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AUSTRALIAN SECTOR AND COMPANY OUTLOOK

Global markets were dragged down in 2022 by the trifactor of multi-decade high inflation, the Russian invasion of Ukraine and China's COVID-zero policy. While almost every major asset class took a sizeable hit last year, Australian equities presented a different story. Australian equity, as measured by the S&P/ASX 200, was one of the best performing asset classes in 2022.

We analyse the key sectors and reveal our outlook for 2023.

Introduction

The wave of liquidity that flooded markets in 2020 in the wake of the COVID-19 crisis set new records. What followed was the most aggressive tightening cycle since the early 1980s, with 2022 heralding in a new world order, and markets and some sectors started rhyming with outcomes akin to the Global Financial Crisis (GFC) and dot-com bubble. For the first time since 1994 both bond and equity markets were down.

Huge hits were felt across the tech sector and more broadly across US and UK equities, to name a few. However, Australian equities, as represented by the S&P/ASX 200 was one of the best performing asset classes in 2022 thanks to a Q4 resources rally and higher 'value' exposure relative to other country equity benchmarks. The S&P/ASX 200 was down 1.08% over the year. The best performing sector was energy up 49.0% and the worst performing was information technology which fell 33.7% over the year. In terms of size, large caps significantly outperformed small caps and were up 1.89% for the year compared to midcaps which fell 6.3% and small caps down 18.3%.

According to the 2022 VanEck Australian Investor Survey, Australian equities is going to be the go-to investment destination in 2023 with 70% of respondents planning to invest.

For investors, the question is which sectors should be considered for 2023.

Below we analyse:

1. Banks and ASX: CBA
2. Resources and ASX: BHP
3. A-REITS and ASX: GMG
4. Energy and ASX: BHP
5. Consumer discretionary and ASX:WES
6. Consumer staples and ASX:WOW

Banks (neutral)

Australia's big 4 banks were some of the best performing stocks after reporting net interest margin (NIM) expansion. The rapid increase in mortgage rates and delayed marginal increase in deposit rates helped expand NIMs.

However, NIMs may have peaked for several reasons as we head into 2023.

1. Wages cost pressures. Wages account for more than 50% of bank expenses. The banks have come under significant pressure from bank unions to increase compensation rates to be in line with headline inflation. The days of annual wages expense growth of 1-3% are likely over, at least in the near terms with the RBA forecasting inflation to be 4.75% in 2023.

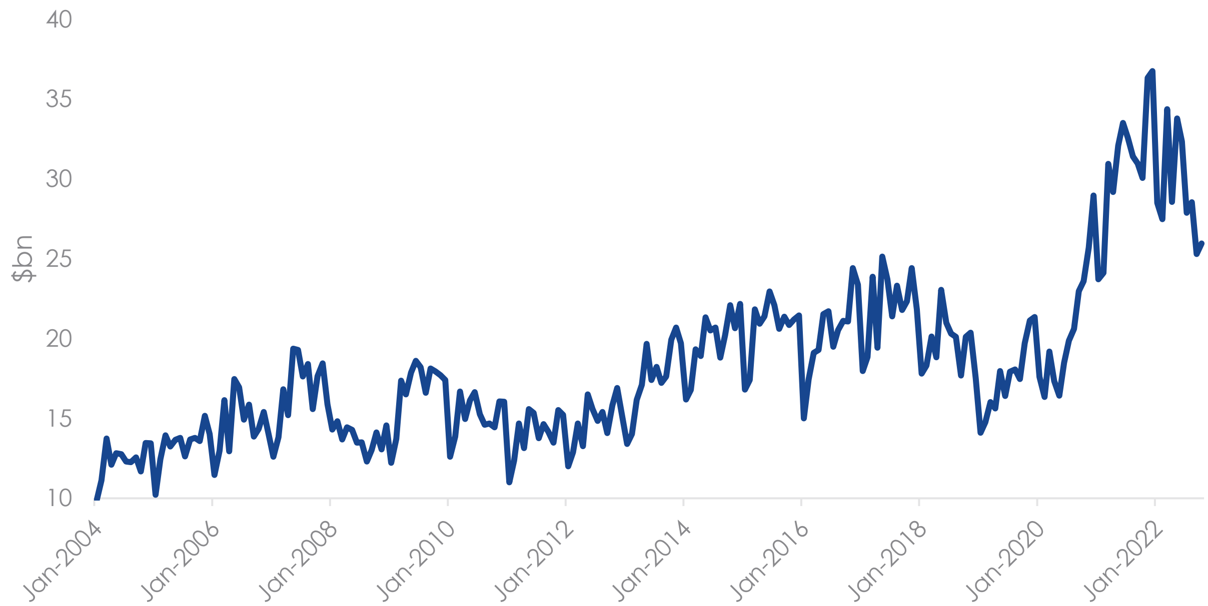
2. Higher funding costs. Australian corporate bond credit spreads for unsecured paper are above COVID-19 highs.

Australian financials average credit spread

Source: Bloomberg, Bloomberg Ausbond Credit Financials Index. You cannot invest in an index.

3. Slowing loan growth. Increase in mortgage rates has slowed loan growth which previously provided a major tailwind for banking revenue growth. Expect loan growth to slow further in 2023 as higher rates squeeze household and business balance sheets.

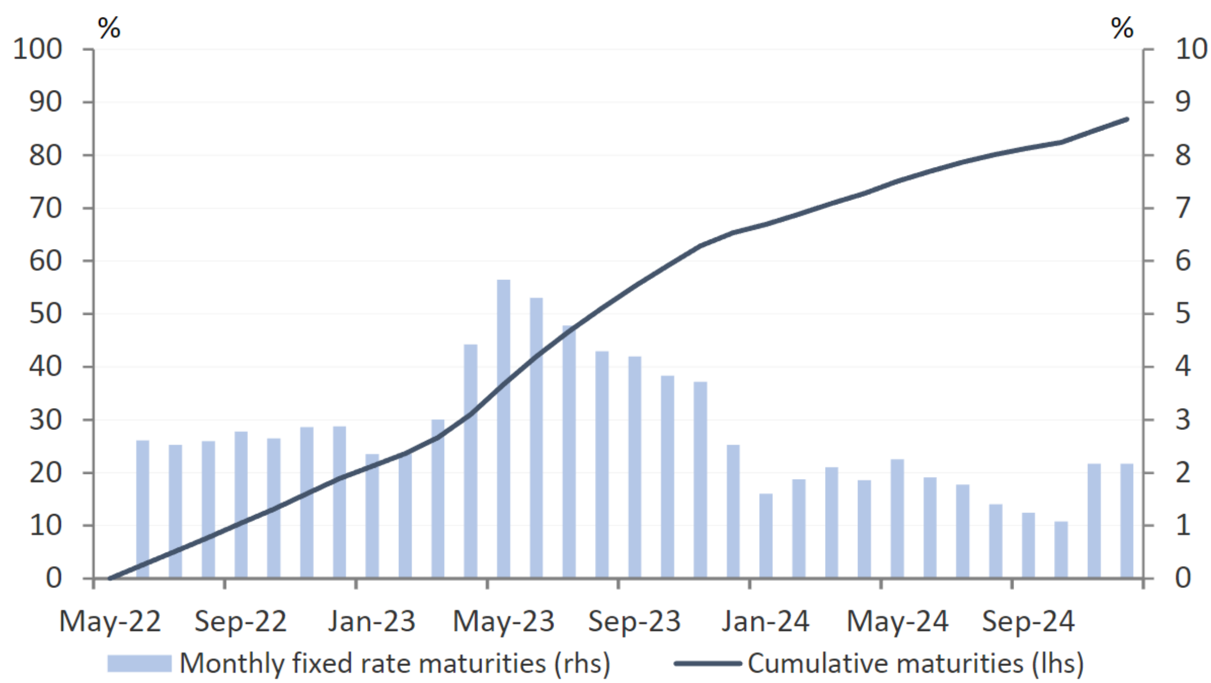
New loan commitments, total housing



Source: ABS

4. Higher delinquencies, rapid mortgage rate increases and roll-off of fixed rate mortgages this year is likely to put pressure on households and result in mortgage stress.

