morgans

Investment Watch

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Recently published research

Equity strategy: Summer 2023 sector outlook and strategies	6 December 2022
Equity strategy: Morgans Best Ideas	1 December 2022
Investment strategy: Asset Allocation 2023 outlook	6 December 2022
Economic Strategy: The Fed gets more aggressive	30 November 2022
Morgans model portfolios: Morgans core and growth equity portfolios	16 November 2022

To our valued clients

It's hard to believe that 2022 is already coming to a close but we would like to take a moment to express our deepest gratitude for your support and trust.

It's this time of the year where we take the opportunity to reflect on the year that was. The team at Morgans is very proud of what we have achieved during 2022 including:

- celebrating the 40-year anniversary of Morgans
- being named Best Australasian Retail Broker at AIRA's 2022 Best Practice Investor Relations awards for the sixth time
- winning the Small Cap Execution award in the Peter Lee Survey
- producing 3,500 research products and notes containing valuable insights
- our Morgans Foundation donated over $2.3 million to Australian charities in 2022
- our annual charity day Big Dry Friday raising $1.3 million for rural and regional Australia

These achievements mean that Morgans continue to provide top-line advice and investment opportunities that benefit clients across our national branch network.

Markets have faced a tumultuous 2022 as a new regime of higher macro volatility took shape. 2022 will long be remembered as the year of rising inflation and interest rates. Indeed, in 2022 we witnessed the fastest pace of cash rate increases since 1994. As we look to 2023, the most important question is actually quite simple: can inflation be tamed as economic activity slows? We are reasonably optimistic, but there are substantial risks. Fortunately, there are convincing signs that inflation pressures are abating and 2023 is shaping up to be a much better year for investors.

We remind investors to remain vigilant against a series of macro-economic risks that are likely to make for a bumpy ride and as always, some asset classes will outperform others. That is why this extended version of Investment Watch includes our key themes and picks for 2023 and our best ideas. As always, speak to your adviser about asset classes and stocks that suit your investment goals.

2022 has been a challenging and disruptive year and from all the staff and management at Morgans we appreciate your ongoing support as a valued client of our business. We wish you and your family a safe and happy festive season and we look forward to sharing with you what we hope will be a prosperous 2023.

HAPPY FESTIVE SEASON

Fixed Interest

Income opportunities in 2023

The Reserve Bank of Australia (RBA) has increased the official cash rate for the eighth consecutive month providing welcome relief to income investors. We outline below a range of attractive options to consider into 2023.

Term deposits

Australian banks have followed the RBA raising interest rates on cash accounts and term deposits as they continue to grow their deposit books. This has prompted investors to reconsider term deposits as an investment alternative. We see banks offering up to 4.0% for 6 to 12-month terms.

Listed Capital Notes

We have recently seen CBA, BOQ and IAG launch successful capital note offers with CBA and BOQ capital notes trading above face value since listing and IAG expected to list on 23 December 2022. With ANZ and Challenger having the only capital notes with call dates in 2023, opportunities look limited. We note that NAB has the only ASX listed subordinated debt security, also due to be called in 2023. Dependent on market conditions, some issuers seek to pre-fund 2024 calls.

Mutual Capital Instruments (MCIs)

Mutuals (member-owned entities) play an important role across many areas of Australian society. They touch our lives through the provision of health care, aged care, home care, insurance, banking, food production and even roadside assistance for our cars. Well-known brands include Australian Unity, Great Southern Bank, RACQ, RACV and Dairy Farmers to name just a few.

MCIs have been created exclusively for mutuals so they can access permanent capital without compromising their status as a member-owned entity. This innovation has also created an opportunity for investors seeking higher levels of income by incorporating MCIs into a diversified income portfolio. Australian Unity MCIs are currently the only MCIs listed on ASX (ASX. AYUPA) and provide investors with semi-annual fully franked dividends. AYUPA last closed at $88.80 which equates to a yield of 8.03% p.a[1].

Read more on MCIs

Listed Investment Trusts (LITs)

LITs provide investors with the opportunity to diversify their income portfolios across a broad range of credit asset classes such as residential mortgage-backed securities, asset backed securities, global private debt, domestic and global loans as well as corporate bonds; all managed by specialist investment managers. LITs continue to pay reliable monthly distributions which have been rising as interest rates rise. ASX prices of a number of LITs have fallen more than can be justified and are trading at discounts to their NTAs which is not a true reflection of the asset class and the defensive nature of the investment strategies of the LIT sector. As the economic outlook becomes clearer, we see good opportunity for price appreciation in addition to the attractive yields.

