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PORTFOLIO COMPASS: AUSTRALIAN EQUITIES 2023

Global markets were dragged down in 2022 by the trifactor of multi-decade high inflation, the Russian invasion of Ukraine and China's COVID-zero policy. While almost every major asset class took a sizeable hit last year, Australian equities presented a different story. Australian equity, as measured by the S&P/ASX 200, was one of the best performing asset classes in 2022.

We analyse the key sectors and reveal our outlook for 2023.

Contents

Introduction

The wave of liquidity that flooded markets in 2020 in the wake of the COVID-19 crisis set new records. What followed was the most aggressive tightening cycle since the early 1980s, with 2022 heralding in a new world order, and markets and some sectors started rhyming with outcomes akin to the Global Financial Crisis (GFC) and dot-com bubble. For the first time since 1994 both bond and equity markets were down.

Huge hits were felt across the tech sector and more broadly across US and UK equities, to name a few. However, Australian equities, as represented by the S&P/ASX 200 was one of the best performing asset classes in 2022 thanks to a Q4 resources rally and higher 'value' exposure relative to other country equity benchmarks. The S&P/ASX 200 was down 1.08% over the year. The best performing sector was energy up 49.0% and the worst performing was information technology which fell 33.7% over the year. In terms of size, large caps significantly outperformed small caps and were up 1.89% for the year compared to midcaps which fell 6.3% and small caps down 18.3%.

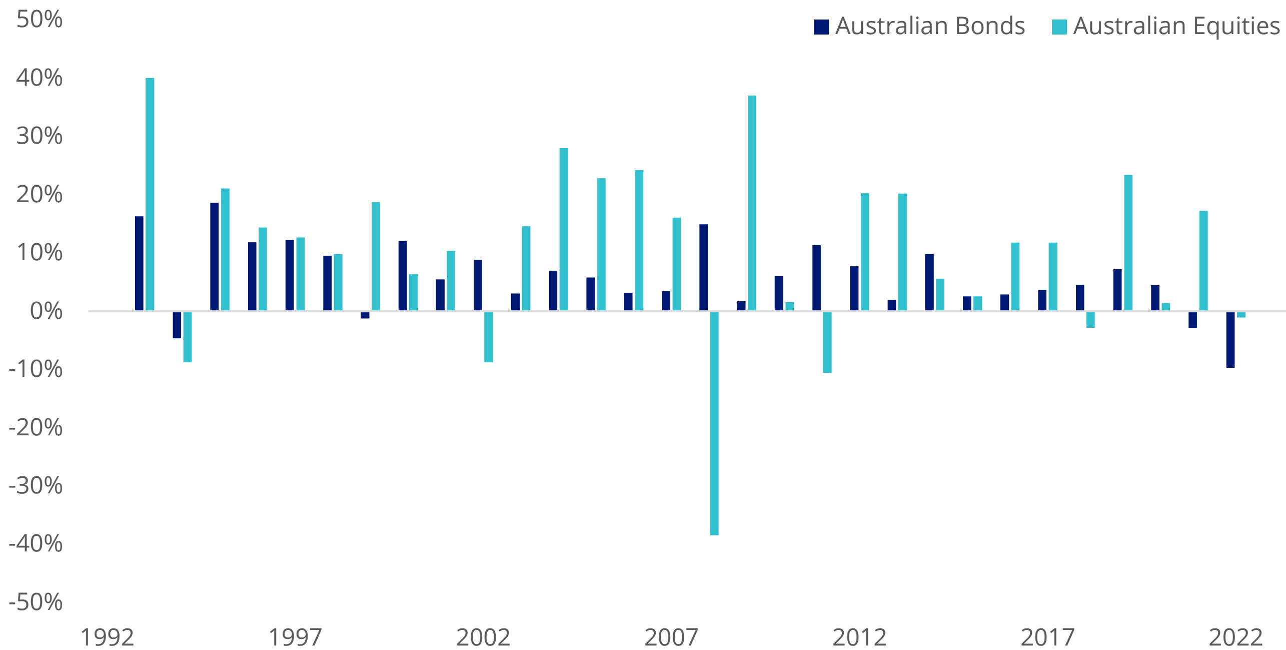
According to the 2022 VanEck Australian Investor Survey, Australian equities is going to be the go-to investment destination in 2023 with 70% of respondents planning to invest.

