View from the
OUTER

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Australian dawn

The macro environment is rapidly changing as health concerns ease faster than expected and economies emerge from hibernation. While overall equity market valuations appear challenging there are a range of sectors that will benefit from this next phase.

Looking first at restart beneficiaries, a few areas that we think are interesting are:

- The auto sector. Auto usage is picking up as we re-emerge but many are reluctant to return to public transport. Auto related companies include toll roads (TCL), service stations (Waypoint), auto parts (Supercheap and ARB) and car sales (Carsales).
- Housing sector. The earlier return of open-houses and auctions suggests a quicker bounce for turnover that will benefit the selling platforms (REA and Domain) and some of the developers (Stockland and Mirvac).
- Financials were particularly affected in the early stages of the crisis particularly the banks, fund managers (Janus, Pendal, Magellan, Platinum) and other stock market related stocks (Computershare). These will benefit from a shorter downturn.
- Activity through malls is returning faster than expected (Scentre and Vicinity).

Government policy has so far been directed at mitigating the economic damage from the crisis. Over the next few months there is likely to be a switch towards policies directed to supporting the economy and jobs over a longer period. There are two obvious areas where such policy could be directed:

- Housing. An introduction of more targeted housing support would result in broad-based benefit to the entire housing supply chain from materials (CSR, Boral, James Hardie) to developers (MGR, SGP) and the platforms (REA, Domain).
- Infrastructure. This is another sector favoured by policy makers to drive growth. This will be a broad support for commodity producers and contractors (Downer, CIMIC) and materials (ABC).

Recommendation

Given that overall market valuations are stretched and many sectors are back close to historical high valuations, investors need to be particularly selective in where they invest at the moment. Some areas where valuations are high are the “quality” companies that benefitted most from the first phase of the bounce back such as in healthcare and technology.

Instead, investors need to focus on areas where reasonable value remains or where there is a positive macro catalyst. The sectors we have identified in this note are autos, property, financials and malls. This is the case in Australia as well as globally.

Overall, we retain our neutral recommendation on Australian equities and a small underweight in international equities in regions where the health crisis lingers and the economic damage has been more acute particularly in emerging markets and Europe.

Australian dawn

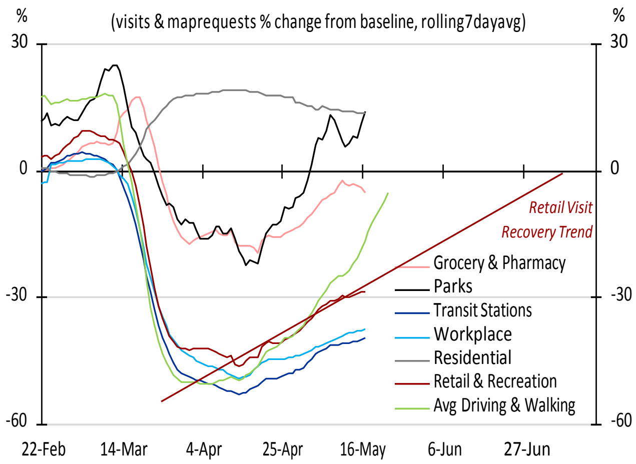
The macro environment is rapidly changing as health concerns ease faster than expected and economies emerge from hibernation. Equities markets have moved very quickly too factor this in overall – and may be moving too quickly considering health risks will linger for some time and we are not yet able to assess the permanent damage to businesses and labour market from the shock. Nevertheless, there are a range of sectors that will benefit from the early restart, further policy measures and the permanent changes in behaviour that will result from the crisis.

Restart winners and losers

When thinking about some of the winners from the restart, it is important to note that the return to normalcy is likely to be slow and uneven. Households are still cautious on the health front and making a slow return to many activities. A survey in China – the first country to emerge from lockdown – found that only 25% of consumers are willing to leave the house for discretionary shopping or leisure. It is also interesting that Sweden – which famously did not have a lockdown – has experienced broadly similar economic outcomes than many countries that did. In other words, it seems likely that consumer behaviour would have changed significantly even if lockdowns did not occur and will remain affected for some time even now some shackles are being removed.