Read more on LITs

Morgans was involved in all listed capital note offers this year as joint lead manager[2].

IAG Capital Notes 2

$500m

BOQ Capital Notes 3

$400m

CommBank PERLS XV Capital Notes

$1.78b

Macquarie Group Capital Notes 6

$750m

Westpac Capital Notes 9

$1.50b

NAB Capital Notes 6

$2.00b

CommBank PERLS XIV Capital Notes

$1.75b

ANZ Capital Notes 7

$1.28b

Speak to your Morgans adviser to find out more.

(1) Source: Morgans, IRESS. Price as at 2 December 2022.
(2) Morgans Financial Limited was a Joint Lead Manager to these issues and received fees in this regard.

Economics

Staying the course while Central Banks tighten

The world economy seems to be entering a shallow slowdown as we move into 2023. We think that after 1.8% growth in 2022, the US will record a slightly negative -0.2% GDP growth in 2023. The reason for this slowdown is continuing rate increases by the Federal Reserve.

The Euro Area, after 3.1% growth in 2022, should decline to only 0.2% growth in 2023. Germany and Italy should both suffer negative GDP number in 2023. The United Kingdom, which is no longer in the European Union, should also suffer a small negative GDP number.

Real GDP growth	2021 (%)	2022 (%)	2023 (%)
US	5.9	1.8	(0.2)
Euro area	5.2	3.1	0.2
China	8.1	3.2	4.4
India	8.7	6.9	6.1
Australia	4.2	4.0	2.0

Consumer price inflation	2021 (%)	2022 (%)	2023 (%)
US	4.7	8.1	4.3
Euro area	2.6	8.8	4.7
China	1.8	2.7	1.8
India	6.3	6.4	4.9
Australia	3.5	8.0	4.8

The Chinese economy, which has struggled through 2022 with much of its economy in COVID-19 shutdown, should grow by only 3.2% in 2022. COVID-19 is not the only problem that China has. The slowing growth rate of an aging workforce means that the structural growth rate that China can produce in terms of its national income, is slowing. By the end of this decade, the Chinese workforce should begin to decline. This means that Chinese growth will be determined entirely by productivity growth. China will enter a period of slow Japanese-like growth rates.

The economy that replaces China as the major world growth economy will be India. The growth of the Indian workforce will continue to be strong for decades ahead. After 6.9% growth in 2022, the Indian economy should grow by 6.1% in 2023. These high Indian growth rates are sustainable through this decade and the next. This year, India moved from being the world's sixth largest economy, to being the fifth largest economy. By 2050, India could become the world's largest economy.

After 4% growth in 2022, the Australian economy should grow by 2.0% in 2023. The Australian economy will continue to grow solidly, even as other major developed economies slow towards zero. Australian growth, while other countries are in recession, is supported by our bipartisan skilled immigration program.

The reason that Central Banks are increasing interest rates to slow the world economy, is the problem of high inflation. This inflation was not caused by Central Banks. This inflation was caused by the enormous expansions of fiscal deficits in 2020 at the beginning of the pandemic. Politicians, particularly those in the US, seemed unsatisfied by merely filling the need to support their economies during the pandemic shutdown. They also found the need to fill the pockets of their political supporters with generous programs. The result of this was a dramatic expansion of budget deficits, especially in the United States. The US budget deficit in 2020 rose to 15.9% of US GDP. This budget deficit was the largest budget deficit since WWII. This was followed by a further budget deficit in 2021 of 11.1% of GDP. Unfortunately, the US economy did not have enough excess capacity to grow as rapidly as this demand suggested. The excess stimulus then spilled directly into high inflation. This is the high inflation that has burdened the whole of the world economy through 2022.

Inflation should peak in the US at 8.1% in 2022 before falling to 4.3% in 2023. Inflation in the Euro Area should peak at 8.8% in 2022, before falling to 4.7% in 2023. Australian inflation should peak at 8.0% in 2022 before falling to 4.8% in 2023. All of these countries expect inflation to fall to 3% or lower by the end of 2024.

China, with a softening economy, should have inflation of only 2.7% in 2022, easing to 1.8% in 2023. Rapidly growing India, with a 4% inflation target, should have 6.4% inflation in 2022 and 4.9% in 2023. These inflation levels are not a problem within the context of the Indian economy.

