Summer 2024 Outlook

morgans

Investment Watch

Welcome

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To our valued clients, as we approach the end of 2023, it's truly astonishing how quickly time has passed. We want to pause for a moment and extend our heartfelt thanks for your unwavering support and trust. This season prompts us to reflect on the accomplishments of the past year, and the Morgans team takes great pride in the milestones we've reached in 2023, including:

- being inducted into the Queensland Business Leaders Hall of Fame
- presented with the Best Retail Investor Access Award at AIRA's 2023 Best Practice Investor Relations awards
- producing 3,500 research products and notes containing valuable insights
- our Morgans Foundation donated over $2.4 million to Australian charities in 2023
- our annual charity day Big Dry Friday raising $1.5 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.

HAPPY FESTIVE SEASON

2024 Outlook

Shaping up to be a much better year

A rapidly evolving investment landscape and a year of likely political uncertainty make forecasting difficult in 2024. We outline three possible scenarios:

1) **Economic soft landing** involves a modest deceleration below trend in major economies, without significant shocks disrupting markets. The decision to maintain higher interest rates will bring inflation near central banks' target range. This would enable a shift towards reducing interest rates, alleviating the strain on households and companies.
2) **A cyclical slowdown/mild recession** resilience driven by fiscally supported consumers and companies has been the biggest surprise of 2023, but barring something extraordinary, next year could see the global economy finally turn lower. Inflation would be sticky for a period before returning to target, with interest rates staying higher for longer periods, resulting in bouts of asset price volatility.
3) **Economic hard landing/balance sheet recession** will be defined by a sharp downturn in the global economy. A sharp acceleration in corporate defaults would significantly reduce corporate and consumer spending. Central banks would respond by cutting interest rates as growth and inflation fall away.

We are reasonably optimistic that the world will only see a cyclical slowdown and experience a mild recession, but there are substantial risks. Fortunately, there are convincing signs that inflation pressures are abating and interest rates may have peaked so 2024 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 2024 and our best ideas. As always, speak to your adviser about asset classes and stocks that suit your investment goals.

Sharply higher interest rates and inflation in 2023 have been challenging and disruptive for so many of our clients, so from all the staff and management 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 2024.

Morgans was involved in all listed capital note offers this year as joint lead manager[(1)].

Westpac Capital Notes 10 **$1.75b**	Australian Unity Series E Bonds **$250m**	Judo Capital Notes **$75m**	NAB Capital Notes 7 **$1.25b**
CommBank PERLS XVI Capital Notes **$1.55b**	Challenger Capital Notes 4 **$350m**	ANZ Capital Notes 8 **$1.5b**	IAG Capital Notes 2 **$500m**

[1]Morgans Financial Limited was a Joint Lead Manager to these issues and received fees in this regard.

Speak to your Morgans adviser to find out more.

Asset allocation

Positioning for a cyclical slowdown/mild recession

We outline three possible scenarios and investment implications for asset allocation.

Our base case remains a cyclical slowdown/mild recession

We expect economic growth to contract in the first half of 2024 before returning to growth later in the year. Sticky inflation will keep interest rates higher for longer. Equities will likely remain range bound until there is more certainty on the interest rate trajectory either peaking/falling. This scenario could have an interesting dynamic around small and mid-cap stocks. These companies were de-rated in 2023 as they grappled with higher interest rates, and their risk-reward profile looks attractive despite the recession risks. With central banks on high alert for persistent inflation, short-dated, high-quality credit should form the core part of the fixed income allocation. A mild recession would be positive for property because a small amount of inflation is positive for real estate. Furthermore, REIT prices have declined materially, which could lead to opportunities in areas that investors have overlooked in 2023 (retail/commercial REITs).

Assessing the risk of a soft landing/hard landing scenarios

The path of interest rates, together with inflation and growth trajectories, will look vastly different in each scenario and will inevitably be subject to high levels of uncertainty both in terms of duration and end points.

An economic hard landing will prompt widespread cuts to spending by companies and consumers resulting in a lengthy default cycle. Here USD, high quality sovereign debt and non-correlated alternatives will provide some cover. The focus is on duration, defensiveness, and sustainable incomes.

