September 2019

ORDS MONTHLY

INTERESTING TIMES

TARIFF TIFFS AND A SEASON TO FORGET

The Australian equities market has had a turbulent few weeks, with the S&P/ASX 200 Index traversing a wide range of more than 400 points between 31 July and 6 September.

The primary driver of volatile global markets has been the escalation in the trade conflict between the US and China, with the presidents of both countries beating their chests over which of the world's two largest economies can be tougher on tariffs.

The latest shots in the textbook tariff fight, fired on 1 September, imposed a 15% tariff on US$125 billion of Chinese imports to the US, while Beijing slapped additional imposts on US$75 billion of US imports.

At time of writing, high-level talks were scheduled to resume later in September in Washington, but both parties remain a long way apart and it is clear a quick resolution is not on the cards.

These trade ructions, combined with questions over the effectiveness of levers at central banks' disposal, increasingly bearish signals from the bond market, and an equities market performance that has diverged from fundamentals, have led us to reduce our allocation to risk assets by trimming exposure to equities and increasing positions in cash and bonds.

Our Investment Strategy article on page 2 details the changes to our asset allocation positions.

The article also outlines the resultant changes to our preferred investment ideas for 2019.

The key change is the addition of a new category, 'structural leverage', and the removal of the 'oversold cyclicals' theme.

We still do not see a recession as likely this year, but the same reasons that underpin our asset allocation changes also mean cyclical exposure is no longer a dominant theme.

Given this, we now favour companies that are less dependent on economic conditions, and instead will benefit from structural changes in their industry.

The remainder of this edition of the *Ords Monthly* analyses the numbers from a corporate results season where positives were hard to find.

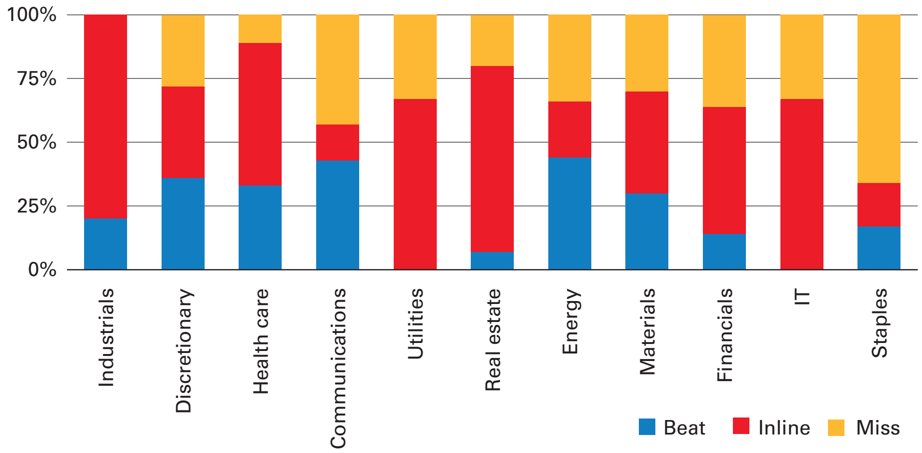
> "The key change is the addition of a new category, 'structural leverage', and the removal of the 'oversold cyclicals' theme."

The season's beat ratio, i.e. the proportion of companies whose results exceeded expectations, was a meagre 25% – the second-lowest in the past eight reporting seasons..

Headline earnings revisions post results were also very weak, and our analysts see further downside risk to consensus earnings forecasts for fiscal 2020.

Our summary of the corporate report cards starts on page 4 and a sector-by-sector scoreboard begins on page 6.

Figure 1: Beat-miss sector proportions - FY19 reporting season (%)



Source: Ord Minnett Research, Bloomberg

INVESTMENT STRATEGY

RETHINKING OUR CHOICES

Ord Minnett has recently revised its preferred investment options in the wake of the ongoing tit-for-tat US-China trade conflict, a disappointing earnings season and doubts about the local economy's momentum.

Despite Beijing and Washington aiming to restart high-level talks later in September, any chance of a resolution of the conflict in the near term appears remote, with both parties fortifying their tariff positions in the meantime.

Locally, the just-completed earnings season was disappointing, with just 25% of company results beating estimates, while the downward revision in the fiscal 2020 EPS estimate for the S&P/ASX 200 Index was the deepest since the February reporting season of 2009.

Meanwhile, June-quarter gross domestic product rose 0.5% from the March quarter, just above Ord Minnett's forecast of 0.4% and matching consensus estimates, while the annualised rate of GDP growth slowed to 1.4% from 1.7% – the slowest pace since the GFC trough in 2009.