Inflation and financial markets

Rising inflation has caused problems for financial markets because rising inflation leads to rising bond yields. Rising bond yields put downward pressure on stockmarket prices, even if earnings are stable. This is the circumstance which gave both the US and Australian stockmarkets a rough ride in calendar 2022. As we reach the end of 2022, the Australian market seems to be producing better earnings than the US market.

A decline in bond yields, which may turn out to be a counter-trend rally, has allowed a recovery in US and Australian equities since late September 2022. Australian equities seem to be performing especially well because of superior earnings. These superior earnings seem based on the out-performance of the Australian resources sector.

Our model of the ASX 200 at the end of November 2022 stood at 7,370 points. As we reach the end of 2022, Australian commodity export prices, seem to have declined slightly but remain well above the peak levels achieved during the previous resources boom earlier in the century. It is likely that this out-performance of the Australian equities market, over the US equities market, can be maintained in 2023.

It is possible that renewed increases in short rates will provoke a further sell-off in US and other treasury securities as we move into calendar 2023. This could generate further downward pressure on world equities in the first half of 2023.

Staying the course

The problem we see is that Central Banks have yet to come to the end of their tightening cycle. It is entirely possible that bond markets have underestimated the willingness of Central Banks to move to higher ground. It is entirely possible that renewed increases in short rates will provoke a further sell-off in US and other treasury securities as we move into calendar 2023. This could generate further downward pressure on world equities in the first half of 2023. We will have to live through this difficult period to find what exactly Central Banks have in store.

Still, we may be confident that by the time we reach the middle of 2023, this process of Central Bank tightening will be completed. The outlook then is for falling inflation, inflation that is falling throughout calendar 2023 and 2024. This should then generate an extended rally in long term bonds. This rally in long term bonds should allow an equally long rally in US and Australian equities. It is just a matter of staying the course until Central Banks are satisfied that they have completed their program.

For more economic coverage subscribe to our podcasts

Asset allocation

Getting tactical – selectively increasing risk exposure

Lower valuations mean that asset markets today offer much better prospects for returns in 2023. It took a painful slump in 2022 to get there and challenges remain but we think those with a long-term horizon will be well rewarded.

We step down our defensive positioning as we are near the inflection point for the current inflationary wave and the prospect of a pivot in China's zero-COVID-19 policy could pave the way for a revival in risk appetite.

We reduce our overweight cash position and bring fixed income back to neutral.

Are we there yet?

Markets have faced a tumultuous 2022 as a new regime of higher macro volatility took shape. The key question for 2023 is whether central banks can tame inflation to more acceptable levels without a recession, or at least without a deep recession. We are reasonably optimistic, but there are substantial risks.

Suppose inflation pressures remain pervasive enough that central banks have no choice but to keep tightening aggressively. In that case, a recession might become unavoidable, not just in Europe but also in the US. Beyond the inflation concerns, political and geopolitical shocks could continue to affect markets via higher uncertainty, tighter financial conditions, or negative effects on commodity supply.

However, risk presents opportunity and we see a path for investors to succeed in the new regime. Investing in the energy transition, Australian equities with a value/quality bias, investment grade credit and alternative sub-classes, offer the best risk/return profile for a market fretting about what is to come.

China: could a parallel pivot story be playing out?

China's COVID-19 policy 'pivot' can potentially be a major driver of asset prices in 2023. We see a possible end to the zero-COVID-19 policy in 1H23 as economic challenges and social unease are likely to prompt change. A re-opening could allow consumption to rebound sharply and boost GDP. Importantly, as China pursued a very different policy response to COVID-19 from most of the West, it is not experiencing high inflation or rising interest rates. This gives Beijing a significant runway for stimulus.

Key changes to our asset allocation settings

We increase our risk exposure this quarter, decreasing our overweight cash position and bringing fixed interest to neutral weight. While we increase our risk exposure, we maintain an underweight exposure to global equities. This is because we don't believe the market has fully discounted the risk to earnings from a global slowdown. We take a more constructive view on Australian equities supported by higher commodity prices and strong employment conditions which should see the Australian equity market outperform global peers.

Global Equities

Recommendation

The global economy is headed for a slowdown in 2023, but most major central banks will press on with tightening monetary policy as inflation remains above target. While valuations have come back materially, slowing global economic growth will keep earnings under pressure in 1H23. We don't believe we'll see a typical recessionary slowdown in earnings but one more akin to a mid-cycle slowdown given the starting point for developed market economies (strong employment and healthy household balance sheets). China's COVID-19 policy 'pivot' will also temper downside risks.