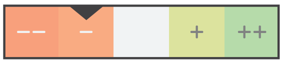
Conversely, a soft-landing scenario will see the economy hold at slightly below trend growth and inflation, providing central banks ample opportunity to cut interest rates to steer their economies back to growth in late 2024. A soft landing would be a risk-on scenario and good news for risk assets with a preference for riskier assets such as Emerging Markets, Resources and Mid/Small cap companies, while under weighting Defensive assets.

Changes to our Q1 2024 allocation

We lower cash to increase our Real Assets (REITs and listed infrastructure) allocation and reduce our underweight to Global Equities. We hold an underweight position Australian equities and neutral fixed interest. Expect market narratives to shift rapidly. Prepare for shorter cycles. A volatile macroeconomic environment demands vigilance.

Global Equities

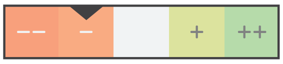
Recommendation



The slowdown in economic growth and central banks still focused on above-target inflation will remain a challenging backdrop for equities. In some ways, the investment environment today resembles early 2000. With the Federal Reserve well into a tightening cycle, real yields on short and long-term fixed income securities have risen materially. Meanwhile, richly-valued equities offer comparably poor earnings yields after a tech-led bull run. Like 2000, we expect the Fed to cut rates as growth slows but unfortunately this won't be painless. Thus, the surprising resilience of economic activity in the first half of 2023 is unlikely to last: we forecast a slowdown in the major advanced economies as the effects of tighter monetary policy feed through and China's recovery falters. Expansionary US fiscal policy, which has fueled risk assets over the past few years is contracting, hitting commodities prices and curbing economic growth. We fear the next leg down will be corporate profits and maintain a lower-than-normal exposure to global equities. Geographically, we prefer US exposure given their exposure to structural growth drivers and relative economic resilience to a global slowdown.

Australian Equities

Recommendation



We underweight Australian equities as we see ongoing volatility from high interest rates and a moderating pace of economic growth challenge returns in the short term. US fiscal policy is contracting, hitting commodities prices and curbing economic growth. Further prolonged weakness in the AUD will continue to drive up cost pressure. Given Australia's economic sensitivity to falling commodity prices, investors need to tread carefully 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, tilting what we believe are the best relative opportunities and the best risk/return profile e.g., small caps, quality cyclicals and reducing exposure to those caught in the expensive flight-to-defensive sectors (staples, telcos, utilities).

Fixed Income

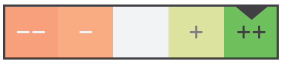
Recommendation

Higher-for-longer policy rates have bolstered the case for short-dated government debt in portfolios in the short term. We stay underweight in long-dated government bonds as we expect investors to demand more compensation for the risk of holding them. With the US yield curve still inverted, investors are not getting rewarded for taking duration risk. In the near term, supply and demand dynamics could push bond yields higher. The US treasury is still issuing debt at a very high rate, while the Fed is reducing its holdings. There are signs that foreign buyers are diversifying away from treasuries. All this suggests that investors should keep duration short for now. If it becomes clear that the US economy is sliding into a recession—for example if jobless claims start to rise rapidly—investors should lengthen duration. Our preferred securities are relatively short duration and investment grade, which should help shield them from the risk of a further rise in yields and a downturn in global growth.

