



WILSONS

Focus List June 2022 - Shifting to a Maturing Cycle

Our monthly view on Australian equities.

08 June 2022

The Market in May

May was a tricky time to be an Australian investor with the market falling 3% over the month, underperforming the MSCI World ex Australia over the same period (-1.1%).

The macro still seems to rule the roost. Inflation remained the market's key concern as inflation pressures proved stubborn, exacerbated by the ongoing war in Ukraine and supply chain issues with lockdowns in China. Growth indicators are still holding up, but higher interest rates throughout the globe (except China) are leading to concern this cycle may be shorter than expected, with recession concerns bubbling up.

Concern around central bank hawkishness eased slightly. However, the outlook for interest rates remains unclear, leading to lingering concern over growth stocks with valuations remaining sensitive to higher bond yields. IT was one of the worst sectors in May, down 8% for the month.

Cyclicals have also not escaped unscathed; the market has become increasingly concerned over whether the US Fed can engineer a soft landing while taming the inflation fire. The US economy is such an important cog in the global economy that a recession will likely be felt globally including Australia.

The typical defensive sectors like utilities and healthcare outperformed in May as market concerns over inflation and growth pushed investors to safe haven equity sectors. We believe a shift towards quality defensives is sensible.

Read [The Case for Quality Defensives](#)

Inflation hedges continued to outperform, with materials and energy also performing strongly. The prospect of an end to China's Covid lockdowns led to a small relief rally in resources (namely iron ore and copper) at the end of the month. Energy continues to be the star sector of the year so far, with a tight market seemingly getting tighter as the Russia/Ukraine conflict persists.

Figure 1: Resources and selected defensive sectors outperformed in May

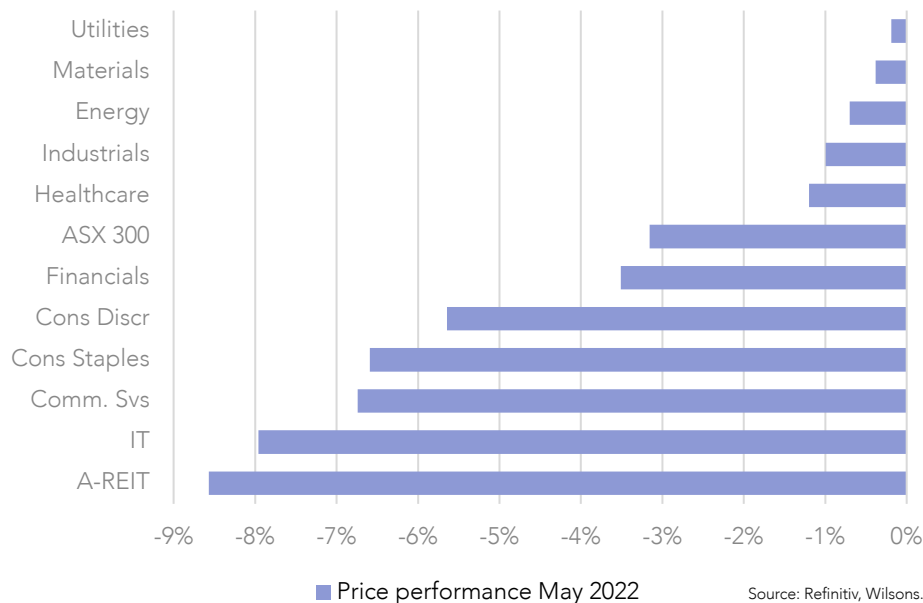
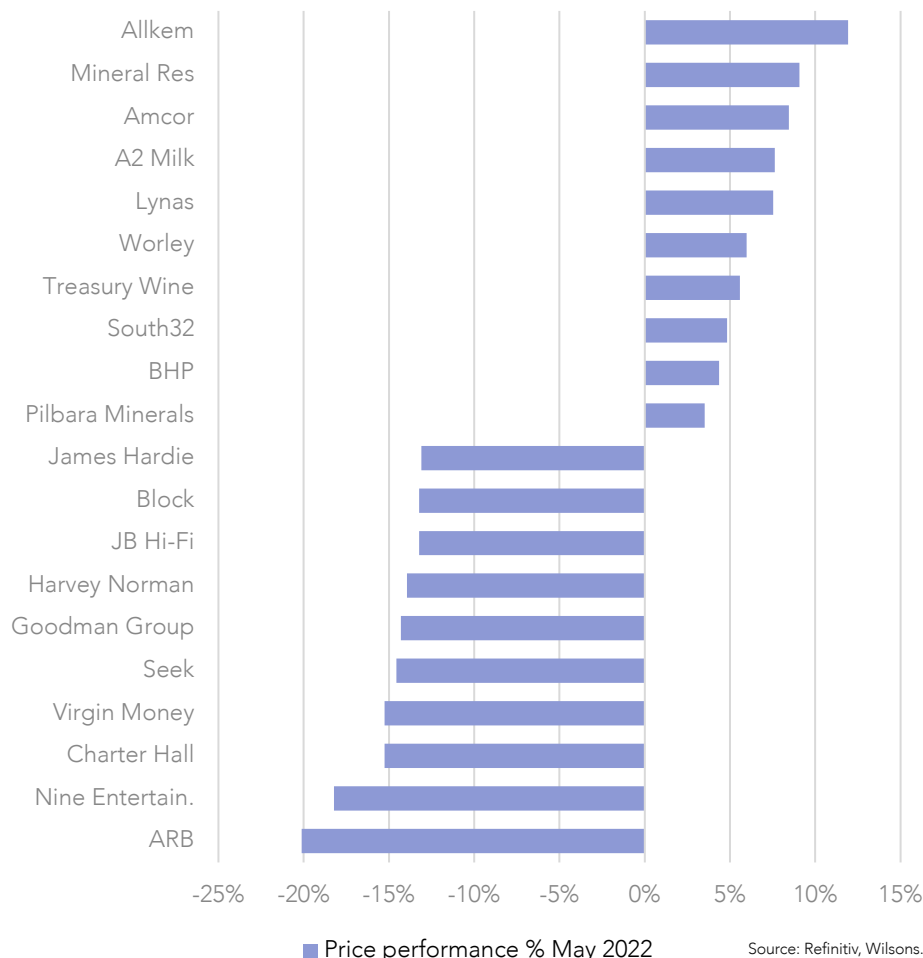


