view from the OUTER

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Australia: struggle street

Australian equity valuations improved during the year-end sell-off but they did not become compelling. The forward price to earnings ratio (PE) briefly dipped below historical averages, however, the positive start to the year has pushed the market back above this metric. It is also the case that "quality stocks" never became particularly cheap and have also bounced back.

This level of valuation does not appear to be sufficient compensation for the unusually large number of risks confronting Australia over the next year, which include:

- **Housing risk and the Hayne Royal Commission**

Three factors will determine the extent of the fall in the housing market and the prospects for recession: the extent of the credit crunch, the hit to consumer confidence and the offset from other construction activity, including infrastructure, office and hotels. Our baseline premise is that the economy muddles through this risk, but nonetheless, these factors require close monitoring.

- **Reporting season: earnings and dividends**

The Australian reporting season will commence from the start of February. The confession season has seen downgrades of around 3%, and the earnings revisions ratio is the weakest since 2015. Some offset may come from a jump in capital returns as firms with excess franking credit balances have an incentive to either increase ordinary dividends, or pay special dividends before mooted changes to the franking system come into play.

- **The Shorten factor**

This year's Federal election raises more uncertainty than usual because of some of the significant policy proposals of the Labor party. Many of these will have a direct impact on asset markets. There is added uncertainty because the proposals may be altered during the campaign and may then need to be amended to pass through the Senate. Financials, energy, private health, construction and consumer stocks appear most at risk.

Recommendation

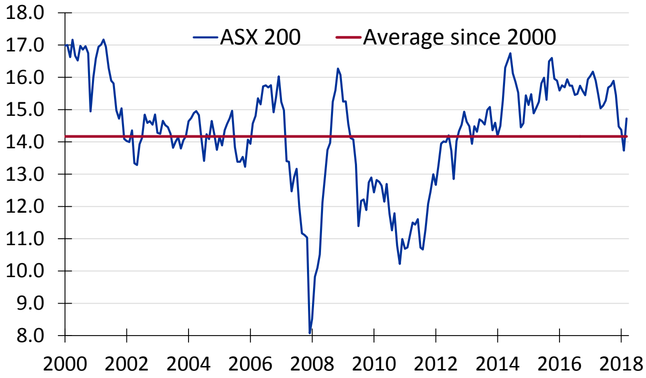
We retain our neutral recommendation on Australian equities, reflecting that even though valuations are reasonable, risks are elevated. We will not return to an overweight recommendation on Australia until risks have eased – or unless valuations significantly improve. These risks will be particularly intense over the next couple of months, in light of the Australian reporting season, the lead-in to the Federal election and the Hayne Royal Commission's potential recommendations.

Struggle Street

Australian valuations improved during the year-end sell-off but they did not become compelling. The forward PE dipped below historical averages briefly, but the positive start to the year has pushed the market back above this level.

ASX 200 Valuations

12 month forward price to earnings ratio

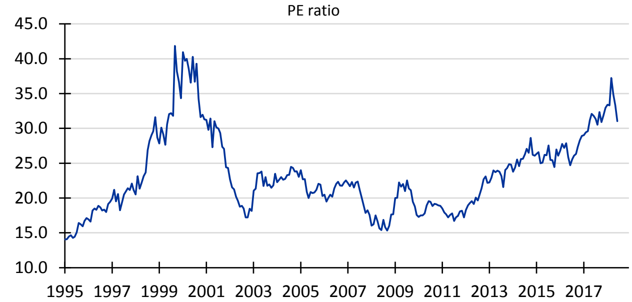


Source: Thomson Reuters Datastream, Evans & Partners

It is also the case that "quality stocks" never became particularly cheap and have also bounced back. The chart below shows our measure of growth stock valuations – these remain very elevated by historical standards.

Growth Stock Valuations*

PE ratio



*PE of the 90th percentile stock in the ASX 200 Industrials when ranked by PE
Source: Thomson Reuters Datastream, Evans & Partners

Risks are elevated

This level of valuation does not appear to be sufficient compensation for the unusually large number of risks confronting Australia over the next year. Macro, regulatory, political and earnings risks are particularly high. These include:

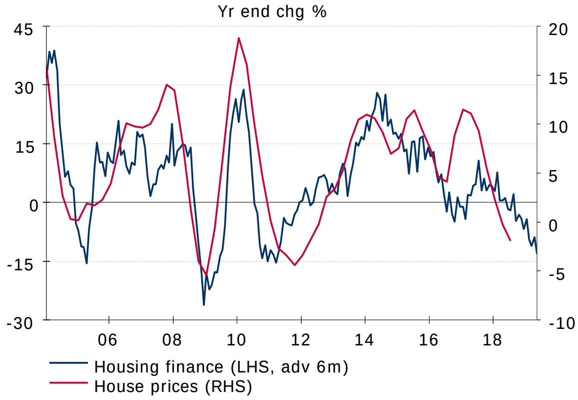
Housing risk and the Hayne Royal Commission

Three factors are likely to determine the depth of the housing downturn and whether this pushes the economy towards a recession:

- The extent of the credit crunch. Housing finance approvals are the critical series to watch and a proven lead indicator of house prices as shown below. They continue to slide. The findings of the Hayne Royal Commission and the response to them by the opposition and government will be critical here, making this particularly difficult to assess at the present time.