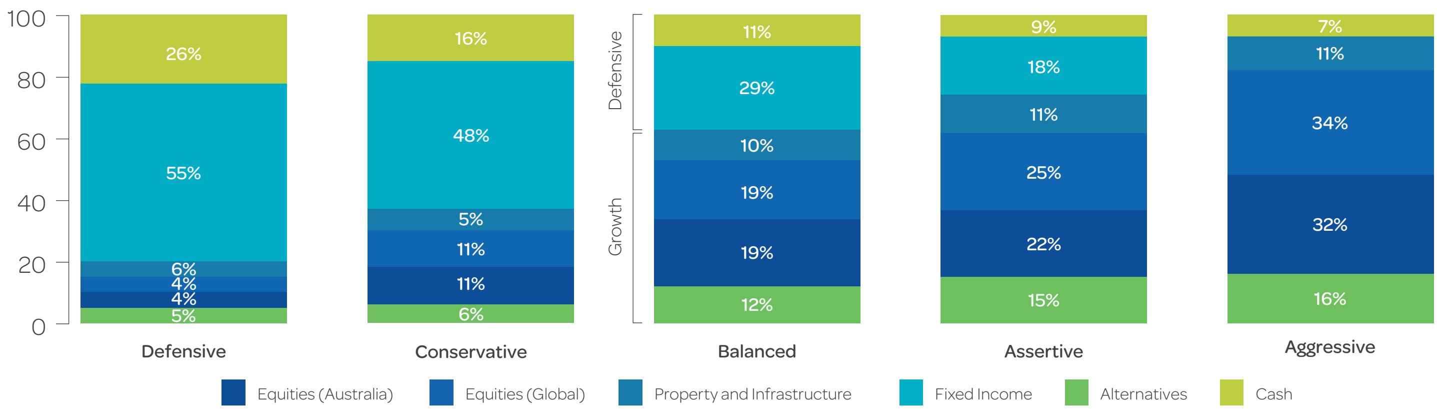
Property and Infrastructure

Recommendation

A mild recession/cyclical slowdown with interest rates nearing a peak despite higher-than-average inflation, is a sweet spot for real assets with their reliable cash flows protected to a degree from inflation. Furthermore, the discount to NTA applied to sectors such as REITs is already pricing significant downside risks. We continue to expect a key catalyst for sector outperformance will coincide with any interest rate/inflation stabilisation or M&A activity; however, in the near term the focus will remain on managing balance sheets and impacts from higher interest costs as well as delivering rental growth to help offset higher costs. Ultimately, these factors are key determinants in ensuring sustainable distributions for investors.

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 in a period of elevated market risks. Higher-than-average correlation between traditional growth and defensive assets will also mean investors need to look to alternatives for 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 underweight this quarter to fund our increased allocation to Property and Infrastructure and Global Equities. We leave some dry powder available to seize opportunities as macro damage gets priced in. Our tactical position retains higher cash but to remain close to fully invested given our view that inflection points for risk assets will be difficult to time. Cash rates are less of a drag on real returns so investors can afford to be patient.

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

Source: Morgans

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 – 2024 Outlook for product recommendations.

Read publication

Equity strategy
Moving on from defensives

Our Asset Allocation update discusses three possible economic scenarios in 2024 and their investment implications in terms of portfolio asset allocation. Our base case scenario expects economic growth to contract in the first half of 2024 before returning to growth later in the year. Sticky inflation will keep interest rates higher for longer. Equities will likely remain range-bound until there is more certainty on the interest rate trajectory either peaking/falling.

Given Australia's economic sensitivity to falling commodity prices, investors need to tread carefully over the next 3-6 months. 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, tilting toward what we believe are the best relative opportunities and the best risk/return profile e.g., small caps, quality cyclicals.

Morgans sector analysts have downgraded their rating on the Telco sector to Slightly Underweight (from Neutral). Telco sits in the expensive defensive basket with the positives looking priced-in. The sector could easily see downside risks, potentially as a funding source for a rotation into growth sectors in 2024.

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

Key sector outlooks

Category	Sector	Rating	Best ideas	Overview
Financials	Banks	–– – + ++	WBC, MQG	While highly geared, the Aussie majors are amongst the most well capitalised banks globally. However net interest margin pressures, declining credit growth, and cost increases suggest potential earnings declines in coming periods.
	Diversified Financials	–– – + ++	QBE, GQG, SOL, TYR	We continue to see the sector trading at reasonable multiples, offering a good hedge against frustratingly "sticky" inflation (further rate rises), and having defensive properties as we potentially head into a slower global economy.
Defensives	Consumer Staples	–– – + ++	WES, TWE, A2M	Consumer cautiousness is likely to endure. We think the sector, with its defensive characteristics, strong balance sheets, and consolidated industry structure, provides a solid anchor for diversified portfolios as the outlook remains uncertain.
	Healthcare	–– – + ++	CSL, RMD, M7T	The long-term demand drivers including increases in complex and chronic conditions will underpin earnings growth. After almost 12 months of sector under performance, the rotation back into the sector appears to have started.
	Telco	–– – + ++		Telco sits in the expensive defensive basket with positives looking priced-in. The sector could easily see downside risks, potentially as a funding source for a rotation into growth sectors in 2024.
	Infrastructure 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	–– – + ++	GMG, DXI, HDN	While inflation can be positive for REITs, higher interest rates does create uncertainty on asset values. We expect any potential softening in asset prices to become evident in 2024, with some REITs flagging that growth in rent may help offset any cap rate expansion.