Fixed rate mortgages rolling off in 2023



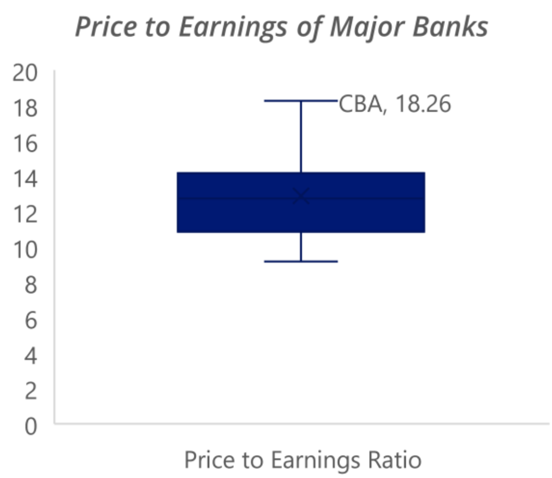
Source: RBA, Morgan Stanley Research

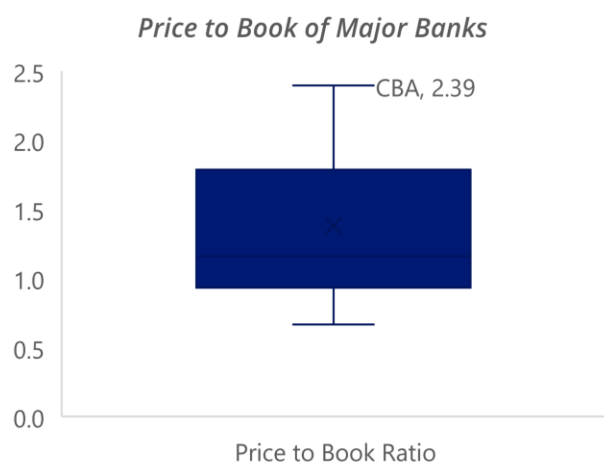
Commonwealth Bank of Australia (ASX: CBA)

The Australian Banks have held up during the calendar year with 1.31% return in an uncompromising year for equities[1]. CBA is a market darling of the ASX, its large market capitalization coupled with the Australian market's general positive view on the banking sector has allowed the stock to exhibit strong price support returning 5.58% for the year[2]. The bank is Australia's leading deposit franchise, is highly capitalised and has exhibited strong rate leverage which has contributed to revenue growth which was highlighted in the August reporting season followed by November AGM's were higher than expected deposits to loans have generally offset against the challenges this year.

The RBA has estimated that most Australian homeowners with variable mortgages are expected to roll within the next two years, with a significant portion of these occurring in the second half of 2023. Mortgage competition is influencing homeowner banking choices with favorable mortgage rates being paramount in a climbing rate environment. Greater competition will prove to be a headwind for the bank going into the new year.

From a valuation perspective, the bank is also more expensive than its peers on a relative to peer and historic basis, having the highest PE and price to book ratio in the sector.



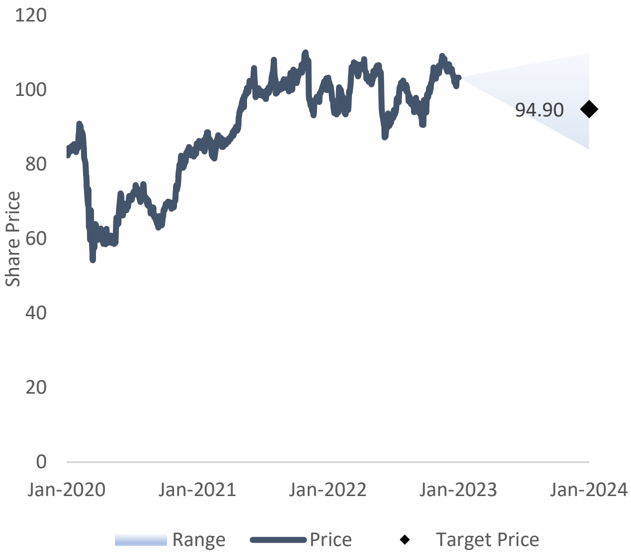


Source: Bloomberg; ANZ, BEN, BOQ, CBA, MQG, NAB and WBC

Given the expensive valuation for CBA, rising operational cost, slowing loan growth and higher funding cost, the company faces significant obstacles in the year ahead. However, if the bank can continue to expand their net interest margins (NIMs) as rate hikes come to fruition in 2023, the stock price may be more resilient than expected.

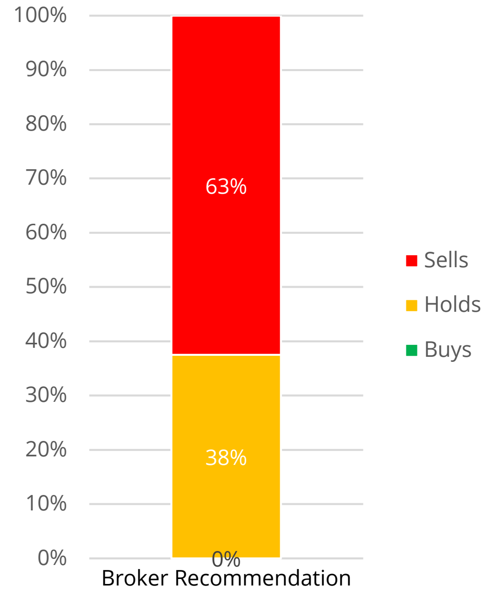
[1] As at 30 December 2022 using MVIS Australia Banks Index.
[2] As at 30 December 2022.

Median Share Price 12 month target (-7%)



Source: Bloomberg, as at 30 December 2022.

Broker buy/hold/sell split (16 analysts)



Source: Bloomberg, as at 30 December 2022.

From an income perspective, CBA looks unattractive when comparing to the past three years. CBA fully franked dividend yield is 5.35%, relative to the 6 Month Australian Bank Bill Rate at 3.77%[3]. It is evident the yield gap is closing in the current climate and with market conditions not boding well for overvalued equities, investors should consider the risk reward payoff in terms of capital risk for stocks with diminishing relative yield returns.

CBA Franked Dividend vs 6 Month BBSW

Source: Bloomberg. Past performance is not indicative of future performance

[3] As at 30 December 2022.

Resources (overweight)

During the global financial crisis, China's demand for Australia's natural resources was the saviour in helping the country avoid a technical recession defined as two consecutive quarters of negative gross domestic product (GDP) growth. Governments such as China often turn to infrastructure spending as a fiscal measure to expand economic growth in an economic downturn. This could be repeated.

Chinese President Xi Jinping has cited infrastructure spending as the government's main lever to rescue economic growth. China is finally transitioning to a 'living with COVID' environment. The Australian resources sector could once again be a major beneficiary of this investment, as it was during the GFC.

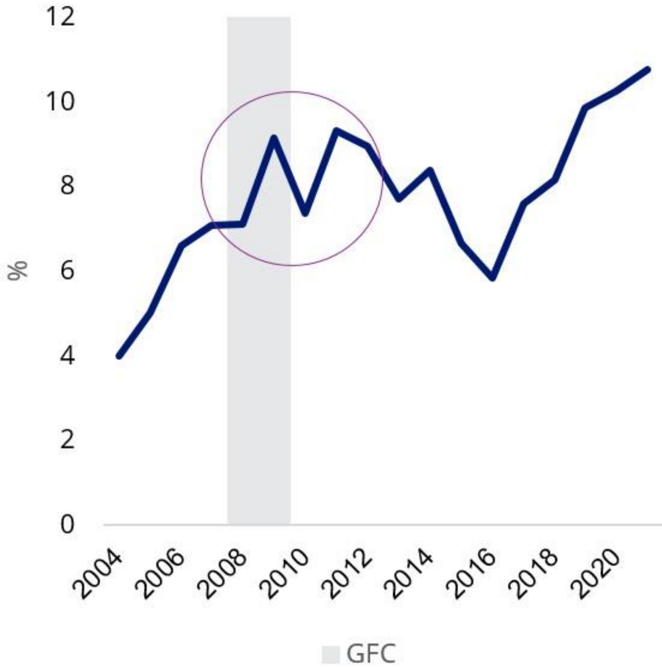
At the end of 2009, China's year on year infrastructure investment sky rocketed to 54 per cent, from 10 per cent the previous year as shown earlier. The spending helped resurrect economic growth during the lows of the GFC. As a result, Australian commodity export prices soared, and mining as a percentage contribution of Australian GDP jumped, boosting Australian resource companies.