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. We think investors will do well tilting toward value and quality.

Fixed Income

Recommendation

After the sharp increase in global interest rates and credit spreads in 2023, the fixed-income risk/return has become more favourable. 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. As long bond yields have pulled back recently, there is a risk that investors demand higher compensation for holding government bonds amid higher 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

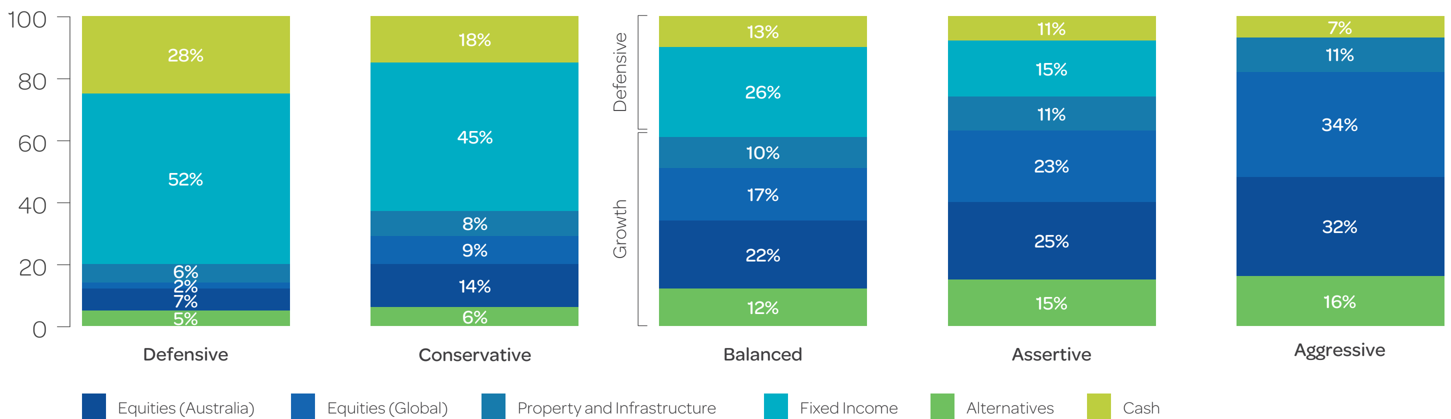
We believe non-traditional return streams, including private credit/equity, unlisted infrastructure, venture capital and real assets have the potential to add value and diversification. Our neutral view is based on a starting allocation that is much larger than what most qualified investors hold. Many 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

We reduce our overweight this quarter. With the normalisation in interest rates, we see fixed income returning to its role in portfolio defensive and less of a need to hold above-average cash levels. 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 (Aggressive*)
Equities (Australia)	7%	14%	22%	25%	32%	0%
Equities (Global)	7%	14%	22%	28%	39%	-5%
Property and Infrastructure	6%	8%	10%	11%	11%	0%
Fixed Income	55%	48%	29%	18%	0%	0%
Alternatives	5%	6%	12%	15%	16%	0%
Cash	20%	10%	5%	3%	2%	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.

Read publication

Refer to our full publication Asset Allocation Update – 2023 Outlook for product recommendations.

Read publication

Equity strategy

Valuation appeal amidst some earnings uncertainty

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

Equity portfolio construction

While valuations have come back materially, slower economic growth will keep earnings under pressure in 1H23. We don't expect a typical recessionary slowdown in earnings but one more akin to a mid-cycle slowdown given the strong starting point for developed market economies (employment, household savings). China's COVID-19 policy 'pivot' will also temper downside risks.

We have a neutral view on Australian equities as we see ongoing volatility from higher interest rates and a moderating pace of economic growth challenging short-term returns.

We prefer a targeted portfolio approach favouring defensives, select 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.

The ongoing volatility and market dislocation will present tactical opportunities, so investors are advised to be nimble with their cash holdings.

In this update, Morgans sector analysts have upgraded their ratings on the Online and Technology sectors (to neutral) and the Consumer Discretionary sector (to neutral/overweight). The sector rating for Agriculture has been downgraded (to neutral).

