view from the OUTER

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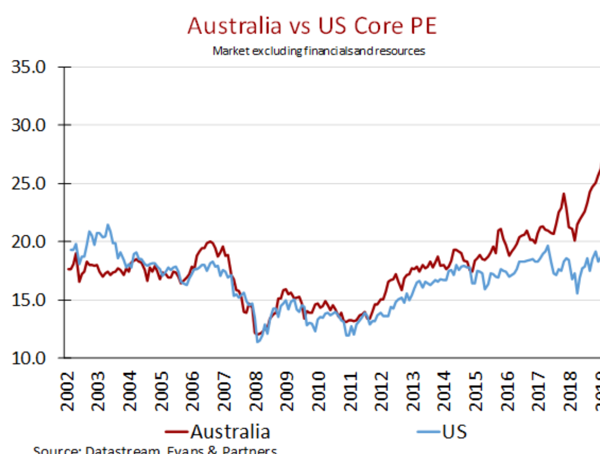
Navigating local risks

Valuations for the Australian market have reached extremes. The forward Price Earnings Ratio for the overall market has only been higher at the peak of the tech bubble in 1999 and valuations have never been higher compared with the US. The added challenge is that this is occurring at a time when economic and earnings risks are high. Concerns around the coronavirus also adds to this picture.



Investors should consider a number of strategies to combat this situation:

- Reduce overall exposure to the Australian market. We would not recommend selling out completely but a trim of around 5% for those with balanced portfolios would be sensible. This could be reallocated to offshore equities (where there are some opportunities), credit or cash.
- A review of individual stocks where valuations are particularly stretched and earnings risk is high. Some stocks in this category are CBA, Brambles and REA. Our analysts also have negative recommendations on Westpac, Mirvac, Resmed, Coca-Cola Amatil, Coles and JB Hifi.
- Consider switching to stocks where valuations are not as stretched such as parts of the Real Estate Investment Trust sector.
- Review exposure to managed products. A period of high overall valuations and the potential for volatility points to better returns being available from active managers, particularly long short ones, compared with passive. Investors might also want to consider introducing option strategies such as buy-write funds that traditionally do better in flat or falling markets.

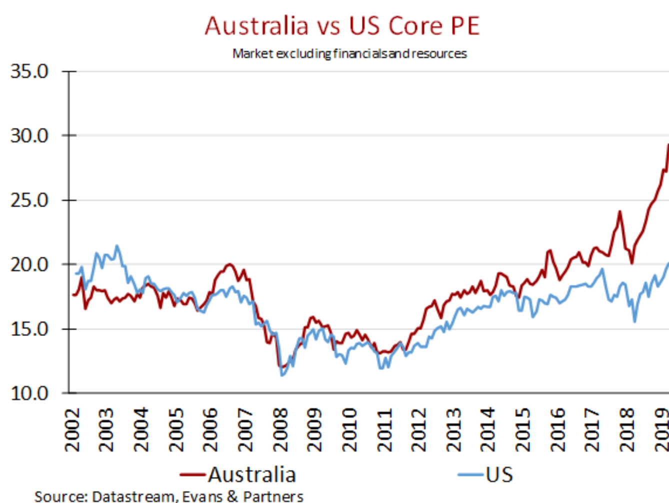
Navigating local risks

Over the past month the Australian market valuations have surged higher again. This has occurred at a time when economic and earnings risks have increased. We are also entering a particularly risky time as the Australian earnings seasons commences at the end of this month, and concerns around the Coronavirus will only add to this uncertainty.

We reiterate our underweight recommendation on the Australian market and in this note we discuss some ways in which investors can adjust portfolios and stock holdings to take account of the current situation.

Valuations are now extreme…

Australian valuations now are at an extreme level and are even more expensive than they initially appear. To demonstrate this in the chart below we have compared Australian and US valuations and have taken banks and resources out of both calculations. We call this the "Core" market PE.