The reopening of a country with 1.4 billion residents offers investment opportunities, particularly within Australian sectors that have high revenue exposure to China.

RBA Commodity Export Price Index

Source: Bloomberg. You cannot invest in an index.

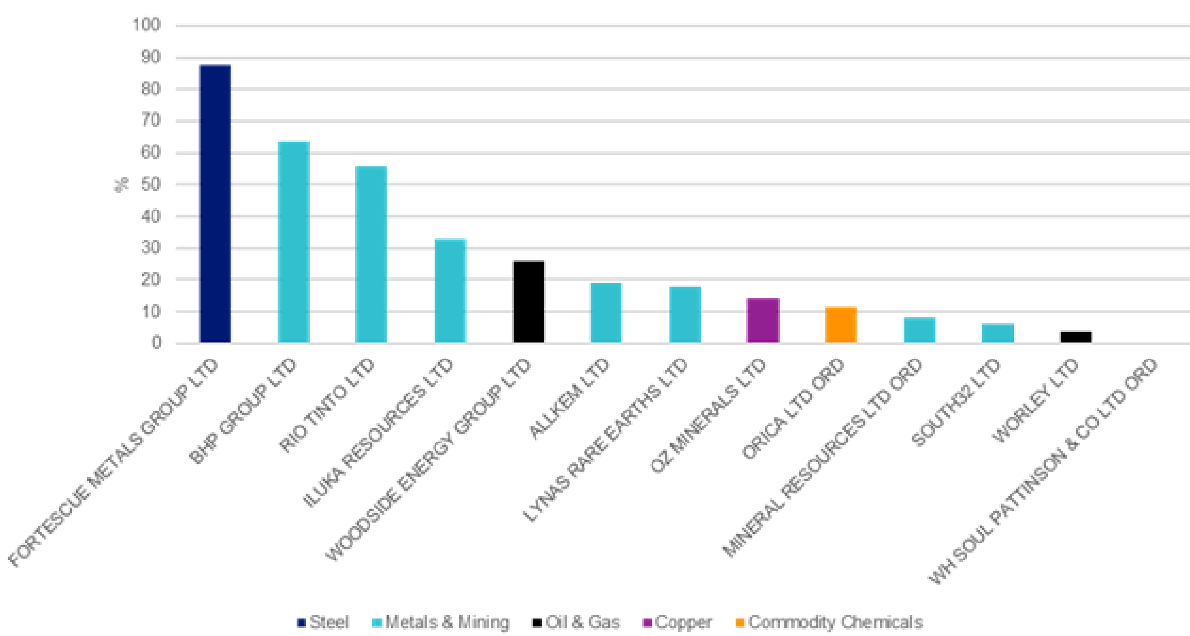
Mining as a share of Australian GDP



Source: ABS

Despite geopolitical tensions, and Chinese sanctions on some major Australian exports, China remains reliant on Australian mining resources. 19 per cent of Australian mining revenue is attributed to China, based on the constituent weighting of MVIS Australia Resources Index.

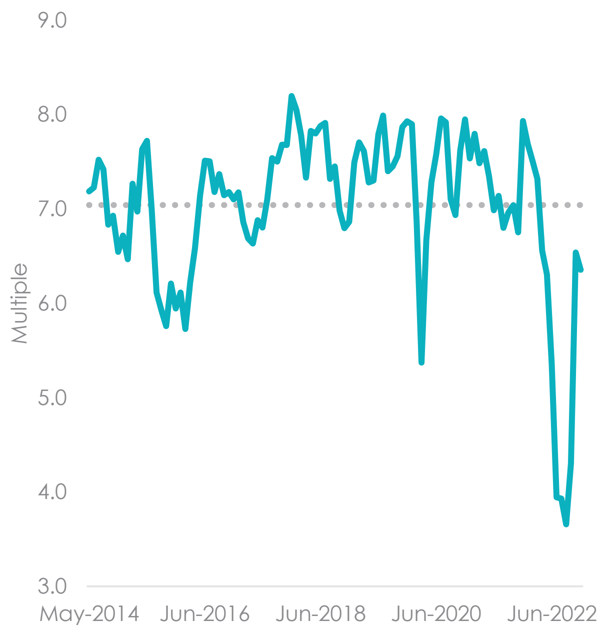
Australia resources revenue attributed to China



Source: Factset, as at 30 June 2022.

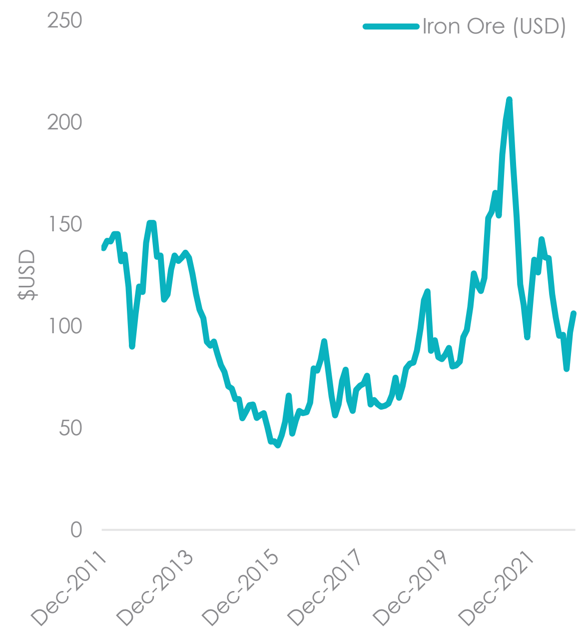
The recent downturn in global markets and economic weakness in China has improved the valuation profile of Australian resources. Price to 12-month forward cash flow is below its historic average and iron ore prices have dropped to 2018.

Australian Resources 12m forward price to cash flow



Source: Bloomberg, Australian resources as MVIS Australia Resources Index.

Iron ore price



Source: Bloomberg, Iron Ore Spot price Index 62% Import Fine Ore.

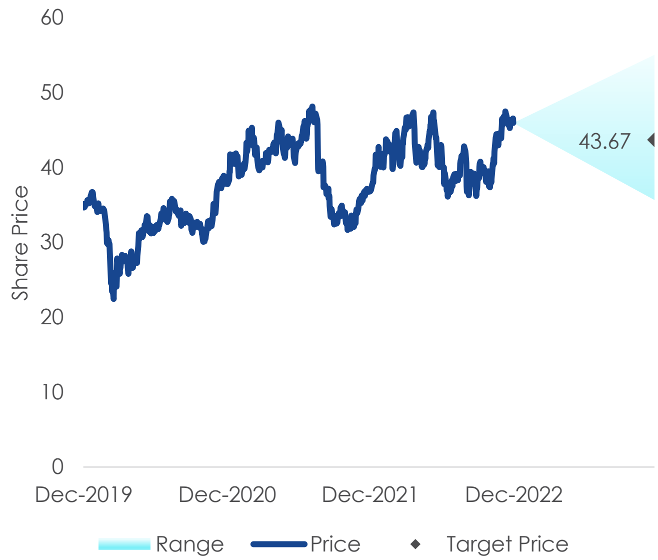
BHP Group (ASX: BHP)

The world macroeconomic climate weakened over 2022 on the back of COVID-19 related disruptions, the Russia / Ukraine war and inflationary headwinds. These headwinds have proved to be a boon for resource stocks, with limited supply and significant demand (primarily driven by China) leading Australian energy and materials stocks to deliver returns of 49% and 13% respectively[4]. This climate has bolstered BHP's return, with the world's largest mining company posting an eye-watering 48%[5] return through 2022.

Turning to 2023, BHP's ability to repeat this stellar performance remains subject to a variety of factors. One key concern remains the resilience of the global economy in the face of rapid monetary policy tightening. Indeed, a demand-sapping recession would drag upon global infrastructure investment and thus the performance of resource stocks. However, China – the world's largest importer of iron ore – has ended its zero-COVID policy. With this decision comes a return to Xi Jinping's policy of economic growth and substantial infrastructure investment. With over 60% of revenue derived from China[6], this is likely to prove a significant tailwind for BHP's stock price.