Figure 2: EV minerals, traditional resources and low beta stocks performed well in May. Retailers and growth stocks were the worst performing



ISG Views for June

We have probably entered a more mature part of the cycle, with GDP likely continuing to slow from here. This is simply a slowdown from the higher growth phase of the cycle. It does not mean we are experiencing negative economic growth, it just means we are not growing at the same rate as previously. However, investors will have to navigate a period where economic and earnings growth could be vulnerable to downward revisions.

Looking ahead, we have increased our weighting to higher quality businesses we believe will be more resilient to the increasing downside risk. We have reduced our overall beta of the portfolio to reflect the lower returns and higher volatility we expect to see. We have also increased our weighting to companies we feel are less likely to disappoint as economic growth and earnings growth slow. Companies with stable earnings growth and margins should be looked at favourably in this stage of the cycle.

Inflation hedging is important as the globe experiences the current price pressures, especially while in the midst of the Ukraine/Russia conflict (and we think this conflict could go on for a bit longer). Energy and materials are a good source for inflation hedging, and we continue to like energy as a source of inflation protection over the next 6-12 months.

Despite slowing economic growth, we still believe banks can outperform as Net Interest Margins (NIM) expand over the next year in tandem with rate rises from the RBA, leading to earnings growth. In our view, the rate hike cycle and corresponding higher NIMs should offset the slowdown in credit growth as rates rise. Asset quality should remain robust as household and corporate balance sheets are generally healthy.

We maintain a substantial underweight to goods retailers, especially those that have benefitted from the pandemic environment, such as electronics and household goods. Stocks like JB Hi-Fi (JBH), Harvey Norman (HVN) and Wesfarmers (WES) have been sold off over the last 6 months. Even so, we still believe that these stocks could face further earnings downgrades as margins are further squeezed by inflationary pressures.

We remain underweight the consumer staples sector, with the pandemic and food inflation leading to earnings volatility that keeps us cautious on this sector. However, we believe this sector should outperform in the latter part of the cycle. We still do not see valuations as compelling, but if more indicators start flashing red on the state of the economy this will likely be a catalyst for adding this sector to the Focus List.

Figure 3: AU market earnings are still being upgraded, but we believe this could change over the 2nd half of CY22

