WILSONS

Australian Recovery to Gather Strength into 2021

Our weekly view on Australian equities.

17 December 2020

Our Outlook for 2021

The outlook for Australian equities into 2021 remains very constructive with the prospect of double-digit total returns on offer. Both the market and economy are likely to move from recovery to outright expansion in 2021, albeit with the market continuing to lead the economy.

Underpinning this outlook is an assumption that the global vaccine roll-out will prove effective, which should help global reflationary trade as economies rebound from the lockdowns of 2020.

With Australia and its largest trading partner China well ahead of many other large trading regions in this respect, we expect the benefits of reflation to be seen first in both countries, regardless of recent trade tensions.

We favour the recovery beneficiaries

The outlook for the first half of 2021 continues to favour the reflation beneficiaries – resources, financials, value and domestic cyclicals. As such, the Wilsons Australian Equity Focus List remains overweight the cyclical recovery beneficiaries.

Read our report on Rotating Further Towards Cyclical Recovery.

What could upset the Australian market?

While our outlook is one of strength, we have our eye on any factors that could upset the Australian market. The combination of rising bond yields with a lack of earnings momentum (perhaps via a significantly higher A$) would be unhelpful, and a relapse into domestic economic lockdowns would significantly change the game. This is not our base case, but we will be watchful of this in 2021.

Exhibit 1: OECD lead indicator remains well below prior recovery levels, suggesting room for further improvement in activity in 2021

Source: Refinitiv, Wilsons.

Global Recovery Outlook

Lead economic indicators suggest recovery momentum will continue well into 2021. The US economic expansion is less than half the initial rebound post-GFC (See Exhibit 1). In China, the rebound remains more progressed but is still well below levels reached post-GFC. In Europe, activity is yet to rebound in any meaningful way.

While a low starting point helps (global growth fell -7% points in 2020), current stimulus measures, and a rebound in activity as lockdown restrictions are eased post-vaccine will likely benefit growth well into 2021. Not since the 1970s have we seen the prospect of global growth printing +6.0%, with China likely to be even stronger at 8.2% in 2021.

A global recovery backdrop should feed through to a global earnings recovery. Value and cyclical sectors are well-placed to outperform given the potential for corporate earnings recovery. As the vaccine allows for global reopening, we should see the private sector reopening and filling the earnings hole that was created in 2020.

The Focus List global earnings recovery beneficiaries include Aristocrat (ALL), James Hardie (JHX), Macquarie Group (MQG) and Reliance Worldwide (RWC) alongside our resource sector overweight.

For more on our thoughts around the global outlook for 2021, look out for the Wilsons 2021 Global Outlook to be published on 21 December 2020.

Resources Corporate Earnings Outlook

The prospect of a V-shaped recovery in resources/energy paints a constructive picture for the commodities sector into 2021.

While supply is not an issue (outside of iron ore) at present, the prospect of tightening supply in the coming years has increased following the significant capex cutbacks in 1HCY20. We think the market is underestimating the significant supply constraints into 2022/23.

Read more on the energy sector in Energy - Ready for Take-Off?

The miners look solid, with balance sheets restored, capital spend contained and free cash flow (FCF) at record levels (in some instances) which should see increased returns in 2021.

The Focus List remains overweight resources/energy into 2021 through miners including BHP (BHP), Oz Minerals (OZL), Northern Star (NST), energy with Santos (STO), and companies that benefit from the global growth/capex cycle such as Seven Group (SVW) and Worley (WOR).

Looking further ahead, while inflation prospects are likely to remain low through 2021, commodities provide some protection should pricing pressures re-emerge in late 2021/22. The prospect of a weak US$ through 2021 remains, which is also supportive of commodity prices and returns.

Australian Corporate Earnings Outlook

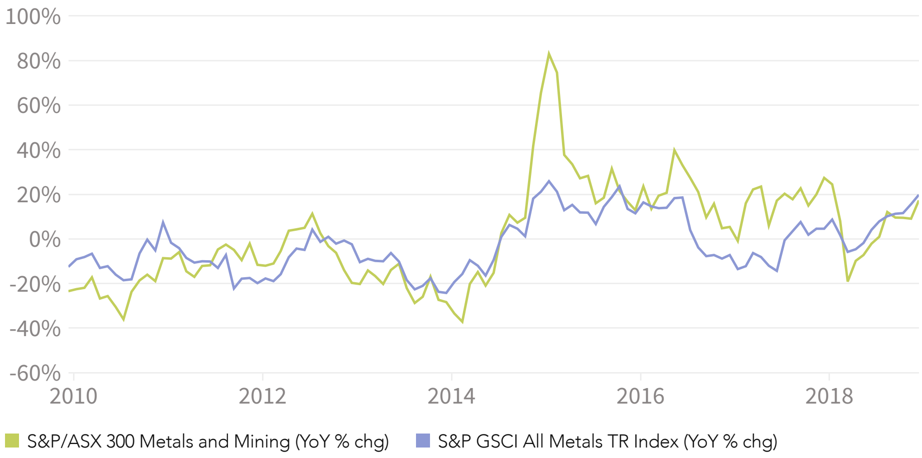
Corporate earnings are yet to return to pre-COVID-19 levels. The recent Australian AGM season provides a template for 2021, which saw the highest level of earnings upgrades/downgrades since the GFC.