Key sector outlooks

Category	Sector	Rating (scale: -- / - / neutral / + / ++)	Best ideas	Overview
Financials	Banks	neutral	CBA, WBC, 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 sector trading at reasonable multiples, offering a good hedge against inflation and having defensive properties as we potentially head into a slower global economy.
Defensives	Consumer Staples	+	WES, TWE	Lockdowns are behind us but consumers are faced with higher inflation and rising rates. While some sector tailwinds will subside (e.g. increased eating-at-home), the defensiveness of the sector puts it in a good position to weather any weakness in the economic outlook.
	Healthcare	+	RMD, HLS, M7T	The healthcare sector is expected to perform better in 2023 after underperforming during 2022. The long-term demand drivers like an increase in complex and chronic conditions will underpin earnings growth.
	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	neutral	TCL, DBI, AGL	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	neutral	DXI, HDN	While inflation can be positive for REITs, higher interest rates 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	+	DMP, LOV, ALL, JIN	The rising cost of living is affecting discretionary expenditure but the slowdown looks less pronounced than previously expected. The best exposures to a recovery will be those retailers with resilient businesses and growth strategies allowing them to grow market share.
	Industrials	neutral	WEB, CTD, ACF, IEL, PPE	Despite uncomfortably high inflation in many countries, global supply chains are improving, providing some relief. While demand remains uncertain, we think high quality companies with experienced management and pricing power can outperform over the next 12 months.

Sector group	Sector	Rating (-- / - / neutral / + / ++)	Stocks	Comment
Cyclicals	Online	Neutral	SEK	Valuations remain around historical five year averages post recent weakness. We 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	Neutral	XRO	2022 has seen unprecedented interest rate rises which crunched valuations. Interest rate rises are or will soften and investors will once again look for high quality companies that can grow above anaemic economic growth. Quality technology will come back into focus.
	Agriculture	Neutral	NUF, IPL	While soft commodity prices remain historically high, given the third La Niña in a row and the resulting rainfall/flooding is now doing more damage than good to the industry in certain regions, we think FY22 was as good as it gets for the ASX listed companies.
Resources	Metals and Mining	+	BHP, S32	Demand risks have risen materially and have the potential to fuel equity price volatility. Investors require a strong stomach but can take comfort from strong sector balance sheets, cost competitiveness and sector-leverage to compelling medium-term fundamentals.
	Energy	++	STO, KAR	The European energy crisis supports pricing into the Pacific market to the benefit of Australian producers (LNG/Coal). That said, energy volatility does also pose macro risks, affecting equity risk premiums, which requires strong stomachs among investors.

Refer to updated Summer 2023: Equity sector strategies for more coverage.

Read publication

Banks

Some insulation from rising rates

We think the 2H22 reporting season in October/November highlighted five key themes for the major banks.

First, banks are benefitting from increases in the RBA cash rate. This occurs due to higher earnings on their reinvested deposits and the rates on their loans increasing faster than rises in the blended cost of funding. Half-year exit margins and management commentary indicate net interest margin improvement should continue into FY23, before headwinds from intense lending competition (including cashback offers), deposit mix shift (from at-call to term deposits) and higher wholesale funding costs outpace the higher rate tailwinds. The rollover of low margin fixed rate loans peaking in mid-late 2023 could support margins.

Second, credit growth continues to be solid, particularly business lending. However, we expect credit growth to decline through to FY24 as rising cash rates make their long and variable impact on the economy.

Third, bank asset quality continues to be strong. Significant loan loss provisioning has been recognised against scenarios of significant economic deterioration (unemployment, property prices, and GDP growth are key factors). Earnings are expected to face headwinds from normalisation of bad debt charges to more normal levels. Regulatory capital is in a strong position (and continues to improve) against regulatory requirements, albeit we don't expect new buyback programs to be announced in the short term absent further asset sales.

Fourth, cost pressures are building, with increases in wage bills and vendor costs likely to outpace productivity initiatives. M&A activity will likely muddy this picture.

Finally, we expect bank dividends to lift into FY23 alongside growing earnings. However, strong share price rises and higher interest rates mean the attraction of bank dividend yields over returns on government bonds, bank hybrids, corporate debt and term deposits has reduced on a risk-adjusted basis.

Recent publications

Commonwealth Bank
HOLD TP A$93.48
Q1 trading update

Read publication

Westpac
ADD TP A$25.80
Rising NIM, rising FY24 cost target

Read publication

Consumer discretionary

A gentle slowdown so far

Inflation and rising interest rates have increased the cost of living for all Australians. Although most retailers report that the consumer is still out there spending, there are early signs that cost of living pressures are starting to cause a slowdown in discretionary expenditure after a post-lockdown spending spree that has persisted for 12 months.