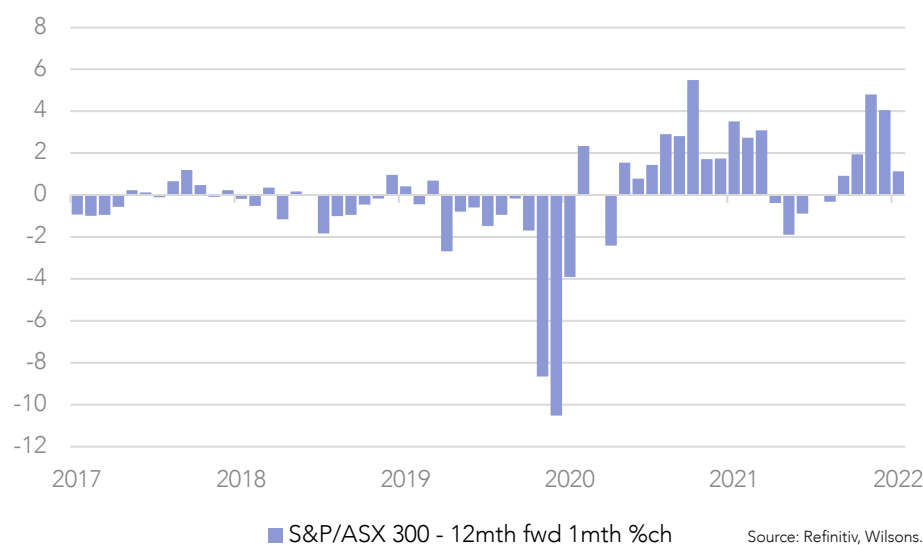


Figure 4: Energy and materials have provided most of the earnings upgrades over the past quarter

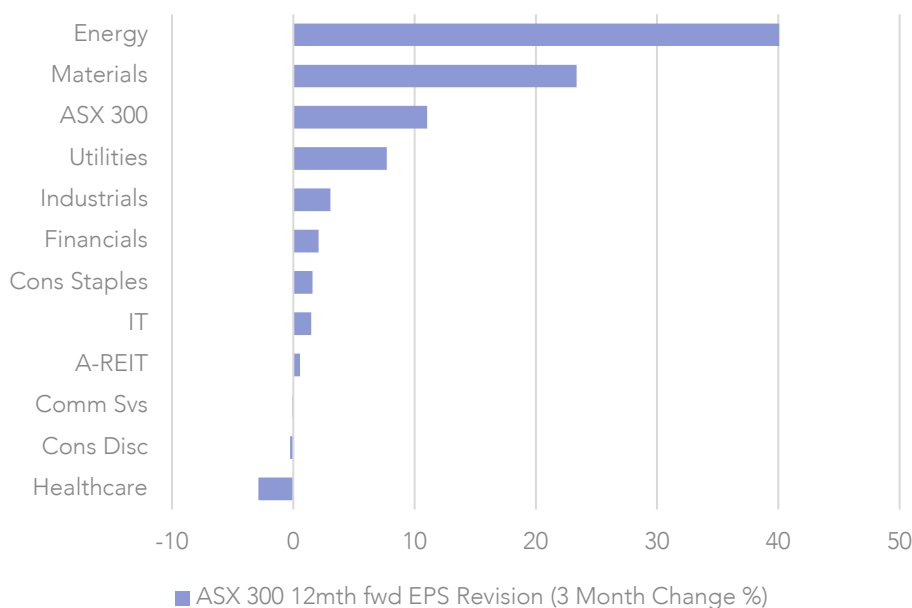


Figure 5: Focus List positioning

Sectors	May Weighting	June Weighting	Focus List Stocks	ISG View
Cyclical				
Resources	23.0%	22.5%	BHP, STO, WDS, OZL, NST, AKE	<p>The Focus List is underweight resources at a headline level, but this is predominately due to our weighting in iron ore focused miners rather than our weighting to other sub sectors. We like resources as an inflation hedge and protection against a longer than expected Russia/Ukraine conflict. China's COVID lockdowns have added some risk to iron ore demand in the short-term, but could lead to more Chinese stimulus in the next 12 months.</p> <p>Energy remains our biggest overweight and we have added Woodside (WDS) to provide the Focus List with a higher weighting to the energy sector while adding some diversification in our exposure to the sector.</p> <p>Focus List is Overweight: Energy, Copper, EV minerals. Underweight: Iron Ore.</p>
Banks	20.5%	22.5%	NAB, WBC, ANZ, JDO	<p>The Focus List moved to overweight the banks in May. After the HY results we have remained positive on the banks. As we enter a period of rate hikes from the RBA, banks' margin pressure will likely ease, and ultimately this will be the key driver of earnings growth over the medium-term.</p> <p>We believe the net interest margins (NIM) of the majors will grow faster than consensus forecasts, leading to earnings upgrades over the next 2 financial years. Additionally, we believe bank valuations are still on the cheaper side, which could provide an opportunity for a rerate in the short-term.</p> <p>We believe business lending bank NAB is better positioned to grow loans in the next phase of the cycle than home loans since there has been such intense competition in mortgages. We therefore have a higher weighting in banks like NAB over the home lenders. However, we believe valuations for Westpac and ANZ will start to rerate as we see margin improvement.</p>
Cyclical Value	7%	7.5%	QAN, SWW, TAH	<p>Resources and banks provide us a large allocation to value but we also hold QAN (as a recovery play) and SWW (proxy to the domestic investment cycle) to gain exposure.</p> <p>We still believe SWW is a misunderstood stock. Boral, Coates, and Westrac have become more defensive over the past decade, more reliant on government infrastructure and mining opex than on the domestic economy.</p> <p>We consider this stock to be good value with a PE ratio of 10x and earnings growth of 16%. Once the market realises that SWW has less volatile earnings than expected, it may rerate the stock.</p>
Quality Cyclical	10%	9%	MQG, JHX	<p>We believe that these quality cyclicals will continue to generate high returns on capital at this point in the cycle, even though higher bond yields are putting pressure on valuations. MQG and JHX remain core holdings of the Focus List.</p> <p>JHX has underperformed YTD as the market seems concerned on the US housing market. We have trimmed our weighting as we get slightly more concerned on the cycle. We still think JHX can increase margins and continue to generate earnings growth over the next few years. At a 12mth fwd PE of 14x, this stocks looks cheap with the risk to the upside in our view.</p>