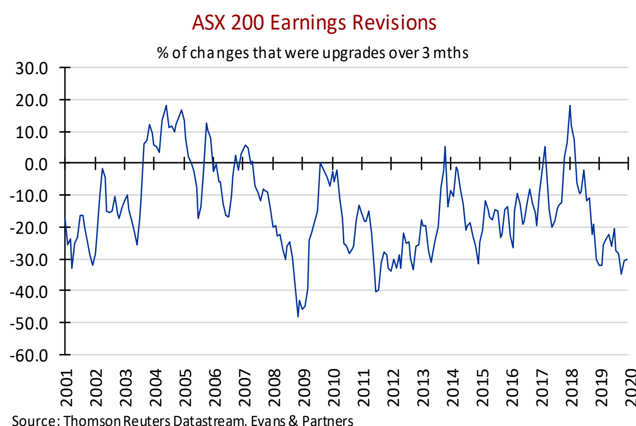
Source: Datastream, Evans & Partners

The main reason for the exclusions is that financials dominate the Australian market and tend to trade at lower PE valuations. This is particularly true at the moment given earnings and regulatory risks. The lower PEs for the banks masks the extent of the overvaluation in other sectors. For resources, PE tends not to be a good measure of valuations because earnings can be very volatile.

The result is stark. The PE of the Australian Core market is now close to 30x compared with the US market at 20x. This is despite the US market generally having better earnings growth prospects. For example, forecast Earnings Per Share growth for the US over the next two years is around 8% compared with 4% for Australia.

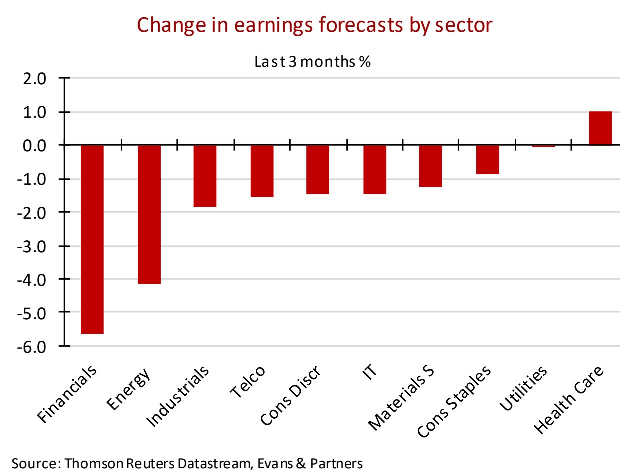
..when earnings are about to be tested

These valuations will be tested during the next Australian reporting season that commences from 1 February. Recent news on earnings has been poor. There were significant earnings downgrades during the last few months of the year. In fact, the earnings revisions ratio (the net percentage of earnings changes that were downgrades) hit a nine-year low.



Source: Thomson Reuters Datastream, Evans & Partners

As a result, the EPS growth forecast for the current financial year has been cut to 4% (from 8% in August). The earnings changes during this period were most extreme in financials, energy and industrials.



Source: Thomson Reuters Datastream, Evans & Partners

Unfortunately for the domestic economy, the outlook does not look any better as we enter 2020. We expect the economy to remain a struggle as the domestic consumer remains hamstrung by low wage growth and an increased appetite to save. Household discretionary spending

remains very weak and there is little evidence that recent initiatives have provided any improvement. The RBA's 2019 interest rate cuts will provide some relief to the economy, but the impact is likely to be small given households are reluctant to spend and that housing construction is unlikely to bounce. The recent bushfire crisis is likely to add to these risks and there is already evidence of a fall in consumer confidence. The evidence from previous natural disasters is that consumer spending can be soft for some months afterwards.

How to adjust portfolios

We see a number of ways that investors should adjust their portfolios to take account of the current state of valuations.

1. Reduce overall Australia equity weightings

In our 2020 outlook piece (Global Allocator 2020 outlook, 14th January 2020) we advocated an underweight position in Australian equities and expressed a preference for Europe and Emerging Markets within global equities and overweight positions in cash and credit. We would not recommend selling out completely but a trim of around 5% for those with balanced portfolios would be sensible.

