Australian Equities Update

March 2021

Warakirri ASSET MANAGEMENT

This report has been prepared by Northcape Capital, the underlying investment manager for the Warakirri Ethical Australian Equities and Warakirri Concentrated Australian Equities Funds.

Market Review

Australian shares rose 4% on a total return basis over the March quarter following a strong advance in the prior quarter as solid profit results during reporting season provided underlying market support.

Changes in key macro variables over the March quarter included:

- An almost doubling in bond yields from 0.97% to 1.79%. A similar trend was seen in global bond markets as investors reacted to strong economic data and additional fiscal stimulus, fuelling inflationary concerns.
- Rising business confidence in Australia and a strong recovery in employment. The US economy also saw a dramatic rise in non-farm payrolls.
- A slight weakening in the Australian dollar against the USD (0.772 to 0.761).
- A modest firming in the iron ore price ($158/t to $165/t).
- A 10% fall in the gold price and a 23% rise in the oil price.

Sector performance was dominated by a 12% gain in Financials, with ANZ(+24%) and Westpac (+ 26%) being the standouts among the big 4 banks. CBA (+7%) lagged considerably as it had outperformed strongly in 2020 during an uncertain environment. We believe this divergence in value between the 4 banks has now largely closed up. The outperformance of the sector has been supported by a 5-10% upgrade in earnings forecasts over the last 6 months as credit growth has begun to accelerate and funding costs have improved, but also by a re-rating to a record PE multiple.

Other sectors to outperform include the telcos (+9%) and energy (4%). Telstra rose 16% over the quarter as the latest result indicated mobile profits could be bottoming. Also a potential spin out of the infrastructure assets into a separate company has heightened investor interest. Oil &Gas stocks advanced but movements were muted relative to the gain in the oil price.

Performance of the major miners diverged considerably with BHP (+10%) leading the gains and Fortescue Metals lower by 8% despite a higher iron ore price. This could be attributable to some concerns over re-investment of future cash flows into new investments outside its core business.

The healthcare sector lagged the ASX 200 with a 2% decline which can be attributed mainly to the sharp spike in bond yields over the quarter leading to valuations being re-assessed. Also, some health care stocks such as CSL and Sonic Healthcare are perceived as facing more difficult earnings comparisons next year as any COVID-19 benefit is cycled out. Our own valuations did not change as we assume a normalised (mid cycle) bond yield when selecting a risk-free rate.

Market Outlook

The near-term direction of markets is being dictated by the normalisation of interest rates (from abnormally low levels). The implementation of stimulatory fiscal policies in some advanced economies, particularly in the US has led to concerns over the potential build-up of inflationary pressures. These variables are invariably difficult to predict but we believe there is sufficient spare capacity in advanced economies to prevent a step change in inflation expectations and the normalisation of interest rates should be orderly.

Earnings revisions over the last 2 quarters have been strong and across most sectors with retail and financials being the standout. FY22 should see a solid recovery in earnings. Absence of international travel (except NZ) over the next several quarters could see discretionary spend maintained at a higher level than analysts are currently forecasting and benefit sectors such as domestic tourism (QAN), and discretionary retail (JBH – consumer electronics, WES – home renovation). Companies have reduced costs aggressively over the last year and while some of these will return as activity recovers, a proportion may not which will allow an expansion in profit margins. Individual companies such as Qantas could see a structural improvement in profitability as they complete a radical restructure of their cost base, although the final outcome will depend on competitive conditions remaining rational (not always a given!)

Low interest rates stimulated corporate activity in recent months and we have seen some takeover activity (Coca-Cola Amatil; Crown Resorts) as well as acquisitions (CPU – Wells Fargo's corporate trust business; REA – Mortgage Choice). We would expect a heightened level of corporate activity to continue. Also of interest are potential de-mergers and/or asset sales from corporates such as AGL (generation assets) and Woolworths (Endeavour Drinks; hotels) and Seek (Zhaopin – sell down). De-mergers may be a zero-sum game in the short term but in the long run could lead to improved management focus on core assets and a higher ROIC.

While investor sentiment has shifted strongly in favour of cyclicals, we see better opportunities in some structural growth and infrastructure stocks which have attractive valuations not seen for some time. On balance low interest rates and solid earnings momentum should be supportive of the equity market.

Stocks in Focus

Medibank has sold off post its profit result despite delivering an outcome above consensus and evidence of some encouraging trends including policyholder growth across both the Medibank and AHM brands as well as growth of complementary services such as patient care in out of hospital settings. Profit growth over the next 2 years should be largely underwritten by COVID provision releases as there has been underspend on claims while longer term growth will depend on productivity dividends from structural change underway in the private healthcare industry. Medibank is driving improvement in patient care at lower cost and should be able to capture some of this gain.

Transurban remains one of our largest active positions. Transurban has a considerable margin of safety built into its share price and the valuation still looks appealing even at a much higher risk free rate. Traffic has normalised on most of its toll roads and the return to work in Melbourne CBD and the ramp up of domestic aviation will deliver above average traffic growth in Australia over the next 2 years. US toll road revenue is highly leveraged to congestion levels and this could be expected to increase over the same time frame.

The Warakirri Ethical Australian Equities and Warakirri Concentrated Australian Equities Funds are long only, low turnover, concentrated and benchmark unaware. As such they will typically hold no more than 40 stocks. These stocks will come from a concentrated Approved List of about 60 stocks based on Northcape's research of selected stocks comprising of resilient businesses with clear opportunities for growth.

For more information, please contact us on 1300 927 254 or visit warakirri.com.au

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