Growth

Structural Growth	15.5%	14.5%	ALL, GMG, SEK, SLA, PNI	The Focus List has a structural bias towards quality growth. We still hold these stocks as we believe they have a strong growth trajectory over the medium-term, but higher bond yields have heightened valuation pressure over the past 3-6 months. In our opinion, the growth stocks in the Focus List have been oversold over the past few months. The average 12mth fwd PE of these stocks is 20x, below the ASX industrials PE and therefore look reasonable value. US and Australian bond yields are likely at or very close to a peak, while our preferred growth exposures have tangible earnings growth prospects.
High Growth	4%	4%	XRO, TLX	We remain cautious on high-growth stocks that are likely to be highly volatile as the market adjusts to the current risks. Even though we believe some of these high-growth companies are excellent companies, we remain underweight from a valuation perspective until we have greater clarity on inflation and interest rates.

Defensives

Quality Defensive	14%	17.5%	CSL, IAG, TLS, HCW, TLC	We currently have a preference for quality defensives. In a mid-late cycle, we prefer companies we believe will be resilient to the downside risks that are more prevalent in this part of the cycle. Additionally, given the level of uncertainty and volatility that is persistent in markets at the moment, we believe holding names that are less sensitive to the economy and rising rates to be a prudent decision. Our picks are healthcare, lotteries, insurance and telcos.
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Hidden Value

Hidden Value	6%	2.5%	NWS	We are always on the lookout for stocks with hidden value. We find this subset of the portfolio can provide above-market returns that are less correlated to the rest of the market. NWS should have catalysts to highlight value to the market over the next 12 months.
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Source: Refinitiv, Wilsons.

Focus on the Tabcorp Demerger

In May, the Tabcorp (TAH) demerger created two new companies, The Lottery Corporation (TLC) and New Tabcorp (TAH). TLC comprises the lottery business while TAH keeps the wagering and media business.

We continue to like and hold both stocks but have a slight preference to TLC over the medium-term.

Why we like both TLC and TAH?

The Lotteries Corporation (TLC) – 3% weighting in the Focus List

We believe that the lotteries can rerate, providing upside to today's share price. This is predicated on 3 factors:

1 _____

Lotteries is a defensive, infrastructure-like business with long-dated licences

2 _____

Lotteries is growing its online presence which could lead to margin expansion.

3 _____

Lotteries is highly cash generative and capital light

We believe holding an infrastructure-like business in the portfolio adds to our quality defensive factor, which is important as we shift from mid-cycle to late-cycle over the next 12 months.

We believe investors attribute a higher value to defensive companies than those at the mercy of the cycle. Therefore, as a standalone entity, we think the lotteries listed entity can rerate from its value today.

A bid could also be made for the lotteries business after the demerger. Private equity firms typically like annuity-like, defensive companies, just like the lotteries business.