The unevenness of the recovery is shown by the chart below that uses data from Google and Apple to track people movements in the US. Since lockdowns eased, the biggest change has been an increase in walking and visits to parks. The increase in visits to retail centres and to public transport ("transit stations" in the chart) has been very low. There has been a desperate need to get out of the house but a reluctance to return to places where there will be a lot of other people.

GLOBAL MOBILITY - US



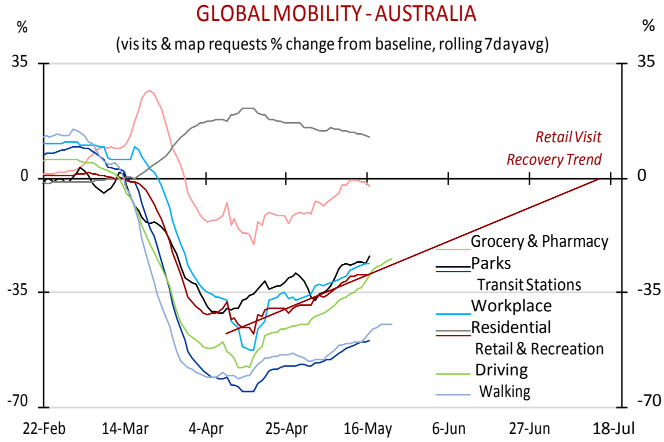
Source: Google, Apple, Evans& Partners

This chart is useful when we are thinking about winners and losers from the restart. The obvious losers now are those that rode the wave of panic buying in groceries, gym equipment, home office supplies and DIY. Demand was brought forward and there now could be an overhang. Even if there are permanent changes in behaviour that support these products, recent trends cannot be sustained.

Looking at some of the beneficiaries of the early restart, a few areas that we think are interesting are:

- The auto sector. Auto usage is picking up as people re-emerge put there could be a permanent increase in car transportation as commuters are reluctant to return to public transport. So even though there may be more workers at home overall road use may rise. This could benefit a broad range of auto related companies in Australia including toll roads (Transurban), service stations (Waypoint), auto parts (Supercheap and ARB) and car sales (Carsales).

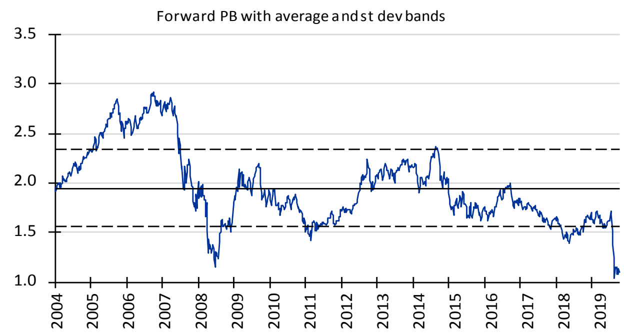
GLOBAL MOBILITY - AUSTRALIA



Source: Google, Apple, Evans & Partners

- Housing sector. The earlier return of open for inspections and auctions suggests a quicker bounce for turnover that will benefit the platforms (REA and Domain) and some of the developers (Stockland and Mirvac).
- Financials were particularly affected in the early stages of the crisis including the banks, fund managers (Janus, Pendal, Magellan, Platinum) and other stock market related stocks (Computershare). These will benefit from a shallower and shorter downturn. On the banks, we note Matt Wilson's concerns that the banks are underestimating the risk of bad debts but the quicker recovery will reduce these risks and valuations are close to 30 year lows particularly for ANZ and NAB.

Price-to-book ratio (PB) for Australian Major Banks



Source: Thomson Reuters Datastream, Evans & Partners

- Activity through malls is returning faster than expected. The challenge here is that there will be some permanent damage to malls because some tenants will default, rents will need to be reset, vacancy rates will stay high and overall turnover will not return fully to pre-COVID levels. Malls will not be fully the same given restrictions on customers per store, the limited operation of food courts and the lack of change rooms. Nevertheless, the early reopening of many stores means that the downside is not as bad as feared. There is also some offsets because if consumers are forced to spend less on overseas holidays then spending will be redirected to other areas which might include more gadgets and clothes. The chart below shows data from ANZ and demonstrates how quickly spending has returned on mall items such as clothes and beauty.