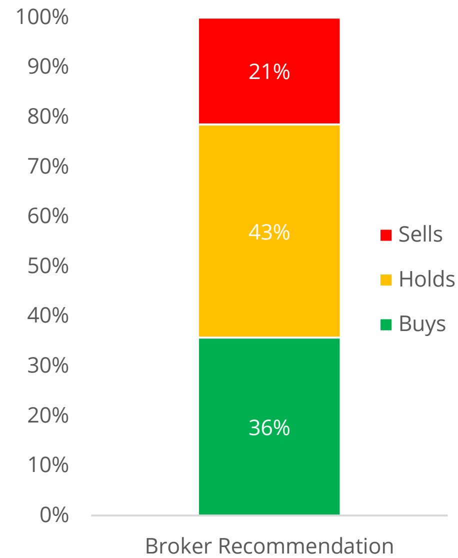
[4] S&P/ASX200 Energy Sector Index & S&P/ASX200 Materials Index. As at 31 December.
[5] As at 31 December.
[6] Factset, as at 30 June 2022.

Median Broker Consensus Share Price 12 month target (-6%)



Source: Bloomberg, as at 31 December 2022.

Broker buy/hold/sell split (10 analysts)



Source: Bloomberg, as at 31 December 2022.

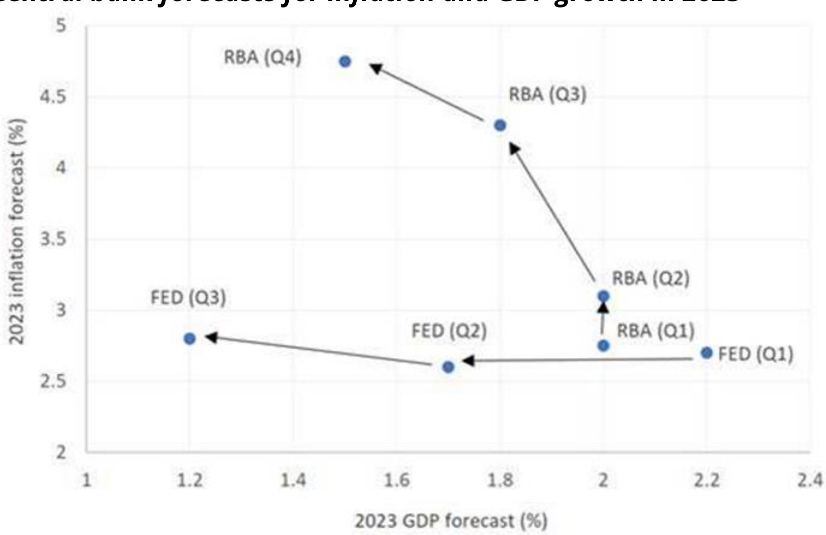
A-REITs (neutral to overweight)

A-REITs have had a 2022 they would rather forget, underperforming the market by over 18%. But, this year's worst performer could become next year's rising star. REITs' rough run in 2022 has mainly been driven by a sharp increase in the 10-year bond yield, which have more than doubled. However, we believe long dated government bond yields could be close to reaching their peak, and the RBA prioritising growth over inflation could provide tailwinds for REIT performance.

The RBA has started to temper the rate of cash rate increases over the past three months despite Australian inflation reaching a 40-year high in Q3 and expectations it will further increase in Q4 2022. The RBA increased the cash rate in October, November and December by 25 basis points, below market expectations of 50 basis point hikes during the first two months. This approach indicates to us that for 2023 the RBA is prioritising economic growth over containing inflation quickly. RBA increased their Australian CPI forecast for 2023 from 2.75% to 4.75% over the past 4 quarters. In contrast, the Fed is resolute on driving down inflation to 2% despite actions increasing the risk of a US recession 'hard landing'.

The RBA's focus is positive for potentially oversold A-REITs for three reasons.

Central bank forecasts for inflation and GDP growth in 2023



Source: RBA, Federal Reserve

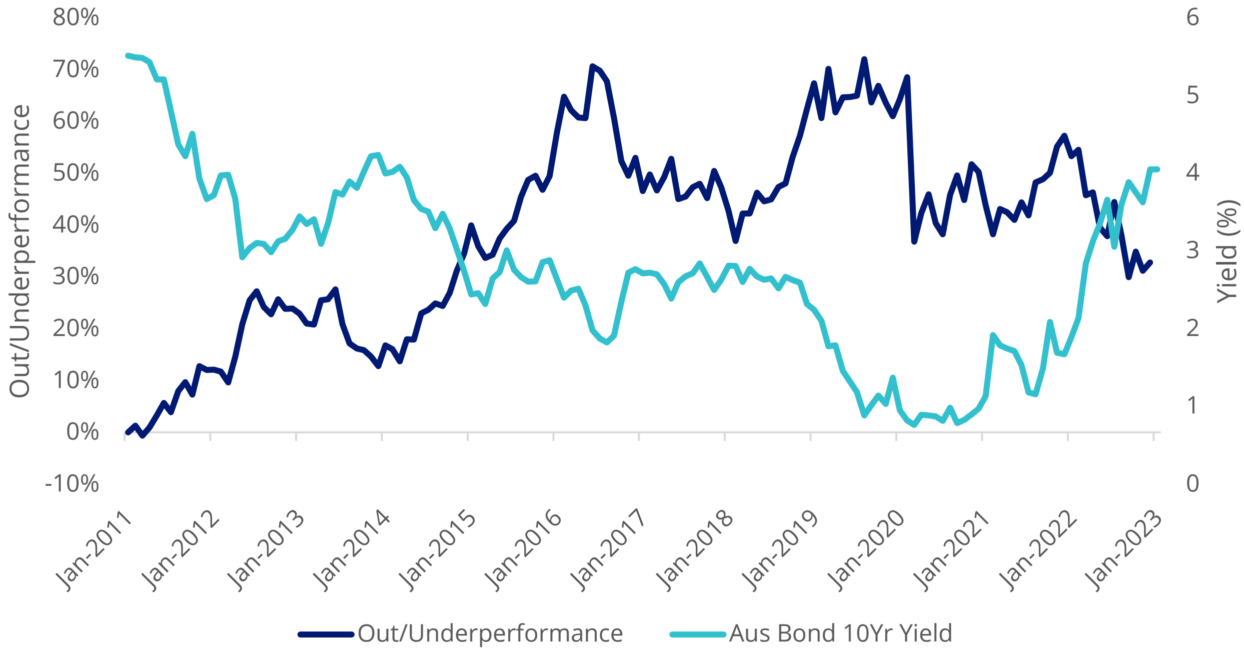
1. REIT income inflation linked

REITs historically outperform during persistent inflation periods. The RBA is forecasting inflation to be above its target in 2023. Commercial leases and contracts in office and logistics typically have inflation linked annual increases in rents written into the contract, providing inflation protection on income. An example was between the end of the dot-com bubble and GFC. During this period, Australian CPI year-on-year was 2.9 per cent on average and Australian 10-year government bond yields steadily increased over this time where A-REITs as represented by the S&P/ASX 200 A-REITs outperformed the S&P/ASX 200 by 3.99% between 1 January 2002 and 31 December 2006. Noting that as always, past performance is not indicative of future performance.

2. Government bond yields moderating

REIT performance is negatively correlated with bond yield movements due to the impact of change in borrowing costs on property valuations. The increase in government bond yields in 2022 due to rapid increases in the expected RBA cash terminal rate has been a major headwind for REIT performance.

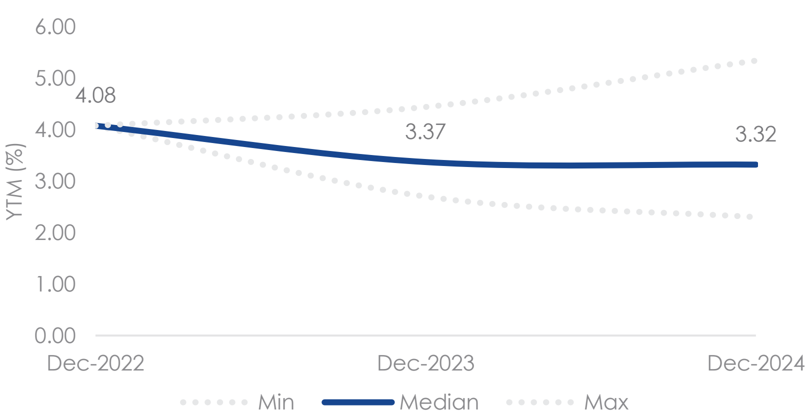
A-REITs performance relative to S&PASX 200 versus Australian government 10-year bond yield



Source: Bloomberg, Out/Underperformance as MVIS Australia A-REIT cumulative performance relative to S&P/ASX 200. Past performance is not indicative of future results. You cannot invest in an index.