Consensus estimates for 2021 have earnings lifting +10%. This looks low in our view and not too dissimilar to how the 'average' year starts out before earnings estimates are typically eroded away. In prior earnings upgrade cycles moves of +20% are possible. Historically, this typically occurs 1 year in 10.

Factors that could make 2021 an earnings upgrade year for Australia include:

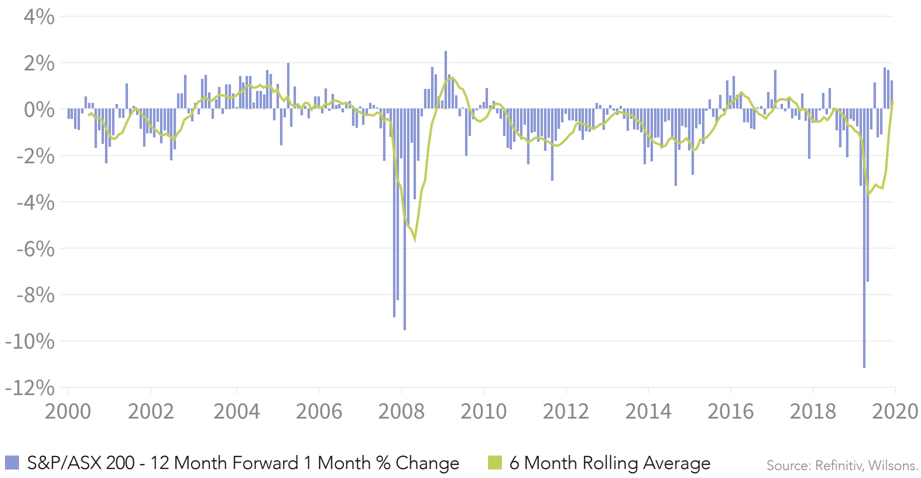
1. Low base effect
2. Vaccine-led spending recovery fuelled by abnormally high savings rate
3. Stimulus
4. Commodity prices led by surging emerging market growth

Exhibit 2: Commodity prices have not rallied as far in prior cycles with resources equities lagging



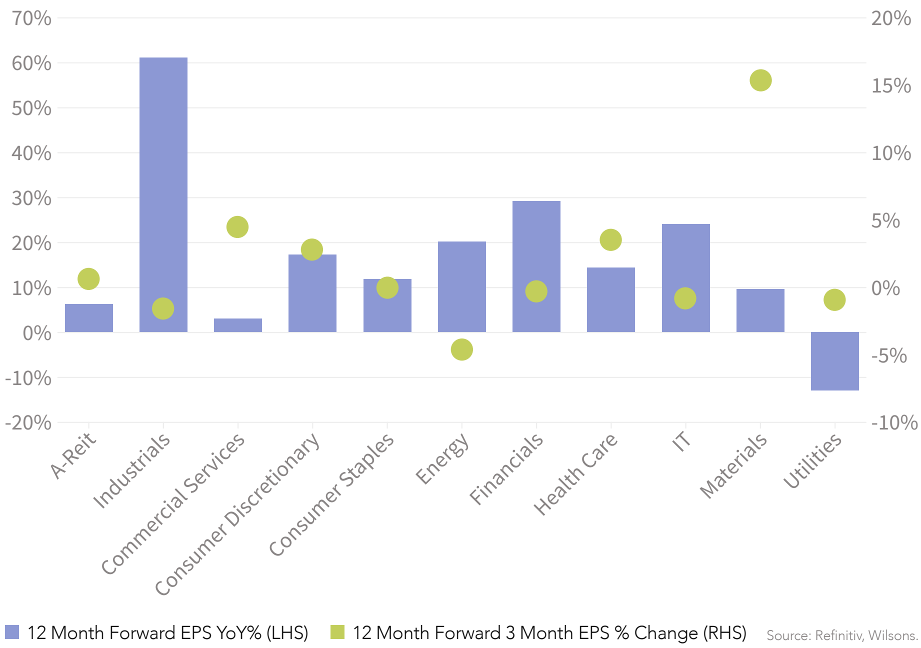
Rolling % change in price.Source: Refinitiv, Wilsons.

Exhibit 3: Australian earnings are seeing the highest level of upgrades since the GFC



Source: Refinitiv, Wilsons.