For investors, the question is which sectors should be considered for 2023.

Key themes from 2022

2022 has been a remarkable year. Australian equity and bond markets are both down for the first time since 1994. The poor performance is a function of three major themes; Multi-decade high inflation, Russian invasion of Ukraine and China's COVID-zero policy.

Calendar year returns

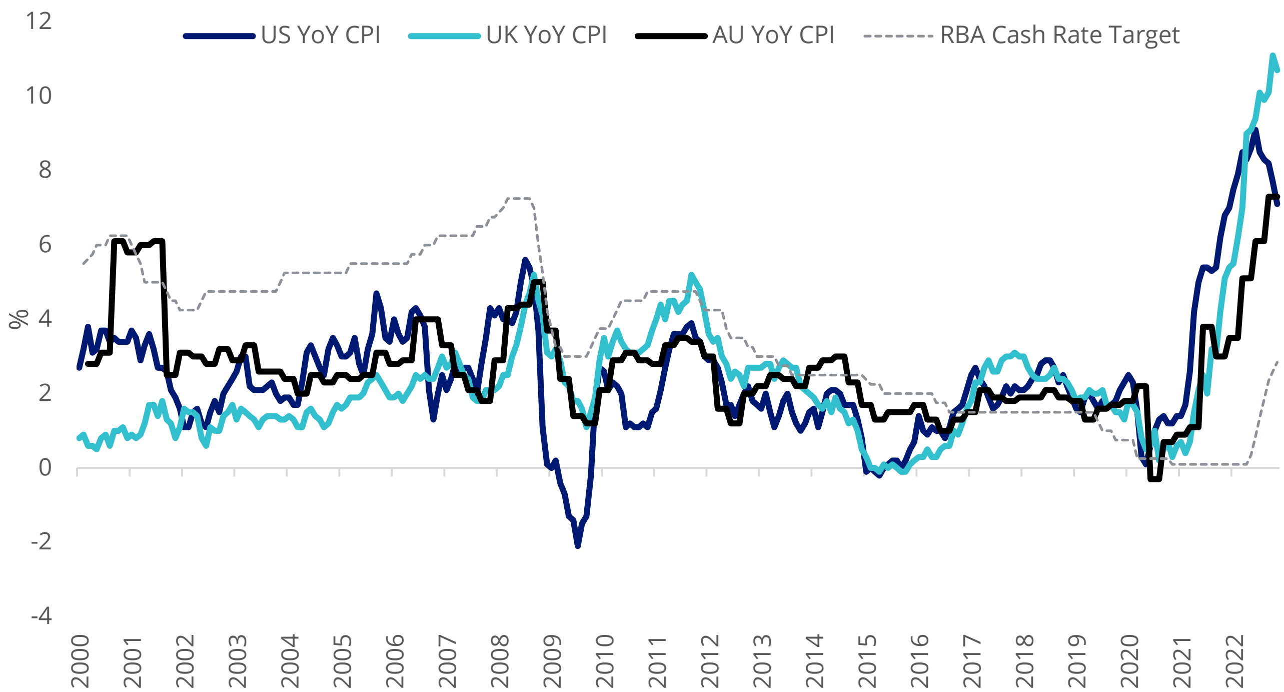


Source: Bloomberg. AUD returns. As at 31 December 2022. Australian Bonds is the Bloomberg AusBond Composite 0+ yrs Index. Australian Equities is the S&P/ASX 200 Accumulation Index. You cannot invest in an index. Past performance is not indicative of future performance.

Multi-decade high global inflation

Global inflation reached multi-decade highs on the back of the enormous amount of excess stimulus being provided by central banks, fractured supply chains and energy crisis driven by Russia's invasion of Ukraine. Once pitched as 'transitory' by Fed chair Powell, quickly became a 'persistent' inflation problem requiring central banks to engage in the sharpest hiking cycle since the 1980s. US Federal Funds Rate jumped to 2008 levels with another 0.5% increase forecasted by the futures market in 2023. Higher interest rate expectations across the government yield curve has resulted in a recalibration of bond and equity prices referred to as an asset deflation bear market, adversely impacting long duration exposures. US treasury 10-year yield more than doubled. Australia was not immune with inflation reaching 7.3% in the third quarter of 2022. The RBA cash rate increased to 3.1%, its highest level since 2012.

