view from the OUTER

EVANS & PARTNERS

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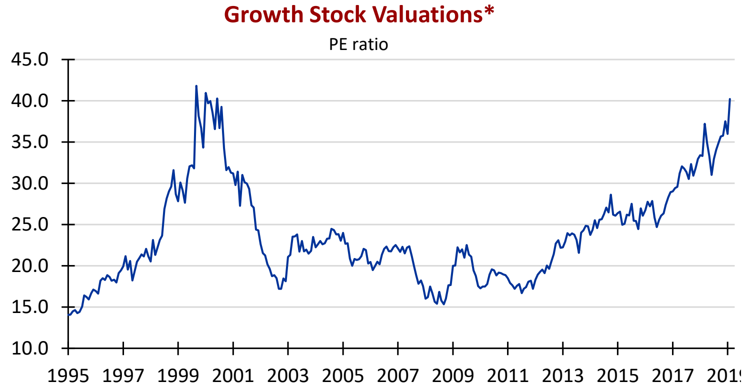
Finding some pockets of value

The recent combination of weak economic data and a dismal reporting season has focused attention back on the Australian market, and valuations in particular. Pressures on the economy may not improve, as further weakness in housing construction appears on the horizon.

The challenge for the stock market is that this is occurring at a time where investors are being compelled into equities due to low expected returns in other asset classes. This has pushed overall market valuations to the high end of recent historical ranges. This is most extreme amongst growth stocks, where valuations are now around the same level as the height of the tech bubble. Stretched valuations are now also apparent in small caps and bank stocks.



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

Some pockets of value

This raises the question of whether there are any pockets of value. Our first observation is that Australia is more overvalued than other markets and more value can be found offshore, for example, in Europe.

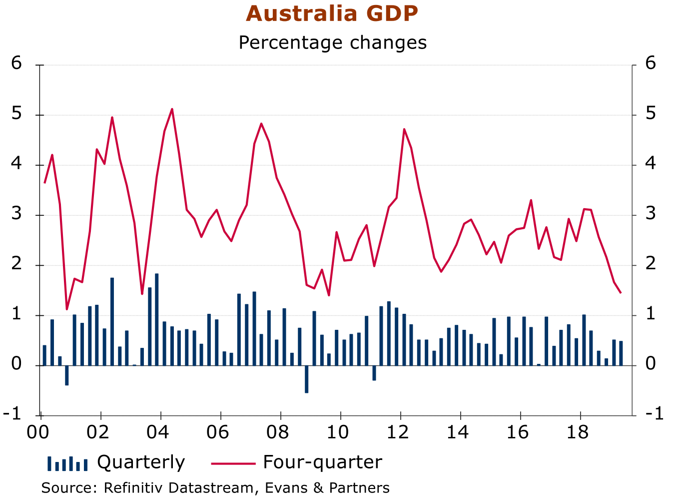
Within the Australian market, as we trawl through various stocks and sectors, a couple of areas have started to appear cheap. The first is the stocks with offshore earnings, particularly those in the industrials sector (Ansell, Brambles, Aristocrat Leisure, Amcor, Reliance Worldwide) and financials (Macquarie Group and Computershare). These companies have performed very well over the past five years as the global economy performed better than the local economy, however the global weakness over the past year has caused a derating.

A second area where the rerating has not been as extreme is in the real estate investment trusts (REITs). While REIT valuations have increased, this has not been as large as expected, given the general rush into yield stocks. The retail REITs in particular have been left behind, based on concerns over the general retail environment.