However, long dated government bond yields could be close to reaching their peak. Broker consensus is that Australian Government bond 10-year yield will remain at similar levels over the next two years. Bond markets have priced in expected further RBA cash rate increases and there is a chance the RBA starts cutting the cash rate in late 2023 as the global economy slows, putting downward pressure on government yields. If yields fall, this would be a tailwind for REIT performance.

Australian government 10-year bond yield median broker forecast



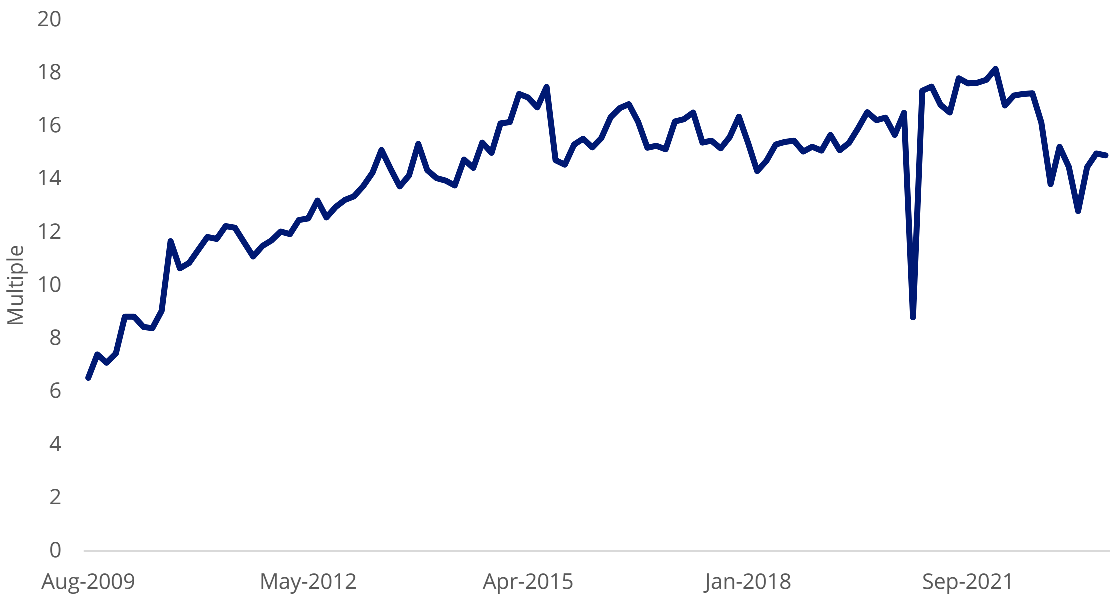
Source: Bloomberg, as at 28 December 2022.

3. Valuations attractive

The asset deflation bear market we have seen year to date has improved the valuation profile of REITs. Price to Adjusted Funds from Operations (AFFO multiple) is at a five-year low and price to Net Tangible Assets (NTA) is at a 9% discount. While not all NTA's may have been revised, prices are reflecting a discount to NTA. We are also seeing an increase in cap rates.

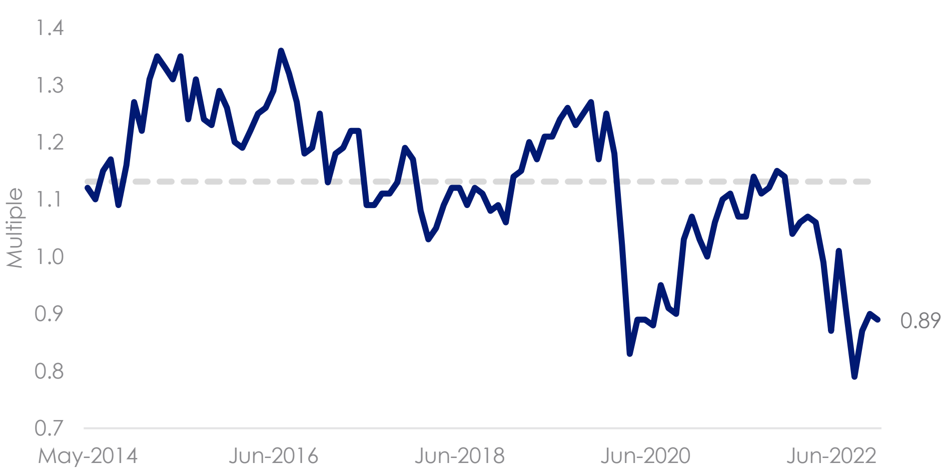
These measures are market convention for valuing REITs and are preferred to metrics such as price to earnings ratios.

A-REIT AFFO Multiple



Source: Bloomberg, A-REIT as MVIS Australia A-REIT Index. You cannot invest in an index.

A-REIT Price to NTA

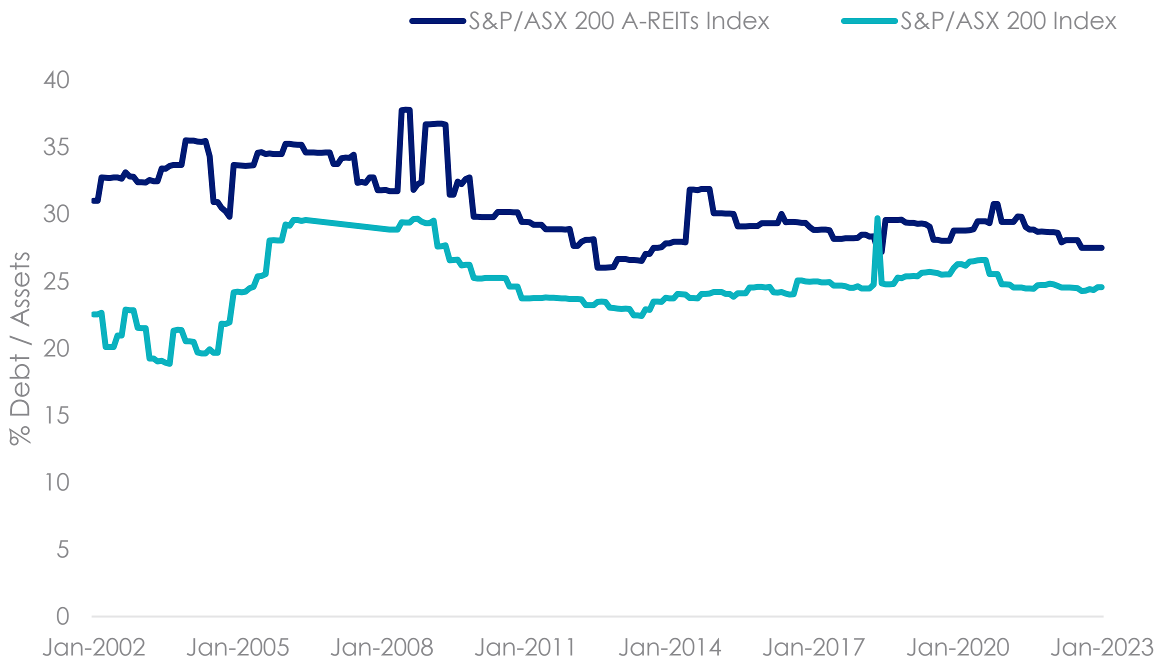


Source: Bloomberg, A-REIT as MVIS Australia A-REIT Index. You cannot invest in an index.

1. Reasonable and maintainable leverage

REIT leverage levels have been falling over the years. This should assist REITs in weathering an increase in their debt costs as a result of rising interest rates. There is also reasonable protection this year due to an average of 65% of interest rate hedging across the REIT universe. Those REITs with the lower interest rate hedging and tighter covenants will be affected the most.

Leverage – Debt/Assets



Source: Bloomberg. You cannot invest in an index.

The asset deflation bear market we have seen year to date has improved the valuation profile of REITs.

