Chris Burrell's
Market View Blog

Reporting Season

Macroeconomics

The February blog outlined the address by Paul Bloxom, Chief Economist HSBC Australia on macro-economic issues.

Paul's view, shared by the diarist, was that whilst the good news is inflation is coming down, in some countries more than others, and has done so without a global recession, the markets were pricing in rate cuts too quickly.

That prediction now seems confirmed with the probability of early rate cuts reduced in the US and even more so in Australia.

US Markets

Since the October lows, US markets have staged a strong run. Two key factors are AI and likely interest rate declines.

With respect to AI, one has to question the current hype in terms of bottom line earnings for companies such as Microsoft and NVIDIA. Many businesses run prior versions of Microsoft. Microsoft has a new product, Copilot, where the user is the Copilot with Microsoft in AI. The US markets appear to be pricing in that many users will upgrade to the current versions of Microsoft and then many will deploy Copilot across all users. This seems unlikely. At first instance businesses will need to receive training and give thought to what AI applications make sense within the businesses. There are data security issues with all users having AI access to databases. What is more likely is that businesses will firstly consider whether they are using all of the current reporting functionality across their business and producing user reports which may lead to productivity increases. Over time, no doubt AI and programs such as Copilot will lead to productivity increases. But it took 20-30 years for computers to add large productivity increases to businesses. Similarly, the US stock markets seem to be somewhat carried away with the AI theme in terms of the bottom line performance.

As commented above with respect to interest rates, the US markets also seem a little exuberant when it comes to interest rate cuts. Usually banks, for example do well in rising interest rate environments, but are subject to margin contraction during periods of downward interest rates. Currently, both Australia and US markets appear to see interest rates falls as positive for banks.

Banks

The Australian banks have had a strong run up in recent months. This may be partly due to the lower likelihood of recession with the base case for most economists being a soft landing or no landing at all. No landing means that the Australian and US economies may well see lower growth but no negative growth. The outlook of lower interest rates does make bank dividends of 4-6% fully franked more attractive, as they are being compared to lower cash and term deposit rates than presently exist in the market.

Some Australian banks are expensive compared to their global peers. As to the first question, i.e. are Australian banks good businesses, the answer with respect to the four majors is yes. As to the second question whether Australian banks represent good value, one would have to answer that question no, particularly with respect to CBA. CBA is trading on a price earnings (P/E) ratio of 20 times when historically lead banks have not traded above 14 times and CBA is trading on a ratio of (price/ net assets): 3 times when usually markets would not price banks above 1.5 times net assets. If one looks at the Bank of America or JP Morgan in the US or DBS in Singapore, these leading international banks trade on P/Es of 9-11 times.

Burrell have streamlined our execution and custodial arrangements over recent such that we can easily buy parcels of these internationally recognized banks for those clients wishing to have a direct international portfolio.

Reporting Season

Reporting season is important as it provides actual sales and profit numbers, debt/equity ratios and updated returns on equity. These statistics are the starting point for evaluating whether a current holding deserves to remain in a portfolio or whether on a pairs analysis, there is another company that would provide increased returns for the same level of risk or the same returns for a lower level of risk.

Commodities

The two key commodities in terms of positive outlook are copper and gold. Copper is broadly classified as one of the carbon minerals. The demand for copper over time is expected to increase. This is also the case for carbon minerals, although the markets for such are often smaller and so more volatile depending on the supply/demand balance at a point in time e.g. lithium

Gold is currently trading ~$US 2200. Some see it as the top performing commodity in calendar year 2024. What is important for gold producers is the difference between the gold sales price and the cost of production. In a recent interview, Newmont CEO Tom Palmer commented upon the go forward plan for Newmont after its recent takeover of Newcrest in Australia. Newmont see the company will hold ten tier one gold assets. This means six existing assets from the combined operations for sale, including Telfer in Australia. It is likely the sales proceeds of $US 2B+ will be realized, with $US 1 billion for a share buyback. Tom Palmer is looking for the cost of production of gold to be reduced from $US 1,300 to $US 1,150 per ounce. In addition, Newmont will have three prospective projects that are tier one copper/gold projects, including one in New Guinea, one in North America and one in South America. When asked about the gold price, he commented that it is not so much the absolute level the gold price, but the difference between the gold price and the cost of production. He highlighted that with Newmont's go forward plan, there will be a healthy margin to be delivered to shareholders and invited investors to get on board. Your diarist suggests we should accept this invitation.