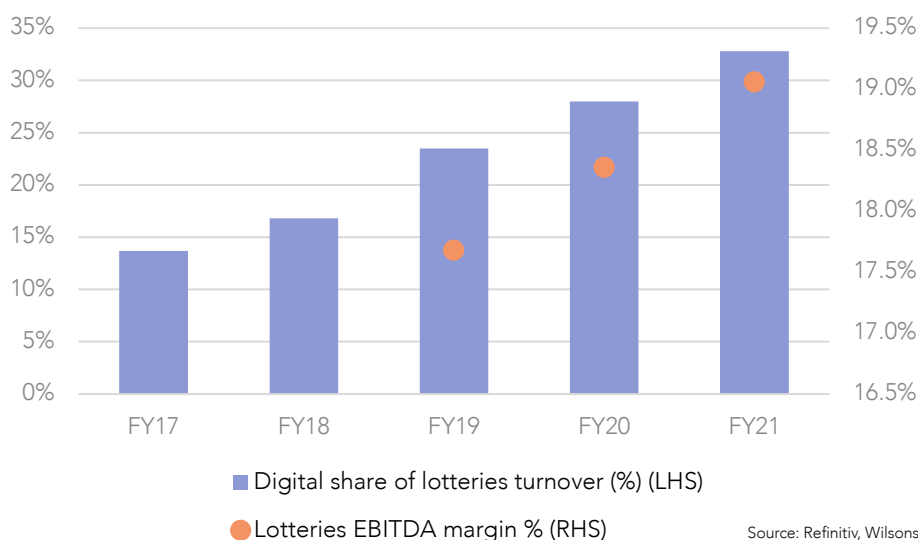
Tabcorp (TAH) – 1% weighting in the Focus List

The wagering and media business should still have upside due to the continued economic reopening. While negatively impacted by COVID-19 these earnings should recover in the next 1-2 years, and we think this could lead to earnings upgrades.

Now that the business is demerged, further bids may be made for the New Tabcorp (Wagering, Media and Gaming Services). Global betting company Entain (ENT.L) and private equity giant Apollo have both bid for TAH's wagering business in 2021. Apollo offered \$4bn for the wagering, media and gaming services businesses combined.

The current market cap of TAH is ~\$2bn and there seems a valuation gap to the bid's pre-demerger.

Figure 6: TLC margins should continue to expand as the digital % of sales increases



Energy Sector Composition Change

Woodside (WDS) - 3% weighting in the Focus List

The energy index has changed since last month after the merger of Woodside (WDS) and BHP's petroleum (BHP-P) assets.

The Focus List received around ~1% in WDS from the in specie dividend from BHP after the merger.

The energy sector is now 5.5% compared to 4.1% at the end of May as WDS's market weight increased substantially after the merger of BHP-P's assets.

We have increased our energy weighting from 5-7% to maintain an overweight position as we still have a positive view on the oil and gas market.

Read [Energy Sector: Stronger for Longer](#)

We still have a preference to Santos (STO) but like WDS after the merger of the BHP-P assets. WDS is well positioned to benefit from the continuing oil and gas upcycle, due to:

- WDS has one of the highest exposures to oil and gas prices in the Australian energy sector.
- We believe the merger between BHP-P and WDS provides substantial benefits to Woodside shareholders, mainly the significant step-up in free cash flow (FCF) that gives WDS the ability to self-fund expansion without coming to the market (a concern for us previously).
- The merger diversifies by product, project and geography.

Santos (STO) – 4% weighting in the Focus List

We have trimmed our exposure to STO by 1% as we diversify our holdings in energy and increase our weighting in Woodside (WDS). We still remain overweight.

BHP (BHP) – 8% weighting in the Focus List

We have trimmed our exposure to BHP by 1% to reflect the change in market weight after the sale of the BHP-P assets in May to Woodside (WDS). We remain underweight.

Other Changes to the Focus List

Increases

CSL Limited (CSL) +0.5%

Increasing our weighting to CSL to add more exposure to quality defensives in a stock we believe still has earnings recovery as the world reopens and plasma collection normalises. We remain overweight.

Trimming

James Hardie (JHX) -1%

JHX has underperformed YTD as the market seems concerned on the US housing market. We have trimmed our weighting as we get slightly more concerned on the stage of this cycle and the impact on JHX's earnings. However, we are still positive on the stock.

We think JHX can still increase margins and continue to generate earnings growth over the next few years, even as the business cycle matures. At a 12mth fwd PE of 14x this stock looks cheap with the risk to the upside in our view.