Retail spending in October fell 0.2% month-on-month, with all categories other than the non-discretionary category of food and drink moving downwards. Compared to the same period last year, though, retail sales in October were up 12.7% year-on-year. The categories up the most on a year-on-year basis were those most closely associated with the reopening of society after months of pandemic-enforced abstinence: eating out, clothing and department stores.

Overall, the long-anticipated slowdown in consumer spending appears to be gentler at this stage than many analysts expected. With unemployment at generational lows and household savings still above pre-COVID-19 levels, consumers seem reluctant to rein in their discretionary expenditure, especially as lockdowns impacted their ability to visit shops during 2020 and 2021.

We think it's inevitable that spending will cool in the first half of 2023 as the post-lockdown surge peters out and as consumers look to economise after the Christmas excess. It may be, however, that the decline proves to be less pronounced than analysts are forecasting.

This may lead to a recovery in the share prices of many of the more resilient retailers, especially those with a strategy for growth that will see them increase their market share. After the blanket selldown that has persisted since at least April, this cannot come soon enough.

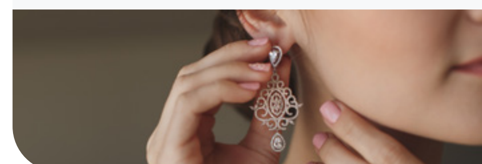
Recent publications

Australian Retail Sales
October 2022: cost of living woes starting to bite

Read publication

Lovisa
ADD TP A$24.50
FY22 Earnings: Goldmine

Read publication



Industrials

Cream rises to the top

Inflation remains uncomfortably high in many countries despite central banks' efforts to moderate the rate of price growth through pushing interest rates aggressively higher. While the war in Ukraine and the threat of a global recession are ongoing risks, there is some evidence that inflation may be nearing its peak and that supply chains are improving. If this trend continues and if economies can avoid more COVID-19-related lockdowns, then that should be positive for the Industrials sector. The key unknown however is how the demand environment evolves from here.

Heading into 2023, we continue to prefer high-quality, defensive businesses with pricing power. Companies with strong market positions that are exposed to food, beverages, healthcare and repairs and maintenance activity should be more insulated from a slowdown in economic activity as the products and services they provide are necessities. As cost-of-living pressures rise, these businesses are in a good position to benefit as households look to crimp spending in other, more discretionary areas.

Size also matters because larger companies can generate greater scale and efficiencies, making them more cost competitive than smaller rivals. This can create opportunities for market share growth in a softer economic environment.

While stocks with favourable quality characteristics generally trade at a premium to lower quality, cyclical alternatives, given the uncertain near-term outlook and the possibility of more market volatility on the horizon, sometimes it's worth paying that little bit extra. While dislocations can exist in the short term, the cream always rises to the top in the long term.

Recent publications

Amcor
HOLD TP A$17.75

Business remains resilient despite FX headwinds

Read publication

Ventia Services Group
ADD TP A$3.25

Making infrastructure work

Read publication

ALS
ADD TP A$14.40

Solid outlook for essential services

Read publication

Earning trust for 40 years.

Read our story

Resources and Energy

Competing forces at play

Competing forces are at work in commodities. The risk of economic recession is an ongoing threat to commodities demand. However, markets now have potential line-of-sight to both a China COVID-19 exit and a moderation in US dollar strength, which are both powerful positives for commodities demand.

This backdrop has increased price volatility across the sector. Ultimately, we think demand risks will weigh on short-term commodities and equities pricing; however, we remain focused on deeper supply trends, which support our medium-to-longer-term confidence in the cycle.

Iron ore and met coal prices have remained surprisingly resilient despite China's economic slowdown, leading us to wonder whether we might see unexpected upside once demand conditions improve.

Investment in the supply-side for energy resources (oil, gas, uranium) remains at multi-decade lows with little prospect for improvement, particularly in Australian gas where political risk is arguably approaching an extreme. It still appears that much of the world interprets 'energy transition' to mean an immediate 'energy switch', but we recognise that this is simply not possible. 50 years from now the world will still source most of its energy from fossil fuels. That is not to say we cannot transition to greener energy sources, it is simply a reflection of how large the global energy market is and, as a result, how long it will take to replace trillions of dollars' worth of installed energy infrastructure.

We continue to see a de-carbonisation rather than a de-fossilisation as a more realistic approach to helping the world get greener faster. This would avoid the economic damage caused by not reinvesting in supply for baseload energy, as we are now witnessing.