Compositionally, domestic demand remained sluggish, while a strong contribution from net trade – exports rose and imports fell in the quarter – salvaged the wider economy's performance.

Looking at the big picture through the lens of dynamic asset allocation, our previous neutral position in equities had assumed that Federal Reserve and China monetary-policy easing could counterbalance trade-war impact.

Given further escalation of trade tensions and the likely material impact on global economic growth, along with full equity market valuations, we have now shifted both Australian equities and international equities to a 2.5% underweight position.

To balance portfolios, we have lifted our cash overweight level to 5.0% from 2.5% to absorb volatility, and moved our fixed-rate securities to an overweight position of 2.5% given the prospect of further monetary policy easing.

We have also kept a tactical hedge against further volatility through physical US-dollar-priced gold and an underweight in low-quality credit assets.

At the individual stock level, the outlook has led Ord Minnett to make some changes to its preferred investment themes for 2019.

Most notably, we have removed the 'oversold cyclicals' category in favour of a 'structural leverage' classification. Our oversold cyclicals theme was based on the view that a global recession was unlikely in 2019.

It is important to highlight that we still do not see a recession on the cards this year. The deterioration in economic momentum and unpredictability of trade policy, however, have led us to become increasingly cautious around how long central banks or governments can stave off a recession, and therefore we no longer see cyclical exposure as a dominant theme.

Companies that were in our oversold cyclicals category included **Alumina Ltd, Aristocrat Leisure** and **Origin Energy**. In the year to date, Aristocrat and Origin have returned 37% and 18%, respectively. Alumina Ltd was added in May, and has fallen 7% since, but we still see upside and have left it in the 'policy tailwinds' category of our preferred themes.

We discuss our latest changes to investment themes below.

Structural leverage (new)

We initiate this category with **CSL**, **Service Stream, Clover** and **HUB24**.

Given ongoing concerns about the economic outlook, we now favour companies that are less dependent on economic conditions, and instead benefit from structural changes in their industry.

CSL's outlook is underpinned by demand for influenza vaccines, a multi-year investment in plasma collection centres (with another 40 to open in FY20), which should see it continue to take market share, and commercialising some potentially significant new therapies, e.g. in treating heart attacks and organ transplants.

Service Stream provides services to defensive areas such as energy utilities, telecommunications and water. It is also leveraged to growth in the renewables industry through its New Energy division which assists with solar, battery storage, and related renewable energy system installations and inspections.

Clover manufactures omega-based oils containing docosahexaenoic acid (DHA), a nutrient considered important for early childhood development which is increasingly being added to infant formula products. The catalysts for the company include a trend towards 'premium' infant formulas, the introduction of minimum DHA-content regulations in the European Union and potentially China, and expansion into new markets, e.g. sports nutrition and ready-to-drink milk.

Like Clover, HUB24 is a smaller-capitalisation company.

HUB provides portfolio management and reporting software for the financial services industry.

The company experiencing record inflows of funds onto its platforms as advisors shift away from bank-aligned platforms towards independent platforms – a trend that is expected to gain steam as recommendations from the Royal Commission into Banking and Financial Services are enforced.

Volatility vigilant

'Late-cycle' phases are usually characterised by higher risk and higher volatility. This then warrants having some relatively defensive exposures as a counterweight.

It also includes considering whether portfolios are positioned to accommodate some more challenging, and non-consensus, events, e.g. geopolitical tensions, resurfacing.

We have added toll-road operator **Transurban**, which has a strategic portfolio of assets capable of generating 3% per annum traffic growth, underpinned by population growth and solid growth in the Australian eastern seaboard economies. Combined with above-CPI price increases, this should drive 6–7% per annum growth in distributions.

Yield leaders

Major developed central banks, including the Reserve Bank of Australia, remain poised to cut interest rates further, so we think the search for income yield in equities will remain strong. We add **Rio Tinto**.

Assuming an average iron ore price of US$85/t in CY20, we estimate Rio Tinto still generates operating earnings margins of circa 50% and, coupled with low debt levels, will be able to offer a dividend yield of 7% (before franking).

Policy tailwinds

We have added rare-earth producer **Lynas** to this category, transferred HUB24 and Service Stream to our new 'structural leverage' category, and removed **Boral**.

Lynas is a potential beneficiary if the US-China trade war escalates further and China restricts exports of rare earths. This threat could prompt the US to explore alternatives for rare earths supply outside China, and Lynas is the largest non-Chinese producer of the commodities.