US / UK / Australian YoY Inflation

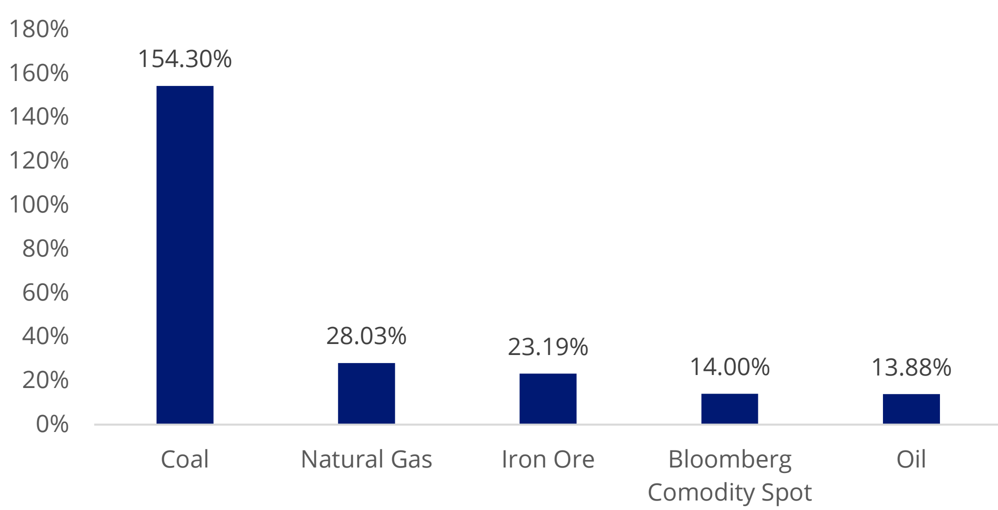


Source: Bloomberg

Russian invasion of Ukraine

On 24 February 2022, Russia invaded Ukraine and the conflict is still ongoing today. What followed was a series of western sanctions including export bans and businesses suspending operations in Russia. The outcome saw energy and commodity prices spike, further fueling inflationary pressures particularly in Europe.

YTD commodity performance

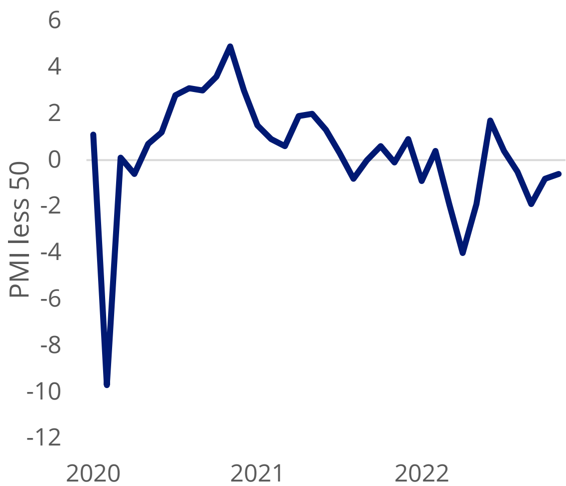


Source: Bloomberg, as at 31 December 2022.

China's COVID-zero policy

China's COVID-zero policy disrupted manufacturing activity and saw economic growth plummet in the country. Manufacturing activity contracted for most of 2022 as represented by the China Caixin Manufacturing PMI Index which further inflated supply chain pressures globally, increasing business input costs. China is also unlikely to have met its 5.5% GDP target for 2022. The escalating property crisis has also weighed negatively on sentiment. However, China in recent weeks has shifted to a 'living with COVID' environment. COVID cases are rampant and cities have scrapped COVID testing requirements in some settings. The next 6 months will be bumpy as the COVID waves makes their way through the country. Businesses are reporting a sharp increase in the number of staff on sick leave like we saw in Australia at the start of last year. China equity benchmark CSI 300 has been one of the worst performing asset classes in the world. China consumer sentiment also plummeted in 2022, but we expect this to recover with the end of the zero COVID policy.