Housing Finance and House Prices

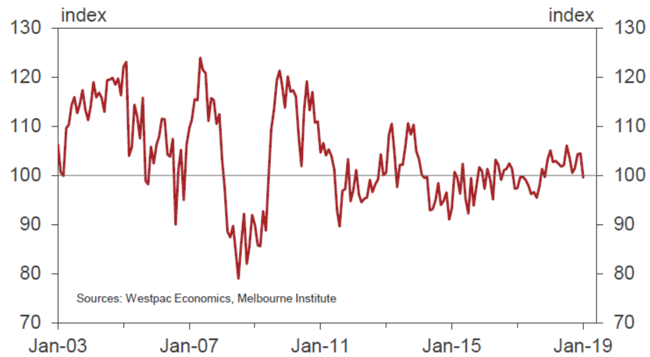
Yr end chg %



Source: Thomson Reuters Datastream, Evans & Partners

- The hit to consumer confidence. The most likely channel through which a housing downturn could cause a recession is through a collapse in consumer confidence and a jump in savings. This would primarily reflect concerns about household wealth. The Westpac series below shows that consumer confidence is weak, but not yet in what we view as danger territory.

Consumer Sentiment Index



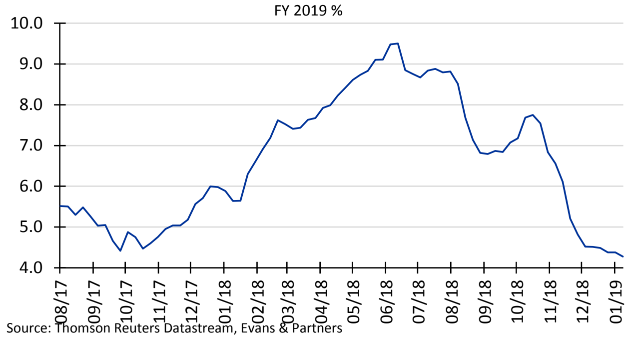
- The offset from other construction activity including infrastructure, office and hotels. The pipeline from these other sectors remains healthy and should mitigate the impact on employment from the fall in apartment construction. There are a significant number of new projects slated in Victoria in particular.

Reporting season: earnings and dividends

The Australian reporting season will commence from the start of February. The confession season has seen downgrades of around 3% and such a move normally portends a poor reporting season. The recent profit downgrades from Kathmandu and Kmart, and disappointing news from David Jones suggests the Christmas season was poor, and the consumer sector may be at risk. The housing downturn will also challenge a range of sectors including banks, materials, developers, hardware and furniture sales, and online classifieds.

ASX 200 EPS Growth

FY 2019 %

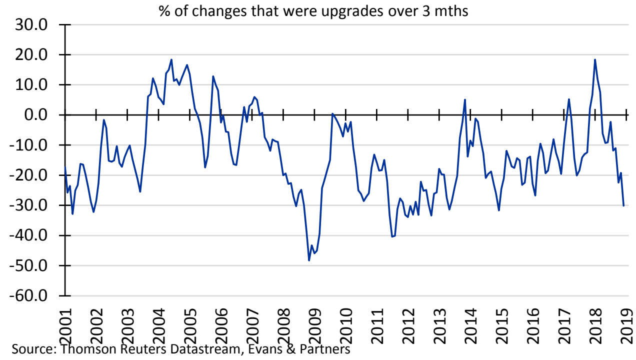


Source: Thomson Reuters Datastream, Evans & Partners

The earnings revisions ratio (the net percentage of analyst earnings changes that are positive) shows how sharp the change in the earnings environment has been. This ratio is now the weakest it has been since 2015.

ASX 200 Earnings Revisions

% of changes that were upgrades over 3 mths



Source: Thomson Reuters Datastream, Evans & Partners

The following table looks at all industrial companies where there has been a significant change in earnings forecasts in recent months. In the ASX 200 (ex-resources) there have been 27 companies where analysts have cut their forecasts by more than 5%, compared with only seven companies that have raised their forecasts by more than 5%. These are based on consensus forecasts compiled by Bloomberg.