Seven Group Holdings (SVW) -0.5%

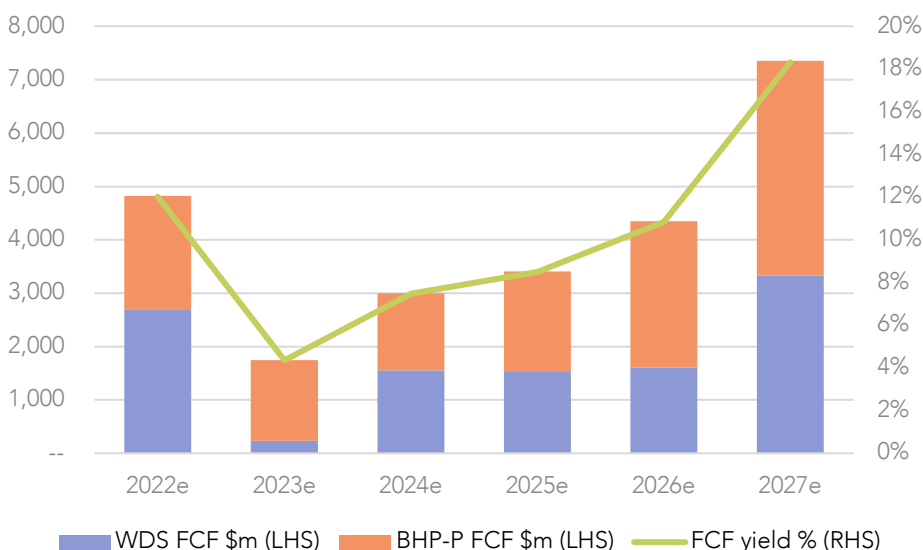
We have trimmed SVW to be less overweight as we enter a slower part of the cycle.

We still believe SVW is a misunderstood stock. Boral (BLD), Coates, and Westrac have become more defensive over the past decade and more reliant on government infrastructure and mining opex than on the domestic economy. We consider this stock to be good value with a PE ratio of 10x and earnings growth of 16%. Once the market realises SVW has less volatile earnings than expected, it may re-rate the stock.

Northern Star Resources (NST) -0.5% and SEEK (SEK) -0.5%

In response to the market moves in these stocks we have trimmed our overweight in NST and SEK.

Figure 7: The merger maintains a higher FCF yield than WDS would as a standalone business



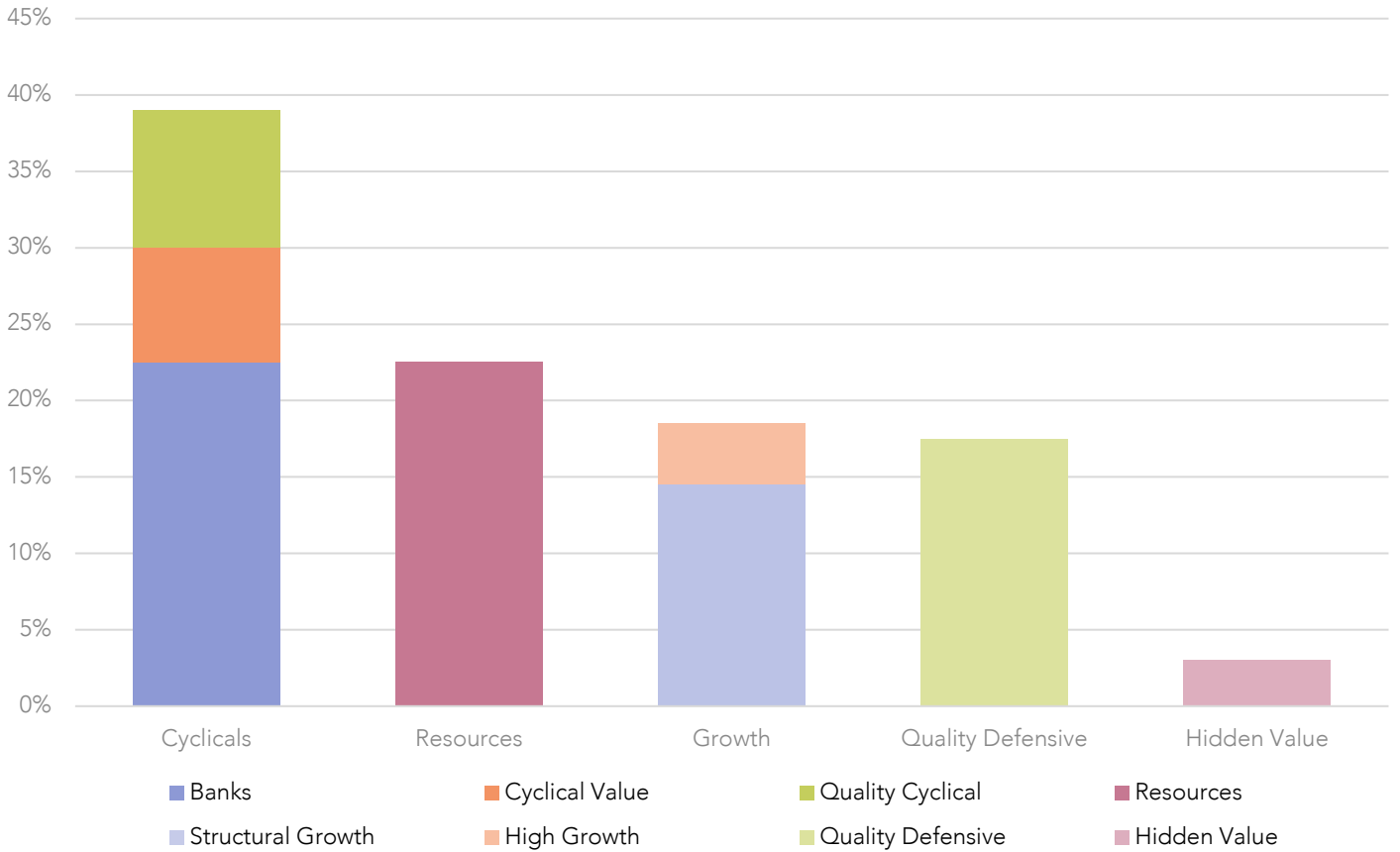
Source: UBS, Wilsons.