China Caixin Manufacturing PMI

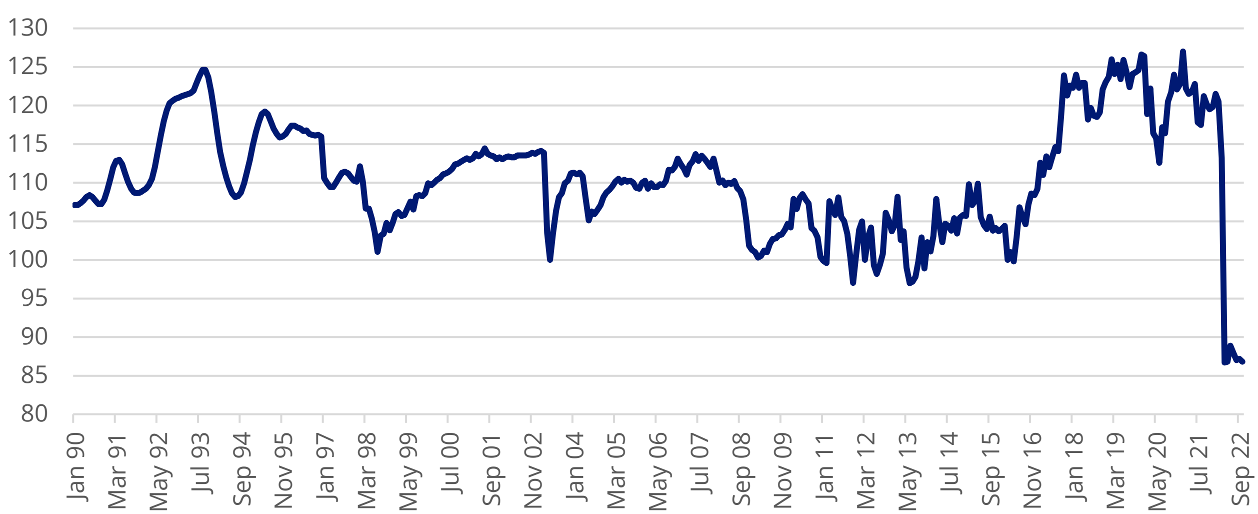


Source: Bloomberg

China GDP QoQ

Source: Bloomberg

China Confidence Indicator



Source: Organization for Economic Co-operation and Development

2022 Australian equity market performance

The Australian equity benchmark, the S&P/ASX 200 was one of the best performing asset classes in 2022 thanks to the Q4 resources rally and higher 'value' exposure relative to other country equity benchmarks.

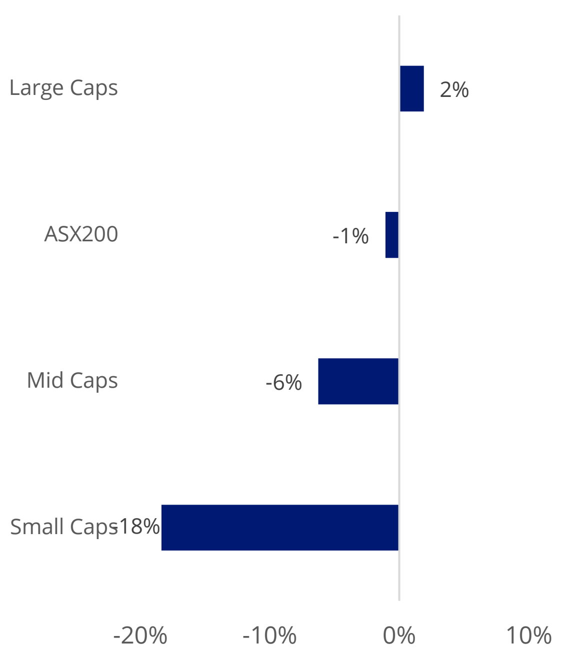
Rising yields and asset deflation bear market has adversely impacted small caps and long duration exposures including information technology, real estate sectors and growth stocks which the S&P/ASX 200 is underweight.

Australian resource stocks rallied over the past few months on China reopening optimism. Chinese President Xi Jinping has cited infrastructure spending (aka Australian resources) as the government's main lever to rescue economic growth.

Global energy crisis has seen energy companies become the best performing sector.