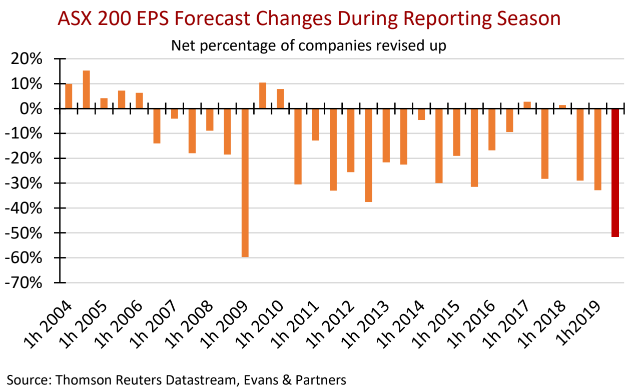
Pockets of value

The recent combination of weak economic data and a dismal reporting season has focused attention back on the Australian market, and valuations in particular.

Recent gross domestic product (GDP) data show that the Australian economy is running at close to stall speed. Overall GDP growth is now the weakest since the global financial crisis (GFC) and, were it not for a big jump in exports due to the high iron ore price and strong government spending, the results would have been worse. It would not take much to tip the economy into recession from here, and this is clearly entertaining the mind of Reserve Bank of Australia (RBA) Governor Philip Lowe with his recent unprecedented media campaign to encourage the government to raise spending.

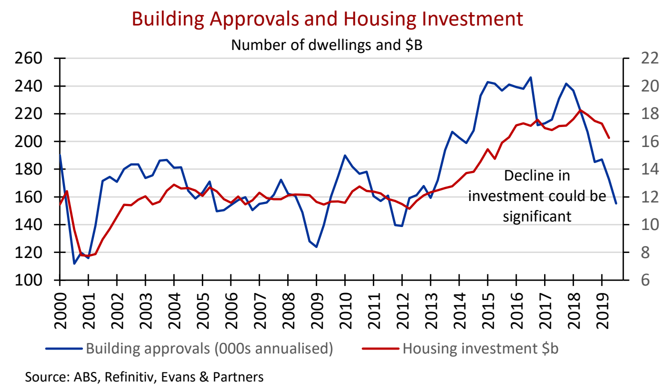


This weakness translated directly into the reporting season which, measured by the extent of downgrades to profit forecasts, was also the worst since the GFC.



Governor Lowe's concerns may be based on some ominous signs from the housing industry. Even though home sales are starting to pick up, housing construction is likely to deteriorate further. Housing construction matters more for the economy than housing sales because of the impact on employment, and the problem is that construction indicators are pointing to more weakness. Construction scandals in Sydney and Melbourne will play a major role here – at a minimum these will delay the next round of approvals and add to the cost of building. The challenge for Dr Lowe is that if interest rate cuts will not boost construction, they will add to housing demand and not supply and may therefore just push up prices.

Added to this is the problem that the public infrastructure boom is now well advanced. Although total spending on infrastructure is expected to remain strong over the coming decade, a lack of shovel-ready projects means there are now as many projects finishing as starting. This means that this sector may not soak up jobs lost in the housing sector in the near term.



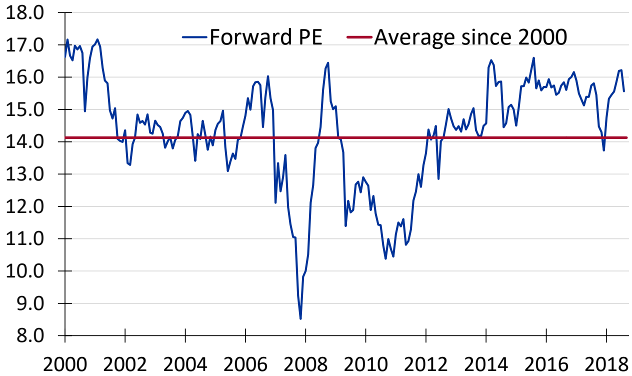
The best hope for the economy is that tax rebates will boost the consumer side, but with half of the refunds already distributed in July and August, there is little evidence of a significant effect.

Where has all the money gone?

The challenge for the stock market is that this is occurring at a time where investors are being compelled into equities due to low expected returns in other asset classes. This has pushed overall market valuations to the high end of recent historical ranges.