Cyclicals	Consumer Discretionary	–– – ▼ + ++	SUL, LOV, ALL, THL	Consumers are approaching the Christmas spending bonanza with caution. Household balance sheets have softened, and elevated inflation plus rate rises have tightened consumer budgets. Low unemployment is keeping things afloat for now but the investor must have patience.
	Industrials	–– – ▼ + ++	QAN, ACF	Despite clear headwinds (slowdown, geopolitics) many Industrials have proven to be resilient having dealt with COVID, cost inflation, and supply chain disruptions in recent years. This gives us confidence that management teams are well-prepared for what may lie ahead.
	Online	–– – ▼ + ++		We continue to favour a tilt toward the larger, higher quality and high free cash flow generating sector leaders. However, we acknowledge there are opportunities in some smaller cap companies with the balance sheet capacity to fund medium-term growth ambitions. Valuations remain a hurdle and we wait for opportunities to add to our best ideas.
	Travel	–– – ▼+ ++	CTD, FLT, HLO	Overall, travel demand remains strong with consumers prioritising travel over other categories.
	Technology	–– – ▼ + ++	NXT, OCL	High quality tech names are likely to continue to shine but large cap names look fully price while small caps looks underpriced.
	Agriculture	–– ▼– + ++	ING	Agribusiness earnings peaked in FY22 following three consecutive La Nina years and given below average forward rainfall forecasts. El Nino conditions create earnings uncertainty and may see the sector trade lower.
Resources	Metals and Mining	–– – ▼+ ++	MIN, S32	Commodities are vulnerable to short-term cyclical impediments to demand (China). Investors require a strong stomach but we think can take comfort from strong sector balance sheets and strong medium-term, structurally driven upside linked to supply-side constraints.
	Energy	–– – ▼+ ++	STO, KAR	Supply-side issues are slowly overtaking recessionary fears to see energy markets ratchet higher. Growing difficulties facing the implementation of the global energy transition suggests transition fuels will enjoy robust demand and price.

Source: Morgans

Refer to our updated Summer 2024: Equity sector strategies, for more coverage.

Read publication

Economics

US economic growth to slow

The most popular forecast in 2023 was that the US would fall into recession. At the end of 2022, the Federal Reserve suggested that US GDP growth in 2023 would be only 0.8%. Instead, it appears that US GDP will grow by 2.4% in 2023. Why is the US economy so strong? Because of the enormous budget stimulus.

The US budget deficit was 14% of GDP in 2020 and 11% of GDP in 2021. This slowed to 3.7% of GDP in 2022. The pause in spending is brief. In 2023, the deficit is expected by the US Congressional Budget Office to expand to 8.2% of GDP, 7.4% in 2024 and 7.0% in 2028. These big deficits come from two pieces of legislation passed in 2022 by the outgoing Democratic Party dominated Congress under Speaker Nancy Pelosi. The two crucial pieces of legislation were the Chips Act and the Inflation Reduction Act.

- The Chips Act provides accelerated tax write-offs for firms investing in microchip production. This legislation was passed with the possibility of China perhaps successfully occupying Taiwan - the world's major chip producer.
- The Inflation Reduction Act is the "new green deal" in our view. This provides expanded subsidies to support the US energy transition away from fossil fuels. The biggest subsidies are for the production of electric vehicles. These subsidies are provided to major existing motor vehicle producers operating unionised production facilities.

These are both deficit-funded activities that provide continued stimulus to the US economy through to 2028.

The Federal Reserve has been acting against this stimulus by increasing the Fed Funds rate. At the time of writing, the Fed Funds rate has risen to 5.35%. Increasing interest rates act with a lag of up to nine quarters on the US economy. Even with all of the budget stimulus, a slowdown is expected in the US economy in 2024. Still, because of the budget stimulus, the slowdown will be modest, with US growth declining to around 1.4%. This should be enough to generate a modest increase in unemployment in 2024 and 2025. This modest increase in unemployment should put downward pressure on US inflation and return it towards the Fed target of 2% for the personal consumption deflator. This translates to 2.5% for the core CPI measure.