2. A review of individual stock holdings

To consider some stocks that might be vulnerable, we have prepared a screen of stocks that have experienced recent downgrades and are trading above historical valuations. Some stocks that stood out on this were REA Group (REA, Neutral), Cleanaway Waste (CWY, Neutral), Brambles (BXB, Neutral) and Commonwealth Bank (CBA, Negative) stand out. We also highlight those companies where our analysts have negative recommendations. These include Westpac, Resmed, Coles and Mirvac.

Some of our stock analysts have been reviewing the outlook for earnings and have come up with the following findings.

- **Banks**. The fundamental outlook for the banks remains challenged. Margin pressure, fee headwinds, subdued credit growth, remediation charges, expenses growth and increasing competition all look to persist. While we recognize there is some relative value in the sector, we believe the discount will endure and it will be difficult for the sector to outperform as earnings and dividends come under pressure. Top picks in the space are Australia & New Zealand Banking Group (ANZ, Positive) and National Australia Bank (NAB, Positive), while CBA (Negative) has the most downside risk.

- **Healthcare**. The domestic healthcare sector continues to perform well, outperforming the broader market with a combination of earnings growth and valuation expansion. Large caps CSL (Positive) and Ramsay Healthcare (RHC, Positive) are the team's key picks for the upcoming reporting season, driven by earnings expectations and strong volume growth respectively.

High Valuations and Downgrades

Code	Company	Sector	E&P Rec	Market Cap $B	Forward PE		Book Value		Dividend Yield		Revisions last 6mth mths	
					Now	Prem to 10yr ave %	Now	Prem to 10yr ave %	Now	Prem to 10 yr ave %	EPS	Sales
REA	REA Group	Communication Services	Neutral	15.2	46.8	52.3	14.1	37.4	1.1	51.9	-10.8	-8.6
NEC	Nine Entertainment	Communication Services	NR	3.3	16.2	41.1	1.3	7.4	5.1	22.5	-16.0	-7.1
IAG	Insurance Australia	Financials	NR	17.8	19.5	36.1	2.7	29.8	4.1	29.1	-8.1	-2.5
CWY	Cleanaway Waste Limited	Industrials	Neutral	4.3	29.9	35.0	1.6	85.0	1.8	-39.0	-17.4	-5.1
BXB	Brambles Limited	Industrials	Neutral	19.0	24.8	33.4	6.5	35.6	4.1	-23.1	-18.0	-10.3
TPM	TPG Telecom Limited	Communication Services	NR	6.5	25.0	30.1	2.1	-41.1	0.6	nm	-6.4	-6.0
CWN	Crown Resorts Limited	Consumer Discretionary	Neutral	8.5	23.4	25.0	1.7	-12.3	4.8	-5.0	-9.4	-7.8
CBA	Commonwealth Bank	Financials	Negative	148.6	17.2	23.8	2.1	-6.9	5.1	8.6	-5.6	-1.8
NHF	Nib Holdings Limited	Financials	NR	2.6	19.2	16.8	3.4	1.1	3.4	28.4	-12.3	-0.9
MPL	Medibank Private Limited	Financials	NR	8.8	22.0	12.1	4.6	1.3	3.9	-1.3	-7.7	-0.5
ILU	Iluka Resources	Materials	NR	4.0	16.4	nm	4.1	47.4	1.6	54.1	-38.1	-14.4
OZL	OZ Minerals	Materials	NR	3.6	21.9	nm	1.2	36.3	1.9	58.5	-14.1	-4.4
BSL	Bluescope Steel Limited	Materials	NR	7.9	18.7	nm	1.1	40.9	0.9	39.3	-18.0	-3.1