We have removed Boral as a beneficiary of infrastructure spending, following guidance from the company that FY20 net profit will decline by 5–15% due to earnings pressures in Australian residential construction and a poor performance from the USG Boral business.

Risky business

This list contains companies where we see downside risks developing, and which we would avoid.

We have added **ASX Ltd** as in our view is the shares have run too hard in the near term. ASX trades at a premium to the S&P/ASX 200 Index and its global peers despite its low EPS growth. Ongoing cost increases are expected to weigh on margins in FY20. A market downturn would also be negative.

We have removed **Steadfast** due to a positive change in the near-term outlook following a capital raising and acquisition.

For the complete asset allocation report and changes to our preferred themes, please contact your Ord Minnett adviser.

SCORE CARD

A SEASON OF DISCONTENT

The August results season this year proved a disappointment for Ord Minnett on several fronts.

Only a small minority of companies managed to exceed our expectations, with the season's beat ratio, i.e. the proportion of companies whose results exceeded expectations, coming in at a meagre 25%.

Headline earnings revisions were also very weak, with the 1.9% decline in the S&P/ASX 200 EPS estimate being the deepest result season scale-back since the February 2009 reporting season.

It is worth highlighting here that our analysts foresee further downside risk to consensus earnings. Our current estimate for fiscal 2020 S&P/ASX 200 Index EPS growth is a paltry 1.1%. See Figure 2 for a sectoral breakdown of forecast growth in fiscal 2020.

Themes prominent during the season included the continued rise the high- and hyper-P/E stocks, albeit at a less frenetic pace than in recent seasons, the comeback of some domestic cyclicals, re-emerging cost pressures and rising capital expenditure. We examine these in more detail below.

P/E ratio expansion

Yet again, results season was witness to an expansion in top-quintile P/E multiples, albeit to a lesser extent than in recent seasons.

Interestingly, the traditional 'high P/E' cohort, such as **carsales.com**, **Domino's Pizza Enterprises** and **Treasury Wine Estates**, made something of a comeback in August, outperforming the 'hyper P/E' group that contains stocks such as **Afterpay Touch** and **Wisetech Global**.

The move higher was, yet again, due to a combination of price appreciation and negative earnings revisions. On our count, 50% of the top quintile moved higher in August, while 73% of the group had EPS estimates revised lower.

EPS trends

This results season will go down as one of the worst on record in terms of EPS revisions, with only two sectors, health care and energy, registering a positive month.

Across the rest of the market, revisions were negative with every sector, except REITs, seeing declines of more than 2%.

Health care was the standout in positive revisions, with the sector's one-year-forward EPS estimate rising 2.9% over the month.

This was driven principally by upgrades for **CSL**, but **ResMed** and health imaging software group **Pro Medicus** also enjoyed upgrades in August.

Domestic cyclicals

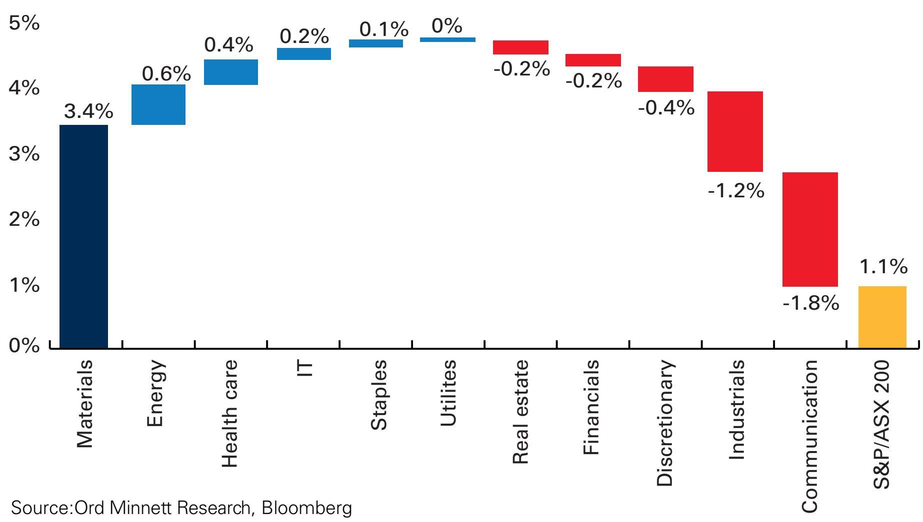
In a month where retail conditions were classified by the NAB survey as *"recessionary"*, **JB Hi-Fi** and **Super Retail Group** markedly outperformed on their result days and pointed to positive trading trends in the first 5–6 weeks of fiscal 2020.