ASX 200 Valuations

12 month forward price to earnings ratio

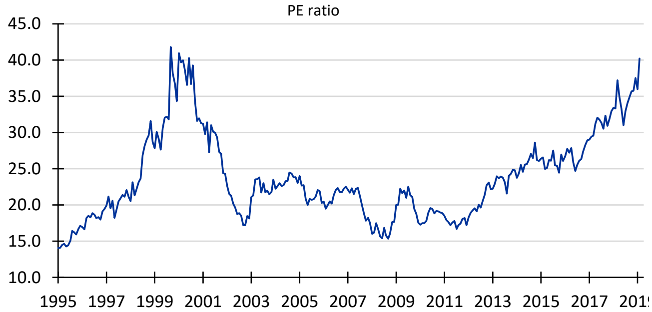


Source: Refinitiv, Evans & Partners

While this chart may look uncomfortable, a deeper dive shows that valuations are even more extreme in some sectors. The most stretched is 'growth' stocks, which in the Australian case is mostly healthcare and IT companies. Australian investors have been squeezed into fewer and fewer 'good' stocks as more companies have been affected by weak macroeconomic conditions. This means that valuations in these stocks have been pushed higher and higher. It is remarkable that the current collection of growth stocks are almost as expensive as their equivalents were at the height of the tech bubble in 1999 – a period we now look back on as almost the definition of a bubble.

Growth Stock Valuations*

PE ratio

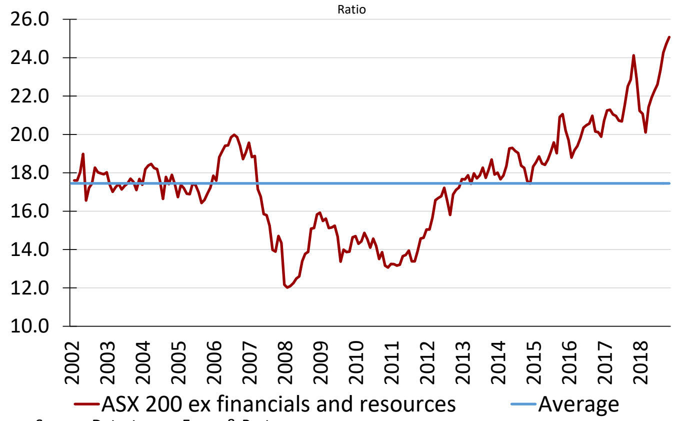


*PE of the 90th percentile stock in the ASX 200 Industrials when ranked by PE

Source: Refinitiv, Evans & Partners

Another way to see this is to look at the Australian market excluding financials and resources, which we call the 'core' market in the chart below. Financials have been affected by the Royal Commission and resources are trading at low multiples because they are close to peak earnings. The core market is now trading at a price to earnings ratio (PE) of above 24x, which is well in excess of historical norms.

