Contactus@
ausbil.com.au

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Research and Insights

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Economic and equities outlook: Summer of 2021/22 and beyond

What is the outlook for the economy and equities as health measures bring the risk of COVID under control? Ausbil's Executive Chairman, Chief Investment Officer and Head of Equities, Paul Xiradis (PX); and Chief Economist, Jim Chronis (JC) share their views.

Paul Xiradis
Executive Chairman, Chief Investment Officer, Head of Equities

Jim Chronis
Chief Economist, Associate Director – Debt and Diversifieds

Q: How is the Australian economy looking post-lockdown?

JC: Fortunately, given the background of rising and broadening vaccination rates in Australia, Ausbil has held the view that there would be a sustained economic rebound. As we move beyond lockdowns and into living with and managing COVID risk, we see a re-acceleration in the momentum of global growth in the forthcoming December quarter and throughout calendar year 2022. With this in mind, Ausbil is forecasting US economic growth for 2022 at 4.6%-year average, ahead of consensus of 4.2% and well ahead of trend. A strong US will also see global growth of 5.1% (well ahead of the 10-year average of 3.7%), with China slowing to 5.2%, the Eurozone at 4.7% and Japan with growth of 2.8%.

US core PCE inflation continues to overshoot for the near term with a rate hike expected in January 2023. For Australia, our position has been, and remains, for a 2024 rate rise, and following the latest RBA update, earlier if warranted. The timing of such is entirely dependent on the evolution of nominal wage inflation and whether it exceeds the key 3% threshold so as to ensure consistency with core inflation remaining sustainably within the RBA's 2-3% target range.

Looking through what we see as a saw-tooth pattern in activity for the September and December 2021 quarters, Australia's GDP growth is expected to resume its well-above trend pace heading into next year, averaging a robust 5.2% in 2022. This is based on our view that pent-up demand, post-lockdown, will fuel a resurgence in household and business spending leading into Christmas, and beyond. This will be stronger than anticipated as consumers and the business sector return to more normal levels of activity, funded from excess savings, and improving corporate sector balance sheets. Moreover, the resources boom will underpin the Australian dollar, firming back to within US75-80 cents, with a further upward bias likely in the latter part of 2022.

The key risk to our outlook will be inflation and how quickly it appears relative to expectations.

Q: Where are we in the inflation cycle? Is it a growing risk?

JC: Ausbil's view remains that US inflation should moderate as supply constraints and labour shortages correct throughout 2022.

According to the US Federal Reserve, their assessment has shifted to inflation remaining elevated for longer than previously thought. The factors driving the acceleration in inflation to date are supply constraints and bottlenecks rather than a tight labour market, and the reopening of the economy which has contributed to sizable price increases in some sectors. Expectations over 2022 are for an easing of supply constraints, employment growth and a reduction in inflation. As Federal Reserve Governor Quarles stated, "transitory" does not necessarily mean "short lived." And more importantly, given that the drivers of inflation so far are principally attributable to a small set of factors, then "monetary policy often can look through those types of disruptions to consider what inflation will be in the future when this [COVID] episode passes," said Quarles. Further, recent Federal Reserve research concluded that there is little empirical evidence supporting the thesis that a tight labour market (where job openings are greater than the number of job seekers) is contributing to a 'wage-price spiral' that explains much of the rise in core measures of inflation. To date, US trimmed mean and median core inflation measures produced by the regional Federal Reserves are consistent with around a 2% plus underlying inflation pace.

There are three conditions required before there is a risk of lift-off in US cash rates. Firstly, there needs to be a labour market that is at maximum employment. Secondly, inflation needs to have been at 2% for at least a year. Finally, the level of inflation needs to be on track to exceed the 2% level "for some time," as noted by the Federal Reserve. Governor Lowe of the Reserve Bank of Australia has outlined similar conditions for lift-off with inflation at 2.5% and the critical inclusion that nominal wage inflation should exceed 3%.

Q: How are Australian companies going? Can you give us a post-reporting season update?

PX: Reporting season closed, confirming a full rebound in earnings, strength in balance sheets, and optimism across management teams, despite ongoing lockdowns. This earnings rebound has been nothing short of astounding, FY21 generating +27% in EPS growth, a major turnaround to the tune of +44% from a -17% decline in FY20 earnings.

Australian resources delivered their biggest profits and dividends ever. Banks delivered major capital management and buybacks (ANZ, Commonwealth Bank, NAB, Suncorp and Westpac) on the back of a significantly better than expected COVID impact on loans. Moreover, inflation impacts on costs were noted but not as a major concern, though we maintain a watching brief on any persistent inflationary impacts on balance sheets and earnings. The balance sheets of Australian listed companies are strong, and capable of supporting expansion in investment as opportunity arises.

Cyclicals performed well in FY21. The outlook for FY22, particularly from late calendar 2021, is for another year of strong earnings growth from select cyclicals, particularly those exposed to services such as travel, entertainment, dining and other recreational activities. A strong rebound is also expected from structural growth leaders.

Market earnings growth for FY21 was one of the best outcomes on record. Market consensus growth for FY22 is for growth of 15% and very little growth for FY23. We are of the view that forward estimates for the next two years will be upgraded, driven by an under-appreciated pick-up in activity beyond COVID lockdowns. The December quarter '21 is shaping up to be a very strong period, making up for the lockdown-induced slowing in the September quarter. We expect activity levels will remain elevated for the whole of calendar year '22, before it starts its march to trend growth commencing in '23. Looking ahead to next year, 25 of 32 functional GICS sectors are expected to deliver positive EPS growth in FY22 representing 80% of market cap for the S&P/ASX 200.