Base metals are widely seen as future-facing metals given their high use in electrification. Their long-term supply outlook is generally not that much better than for energy. The world is increasingly dependent on consuming larger amounts of these metals, while the major supply sources are not being replaced and continue to deteriorate, particularly in copper.

Meanwhile, our view on gold has improved. The yellow metal has been under sustained selloff since peaking in March 2022, coming under pressure from a surging US dollar and rapid real rate cycle. With both of those forces now potentially having peaked (or at least starting to moderate), we see potential for a healthy bounce in gold.

Recent publications

Iron Ore
Recovering faster than fundamentals

Read publication

Woodside Energy
HOLD TP A$34.50
FCF profile under some pressure

Read publication

New Hope Corporation
ADD TP A$6.80
20% upside + near 20% yield

Read publication

Infrastructure
Ongoing appeal

We think ASX-listed infrastructure continues to appeal to unlisted investors, given the attractiveness of Australia as an investment destination (regional economic growth, political stability, legal/property rights), the significant capital being allocated by investors to the sector, the limited infrastructure opportunities available to deploy this capital and the lower valuation multiples that listed assets trade at versus the private market.

The increased allocation of capital to the sector is due to investors recognising the structural growth opportunities, resilience of cashflows, long-life nature of assets and strong balance sheets. These attributes dovetail with the long-dated liabilities of superannuation and offshore pension funds. They also explain ongoing sector M&A interest.

Share prices of the sector's 'survivors' have been resilient compared to broader weakness. The sector has been able to resist the valuation and sentiment headwinds typically associated with rising government bond yields. As well as the factors discussed above, we think this is because of inflation-linked revenues (noting significant spikes in CPI both domestic and offshore), the scarcity value of remaining exposures and investors positioning for potential M&A.

Electricity markets will continue to be of interest as wholesale prices have soared above COVID-19 lows. In contrast to other infrastructure assets, we see share price weakness in pure play names as equity markets are treating the resurging energy market with caution. In our view, the stage is set for multi-year earnings recovery for unloved names like AGL as wholesale prices drive customer pricing higher during FY24-25. Australian electricity generators are also potential targets from both traditional infrastructure investors and large international energy companies.

Overall, we think the sector is trading around fair value but its earnings resilience during a period of economic uncertainty justifies continued holding in a portfolio.

Recent publications

Transurban
HOLD TP A$13.85
DPS growth lower / cost growth higher than expected

Read publication

Infrastructure
Updating forward interest and inflation rates

Read publication

Healthcare
Looking to a strong 2023

As the year draws to a close, the healthcare sector has been one of the underperforming sectors reflecting a fairly quick transition out of COVID-19 at the beginning of the year and a rotation into more cyclical sectors. As a result, a number of the quality healthcare companies (pathology, radiology, pharmaceutical) are trading well below their 12-month highs. For investors this provides a good opportunity to increase holdings in companies that have sustainable earnings growth as the world gets back to normal.

The long-term demand drivers for healthcare include: an ageing population; more complex and chronic health issues (Alzheimer's disease, obesity and diabetes), a move towards precision (personalised) medicine, the rise of hybrid care models combining virtual and in-person services and the digitisation of healthcare specialities (i.e. improved work flow, scheduling, coordination and data security).

However, the healthcare sector has not been immune to the staff shortages, wage increases and work flow disruptions that have affected all walks of life. Looking at Medicare data we can see surgical procedure volumes returning to pre-COVID-19 levels and the backlog of many elective procedures starting to moderate. Unfortunately, we are only just starting to see the consequences of underdiagnosed disease over the COVID-19 period and this will play out over the next few years.

We believe the healthcare sector will outperform in 2023 after a relatively soft 2022. It's now time to add quality healthcare names to portfolios.

Recent publications

Healius
ADD TP A$3.77
Aiming for a more flexible cost base as COVID-19 falls

Read publication

Ramsay
Health Care

Ramsay Health Care
ADD TP A$74.41
1Q trading update - moving in the right direction

Read publication

Property
2023 outlook

2022 was a challenging year for property with the sector underperforming the broader market due largely to concerns around rising interest rates. Although we note there has been improved performance over October/November. Bond yields have been volatile starting the year at 1.7% and currently trading around 3.6% after hitting a high of 4.2% in October. We expect a key catalyst for outperformance will coincide with any interest rate/ inflation stabilisation or M&A activity given the large discounts to NTA.