US Economic Forecasts

Real GDP Growth (%)	2022	2023	2024
US	1.9	2.4	1.4
Euro Area	3.5	0.7	1.2
China	3.0	5.0	4.2
India	7.2	6.3	6.3
Australia	2.7	2.0	1.8

Consumer Price Inflation (%)	2022	2023	2024
US	8.0	4.1	2.7
Euro Area	8.4	3.3	2.7
China	1.9	0.9	1.9
India	6.2	4.9	4.4
Australia	7.8	4.5	3.5

Source: Morgans

There is market speculation of major declines in the Fed Funds rate as the US economy slows, although we think this is unlikely. Continuing budget deficits and the stimulus generated from them, mean that the Feds Funds rate is unlikely to fall below 4%. Continuing deficit-supported growth in the US economy will lead to continuing improvement in earnings in US corporations in 2024 and beyond. In spite of the expected near-term volatility as the US economy slows, we think that the outlook for the US equity market continues to be very positive over the long term.

For more economic coverage subscribe to our podcasts

Banks
Earnings to trough in 2024?

The Banks sector provides investors with large fully franked dividends and highly leveraged exposure to the domestic economy.

On the negative side, we believe the decline in bank earnings is likely to continue into 2024. Net interest margins are under pressure from home loan and deposit competition, adverse deposit mix, and higher wholesale funding costs. Credit growth is slowing, ultimately the result of higher RBA cash rates and customer cost pressures. Operating costs are rising, with wage growth and third party cost inflation the key drivers. The rise in long-term interest rates is also a valuation headwind not just for banks, but for all asset classes.

On the positive side, the major domestic banks are amongst the most well capitalised globally from a regulatory perspective. Liquidity ratios are also comfortably above those set by APRA. This provides them with capacity to undertake share buybacks. All bar ANZ have an on-market buyback underway and have an appetite to reduce shares on issue. The capital strength, as well as current positioning within target earnings payout ratio ranges, supports an outlook for relatively stable dividends even during a period of declining earnings.

Resilient asset quality has been a persistent theme through recent results and loan loss provisioning levels also remain conservative. There is an increasing possibility that future earnings may be supported by provision releases if asset write-offs remain benign. Key factors to watch for are low unemployment, strength of property prices, and general economic activity levels.

A key event expected in February is the Australian Competition Tribunal's decision on ANZ's proposed acquisition of Suncorp Bank. If granted, it could see other smaller banks targeted. If blocked, we expect ANZ to return to shareholders the capital raised to pre-fund the acquisition.

Recent publications

(Mostly) Major Banks

Sector summary post reporting season

Read publication

Stock	Recommendation	Share Price	Target Price	Dividend Yield	Gross Yield	12m Forecast TSR
ANZ	HOLD	$24.61	$24.60	5.5%	8.2%	8%
WBC	HOLD	$21.92	$21.51	5.4%	7.7%	6%
NAB	HOLD	$29.20	$27.60	4.3%	6.2%	1%
CBA	HOLD	$106.44	$90.18	3.3%	4.7%	-11%

Source: Morgans, Data as at 11 December 2023

Industrials
The good will adapt

The macroeconomic backdrop for Industrials companies heading into 2024 remains challenging with consumers under pressure from higher interest rates and rising living costs. Together with the uncertainty created by geopolitical events, there are many issues keeping management teams awake at night. The good news is that inflation appears to have peaked and is heading back towards central banks' targets. This means the interest rate tightening cycle is also near to an end and in a world with many uncertainties, some stability on this front will at least allow households and companies to better plan the path forward.

Industrial company share prices have proven reasonably resilient over the past few years, which gives us confidence that management teams are well-prepared for the challenges ahead. Aside from COVID, companies have had to deal with high cost inflation, labour shortages, and supply chain disruptions. To their credit, most companies have handled these challenges well by passing costs onto customers where possible and managing inventory levels prudently. Operating conditions could get tougher from here, but the good companies will always find a way to adapt.

The pipeline of existing work across detached housing, multi-unit apartments and commercial projects all continue to support earnings across the building materials space. That said, some companies are flagging an expectation for reduced residential demand through the latter parts of FY24. Offsetting this short-term weakness in the expectation of emergent demand driven by record low residential vacancies and immigration, along with the continuation of, albeit moderated, infrastructure spend.

Our preference in the Industrials sector remains high quality businesses with defensive characteristics and an experienced management team that has a good track record of managing costs. 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 even in a softer economic environment.

