FLINDERS Investment Partners

Warakirri ASSET MANAGEMENT

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Australian Small Companies - Market Outlook 2023

2022 has been a difficult year for small caps with a sustained period of market decline relative to large caps. Sectoral divergences have also been significant within the asset class. There are a number of reasons for what has been the worst period of relative underperformance by small caps since the GFC. Here we share our perspective on what lies ahead for the asset class and our expectation for a reversal of this trend in 2023.

This information has been prepared by Flinders Investment Partners, investment manager of the Flinders Emerging Companies Fund.

Recap on key themes of 2022

This year has not been a good one for small caps. To the end of November, the Small Ordinaries Accumulation Index (Small Ords) had fallen 15.2% compared with a rise of 4.0% for the Top 100 stocks. The sectoral divergence has also been significant with the Small Industrial Index falling 19.0% while the Small Resources Index fell only 1.8%. There are a number of reasons for what has been the worst period of relative underperformance by small caps since the GFC. It will also set the scene for our expectation of a reversal in 2023.

The overwhelming influence on equity markets, and especially smaller companies in 2022 has been the global pattern of interest rate rises by central banks to curb inflation. This led bond yields to rise, money supply to tighten, and in the back half of the year, economic growth in virtually all economies to slow. The Russian invasion of Ukraine amplified these factors with the resultant surge in energy prices.

Small Ords under pressure in 2022

The impact within equity markets has also been significant. Rising yields impact the discount rate used to value securities, particularly 'long-dated' growth sectors such as technology and biotech. Falling liquidity impacts the ability of smaller companies (often unprofitable) to raise equity capital and higher interest rates negatively impact the attraction of sectors such as property trusts. And lastly, the spectre of slower economic growth and higher living costs, meant consumer facing companies such as discretionary retailers also came under pressure. The Small Ords has a much greater population of these sectors than the Top 100.

What has also been a feature is the derating of many smaller companies while they continue to exhibit good earnings growth. This is most likely due to liquidity leaving the smaller end of the equity market through the year. This certainly seemed to be changing towards the end of 2022.

The disparity of performance within the Australian equity market is also worth mentioning. As above, small resources fell only 1.8% - supported by energy and battery material stocks. However, large cap (Top 100) resources actually rose a massive 26.5%, due to a much higher weighting to energy, iron ore and battery material stocks. Large industrials fell only 2.1% due to the lack of consumer discretionary and technology stocks in that part of the market.

So, with that background, we will focus on what's ahead. The year is finishing with a little more confidence and we expect that to grow – not in a straight line but over the course of the next year.

An uncertain macro picture ahead

In the next section, we'll make some economic observations, as the macro, including inflation and interest rates, heavily influenced markets in 2022. But we don't profess to be experts in this. We're reminded of John Kenneth Galbraith, who mentioned that there are two kinds of forecasters:

'Those who don't know, and those who don't know they don't know'.

So, recognising how fraught it is to make macroeconomic forecasts, we'll make limited observations on the impact of such forecasts on 2023. As a side note, our approach to managing a portfolio of Australian small companies, especially since the onset of COVID, has been very deliberately not to have big sectoral or thematic positions. This also seems prudent going into 2023 as economic outcomes remain unclear.

Interest rates in Australia

The consensus view that the pace of interest rate increases slows in 2023 seems reasonable. The inflation rate is arguably near a peak (7-8%), and several economic indicators are showing weakness: domestic growth has been slowing, house prices have fallen several percent, homeowners are paying more on their mortgages, retail sales fell for the first time in October 2022, and consumer confidence is down ~25% yoy. With a lag impact typically from interest rate moves, we feel it likely that the RBA proceeds with smaller cash rate advances into next year. At the time of writing, markets were pricing in the cash rate to peak at ~3.5% in mid-2023, from a cash rate of 3.1% as at December 2022. This seems reasonable. The 3.5% peak expectation has actually been revised down towards the end of 2022 from ~4.5% previously.

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Australia likely to avoid recession in 2023

While much of the Western World including the US and Europe is more likely than not to go into recession next year (the UK and Europe are a clear case, while a Bloomberg survey of economists in November 2022 put the chances of a recession in the US within the next 12 months at 65%), our view is that Australia is likely to avoid a recession. As mentioned above, several factors have been weakening, and it seems like growth will slow to a below trend level, perhaps ~2%. However, the starting point for unemployment is a very strong 3.4%, and balance sheets are very healthy, which should allow for the consumer to keep spending.

Furthermore, Australia as a resource rich nation continues to benefit through the export of commodities including iron ore, coal, gas, metals such as copper and gold, as well as soft commodities like wheat and livestock. Australia's exports contribute meaningfully to GDP, at over 22% of GDP currently.

Finally, the potential for China to reopen next year as it inevitably moves away from its disastrous zero-COVID policy would likely benefit Australia as well (given its resources exposure). All countries emerging from COVID have had an economic surge of some duration. With China's lockdown as severe and as protracted as it has been, it could be costly to underestimate its rebound. Plus, in recent months, both monetary and fiscal policy in China has provided economic support (eg. Loan Prime Rate cuts and Reserve Requirement Ratio cuts, and China's 16-point plan to support the property sector).