Recent quarterly updates from a broad range of REITs saw key portfolio metrics remain stable/slightly positive, current guidance reiterated, solid leasing activity with improved re-leasing spreads (office stable/industrial strong/retail improving) and strong rent collection (excluding CBD retail). Commentary within quarterlies suggests the impact from higher interest rates and inflation is not yet evident although it clearly remains a headwind. In general, FY23 guidance has factored in higher interest costs, conservative leasing up assumptions and no transactional activity. We note many groups have assumed an average BBSW rate in setting guidance between 2.70-3.75% vs the current rate of ~3%.

While inflation can be positive for REITs, there is uncertainty around impacts to asset values given higher interest rates. We note that cap rate tightening moderated in 2H22 vs 1H22 and we expect any cap rate expansion will become evident in CY23 although we are unlikely to see much movement with results in February 2023 given the lack of transactional activity. Goodman Group recently noted that "cap rates across our portfolio have increased by up to 40bps in some markets but the impact on values has been more than offset by rental growth". Most REITs continue to trade at large discounts to NTA (see below) reflecting the current disconnect between the listed market and direct market. We note assets that have recently been divested have been largely executed at current book values or around June 2021 book values.

Moving into 2023, a key focus remains on debt and hedging given higher interest costs and the ability to grow rental streams via inflation linked leases and/or developments. While overall balance sheets remain sound, many REITs are actively looking to divest assets to further bolster liquidity and/or recycle capital into development projects.

Next newsflow will likely revolve around December revaluations across portfolios prior to the February reporting season. We also note that most REITs go ex-distribution on 29 December 2022.

While we are still in a period of uncertainty leading into February reporting season, it may be time to consider looking at adding some selective REITs to portfolios.

Recent publications

A-REIT Compco
November 2022

Read publication

HealthCo REIT
ADD TP A$2.05
Partnering up

Read publication

Recent initiations

Qantas ADD | TP A$8.50	QAN is Australia's largest airline operating under two complementary airline brands, Qantas and Jetstar, flying international, domestic and regional services.
Ventia Services Group ADD | TP A$3.25	VNT is an essential infrastructure services provider in Australia and New Zealand, providing those services that keep the infrastructure working.
Tourism Holdings Rentals Limited ADD | TP A$4.00	THL is a diversified travel company with operations across Australia, New Zealand, North America, Europe and the UK. thl merged with Apollo Tourism & Leisure in late 2022.
Adrad ADD | TP A$1.85	AHL specialises in heat exchangers for industrial applications, and automotive parts for the aftermarket in Australia and New Zealand and for Original Equipment Manufacturers globally.
Genmin SPEC. BUY | TP A$0.52	GEN is an iron ore explorer and developer. Its key asset is the Baniaka iron ore project in Gabon.

Agriculture

Rain, rain go away

The third La Niña in a row (not seen since 1998-2001) is now doing more damage than good. It is causing crops and livestock to be lost in some regions on the east coast of Australia, it has downgraded the quality of crops (from milling varieties to feed), caused supply chain/logistics problems and difficulty getting crops/livestock to market. The adverse weather has also reduced planting of summer crops, particularly cotton and rice and has increased the risk of pests and diseases.

Additionally, soft commodity prices have fallen from their recent peaks. However, the lower Australian dollar will increase the competitiveness of Australia's agricultural exports in international markets. China's zero-COVID-19 strategy and rolling lockdowns also doesn't help and in some cases is seeing reduced demand for food and fibres.

Despite the near-term risks, the positive is if La Niña remains well into 2023 and sets the east coast up for another large winter planting program in April-June, keeps the dams full and underpins big summer crops for at least the next couple of years and produces lush pastures to fatten livestock and therefore rebuild herd numbers.

The question is: was FY22 as good as it gets? We think so. ABARES is forecasting the value of Australian agricultural production to fall only marginally to A$85bn in FY23 (still the second highest on record). However, ABARES did caution that considerable uncertainty remains over winter crop harvest progress and grain quality in NSW and Victoria given ongoing high rainfall, which could lead to downgrades in production value.

ABARES forecasts bode well for FY23 earnings, albeit they will fall on FY22 which was a record high for many of the listed companies. Even if the companies are forecasting growth in FY23, 1H23 earnings are likely to be down on the pcp as seasonally the skew won't be as great to the 1H as it was in 1H22 which saw a strong pull forward of demand given rising prices and supply chain issues caused by security of supply concerns.

Recent publications

Graincorp
HOLD TP A$8.50
It doesn't get any better than this

Read publication

Incitec Pivot
ADD TP A$4.55
Rewarding shareholders

Read publication

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