Recent publications

CSR
ADD TP A$6.75
Stronger margins point to a more resilient business

Read publication

Vulcan Steel
ADD TP A$9.00
Cyclical low earnings presents the opportunity

Read publication

ALS
ADD TP A$13.35
Resilience sets up a bright future

Read publication

Resources and Energy
Longer term gain

We remain bullish on major commodity indices over the medium and longer-term despite broad weakness through 2023, with the notable exceptions of iron ore and metallurgical coal. Demand has softened this year primarily due to slowing global economic activity, easing supply conditions and inflationary pressures across several advanced and developing economies, particularly in the US, Europe and China. Looking at oil, prices have dipped in recent weeks as the risk of the Middle East moving into other oil rich countries appears to have subsided.

We are especially positive on those markets dominated by Chinese demand after being encouraged by accelerating fiscal stimulus, and despite recent subdued economic and financial data. Iron ore has remained robust driven by resilient Chinese steel production and seemingly no intervention from the Chinese government to curtail annual production. Base metals meanwhile have struggled due to a short-term oversupply into weaker demand. Sentiment across commodities remains challenged, but improving Chinese demand could be further helped by a possible peak in rate cycles and a subsequent fall in the US dollar.

These conditions have resulted in broad selling pressure across sector share prices, again outside of iron ore. Our positive longer term thematic supports the view that this sector-wide selling is uncovering attractive multi-year value for those investors willing to tolerate some short-term uncertainty and volatility.

Recent publications

Iron Ore
Solid outlook beyond possible late year dip

Read publication

Gold: Producers & Developers
Gold mining insights

Read publication

South32
ADD TP A$4.80
Sector weakness drags

Read publication

Travel
Conflict creates uncertainty

Volatile oil prices and some uncertainty in travel demand given global events are key areas we're watching ahead of the February reporting season. Although airline capacity continues to be added back, airfares are not falling as fast as the industry would have hoped. Volatile oil prices and extremely high refining margins are resulting in increased fuel prices for airlines all around the globe which is being passed onto consumers.

Overall, travel demand remains very strong with International outpacing Domestic and Leisure continuing to lead Corporate. Industry participants are all keeping a close eye on macro-economic conditions and world events, particularly the current conflicts in the Middle East and Ukraine. Historically, travellers have tended to adjust plans to bypass affected areas during times of unrest and overall travel volumes have not been materially impacted for prolonged periods.

Currently, impacts from the conflict appear to be mainly isolated to the Middle East and Europe. However, it's important to note that history shows the impacts on travel demand from geopolitical issues are generally short lived and provided the conflict doesn't escalate further, we would expect travel demand to return to normal levels over the coming months. It is also important to highlight that travel demand is still recovering from COVID so all our companies under coverage are well placed to grow earnings in 2024.

Recent publications

QANTAS
ADD TP A$7.30
Near-term turbulence

Read publication

Corporate Travel Management
ADD TP A$23.20
On track for a full EBITDA recovery in FY24

Read publication

Flight Centre
ADD TP A$26.00
New leisure business model is delivering

Read publication

Consumer discretionary
Rewards in time

Retailers' earnings generally exceeded downbeat expectations during the August reporting season. Recent trading updates suggest the deterioration of spending patterns as a result of cost of living pressures is starting to be felt, albeit are not falling off a cliff. AGM's updates have largely been more resilient than expected, although comparable sales are generally in negative territory against elevated comps in the previous period.

The end of the year is peak season for retailers with Black Friday and the lead-up to Christmas. We've seen many retailers launch promotions early for Black Friday to generate sales and, as such, expect some gross margin degradation in response. Overall, we see gross margins broadly stable in the coming year, with international freight and other supply costs now in a state of deflation offset by the effect of a weaker Aussie dollar. Below the gross margin line, there continues to be inflationary pressure on operating costs, with wages materially stepping up in FY24. We think price rises will be more difficult to pass through in the current environment.

The discretionary retail market will continue to be challenging for some months to come, but we believe opportunities abound for patient investors to build positions in quality retailers at reasonable entry levels. We believe stocks with the ability to deliver growth in a subdued environment, whether through the rollout of new stores, international expansion or entering new markets, will reward investors in time.

Recent publications

Australian Retail Sales
Hanging out for Black Friday

Read publication

Discretionary Retails
Who is giving customers what they want?

Read publication

Healthcare
Staging a comeback

Healthcare has significantly underperformed most other sectors of the ASX over the last quarter. However, since the beginning of November we have seen a rotation back into healthcare, partially unwinding that underperformance.