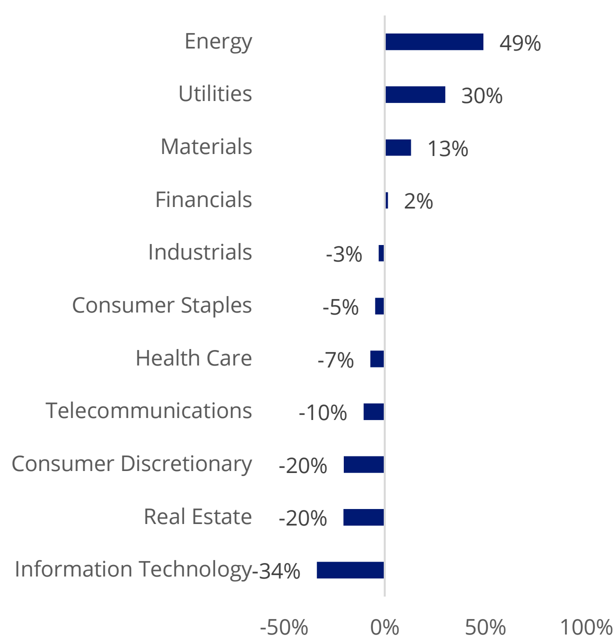
Mid cap and small cap Australian stocks underperformed for the year with investors reverting to large caps in a volatile and uncertain market.

2022 Australian Size Performance



Source: Bloomberg, MSCI World Sector Indices. As at 31 December 2022, AUD returns. ASX200 is S&P/ASX 200 Accumulation Index, Small Caps is S&P/ASX Small Ordinaries Index, Large Caps is S&P/ASX 50 Leaders Index, Mid Caps is S&P/ASX Midcap 50 Index. You cannot invest in an index. Past performance is not a reliable indicator of future performance.

2022 Sector Performance



Source: Bloomberg, S&P/ASX 200 Sector Indices. As at 31 December 2022, AUD returns.

Australia's big 4 banks were some of the best performing stocks after reporting net interest margin (NIM) expansion. Companies trading at high valuations such as REITs were the worst performing in the asset deflation bear market.

Top 5 S&P/ASX 200 contributors / detractors for 2022

Top 5 contributors	Avg weight (%)	Return (%)	Contribution to return (%)
BHP Group Ltd	10.34	37.85	2.51
Woodside Energy Group Ltd	2.40	78.58	1.08
Westpac Banking Corp.	3.83	15.31	0.61
Commonwealth Bank	8.26	5.57	0.58
National Australia Bank	4.71	9.45	0.49

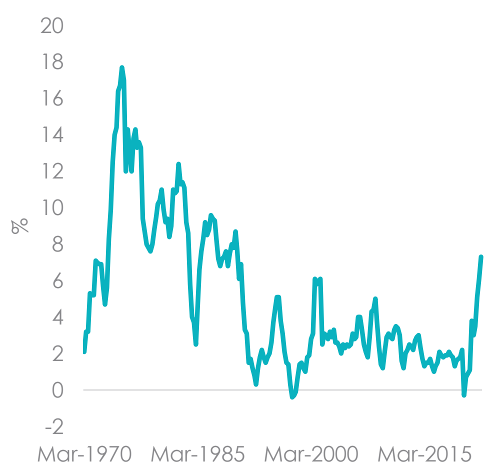
Top 5 detractors	Avg weight (%)	Return (%)	Contribution to return (%)
Goodman Group	1.64	-33.38	-0.71
James Hardie Industries	0.80	-51.82	-0.61
Wesfarmers Limited	2.63	-19.63	-0.59
Macquarie Group, Ltd.	3.14	-15.65	-0.56
Xero Limited	0.57	-50.32	-0.44

Source: FactSet, as at 31 December 2022

Macroeconomic environment

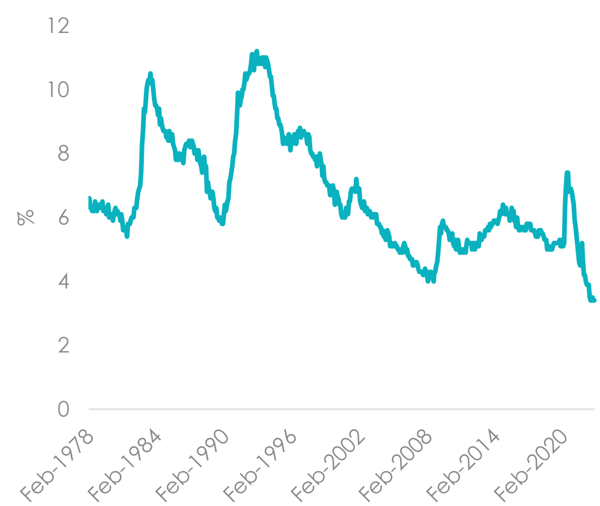
Sharp economic rebound from COVID-19 has seen unemployment and inflation reach historic lows and multi-decade highs respectively.