Cyclical headwinds ahead

Given the economic slowdown expected in 2023, we'd expect sectors exposed to the consumer and other domestic cyclical sectors to have headwinds to their earnings. While the portfolio is underweight sectors like Retail where earnings have downside risk, the caveat is valuation, as many of these stocks on the ASX have already sold off >50% in 2022. Opportunities have and will be coming up in this part of the market.

Cost and inflationary pressures such as freight and logistics, staffing and energy has been a key theme in 2022. This will likely continue in 2023, albeit the impact should moderate as these pressures ease. With this backdrop, businesses that have genuine pricing power are relatively well positioned, as their earnings should be less susceptible to a negative impact.

Rather than picking particular sectors, our focus in this slowing growth environment has been to hold companies that are demonstrating growth (regardless of their industry). As a general rule, when growth is scarce, investors pay a premium for growth (and these stocks can subsequently perform well). Furthermore, being able to buy growing names at a reasonable or cheap valuation provides a margin of safety.

Growth stocks looking attractive

The good news is, given the weak equity markets experienced in 2022, opportunities exist across various sectors where growth stocks are very reasonably priced. We're seeing these opportunities in most sectors including Industrials, Consumer Discretionary, Financials, IT, and Property – many of our holdings are trading at a discount to the market, and are expected to have good earnings growth over the next couple of years at least. Most also have a business model where margins should be protected in a weaker environment.

Positive on resources

If there was one sector that we'd call out as being positive on, it's the resources sector. This may not seem intuitive in the face of slowing global growth as it's a cyclical sector. However, there are several factors in its favour.

Over the shorter term, a peak in the US dollar (given peaking inflation and consequently rate hikes), as well as the likely reopening of China are very favourable. The ongoing Russia/Ukraine War continues to cause severe disruption on the supply side to many commodities. Over the longer term, decarbonisation is a major theme that will be around for decades, which will draw on substantial demand for commodities.

Furthermore, it's a substantial part of the Australian small companies universe, currently making up over 25% of the asset class. To name a few commodities that we're positive on:

1. Domestic gas – given strong supply/demand dynamics and the integral role it will play as a transition fuel as we move to renewables.

2. Industrial metals including lithium and graphite, as well as base metals such as copper and nickel. These are supported by the decarbonisation theme and the structural growth in electric vehicles (EVs).

3. Iron ore is positioned well for a reopening in China.

4. Gold is interesting as well. At a very basic level, gold equities have moved lower with a stronger US dollar (due to US dollar safe-haven status, and inflation and rates increasing) over 2022. With these factors potentially reversing, geopolitical tensions continuing, and Australian gold producers continuing to generate substantial amounts of cash, we expect the gold sector to be a good outperformer in 2023. Many gold producer valuations look compelling.

Inflationary pressures weigh on expected profits

What about earnings expectations for the small company universe?

While consensus Earnings Per Share (EPS) growth in FY23 for the Small Ords index was tracking at around 10% for the first half of calendar year 2022, the second half of 2022 unsurprisingly showed downgrades to this number, and currently sits around 2.5% EPS growth for FY23.

Table 1. Market and Flinders Emerging Companies Fund Fundamental Attributes (as at 30 November 2022)

FY23 Attributes					
	ASX 100	Small Ords	Small Industrials	Small Resources	Flinders Portfolio
EPS Growth	-0.3%	2.5%	-1.4%	12.2%	14.6%
PE	14.9	16.4	18.5	12.0	14.3
Dividend Yield	4.2%	3.6%	3.6%	3.7%	2.5%

Source: FactSet; Flinders Investment Partners

Interestingly, over this time, sales growth expectations have barely moved and remain at around 5% growth. Cost and inflationary pressures have obviously impacted expected profit margins. And clearly, the large negative equity market returns in 2022 have mostly been driven by multiple compression, in response to the large and swift moves in interest rates.

Over the course of 2023, consistent with an economic slowdown, it wouldn't be surprising to see sales growth expectations come back as well. On the cost front, we expect costs to remain elevated, yet the rate of growth should normalise as inflation peaks over the near-term.

Pockets of opportunity

Despite this overall slowing view, it's important to stress that pockets of opportunity exist. And markets are forward looking.

As mentioned earlier, we're finding opportunities to invest in companies demonstrating double digit earnings growth, that are well capitalised with good management, priced at a discount to the market.

This is best demonstrated by the current statistics for our strategy for FY23 (based on consensus data) of EPS growth of 15% and a PE multiple of 14.3x versus the index at 2.5% EPS growth and PE of 16.4x. This gives us confidence that our portfolio is well positioned for whatever the economic environment throws at us – small caps have de-rated significantly and that will reverse quickly if business conditions start to show early signs of improvement.

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

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