Gas has again been in the press. This is usually with politicians seeking to create some political avenue or some political rhetoric. Gas stocks in Australia look to be good value. There is an interesting question as to why their prices do not look challenging. Part of the answer may be in the continuing ESG rhetoric which often groups coal and gas together. With respect to those who see these as being in the same bucket, gas has half the carbon emissions of coal is likely the only transitional fuel that has any chance of letting those countries who wish to achieve Net Zero etc do so in a reasonable timeframe.

The one commodity which was a disaster during reporting season was nickel. BHP wrote off its Western Australian nickel investment of $US 2.5B on Indonesian cheap nickel flooding the markets after Indonesia banned unprocessed nickel exports and China invested in response. This is the biggest domino to fall in Australian nickel. That a company of the like of BHP would have been blindsided by the Indonesian investment coming on surprised your diarist, as usually BHP is on top of its game. There has been much talk since that announcement around the fact that Australian nickel production has taken strides to be more carbon neutral whereas the Indonesian nickel processing is seen as a dirty process. China has coveted its developing country status, so that it does not have to accord with green targets such as 2030 and 2050.

The more challenging question looking forward is whether the Chinese are seeking to do to iron ore what they've just done to nickel. The iron ore reserves at Simandou in West Guinea are enormous**.** The Guinea government have pushed on development based on undertakings by the Chinese to fund the billions of dollars required. The development of these mines is now advanced and production will arrive on the markets in a couple of years. It may be that we have seen the golden era of Australian iron ore. It may be that we need to think about whether BHP will continue to carry its premium position, or whether we need to diversify away from materials and to other sectors both in Australia and overseas. Your diarist is of the view that in five years' time most portfolios will have an additional 5% weighting in international exposure and we need to give considerable thought to how to achieve this paradigm shift.

Retail

As commented in previous blogs, retail spending in Australia started to turn down in April 2023. There were numerous examples through December and then into reporting seasoning in February/March where retailers have experienced reduced sales. It is clear that higher interest rates are not only impacting on those consumers with mortgages, but are affecting the psychic of people in terms of spending. Consumers are being more selective with their purchases, enjoying restaurants and other outings less frequently and being price conscious in the current inflationary environment.

Large Daily Movements During Reporting Season

This reporting season was characterized by large daily movements, particularly on negative reports. Woolworths fell from $38 to around $32.50 on its profit report. We view Woolworths as the best consumable staples company and so, such corrections should be considered as a possible buying opportunity. Likewise Corporate Travel fell on a poor report concerning a UK contract. Again this correction seemed quite disproportionate to the contract from the UK Government which did not deliver the profits predicted. It is just one contract and in no way justified the fall in price of Corporate Travel. Domino's Pizza fell from $57 to $40 on its report and again, this degree of correction is difficult to reconcile based on the numbers.

Investments

The take away from the above discussion is that advisors and research personnel have spent a good part of the last month reading the results and analysts reports across a wide range of companies. There are clearly winners and losers in stocks where valuations differ from market prices. Mostly we are considering the value at reasonable price (GARP) sectors, with little interest in the growth-at-any-price (GAAP) area. Moreover, whilst industry themes are useful, there are divergences across industries e.g. Sonic has done well, whilst Healius has had a shocker. Commonwealth Bank appears overpriced, whilst Westpac and ANZ appear fairly priced. In this environment, index investing and exchange traded funds (ETF's) whilst they have their place, they have the possible disadvantage of grouping the good with the bad.

Property Trusts

A number of property trusts have recovered from their oversold positions. This will be a topic for the next Blog. In the meantime please do not hesitate to discuss with an advisor or our property specialist group.

Happy investing

Chris Burrell

25/03/2024