Figure 8: Fundamental table for the Focus List

Company Name	Ticker	Old Weighting	New Weighting	Change	Share Price	Market Cap (A\$b)	Forecast Multiples 12mth fwd PE	EPS CAGR % (FY1-FY3)	Dividend Yield % 12mth fwd	ROE (FY1)	Net Debt/EBITDA (FY1)	Consensus Recommendation Mean (5 = Strong Sell, 1 = Strong Buy)
Banks		23%	23%									
Westpac Banking	WBC	6.0%	6.0%	0.0%	23.92	83.9	13.2	18%	5%	8%		2.6
National Australia Bank	NAB	8.5%	8.5%	0.0%	31.11	100.1	13.9	7%	5%	11%		2.4
Australia and New Zealand Banking Group	ANZ	5.0%	5.0%	0.0%	24.82	69.5	11.3	7%	6%	10%		2.5
Judo Capital Holdings	JDO	3.0%	3.0%	0.0%	1.86	2.1	31.5	239%	0%	1%		1.8
Cyclical Value		7%	8%									
Qantas Airways	QAN	4.0%	4.0%	0.0%	5.32	10.1	13.9		2%	-138%		2.2
Seven Group Holdings	SWW	3.0%	2.5%	-0.5%	18.90	6.9	10.1	16%	3%	16%	2.7	2.0
Tabcorp Holdings	TAH	3.0%	1.0%	-2.0%	0.99	2.2	25.4	46%	39%	4%	1.6	2.7
Hidden Value		6%	3%									
News Corp	NWS	2.5%	2.5%	0.0%	24.42	14.2	18.1	13%	1%	6%	0.5	2.0
High Growth		4%	4%									
Telix Pharmaceuticals	TLX	2.0%	2.0%	0.0%	4.15	1.3			0%	-89%	2.9	1.5
Xero	XRO	2.0%	2.0%	0.0%	84.38	12.6	206.6	89%	0%	5%	-0.5	2.2
Quality Cyclical		10%	9%									
James Hardie Industries	JHX	4.0%	3.0%	-1.0%	33.86	15.1	13.8	7%	4%	46%	0.5	1.9
Macquarie Group	MQG	6.0%	6.0%	0.0%	182.90	70.3	16.9	4%	4%	14%		2.3
Quality Defensive												
CSL	CSL	7.0%	7.5%	0.5%	270.86	130.7	33.3	18%	1%	19%	2.3	1.8
Insurance Australia Group	IAG	3.0%	3.0%	0.0%	4.21	10.4	13.7	30%	6%	8%		2.4
Telstra Corporation	TLS	2.0%	2.0%	0.0%	3.89	45.0	23.3	14%	4%	11%	1.6	2.2
Healthco Healthcare and Wellness Reit	HCW	2.0%	2.0%	0.0%	1.73	0.6	18.8	32%	5%	4%	7.9	2.0
Lottery Corporation	TLC	0.0%	3.0%	3.0%	4.42	9.9	25.2	7%	4%	193%	3.1	2.3
Resources		22%	23%									
BHP Group	BHP	9.0%	8.0%	-1.0%	46.34	235.1	8.8	-21%	8%	43%	0.1	2.4
Santos	STO	5.0%	4.0%	-1.0%	8.57	29.1	7.9	-17%	4%	19%	0.6	2.0
Allkem	AKE	2.0%	2.0%	0.0%	11.66	7.5	8.5	42%	0%	17%	-0.4	2.1
OZ Minerals	OZL	3.0%	3.0%	0.0%	24.15	8.1	14.7	-8%	1%	14%	0.5	2.5
Northern Star Resources	NST	3.0%	2.5%	-0.5%	8.58	10.0	16.9	45%	3%	4%	-0.1	1.7
Woodside Energy Group	WDS	0.0%	3.0%	3.0%	32.83	62.5	8.0	-12%	8%	25%	0.4	2.1
Structural Growth		15%	15%									
Aristocrat Leisure	ALL	4.0%	4.0%	0.0%	33.91	22.8	18.6	10%	2%	23%	-0.1	2.1
Seek	SEK	3.0%	2.5%	-0.5%	23.51	8.3	29.9	13%	2%	14%	2.3	2.5
Goodman Group	GMG	4.0%	4.0%	0.0%	20.20	37.8	21.6	13%	2%	11%	0.9	1.9
Silk Laser Australia	SLA	2.0%	2.0%	0.0%	2.65	0.1	11.3	30%	0%	9%	0.6	1.5
Pinnacle Investment Management Group	PNI	2.0%	2.0%	0.0%	7.98	1.6	17.6	13%	5%	23%	-0.4	2.0