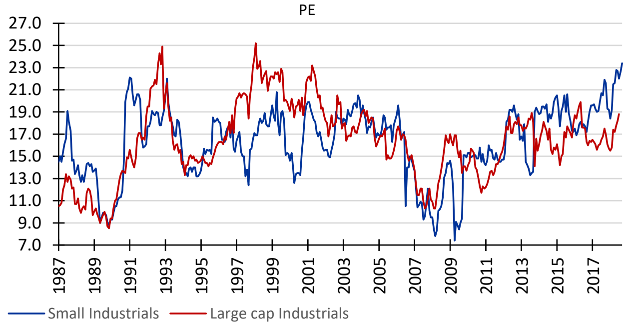
Australia Core Market Forward PE



Source: Datastream, Evans & Partners

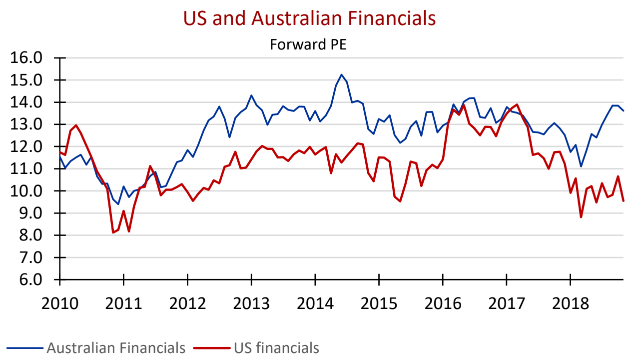
The search for good ideas has also pushed into the smaller end of the market. Small caps have traditionally traded at discounts to large caps, reflecting the greater risk normally associated with smaller firms. However, small caps are now trading at a significant valuation premium to large caps in the industrial sector.

Small vs Large Cap Industrials Valuation



Source: Thomson Reuters Datastream, Evans & Partners

More recently the search for relative value has even taken investors back to the banking sector. Since the federal election, the forward PE of the banks has jumped up to around 14x earnings, with CBA closer to 16x. This is very different to the performance of banks around the rest of the world, where the collapse in interest rates has seen banks largely abandoned by investors. This is apparent from the wide valuation gap between US and Australian banks in the chart below.

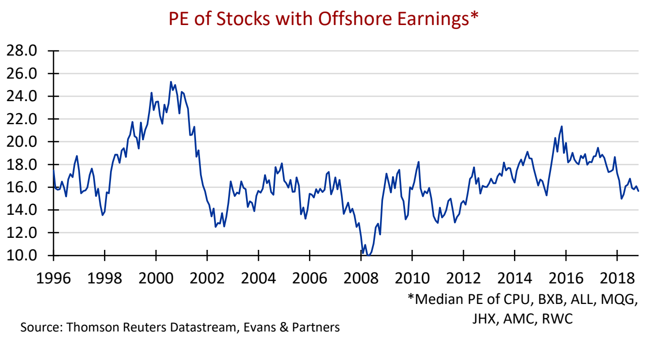


Source: Thomson Reuters Datastream, Evans & Partners

Is there any good news?

This raises the question of whether there are any pockets of value. Our first observation is that Australia is more overvalued than other markets and more value can be found offshore, for example in Europe.

Within the Australian market — as we trawl through various stocks and sectors — a couple of areas have started to appear cheap. The first is the stocks with offshore earnings; companies that have successfully developed offshore growth strategies in the industrials sector (ANN, BXB, ALL, AMC, RWC) and financials (MQG, CPU).

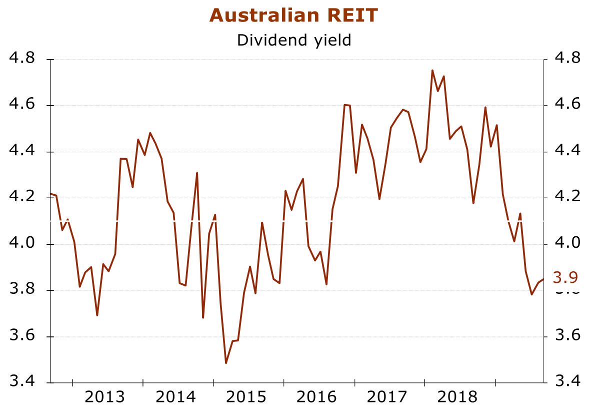


Source: Thomson Reuters Datastream, Evans & Partners

These companies have performed very well over the past five years as the global economy performed better than the local economy. However, with the exception of the healthcare companies, the global weakness over the past year has seen a derating of these stocks and the industrial companies in particular.

This is one interesting area because, assuming we are correct that the global economy does not enter recession next year, better conditions should see these companies recover over the next year.

A second area where the rerating has not been as extreme as in other sectors is for REITs. While REIT valuations have increased, as shown by the fall in the dividend yield in the chart below, this has not been as large as expected given the general rush into yield stocks. The retail REITs in particular have been left behind, based on concerns over the broader retail environment.



Source: Refinitiv Datastream, Evans & Partners

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