In stark contrast, the owners of the stores where JB Hi-Fi and Super Retail ply their wares, the likes of **GPT, Scentre, Stockland** and **Vicinity Centres**, expressed concern about the *"challenging"* retail environment.

Similarly, mixed messages emanated from housing-exposed companies, with **REA Group** pointing to a marked increase in *"real buyer"* activity on their site, while banks highlighted *"intense mortgage market competition",* suggesting credit demand remains subdued.

Companies with broader macro exposure, such as **Adelaide Brighton, Boral, Cleanaway, Qantas Airways** and **Sydney Airport**, have all been circumspect in their outlooks.

Figure 2: Fiscal 2020 net profit bridge for S&P/ASX 200 Index



Source:Ord Minnett Research, Bloomberg

It seems to be that a few companies, such as REA, **Domain**, JB Hi-Fi and Super Retail, are well positioned within their respective industries to benefit from the leading edge of tax and interest rate cuts, while most of the aforementioned industrial companies have underperformed.

Capital expenditure

The theme of rising capital expenditure we initially highlighted in the February 2017 season continued through the latest result season, with the forward capex-to-sales ratio ticking up again.

In line with our assessment of the past three seasons, almost every sector remains in a capital expenditure upgrade cycle. As Figure 4 below shows, only two sectors have seen meaningful scalebacks – discretionary, principally **Wesfarmers**, and communication services, dominated by **Telstra**.

Cost pressures

The pressure of escalating costs was evident across a wide range of companies that reported in August.

After three seasons of strong revenue revisions, the February and August reporting seasons of fiscal 2019 saw this growth slow, and any revenue revisions have been offset by a further move higher in cost expectations.

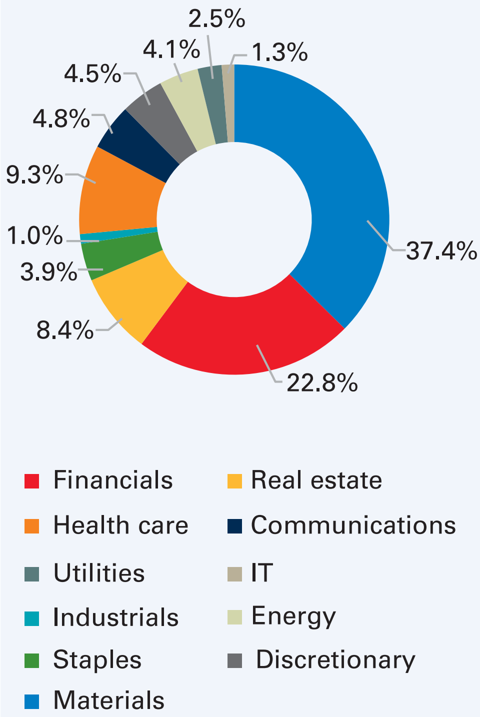
This cost pressure led to operating earnings margins being scaled back by around five basis points in August.

Overall, one-year-forward operating margin expectations for the S&P/ASX 200 Index have steadied in the 26-27% range, where they've been stuck since the middle of fiscal 2017.

See over page for our sector-by-sector analysis of the results season.

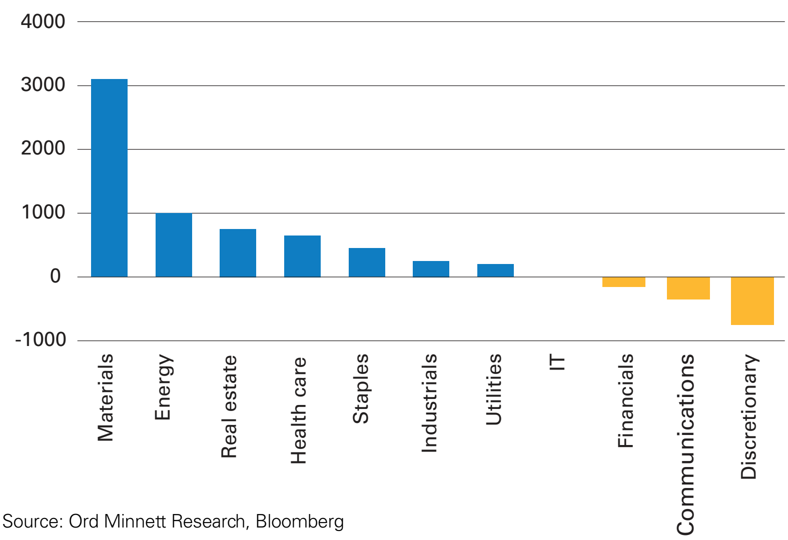
> "Themes prominent during the season included the continued rise the high- and hyper-P/E stocks, albeit at a less frenetic pace than in recent seasons, the comeback of some domestic cyclicals, re-emerging cost pressures and rising capital expenditure."