Negative Recs from E&P

Code	Company	Sector	E&P Rec	Market Cap $B	Forward PE		Book Value		Dividend Yield		Revisions last 6mth mths	
					Now	Prem to 10yr ave %	Now	Prem to 10yr ave %	Now	Prem to 10 yr ave %	EPS	Sales
WBC	Westpac Banking Corp	Financials	Negative	90.5	13.8	9.4	1.3	-26.5	6.3	-1.2	-21.3	-4.5
BOQ	Bank of Queensland	Financials	Negative	3.3	11.4	-17.7	0.8	-27.6	6.9	-7.1	-15.9	-1.2
AMP	AMP Limited	Financials	Negative	6.6	10.9	-23.2	1.3	-37.4	2.0	184.2	-11.3	7.9
BEN	Bendigo and Adelaide	Financials	Negative	5.1	13.6	11.7	0.9	-6.7	6.4	-1.2	-1.0	-0.9
MGR	Mirvac Group FP	Real Estate	Negative	13.1	18.9	30.2	1.2	28.9	3.6	47.0	0.9	4.0
RMD	Resmed Inc	Health Care	Negative	33.6	39.2	69.0	14.0	150.4	1.0	20.4	5.8	1.4
CCL	Coca-Cola Amatil	Consumer Staples	Negative	8.5	22.5	29.5	5.3	27.2	4.1	14.6	1.3	1.6
COL	Coles Group	Consumer Staples	Negative	21.2	23.8	21.1	6.2	16.7	3.5	-11.4	0.9	-4.7
ALL	Aristocrat Leisure	Consumer Discretionary	Negative	23.6	23.2	2.4	7.9	3.4	1.8	32.9	2.9	2.5
JBH	JB Hi-Fi Limited	Consumer Discretionary	Negative	4.6	18.0	32.4	4.1	-23.5	3.7	31.2	6.1	0.2

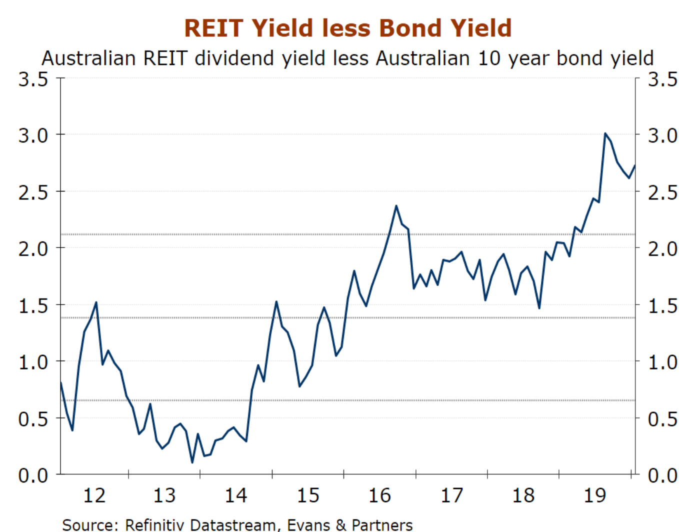
Source: Refinitiv, E&P. Pricing as at 23rd January

- **Technology**. Paul Mason sees more positive than negative themes across his coverage universe. He is optimistic of near-term valuation support given low bond yields and relatively unencumbered growth rates. He highlights short-term trading opportunities in IRESS (IRE, Neutral) and APX (Appen, Neutral), and believes risks are skewed to upside for Carsales (CAR, Positive), NEXTDC (NXT, Positive) and Seek (SEK, Positive).
- **Listed infrastructure**. Sydney Airport (SYD, Positive) and Transurban (TCL, Neutral) should continue to be supported by investors given attractive dividend yields and defensive cash flows in a low interest rate environment. Our preference is SYD given its strong (but cyclical) growth profile, attractive FY20E dividend yield (4.6%) and sound balance sheet. Head of Research, Cameron McDonald, highlights that both SYD and TCL are positively leveraged to the lower for longer interest rate environment: a 100bps fall in the risk-free rate (currently: 5.0%) results in 18% and 13% increases to valuations for SYD and TCL respectively.
- **Small caps**. Within small caps there have been a series of profit downgrades, mainly attributable to weakness in domestic economy, which have largely been ignored by the market. Growth stocks continue to be bid up by investors further expanding PERs and sales multiples, well in excess of large cap counterparts. Executive Director and Small Caps analyst, Julian Mulcahy, highlights Blackmores (BKL, Positive), Catapult (CAT, Positive) and John Lyng (JLG, Positive) as three companies that could outperform over the period and defy the market expectations. Conversely, Julian is watchful over high PER names Nearmap (NEA, Neutral) and Pro Medicus (PME, Neutral), in addition to turnaround story BWX (BWX, Neutral).