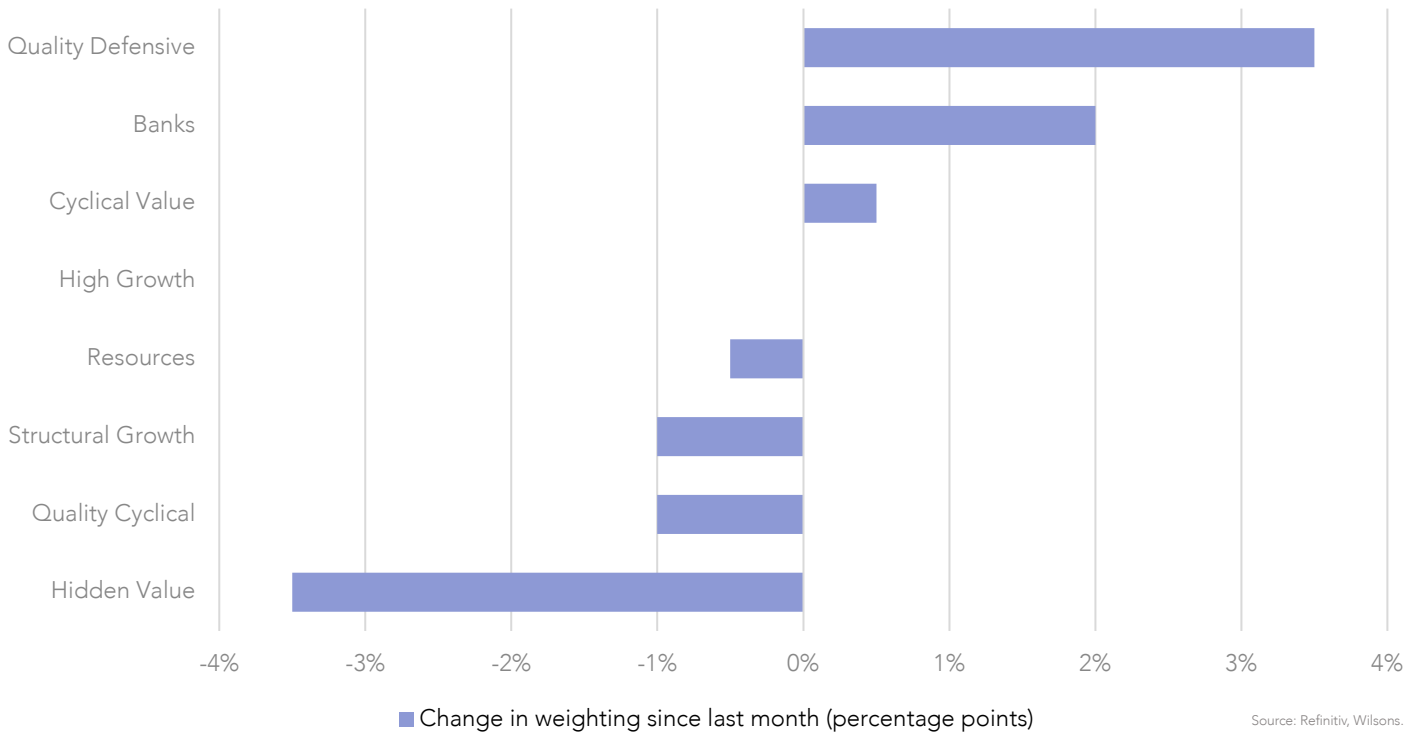
Source: Refinitiv, Wilsons.

Figure 9: Focus List weightings by Wilsons Factor



Source: Refinitiv, Wilsons.

Figure 10: Change in Focus List weightings by Wilsons Factor



Source: Refinitiv, Wilsons.



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Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

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