for the region's economy.

The industrials sector overall had a decent August reporting season with almost all companies reporting FY22 results that were either broadly in line or slightly better than consensus expectations. This was however dampened by softer or uncertain trading outlooks with constrained supply chains, persistent inflation, rising interest rates and weaker consumer sentiment among risks that are making near-term forecasts difficult. Hence, it was perhaps not surprising that few companies provided quantitative earnings guidance for FY23, continuing a trend since the onset of COVID-19.

In this volatile macroeconomic environment, it is best to stick with companies that have defensive characteristics and pricing power. Companies with strong market positions that are exposed to food, beverages, healthcare and repairs and maintenance activity should continue to perform well as the products and services they provide are necessities. As cost-of-living pressures increase, these businesses are in a good position to benefit as households look to crimp spending in other, more discretionary areas.

Recent publications

Amcor
HOLD TP A$18.75
EPS growth to slow in FY23

Read publication

Acrow
ADD TP A$0.80
Plenty more to come

Read publication

Telco

The value of quality digital assets is shining

The Telco sector enjoys the attractions of earnings defensiveness, growth and in some cases yield. We recommend an overweight exposure and see potential for capital growth in key large cap names.

Mobile and home broadband prices are rising after many years of pricing pressure. While not great for consumers, this is good for shareholders. Returns on capital need to rise to support business sustainability. Price rises are sticking which is reflective of the value of quality networks, differentiation in the early years of next generation mobile (5G rollout) and remote/working from home (WFH) which seems likely to persist.

Digital transformation including Cloud, WFH and digitising to deliver operating efficiencies to offset wage growth are long-term structural growth trends. Spending on these key areas and technology will continue to grow as a percentage of GDP. Domestic insourcing including securing Critical National Industries and the broader digital infrastructure that supports Australia will only continue to grow in importance.

The high-profile hacking of Optus highlights the downside when this is not handled well and reinforces the value proposition of quality providers, in our view. Telcos and data centre operators who are high quality and crucial in this digital supply chain will remain well positioned to benefit from these strong medium term structural trends.

Full service incumbent telcos broadly suit balanced investors who are targeting yield and, at this point in the cycle, some capital growth. Those seeking more material capital growth are better suited to the data centre operators who are benefiting from very strong structural growth.

Recent publications

Telstra
ADD PT A$4.60
Restructure scheme vote summary

Read publication

NEXTDC
ADD PT A$13.30
Finely tuned and waiting for the green light

Read publication

Resources and Energy

Looking through uncertainty

Commodity headwinds have emerged quickly in recent weeks on currency and financial market dislocations, leading to growing risks of economic recession. Persistent inflation, extreme energy prices and regional issues (Ukraine conflict, Chinese property concerns) are feeding into this dynamic, which has potential to impact commodities demand, thus lowering support for commodities pricing.

Investors can take comfort from the fact that Australia's established mining companies are in strong financial health with much lower debt/leverage than in previous periods of weakness and generally with cost structures capable of weathering lower prices. The dramatic fall in the AUD also provides an important (and under-recognised) buffer to company earnings and valuations.

That said, share prices are capable of dislocating well below fundamentals in periods of macro-economic uncertainty, with gold stocks notably suffering this effect now, despite Australian dollar gold prices trending flat.

While short-term commodity demand looks at risk, supply continues to struggle. In-fact supply-side constraints only look to be intensifying linked to chronic constraints (labour, inputs), and some signs of capex deferral. Depressed commodity prices wouldn't solve for mismatched supply and demand expectations beyond the short-term and also don't factor in the risk of disruption, which as recently as the March quarter had held commodity markets captive (due to Ukraine) and still do in energy.

These dynamics could very well cause commodity prices to move in shorter cycles and to become just as susceptible to violent upside surprise when demand recovers, as they do in times of cyclical economic weakness.

We take a patient and conservative view, noting compelling, unchanged medium-term commodities/resources fundamentals driven by chronic supply-side constraints. A potential mini-bust in the short term requires a strong stomach, but further supports these medium-term dynamics.

- The **Chinese Communist Party Congress** (16 October 2022) is an important catalyst. President Xi is expected to secure a third term and we see potential for COVID-19 lockdowns to be relaxed further, helping to stabilise China's waning industrial production. Further large scale stimulus is also likely.
- **The European winter** is a clear flashpoint for the energy market. Gas and power shortages in Europe has potential to spike LNG and coal prices further in the Pacific market to the benefit of Australian producers. Note however that extreme energy volatility has the potential to trigger economic shock, affecting capital markets.

We continue to favour established low-cost producers over leveraged producers or explorer/developers. Our sector best ideas including **BHP, STO, S32** and **WHC/NHC** are defined by: proven management, impenetrable balance sheets, lower cost structures and long-life assets providing an option over inevitable future cycles including commodity upside risk.

Recent publications

BHP

BHP
ADD TP A$48.00
Pushes its advantage

Read publication

NEW HOPE GROUP

New Hope Corporation
ADD TP A$7.20
Further catalysts on approach

Read publication

Healthcare
Under recognised safe-haven

Despite its defensive characteristics, the sector has performed only marginally better than the market over the last three months. Blame it on macro concerns (e.g. interest rates, inflation, recession fears) along with a COVID-accelerated, depressed labour supply, stripping the sheen off the sector's unique defensiveness.

While there appear to be few places to hide in these volatile times, we believe investors should recognise the healthcare industry's underlying long-term structural drivers, which remain intact. These include: 1) an ageing population, 2) growing chronic illnesses, 3) government funding, 4) medical innovation (e.g. cell based therapies, genetic testing, next-gen vaccines) and 5) machine learning/AI and predictive analytics, to improve drug discovery prospects and commercialisation efforts, helping to solve for the human labour gap.