Procedural and testing volumes are recovering to normal levels and staff shortages are moderating. Despite higher interest rates trimming investor demand, the financial outlook for these companies continues to strengthen.

The global rise of GLP-1 drugs and their negative impact on the share prices of companies in the metabolic, cardiovascular and respiratory sectors continues to make headlines. Growing demand for these drugs (despite supply issues) has created noise, however whilst the clinical data so far appears positive, we fail to see any long-term structural demand changes at this stage for companies servicing the sleep apnoea and cardiovascular markets.

M&A activity has picked up particularly in areas including aged care, pathology, radiopharmaceutical, and rare diseases. Access to capital for emerging companies has been difficult in 2023 with a number of emergency raisings being undertaken with hefty discounts, or resulting in clinical programs being cut or reprioritised.

Recent publications

ResMed

ResMed
ADD TP A$32.74
Cost base reset; market dynamics unchanged

Read publication

CSL

CSL
ADD TP A$328.22
Targeting sustainable, profitable growth

Read publication

Consumer Staples

Food for thought

The year ahead is likely to see consumers become increasingly cautious about where they spend their money. Inflation in Australia is still uncomfortably high and the Melbourne Cup day interest rate rise suggests the RBA, while nearing the end of its tightening cycle, may not be done just yet. With households under pressure, many are understandably looking for the best ways to stretch their budget as far as possible.

Changes in consumer behaviour that have emerged over the past 12 months are likely to continue and could accelerate if conditions become tougher. Supermarkets are seeing customers increasingly eating in and entertaining at home, looking for better value options, and seeking out loyalty points and bonus offers. Private label substitutes have been a popular alternative to branded products, especially in core pantry items like rice, pasta, oils, and long-life drinks. The quality of private label has improved significantly over the past decade and strong demand for these products benefits both the customer as a money-saving option, and the supermarkets given it increases brand loyalty and in some cases, generates a higher profit margin.

We see modest potential capital upside for the Consumer Staples stocks due to relatively full valuations. In saying that, we also don't see a lot of downside risk due to the sector's defensive characteristics, strong balance sheets, and consolidated industry structure. Ongoing population growth will also be a tailwind. We think the sector provides a solid anchor for diversified portfolios against an uncertain macroeconomic backdrop.

Recent publications

coles

Coles
ADD TP A$16.60
Looking better value

Read publication

endeavour group

Endevour Group
HOLD TP A$5.15
Still some headwinds

Read publication

Woolworths

Woolworths
ADD TP A$39.90
On track but still more to do

Read publication

Online Media & Technology

Outlook favours larger names

We continue to favour the larger free cash generative online media and technology names. These have proven resilient to a volatile operating environment and rapid interest rate rises. The large names (CAR, REA, SEK) have significantly outperformed the ASX 200 in 2023.

Whilst listing volumes are robust across most of the space, yield growth should continue to underpin the outlook and top-line growth for most of these businesses in 2024. It's worth noting the larger names hold dominant market positions across in the regions they operate in, and their ability to iterate and roll out new value-add products will assist their growth strategy over the coming cycles.

Over the medium term, our thesis for the larger names looks intact as conditions remain supportive for outperformance versus the market. That is, we see the structural tailwinds further enhancing demand for their products and platforms. Nearer-term however, we believe share price performances will likely continue to be impacted by macro issues and consumer sentiment.

We think that one of the larger free cashflow generating online classifieds players should remain a long-term component of a core portfolio. However, as we approach the top of the rate hike cycle, some quality smaller growth names appear to be finding support, indicating early signs of the marginal investor looking to add risk. We acknowledge that some of these smaller cap names may be more suited to the patient, growth-focused investor that can tolerate higher volatility. Sector exposure more broadly continues to suit those with a longer time-horizon.

Recent publications

Classifieds
Pulse check on listing volumes

Read publication

REA Group

REA Group
HOLD A$155.00
Volumes volatile but trending in the right direction

Read publication

Infrastructure
Solid in times of uncertainty

ASX-listed infrastructure stocks offer investors attractive distribution yields, resilient earnings (sometimes with structural growth drivers), and the potential for returns being boosted by takeovers from unlisted funds.

The key influences to this return dynamic are the location (Australia is an attractive investment destination), quality of assets (monopoly-like, long life, inflation-linked, cash generative, high margins and operating leverage), and the increasing allocation of capital by pension and superannuation funds to the infrastructure asset class (with increasingly scarce number of listed assets). Key risks are a lift in real interest rates (risk-free rates outpacing inflation), capital management (e.g. we think ALX has destroyed value via Chicago Skyway acquisition), and ESG headwinds (impacting fossil fuel linked stocks).