Australian macroeconomic indicators – CPI YoY



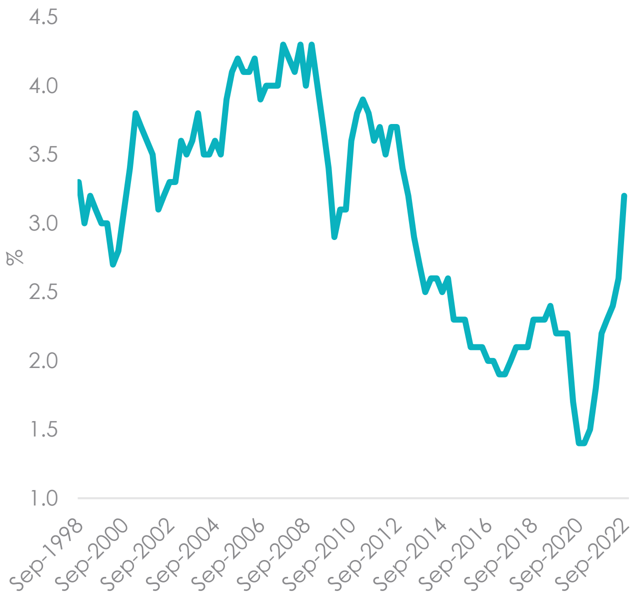
Source: Bloomberg, ABS

Unemployment rate



Source: Bloomberg, ABS

Wage growth YoY



Source: Bloomberg, ABS

Economic Activity (Manufacturing PMI)

Source: Bloomberg, CBA Australia Manufacturing PMI

Australian equities outlook for 2023

Recession bells are starting to toll as central banks around the world aggressively increase policy rates in pursuit of containing multi-decade high inflation. Russia's invasion of Ukraine and corresponding western sanctions have seen energy prices skyrocket particularly in Europe, adding to investor angst. However, the outlook for Australia is somewhat rosier for several reasons. So, is Australia about to get lucky again, or is our luck finally about to run out?

Prior to the COVID-19 recession, Australia held the longest streak of avoiding recession in 28 years among developed nations. The nation avoided a recession during the 1997 Asian financial crisis, dot com bubble, global financial crisis and eurozone crisis. It was also the only developed nation to avoid a recession during the GFC, defined as two consecutive periods of negative gross domestic product (GDP) growth, and why Australia is often referred to as the 'lucky country'.

How did Australia avoid a GFC recession? There were three contributing factors outlined by the Reserve Bank of Australia (RBA).

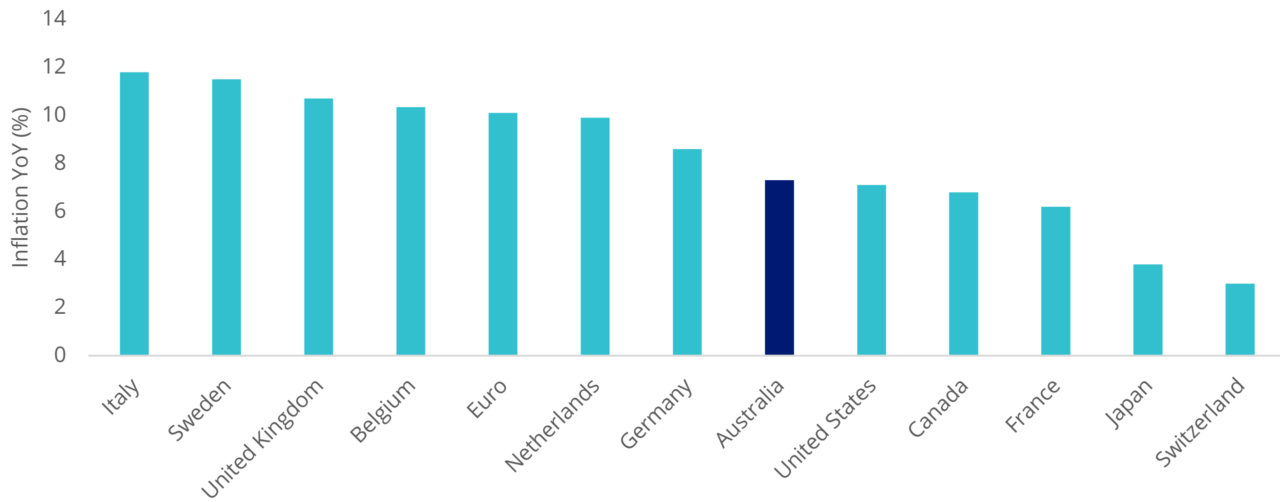
1. Low Australian banking exposure to the US housing market and US banks
2. Subprime and other high-risk loans were only a small share of lending in Australia
3. Chinese demand for Australian resources buoyed economic activity