3. Consider stocks where valuations are reasonable

The Australian REIT sector is one section of the market that looks attractively priced. From a valuation perspective REITs are trading on a forward multiple of 17.6 compared to Industrials which trade at closer to 30x. REITs have historically traded around the same multiple as Industrials, however REIT multiples expanded by 2.5 points in 2019, while Industrials expanded by 5.0 points.

Multiple expansion has resulted in the dividend yield for the sector compressing by 70bps to 4.5%, however when compared to other interest rate securities and the broader market, we believe this looks attractive, especially when considering the more defensive cash flow profile. The yield spread to the Australian 10-year Government Bond also looks positive, sitting 120bps above its 10-year average spread.



Falling interest rates should continue to provide a tailwind for the domestic REIT market, with the RBA's 2019 cuts proving to be a catalyst for cap rate compression. Looking ahead, majority of economists are forecasting at least 2 cuts to the official cash rate this year, something that should be conducive for assets with bond-like cash flows and long lease profiles. The domestic REIT market should continue to attract capital as investors adopt a 'lower for longer' attitude to interest rates.

Our key picks within the specialized REIT space are pub operator, Hotel Property Investments (HPI, Positive), and convenience retailer and petrol station operator, Viva Energy REIT (VVR, Positive). Meanwhile, within the traditional property sector, Senior Research Analyst, Robin Young, prefers APN Industria REIT (ADI, Positive) and Unibail-Rodamco-Westfield (URW, Positive).

4. Review exposure to managed products

Actively Managed Exposures

Given our concerns surrounding the domestic equity market and the potential for volatility, we believe actively managed strategies found in managed funds, listed investment companies or trusts (LICs/LITs) and exchange traded funds (ETFs) have a greater likelihood of outperforming. History tells us that actively managed strategies have outperformed when there are higher than average levels of volatility and greater performance dispersion amongst stocks. This is because active managers are able to avoid those companies most vulnerable to risks,

whether they be systematic or unsystematic, and take advantage of price dislocations when they occur.

Long Short Strategies

Long short strategies go one step further than traditional long-only strategies by shorting stocks or baskets of stocks that they believe are overvalued and are going to fall in price. This theoretically provides the manager with twice as many opportunities to generate value than long-only or passive strategies. Because long short strategies attempt to identify companies that are going to fall in price, they will typically underperform in a bull market where the majority of stocks are rising. Conversely, they have exhibited outperformance during periods of flat or falling markets, where they have been able to generate value from their shorts and weather volatility.

Given our concerns surrounding current valuation levels and earnings risks due to both cyclical and structural factors, long short managers conducting both fundamental and tactical research should be better positioned to outperform and protect capital. Long short strategies also play a valuable role from a portfolio construction perspective as they will typically have a lower correlation to the market and experience lower drawdowns than long-only managers, subsequently providing a smoother ride for investors.

Option Strategies

Generally speaking, options strategies such as buy-write or protective put strategies should outperform in down, flat or mildly rising markets. Buy-write strategies seek to earn greater income than traditional long-only strategies by purchasing stocks and then writing out-of-the-money call options against the stock position. The writing of the call option provides additional income via the option premium, in return for forgoing potential future returns via price appreciation. Buy-write strategies have traditionally generated a 2% income premium to long-only strategies however this will fluctuate dependent on the level of the implied volatility within the market. Put simply, the more volatility, the greater the income premium and the higher probability of outperformance.

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