Exhibit 4: Positive 3-month earnings revisions across all sectors with the exception of energy



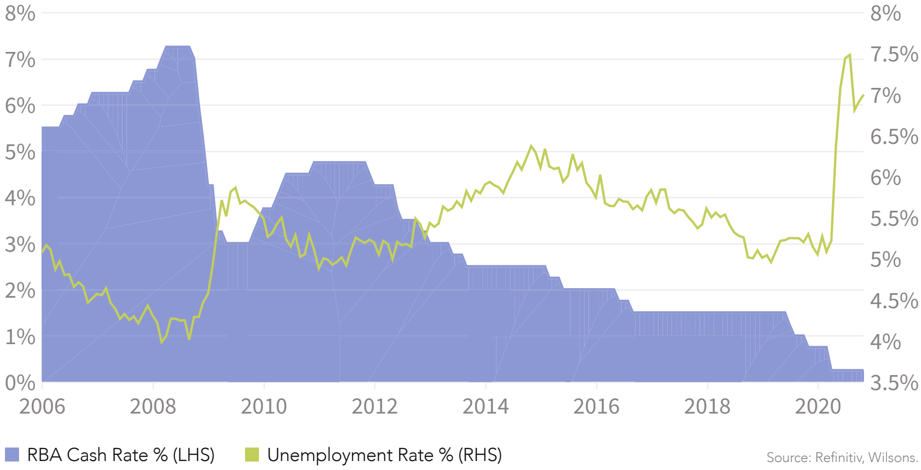
Source: Refinitiv, Wilsons.

The Focus List is overweight banks – ANZ (ANZ), Commonwealth Bank (CBA), Macquarie Group (MQG) and National Australia Bank (NAB) given the attractive valuations and the potential for earnings upgrades as actual bad debt charges in 2021/22 are lower than current provisions. Despite domestic economic conditions being much better than feared in 2H20, market estimates for bank earnings have not changed. Dividends are likely to lift significantly now the regulatory cap on dividends has been abolished.

Other domestic cyclicals within the Focus List include Super Retail (SUL) and News Corporation (NWS), with housing exposure though REA Group (REA) and Seven Group (SVW) and exposure to resources demand in the WESTRAC Caterpillar business and domestic recovery with Coates equipment hire business. Small cap REIT Aventus Group (AVN) is well placed to benefit from the increased domestic consumer demand, particularly with large format retail experience likely to see an enduring benefit post-COVID-19.

While we have a preference for cyclical exposures at present, the Focus List still has a core exposure to secular growth themes, which represent 40% of the Focus List. Healthcare remains a key exposure with CSL (CSL), ResMed (RMD) and Telix Pharmaceuticals (TLX). Technology exposures with Xero (XRO) and the indirect beneficiary of tech and online commerce, global logistics group Goodman (GMG). These names should all continue to do well as the recovery story gathers pace.

Exhibit 5: RBA raised rates too quickly post-GFC keeping unemployment levels elevated



Source: Refinitiv, Wilsons.

Risks to the Australian Outlook

FX risk

The A$/US$ has rallied from the low of high-50s in March/April to now sit in the mid-70s. Of more significance, the A$/US$ is now close to +10% above the average rate of 2019. Predominantly a US$ depreciation story, the broader trade-weighted index (TWI) is currently +5% ahead of the average rate in 2019.

Further appreciation of the A$ could present somewhat of a headwind for corporate earnings, particularly offshore industrial earners. In the Focus List, Aristocrat (ALL), CSL (CSL), James Hardie (JHX) and Reliance Worldwide (RWC) all have significant offshore earnings. At this point, the vaccine-led earnings recovery story is more significant than FX for 2021, but it is worth watching. A mid-high 70s could present an issue for Industrial earnings through 2021.

Stimulus fade

Both arms of stimulatory policy have been fully loaded. So there remains a risk of policy fade with stimulus potentially being withdrawn too quickly.

We saw this after the GFC, resulting in unemployment levels remaining elevated through much of the following decade. The RBA's recent pivot and structural change in how the bank assesses unemployment and inflation trade-offs suggests policy rates are likely to remain low well into this cycle.

COVID-19 vaccine

Markets are anticipating more than 30% of populations will be vaccinated during 2021. Failure of economies to reopen as vaccines are rolled out in 2021 could put a handbrake on the recovery, particularly for service and travel-based businesses.

Australia/China relations

Unpredictable in nature, trade has become collateral damage in a geopolitical debate with China (along with India, South Korea, US and Japan). With 30% of our exports bound to China it remains a sensitive issue for Australia. However, given our most important export to China is difficult for China to substitute, this will lessen the likelihood of trade restrictions on Australian iron ore.

For more on how we think Investors should be positioned in Australian equities read our 2020 Focus List Stocktake.

We wish everyone the very best for the holiday season and look forward to returning in mid-January 2021.

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Disclaimer and Disclosures

Recommendation structure and other definitions

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

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