The asset class can generally be split into patronage use assets and contracted assets. Typically, we expect the lower growth of contracted assets to be offset by their higher distribution yields and vice versa. During a period of weaker economic activity levels we have a preference for contracted volumes/capacity over patronage-driven assets so as to mitigate volume risk. The inflationary environment is impacting the cost structures of these assets, with expenses growing faster than what the market typically expects from such assets.

We're also watchful of the step-up in market interest rates driven by RBA cash rate increases. Investment grade financial management (strong balance sheets, staggered and long dated debt maturities, interest rate risk management) mitigates the impact on existing debt in the short term. However, it will impact new debt raisings (for capex funding or refinancing), replacement interest rate hedges, and valuation discount rates. The increase in costs and debt service has the potential to supress distributable cashflow growth, albeit we generally expect stable to growing distributions.

Recent publications

Transurban
HOLD TP A$12.38
Thinking about volumes and rates

Read publication

Atlas Arteria
HOLD TP A$5.36
Q3 traffic/toll revenue and CS refinancing – updating forward interest and inflation rates

Read publication

Property

Macro dominating but peak rates are on approach

The property sector has delivered a total return of around 3% over the past 12 months vs the broader market at around 2%. The best performers include industrial heavyweight Goodman Group and diversified developer Stockland. The Australian 10 Year Government Bond yield moved higher post reporting season in August which impacted sector performance, and after nearly touching 5% in early November, currently sits around 4.5%.

Divergent views on interest rates persist, particularly as expectations of higher US interest rates have been dampened. Nevertheless, our house view is that there are likely to be two more rate increases in Australia. We continue to expect a key catalyst for sector outperformance will coincide with any interest rate stabilisation/expectation that rates have peaked. However in the near term, the focus will remain on managing balance sheets, executing on asset sales, as well as delivering rental growth to help offset higher costs.

- Balance sheets and impacts from higher interest rates remain in focus with a significant increase in interest costs evident. While most groups are hedged, the focus will also fall on how interest rate profiles impact earnings over the next 1-3 years. Debt reduction via asset sales is a secondary focus.
- Outlook – most REITs have reiterated FY24 guidance with recent updates and AGMs. Higher interest costs will continue to impact earnings in FY24 as well as impacts from any asset sales. Beyond FY24 will depend on the direction of rates with any potentially rate falls becoming an earnings tailwind.
- Revaluations – cap rate expansion is expected to continue into 2024 although rental growth particularly in industrial/logistics assets is expected to help offset impacts. Transactional volumes remain low highlighting the 'wait and see' approach being taken by investors which we don't expect to materially change until there is better certainty around interest rates. Strong balance sheets will help buffer against any falls in book values.

Development pipelines – while construction costs have risen materially over the past few years, development pipelines continue to be a driver of growth for many REITs.

Recent publications

HomeCo Daily Needs REIT
ADD TP A$1.37
YTD trading update

Read publication

Goodman Group
ADD TP A$24.50
Unprecedent data centre demand supports outlook

Read publication

Dexus Industria REIT
ADD TP A$3.17
Further 2H asset sales

Read publication

Recent Initiations

CSR ADD | TP A$6.75	CSR principally manufactures and distributes building products to its 18,000+ customers across Australia and New Zealand, as well as maintaining a portfolio of surplus land and 25% interest in the Tomago aluminum smelter.
Vulcan Steel ADD | TP A$9.00	VSL is a metals distributor and value-added processor with 70 logistics and processing facilities throughout Australia and New Zealand.
Experience Co ADD | TP A$0.30	EXP is a travel/tourism company that operates a diversified portfolio of adventure experience businesses across Australia and New Zealand.
Sigma Healthcare ADD | TP A$0.83	SIG is one of the largest full line pharmaceutical wholesalers in Australia.
Judo Capital ADD | TP A$1.43	JDO is an Australian challenger bank operating in the SME lending and branchless term deposit markets.

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Bowral	+61 2 4851 5555
Chatswood	+61 2 8116 1700
Coffs Harbour	+61 2 6651 5700
Cronulla	+61 2 8215 5079
Gosford	+61 2 4325 0884
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