Figure 3: Fiscal 2019 net profit contribution by sector



Source: Ord Minnett Research, Bloomberg

Figure 4: Changes in capital expenditure expectations (12 month, consensus, $m)



Source: Ord Minnett Research, Bloomberg

SECTOR BY SECTOR

Table 1: Recommendation changes during August

Stock	Recommendation		
	Old	New	Risk Rating
Upgrades			
Adelaide Brighton	Lighten	Hold	Higher
AGL Energy*	Lighten	Hold	Medium
Caltex Australia	Hold	Accumulate	Higher
Charter Hall Retail	Lighten	Hold	Higher
Cleanaway Waste Management	Hold	Accumulate	Higher
Macquarie Group	Hold	Accumulate	Higher
Netwealth Group	Accumulate	Buy	Higher
NIB Holdings	Sell	Hold	Higher
Orora	Hold	Accumulate	Medium
REA Group	Lighten	Hold	Higher
Regis Resources	Lighten	Hold	Higher
Rio Tinto	Hold	Buy	Higher
Steadfast Group	Hold	Accumulate	Higher
Super Retail Group	Hold	Accumulate	Higher
Technology One	Lighten	Hold	Higher
Telstra Corporation	Hold	Accumulate	Medium
Wisetech Global	Lighten	Hold	Higher
Woodside Petroleum	Lighten	Accumulate	Higher
Downgrades			
A2 Milk Company	Accumulate	Lighten	Higher
AGL Energy*	Hold	Lighten	Medium
Alliance Aviation Services	Buy	Hold	Higher
Austal	Accumulate	Hold	Higher
Aveo Group	Accumulate	Hold	Higher
Capitol Health	Buy	Hold	Higher
carsales.com	Buy	Accumulate	Medium
ERM Power	Accumulate	Hold	Medium
G8 Education	Buy	Hold	Higher
IDP Education	Accumulate	Hold	Higher
Integral Diagnostics	Buy	Accumulate	Higher
Magellan Financial Group	Hold	Sell	Medium
Midway	Buy	Hold	Higher
National Storage REIT	Accumulate	Hold	Higher
Origin Energy	Buy	Hold	Higher
Platinum Asset Management	Hold	Sell	Medium
Initiations			
A2 Milk Company	Initiation	Accumulate	Higher
Bellamy's Australia	Initiation	Hold	Higher
Sezzle	Initiation	Buy	Higher

Source: Ord Minnett Research *AGL Energy was downgraded to Lighten from Hold on 1 August but upgraded to Hold from Lighten on 9 August.

Consumer discretionary

This sector delivered a +7 net beat/miss ratio, i.e. the proportion of companies that exceeded our expectations minus the proportion of companies that fell short of our forecasts, shown as percentage points. The earnings surprise was the second-highest among the all the industry groups at 0.7%.

The positive surprise stemmed from strong results from the likes of **Tabcorp, Star Entertainment** and **JB Hi-Fi**. Those that fell short included **Invocare** and **Domino's Pizza Enterprises**.

Consumer staples

This group reported a second consecutive net beat/miss ratio of -49. Our measure of earnings surprise at -4.8 was the most negative among all the sectors. This was driven by two of the smaller stocks in the sector, **Blackmores** and **Bellamy's Australia**, both of which landed well short of our expectations.

Coles beat our expectations, but the stock was largely unmoved on the day. **A2 Milk Co** dived 13.2% on the day of its result following underwhelming guidance commentary, versus a fall in the S&P/ASX 200 Index of just 0.9%.

Energy

The energy group enjoyed a second consecutive season in which beats outnumbered misses, with a net beat/miss ratio of +11.

Woodside Petroleum, the largest stock, fell well short of our projections and accounted for a large proportion of the negative surprise of -0.5% overall.

On the other hand, positive surprises from **Santos** and **Origin Energy** served to lift the average surprise, as well as the beat/miss ratio.

The average on-day stock price move lagged the benchmark index by 0.6 percentage points, with **Beach Energy** the largest positive on-day move at 10.8%, outperforming the S&P/ASX 200 Index by 9.8 percentage points.