Goodman Group (ASX: GMG)

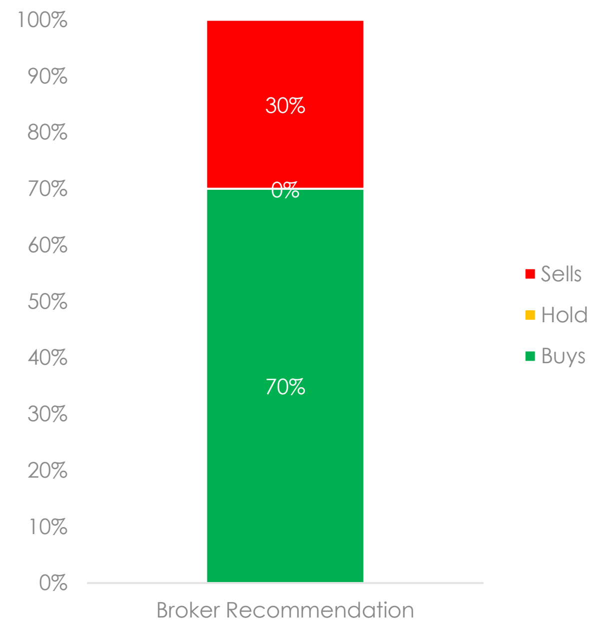
Industrial REIT Goodman Group was one of the worst performing REITs in 2022. The subsector saw an acceleration in warehousing and logistics demand following the emergence of COVID-19 and subsequent lockdowns. Strong sales and earnings growth resulted in Goodman Group becoming one of the most expensive ASX-listed REITs based on Adjusted Funds from Operations multiples, prior to the 2022 asset deflation bear market.

Looking forward, industrial REIT cap rates and net operating income are likely to remain sticky as tenants look to manage excess inventory levels and expand E-commerce channels amid low vacancy rates. Retailers will continue to invest in optimising delivery chains as they address demand for both in-store and online consumer spending. Warehousing provided by industrial REITs will potentially be key beneficiaries.

Median Broker Consensus Share Price 12 month target (+21%)

Source: Bloomberg, as at 31 December 2022.

Broker buy/hold/sell split (10 analysts)



Source: Bloomberg, as at 31 December 2022.

Energy (neutral)

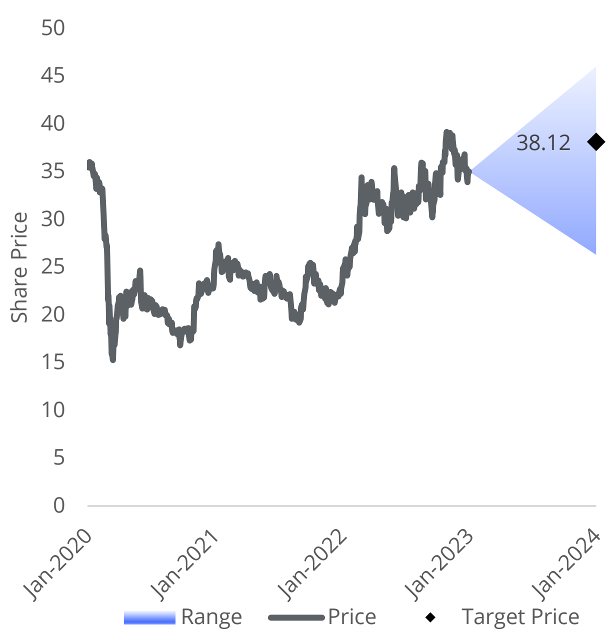
Australian energy was the best performing sector due to skyrocketing gas and oil prices triggered by Russia's invasion of Ukraine (and subsequent western sanctions). Energy prices are likely to remain elevated in 2023 despite expectations of a global recession. China in recent weeks has transitioned to a 'living with COVID' environment which will increase energy demand. China's LNG import volumes are 39% below their trend growth according to UBS. OPEC+ cut output by 1 million barrels per day in Q4 and US Strategic Petroleum releases of 1 million barrels per day have slowed.

Federal and State governments also recently announced 12m price caps on coal and gas provided to domestic markets. The consensus view is that these measures are manageable in the medium term but does increase policy uncertainty.

Woodside Energy Group (ASX: WDS)

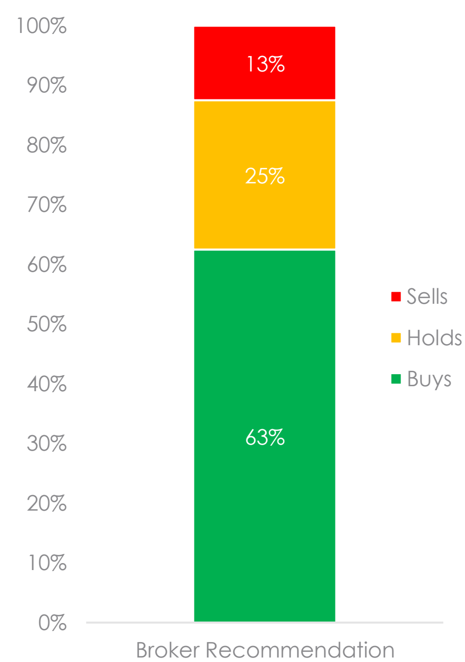
Lingering geopolitical tensions and underinvestment provide favourable risk skew to oil and gas prices. Elevated prices will also assist cashflow.

Median Broker Consensus Share Price 12 month target (+6%)



Source: Bloomberg, as at 31 December 2022.

Broker buy/hold/sell split (16 analysts)

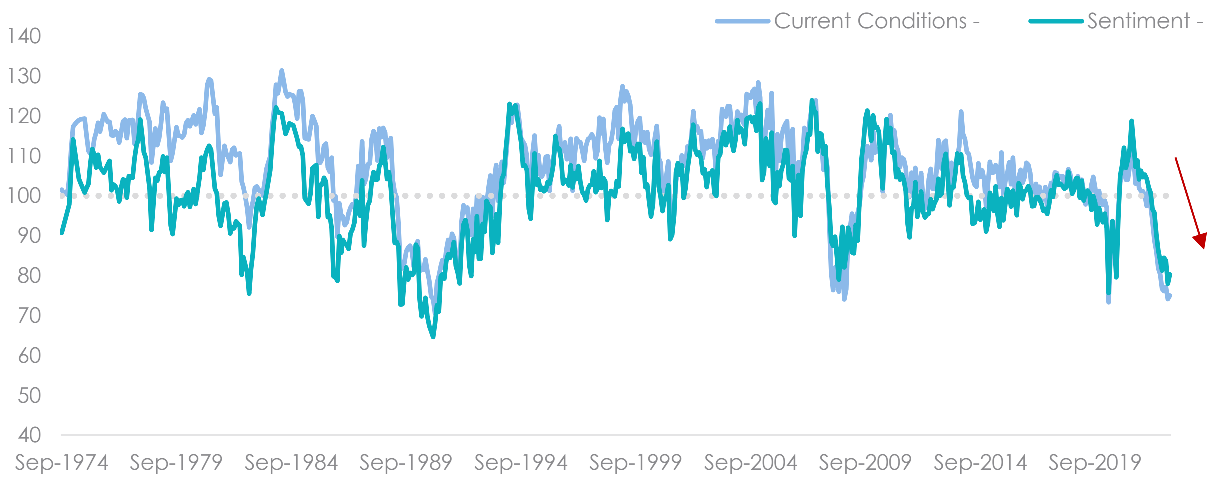


Source: Bloomberg, as at 31 December 2022.

Consumer discretionary (underweight)

Following IT and real estate, the Australian consumer discretionary sector was the third worst performer in 2022, lagging the benchmark by over 19%[7]. The challenging landscape is likely to extend into 2023 for discretionary stocks. It is not surprising that the consumer sentiment decline has coincided with the RBA rate hikes since May last year. While we may see the peak of a hiking cycle soon, Westpac's December consumer survey results indicate that inflation concerns remain high and are not abating despite higher interest rates and a deteriorating economic outlook.