ASX 200 industrial stocks with >5% downgrade to Net Income forecasts in past 3 months

	Name	Sector	Reporting	% revision
LLC	LENDLEASE GROUP	Real Estate	Half year	-43.8
APT	AFTERPAY TOUCH G	Information Technology	Half year	-41.0
NXT	NEXTDC LTD	Information Technology	Half year	-32.6
WES	WESFARMERS LTD	Consumer Discretionary	Half year	-23.4
AOG	AVEO GROUP	Real Estate	Half year	-21.9
BGA	BEGA CHEESE LTD	Consumer Staples	Half year	-19.4
VEA	VIVA ENERGY GROU	Energy	Full year	-16.9
PGH	PACT GROUP HOLDI	Materials	Half year	-15.3
MYX	MAYNE PHARMA GRO	Health Care	Half year	-15.2
SUN	SUNCORP GROUP LT	Financials	Half year	-14.7
AHG	AUTOMOTIVE HOLDI	Consumer Discretionary	Half year	-13.9
IAG	INSURANCE AUSTRA	Financials	Half year	-10.9
CGC	COSTA GROUP HOLD	Consumer Staples	Half year	-10.5
ORG	ORIGIN ENERGY	Energy	Half year	-9.2
PTM	PLATINUM ASSET	Financials	Half year	-8.9
ALG	ARDENT LEISURE G	Consumer Discretionary	Half year	-8.5
AWC	ALUMINA LTD	Materials	Full year	-7.5
GWA	GWA GROUP LTD	Industrials	Half year	-7.4
BIN	BINGO INDUSTRIES	Industrials	Half year	-6.9
PPT	PERPETUAL LTD	Financials	Half year	-6.5
FBU	FLETCHER BLDG	Materials	Half year	-6.3
CTX	CALTEX AUST LTD	Energy	Full year	-6.2
AMP	AMP LTD	Financials	Full year	-6.2
ABC	ADELAIDE BRI LTD	Materials	Full year	-6.0
DHG	DOMAIN HOLDINGS	Communication Services	Half year	-5.5
QBE	QBE INSURANCE	Financials	Full year	-5.5
BSL	BLUESCOPE STEEL	Materials	Half year	-5.5

Source: Bloomberg, Evans & Partners, shading indicates housing-related companies

I have shaded those stocks where the downgrades are at least partly linked to the downturn in the housing market to demonstrate that this is beginning to have an impact.

ASX 200 industrial stocks with >5% upgrade to Net Income forecasts in past 3 months

	Name	Sector	Reporting	% revision
SKI	SPARK INFRASTRUC	Utilities	Full year	7.2
APX	APPEN LTD	Information Technology	Full year	10.1
SHL	SONIC HEALTHCARE	Health Care	Half year	5.0
WEB	WEBJET LTD	Consumer Discretionary	Half year	8.1
NWS	NEWS CORP- CDI B	Communication Services	Half year	10.4
CLW	CHARTER HLW REIT	Real Estate	Half year	11.7
NEC	NINE ENTERTAINME	Communication Services	Half year	49.3

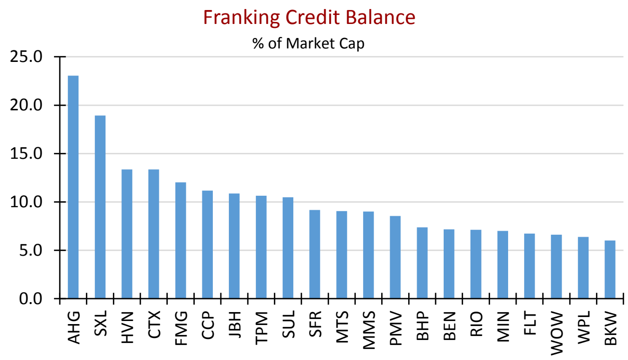
Source: Bloomberg, Evans & Partners, shading indicates housing-related companies

An offset to weak earnings could be increased capital management from firms. Firms with excess franking credit balances have an incentive to either increase ordinary dividends or pay special dividends before mooted changes to the franking system come into play. The Labor party has proposed removing refunds of franking credits for some shareholders.

Labor has suggested they would introduce the changes as soon as they are elected, which suggests that this reporting season could be the last chance for companies to pay dividends under the current framework.

The change will require Labor to win the election and pass the legislation through a hostile Senate, but this may not prevent some companies from increasing dividends anyway. A number of companies have already done so, including Mirrabooka, AFIC, BKI and BHP.

The chart below shows those companies with a large franking balance as a percentage of market cap. These are likely to be the ones which will have the most pressure to increase payouts.



Source: Thomson Reuters Datastream, Evans & Partners

- **The Shorten factor**

This year's Federal election raises more uncertainty than usual because of some of the significant policy proposals of the Labor party. Many of these will likely have a direct impact on asset markets. There is added uncertainty because many of the proposed changes may be altered during the campaign and may then need to be amended to pass through the Senate.

These changes include changes to franking, capital gains tax and negative gearing. There could also be significant changes to the financial sector on the back of the Hayne Royal Commission and to superannuation, following the Productivity Commission report – as well as changes to the energy sector.

Key sectors that may be affected by the election outcome include:

- Energy retailers, as the Labor party seeks to reduce electricity prices.
- Financials, including banks, insurance and wealth managers.
- Construction and consumption companies, due to a range of policies which may place the housing market, and therefore the consumer sector, at further risk.
- Private health, after Shorten indicated he will commission a report into the industry and introduce caps on growth in premia.

In light of these identified factors, we will not return to an overweight recommendation on Australia until some of the inherent and associated risks have eased, or valuations significantly improve.

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