Table 2: Fiscal 2019 net profit growth by sector

Sector	Fiscal 2018 ($bn)	Fiscal 2019 ($bn)	Change (%)
Materials	11643	21433	+84.1
Energy	1851	2355	+27.2
Real estate	5710	4773	-16.4
Health care	4691	5314	+13.3
Staples	2235	2215	-0.9
Industrials	521	590	+13.2
Utilities	1361	1405	+3.2
IT	647	724	+11.9
Financials	14181	13005	-8.3
Communications	4196	2718	-35.2
Discretionary	2422	2563	+5.8
S&P/ASX 200	49458	57095	+15.4

Source: OML Research, Bloomberg

Table 3: Earnings outcome by sector

Sector	No. of cos. reported	Beats (%)	In-line (%)	Misses (%)
Industrials	5	20	80	0
Discretionary	14	36	36	28
Health care	9	33	56	11
Communications	7	43	14	43
Utilities	3	0	67	33
Real estate	15	7	73	20
Energy	9	44	22	34
Materials	20	30	40	30
Financials	14	14	50	36
IT	3	0	67	33
Staples	6	17	17	66
Market	**105**	**25**	**45**	**30**

Source: OML Research, Bloomberg

"CSL, the sector's largest stock, delivered a set of numbers that landed in line with our expectations, but still generated a strong positive on-day market reaction."

Financials

Yet another disappointing season from the financials, with a range of stocks falling short of estimates to give a net beat/miss ratio of -22.

Those that fell short included **Commonwealth Bank, Bendigo and Adelaide Bank, Medibank Private,** and **QBE Insurance.** Those that came in better than expected include **NIB** and **AMP**, although both stocks underperformed on the day of result release.

Healthcare

The overall beat/miss ratio of +22 for this sector was a clear improvement on recent seasons and the highest since the February 2016 season.

The average surprise was +0.4%, with strong on-day outperformance against the overall market.

CSL, the sector's largest stock, delivered a set of numbers that landed in line with our expectations, but still generated a strong positive on-day market reaction, with the stock rising 6.6%, outperforming the benchmark index by 6.2 percentage points.

Elsewhere, a disappointing result came from **Japara Healthcare**, while **Cochlear** posted a stronger-than-forecast result.

Industrials

The industrials sector posted a net beat/miss ratio of +20 and delivered the highest average 'earnings surprise' at 1.0%, although this was due entirely to the 8.3% beat by **Sydney Airport** that carried the overall sector to the top of the ladder.

Information technology

This was a disappointing season, driven mainly by weak numbers from **Computershare**.

On-day performance was strong, however, due largely to **Link Administration**, which surged 9.4% to outperform the benchmark index by 9.3 percentage points.

Sector by sector (cont...)

Materials

A flat ratio of beats to misses somewhat disguised just how much the materials sector disappointed.

The overall group had a negative surprise of 1.0% and on-day share price underperformance of 2.0 percentage points against the S&P/ASX 200 Index.

The on-day measure was dragged into the red by a series of sharply negative reactions, with the 20.6% dive in **Boral**, versus the broader market's 1.3% fall, marking the season's worst on-day performance.

Other laggards relative to the on-day performance of the benchmark index, included **Pact,** down 17.3 percentage points, **Orora**, down 13.1 percentage points **BlueScope Steel**, down 9.3 percentage points, and **Iluka Resources**, down 9.6 percentage points.

Property

Real estate delivered a net beat/miss ratio of -13, with only 7% of companies reporting ahead of expectations. Some 73% of companies met our forecasts, second only to industrials.

The earnings surprise was slightly negative,at -0.4%, but on-day performance strong, outperforming the broader market by 1.5 percentage points.

Lendlease generated the sharpest on-day positive price reaction, running 9.9 percentage points ahead of the S&P/ASX 200 and delivering the strongest earnings beat in the sector of 3.0%.

Communications services

This sector, formerly designated as telecommunications services, delivered a slight positive earnings surprise of 0.1%, as well as the strongest on-day performance across the market.

Telstra buttressed the positive surprise, while **REA Group** and **Domain** disappointed.

Utilities

The utilities group could not muster a single beat this reporting season, although only three stocks in the sector reported in August. (We note that **ERM Power** is excluded from our analysis due to the 'live' takeover offer from Shell.)

Two of the three results were in line, with the positive average share price move due to gains in **Infigen Energy** and **APA Group**.

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