Westpac - Melbourne Institute Consumer Sentiment & Current Conditions



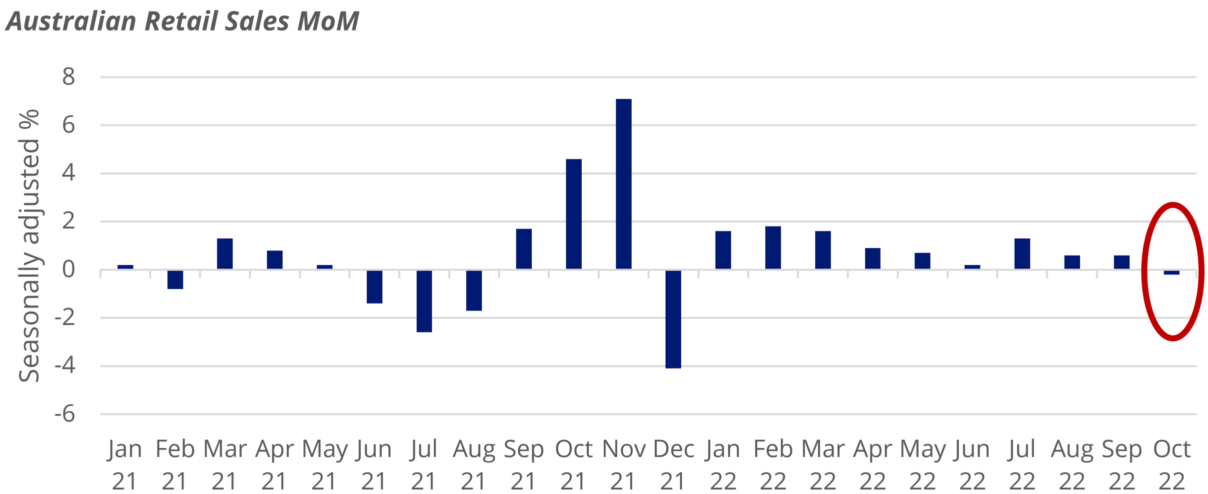
Source: Westpac-Melbourne Institute

There are two factors we consider important for the sector's outlook.

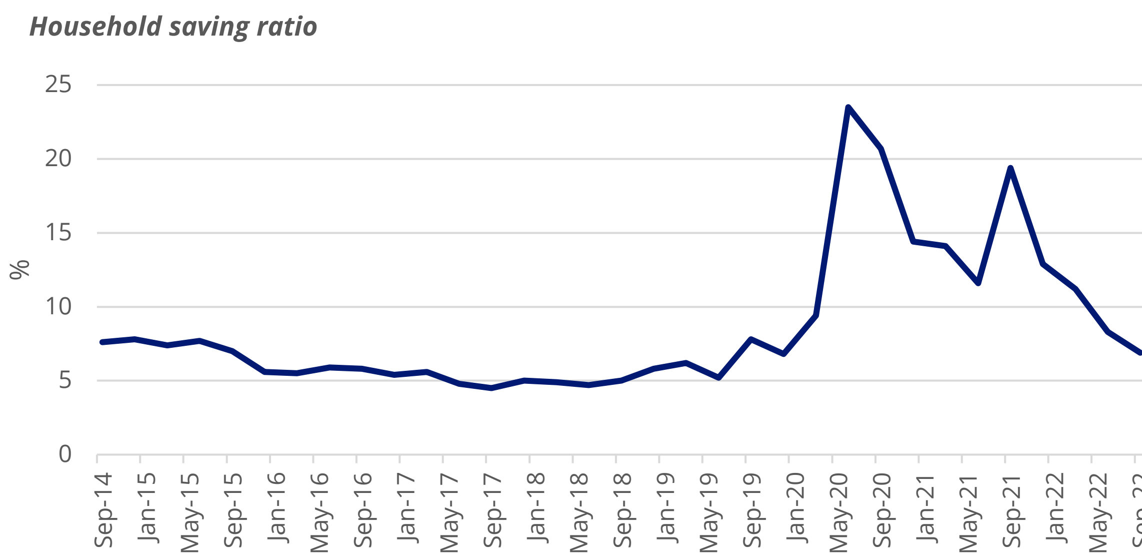
1. Household savings

Since September 2021 the household savings ratio has continued to trend down, in other words the buffer built during lockdowns are now being depleted. While retail sales have held up well this year, we think there is time lag between the change of financial conditions and consumption behaviour. October saw the first MoM decline (-0.2%) in retail sales, which could be some early signs that rising costs of living are eating into household discretionary income. November and December data would draw a clearer picture of consumer pressure as spending is generally 25% higher than the remaining of the year, estimated by Morgan Stanley.

[7] S&P/ASX 200 Consumer Discretionary Sector GICS Level 1 Index vs S&P/ASX 200 for the calendar year



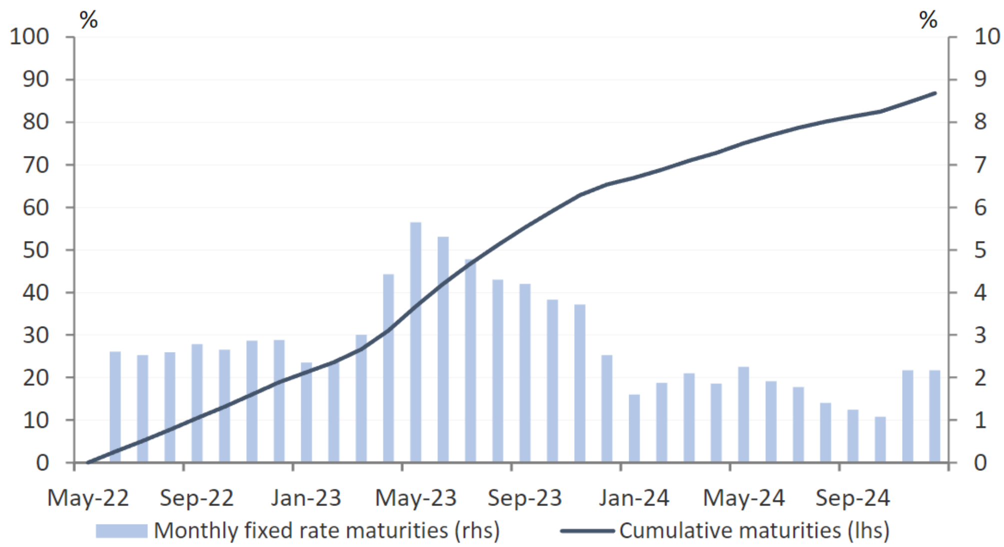
Source: Bloomberg, As at 29 December 2022.



Source: ABS, As at September 2022.

2. Mortgage roll-off

It is estimated by RBA that the fixed rate mortgage roll-off will have a peak impact in 2Q23. Given the high interest rate environment this would adversely impact debt serviceability for households.



Source: RBA, Morgan Stanley Research

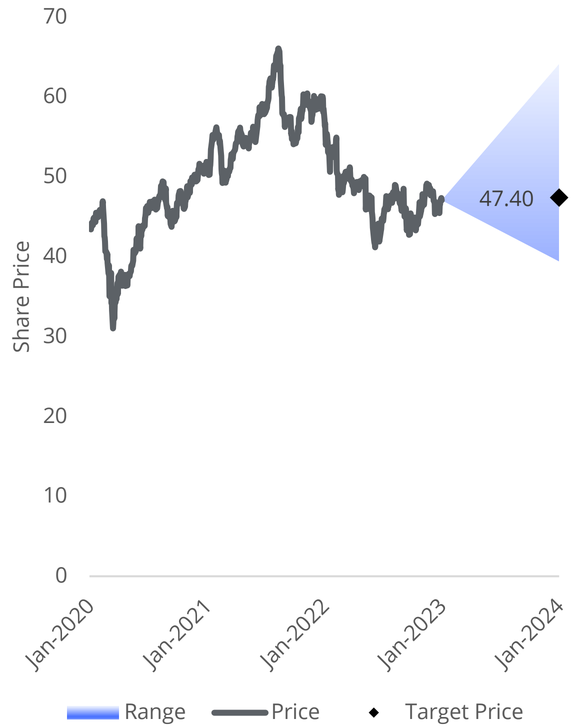
Wesfarmers (ASX: WES)

Wesfarmers hosts a wide range of businesses including general merchandise (Kmart, Target and Catch) and home-improvement (Bunnings). In 2022 Wesfarmers generated -19.63%, marginally outperformed the sector by 0.7%. The macroeconomic tightening and higher cost of energy prices results in a slowdown in consumer discretionary spending, consequently weaker equity performance for Wesfarmers.