About Ausbil Investment Management

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Q: What about valuations? Are stocks expensive now?

PX: We do not believe Australian equities are too expensive on average when you consider them in relative terms against where long-term interest rates are sitting, and their forward earnings growth outlook. The equity market has an implied duration structure which has seen its value adjust as interest rates have fallen to their lows. However, we look at the future earnings growth profile for equities when assessing if sectors are cheap or expensive. On a forward EPS growth view, we believe resources (specifically battery materials, electrification metals and some bulk commodities), banks, general insurance, structural growth leaders and some of the post-lockdown beneficiaries are offering strong potential EPS growth for FY22 relative to value.

Q: Are you worried about inflation with respect to your outlook for equities?

PX: There is an argument that interest rates are expected to remain low, but they are likely to be higher than their COVID lows. Central banks globally have held rates zero-bound for an extended period of time using unconventional methods such as yield curve control and QE. This has clearly helped to stabilise and drive economic growth with little or no inflationary impact up until now. Monetary and fiscal stimulus, together with the rebound of activity beyond COVID lockdowns, is driving strong, above-trend growth which, in turn, is driving higher inflationary expectations. The yield curve has shifted up, and the market is now pricing-in rate lift-off in late calendar '22.

Whilst we maintain the view that inflation will prove to be transitory, global growth in calendar '22 and '23 will be strong and well above trend, particularly in calendar '22. This does suggest that the yield curve should continue to adjust upwards. Cash rates have not risen, in fact they have only fallen since the Global Financial Crisis (GFC), over 13-years ago. With this, and bond yields during COVID driven lower by QE has seen cash rates fall to levels never thought possible, so it is not unreasonable for rates to start to rise and normalise.

Since the GFC, bond proxies have enjoyed a significant rerating on lower bond yields and refinancing costs. Banks have suffered via continued downward pressure on NIMs, and general insurance companies, due to short-duration investment income exposures, have had investment returns and overall insurance margins crunched. These negative long-term influences on earnings for these sectors are now starting to turn positive, whilst the opposite is true for bond proxy sectors.

Q: What do you see as being the main risks in equities at the moment?

PX: Fundamentally, we believe the current economic environment is favourable for equities, and will be for the next year or so. China remains a concern, from both a geopolitical and trade perspective. China remains on watch for us, but we are of the view that eventually there will be a return to more cordial global relationships as there is mutual benefit across nations in peaceful and vigorous trade.

We would be wary of any sign governments or central banks back away from their commitment to stimulating recovery other than actions associated with the steady normalisation of monetary policy. We do not see any signs of this so far.

Of course, any resurgent re-infection issues or return to lockdowns and border closures would be a concern, however with vaccination rates so high we believe this risk of such is low. Furthermore, the breakthrough of a COVID-19 antiviral pill by Pfizer could be a game changer. There remains a slim risk that not all Australian states will deliver on vaccination targets, but we believe this risk is negligible. Finally, there is the risk that the effervescent return of growth post-lockdown brings forward inflation, but for the reasons we have argued, we see inflation as not causing concern in the near term.

Q: Where are you seeing the opportunities?

PX: There are some compelling thematics and tactical developments that are delivering opportunity in the market based on forward potential earnings growth. In resources, the shift towards decarbonisation, which will see significantly more commitment following COP26, is offering compelling opportunities in the electrification and battery materials metals (copper, nickel, lithium and cobalt) – we like BHP as a diversified exposure to these themes; companies like OZ Minerals and 29 Metals in copper and zinc; Orocobre in lithium and IGO in nickel and lithium; and Lynas Rare Earths in rare earths. Macquarie Group also offers good exposure to the decarbonisation and electrification structural thematic.

We like the major banks (NAB and CBA more specifically) as they benefit in positive economic growth conditions, when rates are firming, and have strong capital positions. We are entering an environment where general insurers will benefit from stronger margins and returns, with companies like QBE of interest in this space. Finally, post-lockdown, with borders reopening we see positive earning growth outlooks for companies like Qantas, Webjet and Seek. We also see structural leaders with sustainable growing income streams and large unassailable business models doing well, such as Ramsay Health Care, CSL, ResMed, Xero and IDP Education.

Q: What is your outlook for equities looking forward?

PX: Following reporting season, while companies were hesitant to guide on FY22 given lockdowns, a lead indicator for sustainable earnings growth was the bullish investment plans expressed by management for beyond COVID as the economy normalises. Meetings across reporting season showed that management had a means and a willingness to invest in the future of their companies beyond the current lockdowns, and balance sheets were strong and capable of supporting such investment. Given the rapid progress on vaccines, we believe earnings growth is likely to surprise again. Ausbil's overall macro portfolio positioning remains for an ongoing economic recovery and eventual return to trend growth.

Looking ahead, we expect cyclical leadership will change, but as a grouping will continue to perform, with strong earnings outlooks for FY22, particularly from late calendar 2021. Quality growth and structural leaders are also offering a strong earnings rebound into FY22 and FY23. Our view is that FY23 earnings expectations will also be positive, with growth driven by a very strong post-Delta variant bounce-back, which will be evident in the final months of this calendar year, and will have duration into FY23.

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