Australian credit card spending on mall items

Source: ANZ Research

The previous discussion has been mostly focussed on the Australian situation but many of these same themes will play out globally and could support autos, property, financials and malls in other markets.

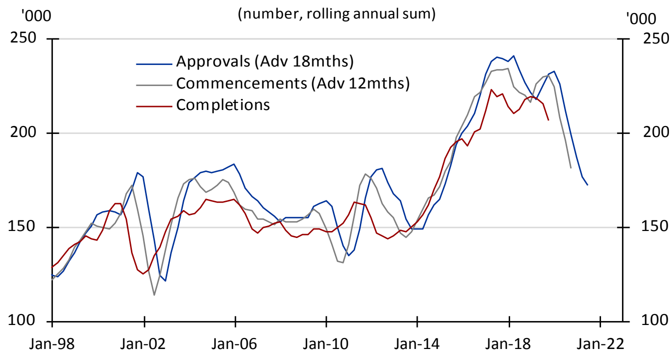
The next wave of policy

Government policy has so far been directed at mitigating the economic damage from the crisis. Over the next few months there is likely to be a switch towards policies directed to supporting the economy and jobs over a longer period. Prime Minister Morrison has indicated this in recent speeches. Note that some countries are better positioned to do it than others and this is one of the reasons why Australia is better positioned than many countries to have a strong recovery.

There are two obvious areas where such policy could be directed:

- Housing. We have already mentioned the housing stocks as beneficiaries of rising housing turnover. However, an introduction of a full package housing support would result in broad-based benefit to the entire housing supply chain from materials (CSR, Boral, James Hardie) to developers (Mirvac, Stockland) and the platforms (REA, Domain). Such housing support is likely to include the full return of First Home Owners Grants as is already being rumoured. In the aftermath of the GFC this was a sector that received a boost for several years in many countries.

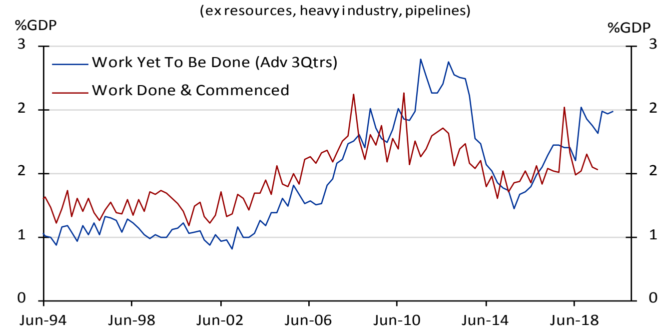
AUSTRALIA HOUSING ACTIVITY
(number, rolling annual sum)



Source: ABS, Evans & Partners

- Infrastructure. This is another sector always favoured by policy makers to drive growth. The nuances this time are that Australian activity is already high and Chinese initiatives look like being much less than in the GFC. Nevertheless, this will be a broad support for commodity producers and contractors (Downer, CIMIC) and materials (ABC).

AUSTRALIA: ENGINEERING CONSTRUCTION
(ex resources, heavy industry, pipelines)



Source: ABS, Evans & Partners

Beneficiaries of the new normal

The other set of beneficiaries are winners from the new normal. It is clear that there will be some permanent changes in behaviour that will have a range of implications (that we will explore more fully in subsequent notes) including:

- An acceleration in the switch to online shopping. According to a survey by the Centre for the Digital Future 39% of people said they would permanently do more shopping online. This benefits the online sellers directly and companies providing the infrastructure to support this including transport and warehousing.
- An acceleration in the demise of cash and use of cards and electronic payments
- The COVID crisis has made working from home more acceptable. The same survey found that 52% of people intend permanently increase the amount of time spent working from home and it is clear many companies are facilitating and encouraging it.
- Travel will be permanently affected. There will be fewer business trips and overseas travel will take some time to normalize even if a vaccine is discovered early.