As nearly all the company's revenue is generated domestically, we might see further headwinds in 2023. While Bunnings (the biggest business segment) sales remain resilient, EBIT margin has seen two consecutive drops as DIY spending slows. Based on Corelogic Data, the aggregate housing value in five capital cities have contracted 7.3% yoy[8], resulting in a negative wealth effect among households. In addition, Kmart inventory levels are building which may present risks this year. Consumers are likely to become more price sensitive amid a high interest rate and high inflation backdrop, as a result Kmart could also face more intense competition from online marketplaces.

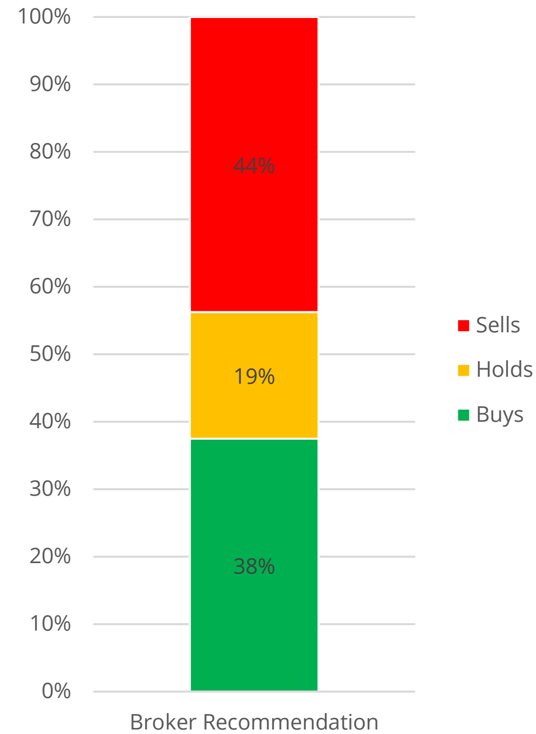
[8] https://www.corelogic.com.au/our-data/corelogic-indices

Median Share Price 12-month target (+0.8%)



Source: Bloomberg, as at 10 January 2023.

Broker buy/hold/sell split (15 analysts)



Source: Bloomberg, as at 10 January 2023.

Consumer Staples (overweight)

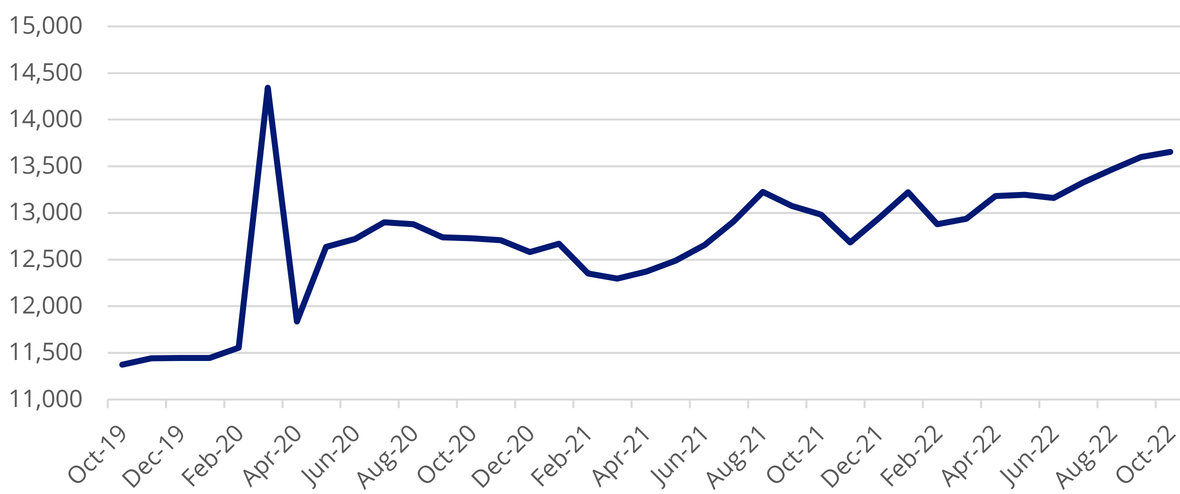
Consumer Staples stocks returned -4.7% in 2022, lagging the benchmark by over 3%. While the performance in the past year was underwhelming, we think the sector will offer some defensive benefits this year as inflation continues its upward trajectory. Generally the demand for staples are price inelastic – volume holds up well even with price increases.

Woolworths (ASX: WOW)

For the past year Woolworths generated -9.39%, significantly trailing the consumer staples sector by 4.7%.

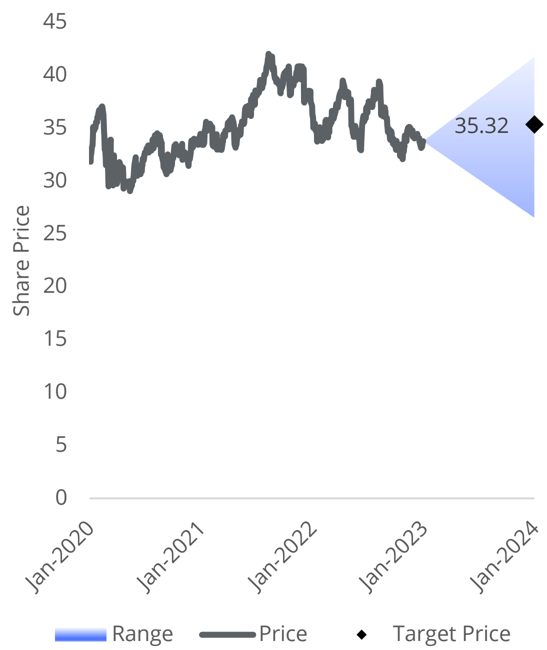
Woolworths as Australia's largest supermarket chain possesses a sticky consumer base, and is well positioned to pass through any cost inflation to protect its margins. Additionally, the steady increase in food retailing bodes well for the company's growth into 2023 and offers defensive characteristics. The company also continues to sharpen its e-commerce capabilities via personalized shopping trends and targeted discounts, which might prove to be a competitive advantage among its rivals.

Seasonally adjusted ($m)



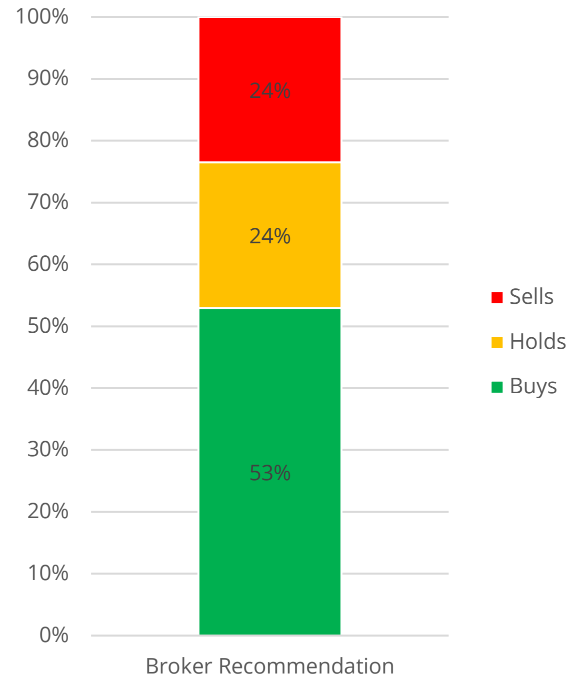
Source: ABS as at October 2022

Median Share Price 12-month target (+4%)



Source: Bloomberg, as at 10 January 2023.

Broker buy/hold/sell split (17 analysts)



Source: Bloomberg, as at 10 January 2023.

Conclusion

An Australian soft landing is likely. Australia on balance, is much better positioned than most countries to manage economic challenges in 2023. Wage growth has been relatively modest, and, the return of migration over the next 12 months will likely ease the labor market tightness. Australia also has abundant natural resources in short supply globally.

For 2023 we expect Australian equities to continue to outperform global equities. We favour Resources, REITs and Consumer Staples, are neutral on Banks and underweight Consumer Discretionary. During the year we expect to see improving relative performance from small cap and mid cap stocks.

We forecast the RBA cash rate to peak at 3.85% with the AUS 10yr yield to remain around the current 4% level, and we may see an inversion of the curve which could support bond proxies like REITs, infrastructure and utilities.

The caveat to the above is a) if the US experiences a recession b) Australian housing market and c) an exogenous shock.

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