As the world moves toward COVID-19 endemicity, prior COVID-19 beneficiaries are tuning into COVID-19 exit trades. Pathology operators are impacted by declining PCR testing volumes, while hospital operators, IVF clinics, radiology practices and medical devices manufacturers stand to benefit as admissions and utilisation rates gradually normalise.

Aside from company specific effects, a weaker AUD should provide a tailwind for a number of the healthcare operators that generate significant sales overseas. Overall, we maintain overweight healthcare and encourage investors to use market volatility as an opportunity to add to positions in a number of the high quality Australian listed healthcare names.

Recent publications

ResMed

Resmed
ADD TP A$37.08

ResMed Inc - 4Q solid; underlying demand remains "incredible"

Read publication

pro medicus
OUR SUPPORT. YOUR SUCCESS.

Pro Medicus
ADD TP $58.18

Expensive for a reason

Read publication

Property
Open for business

REITs have underperformed the broader market year to date on the back of expectations around increasing interest rates. Bond yields continue to move around and currently sit at around 3.9% after starting the year at 1.7% and peaking at 4.2% in June 2022.

The recent reporting season highlighted that cap rate compression was strong in 1H22 however slowed in 2H22. Overall, NTAs increased or remained relatively stable as at June 2022, however most REITs continue to trade at large discounts to NTA.

While inflation can be positive for REITs, there is uncertainty around the impact of higher interest rates on asset values. We expect any potential softening in asset prices to become evident in 2023, with some REITs flagging that growth in rent may help offset any cap rate expansion.

Transactional markets are more subdued than levels seen in 2021 and it is expected to remain the case for the balance of 2022. Rising construction costs and interest rates will also cause increases in economic rents for new developments, likely tempering supply.

As expected, a key focus throughout reporting season was on debt and hedging levels given higher interest costs and the ability to grow rental streams via inflation linked leases/developments. Asset divestments are also on the agenda of many REITs with a view to bolstering balance sheets/further enhancing portfolio quality. Cash collection levels were strong over reporting season with COVID-19 impacts now minimal (traditional retailers biggest hit during COVID-19 are now seeing a strong uplift in activity). Balance sheets will remain in focus (hedging profiles, gearing levels and debt costs).

Most REITs provided FY23 guidance factoring in higher interest costs, conservative leasing up assumptions and no transactional activity. Some guidance numbers provided were below consensus estimates with differences largely due to assumptions around interest costs (most groups have assumed an average BBSW rate of between 2.70-3.75% over FY23 (currently at ~3%).

Our preferred REITs under coverage provide exposure to convenience retail (**HDN, WPR**), pubs (**HPI**), health/childcare (**HCW**) and industrial/logistics (**DXI**).

Recent publications

Home Co. Daily Needs REIT

HomeCo Daily Needs REIT
ADD TP $1.56

NTA and development pipeline boosted

Read publication

dexus

Dexus Industria REIT
ADD TP $3.25

Focus on industrial

Read publication

Agriculture

Global grain stocks are at worrying levels

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!

After reaching record highs following Russia's invasion of Ukraine in February, global soft commodity prices have eased in recent months after an agreement was brokered between Russia and Ukraine for grain to be exported again via the Black Sea. However we understand that exports have been materially lower than pre-war levels. Russia has also produced a record wheat crop.

Drought in the United States, parts of Europe and China are shrinking grain harvests. More poor weather could further reduce global inventories, particularly if the current dry weather in South America continues into the main planting season, as the crop cycle shifts to the southern hemisphere. The International Grains Council has forecast inventories of all harvested grain on hand globally to reach an eight-year low at the end of this crop year. The Black Sea export deal is also back under fresh pressure after Russian officials warned in recent weeks that they are unhappy with the terms.

Following Russia cutting gas supply to Europe, nitrogen fertiliser prices are rising again due to the record high European gas price which has seen many European manufacturers shutdown production given it is uneconomic. The European gas forward curve indicates that prices will remain high in the near term, which likely underpins stronger for longer fertiliser prices.

Australia is about to begin harvesting its third bumper grain crop in a row. It is expected to be the fourth-largest and second-most valuable winter crop on record. Given subsoil moisture levels, above average three-month rainfall outlook, La Nina returning and water in the dams/storages, ABARES is also forecasting a well above summer average crop, with planting up on the pcp but production down.

High prices and bumper crops should see earnings across the listed agricultural and chemical companies peak in FY22. ABARES is forecasting the value of Australian agricultural production to fall 4% to A$81.8bn in FY23 (still the second highest on record) which still bodes well for FY23 earnings. An expected return to more average seasonal conditions in 2023 will mean lower crop production. However, US industry executives believe the current industry expectation is that global grain and oilseeds markets need two consecutive normal crop years to stabilise global supplies, which is when we would also expect that soft commodity prices will decline.

Recent publications

Nufarm
ADD TP A$6.65
Reaping the rewards

Read publication

Incitec Pivot
ADD TP A$4.45
European energy crisis underpins stronger for longer

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Recent initiations

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Objective Corporation ADD PT A$17.30	OCL is a Enterprise software business specialising in Enterprise Content Management (ECM) for the public sector and highly regulated industries in Australia, the UK, New Zealand.
Metallica Minerals SPEC. BUY PT A$0.15	MLM is a resource development company with interests in several north Queensland mining projects.
Bowen Coking Coal SPEC. BUY PT A$0.55	BCB is a small-scale coal producer from the Bluff and Broadmeadow open cut mines in the Bowen Basin, QLD.

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