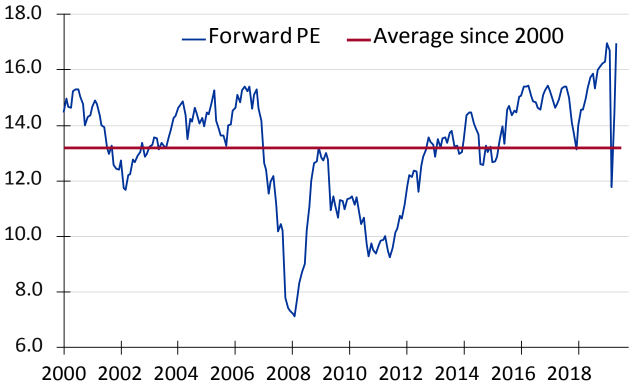
A stock pickers' market

The preceding analysis shows that there are some interesting opportunities within markets at the moment given rapid changes in the environment. However, it is important to note that overall valuations are stretched.

The chart below shows our preferred measure for the moment that compares price with earnings 2 years forward. We do this because earnings will collapse over the next 12 months but return to something closer to normal in the year after that. We also note that risks remain extremely elevated particularly from prospects of a flare-up of the health crisis or second round effects from the economic downturn.

ASX 200 Valuations

2 yr forward Price to Earnings ratio

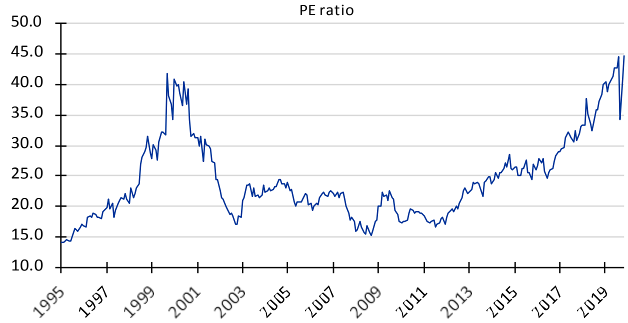


Source: Refinitiv, Evans & Partners

This means that investors need to be particularly selective in where they invest at the moment. Some areas where valuations are particularly stretched are the "quality" companies that benefitted from the first phase of the bounceback. In Australia's case these were concentrated in healthcare and technology. As a group these have now returned back to peak valuations.

Growth Stock Valuations*

PE ratio



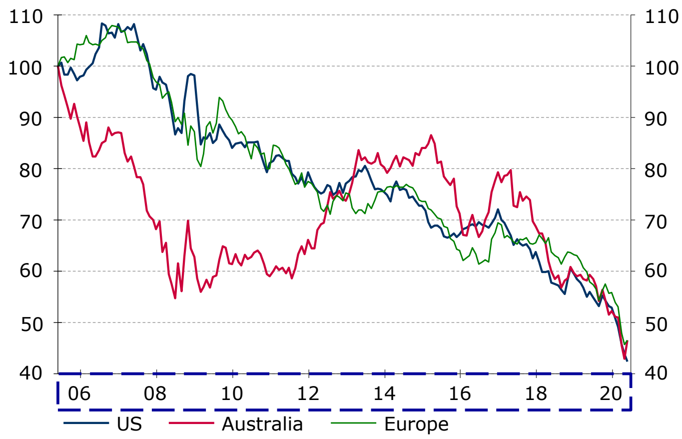
*PE of the 90th percentile stock in the ASX 200 Industrials when ranked by PE

Source: Refinitiv, Evans & Partners

Instead, investors need to focus on areas where valuations remain or where there is a positive macro catalyst. The sectors we have identified in this note are autos, property, financials and malls. This is the case in Australia as well as globally. These sectors generally fall into the "value" universe and value is now trading at the largest discount to growth in recent history. The gap has been wide for some time but what is different now is that there is a clear catalyst to drive this switch.

Value vs Growth by Region

MSCI styles indices, Index to 100



Source: Refinitiv Datastream, Evans & Partners

Overall, we retain our neutral recommendation on Australian equities and a small underweight in international equities in regions where the health crisis lingers and the economic damage has been more acute particularly in emerging markets and Europe.

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