This time round, Australia's fortunes could mean the nation avoids a recession. Below we explain why.

Headline inflation

Australia has lower headline inflation than the US and many European nations. This means the task of the RBA containing high inflation without triggering a recession, aka 'hard landing' relative to other nations is less challenging. The majority of Australian mortgages are variable which means cash rate increases immediately impact budgets and corresponding spending. This allows the RBA to pivot faster based on changes in inflation. US and European mortgages are majority fixed. Policy rate increases delay the need for consumers and businesses to refinance, resulting in a time lag on impacting spending patterns. The US Federal Reserve is effectively throwing darts blindfolded via its aggressive policy rate stance, balancing economic growth and inflation.

G10 Inflation YoY

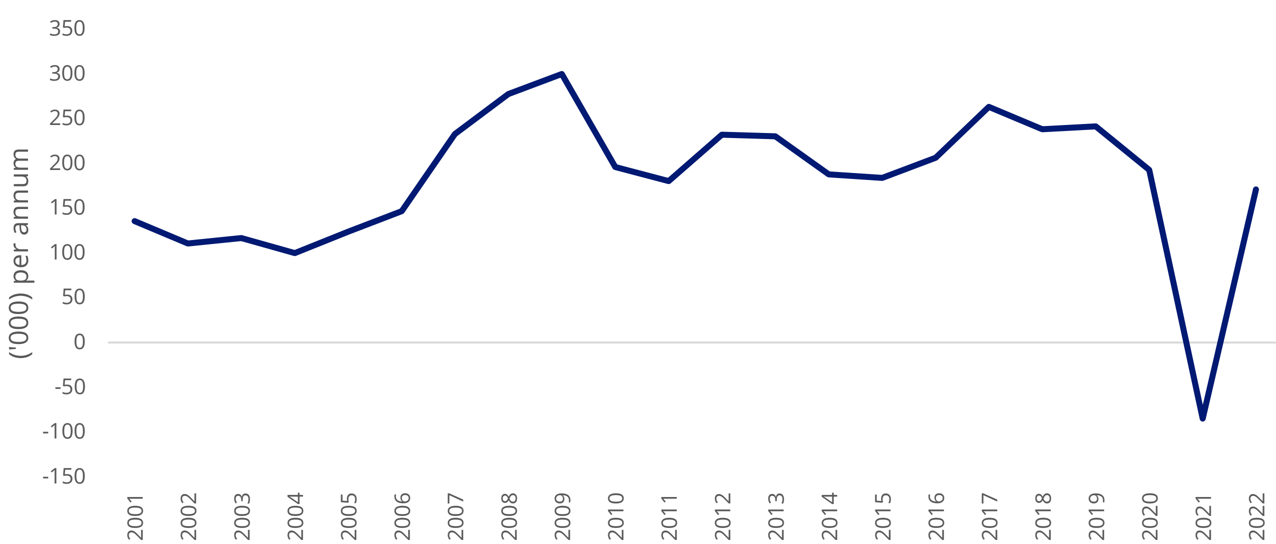


Source: Bloomberg

Wage growth

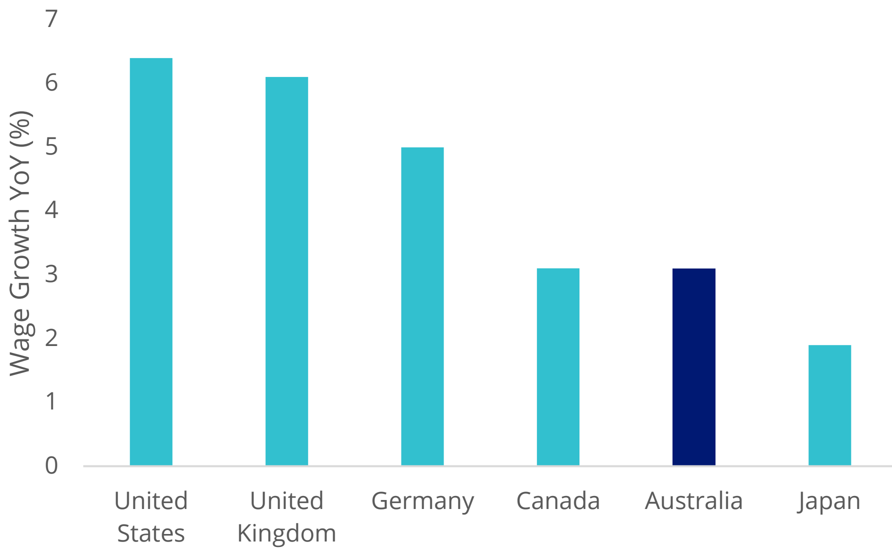
Wage growth in Australia is less pronounced. You may have heard of the Phillips curve which states that changes in unemployment and inflation are negatively correlated. This implies that a level of labor retrenchment, i.e. the increase in unemployment rate required to slow wage growth, cost inflationary pressures on business and ultimately consumer costs, is lower. The Australian government is increasing the number of permanent migration visas available in 2022-23 from 160,000 to 195,000 places. Net migration will help cool the tight labour market and lower wage cost pressures.

Net Overseas Migration



Source: Australian Bureau of Statistics

G10 Wage Growth YoY

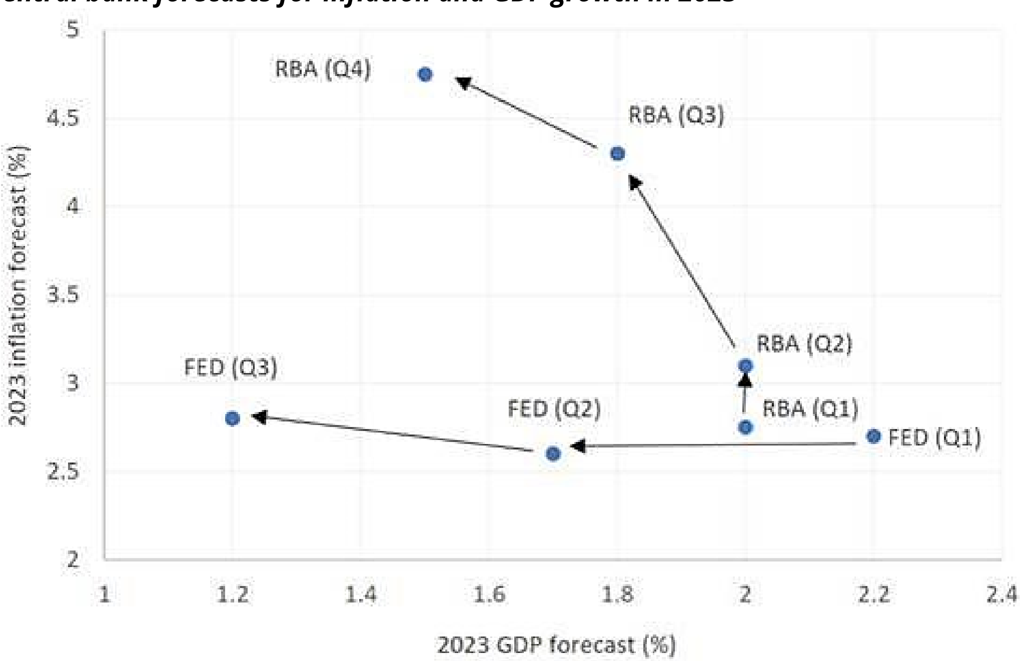


Source: Bloomberg

RBA Pivot

The RBA is prioritising growth in 2023 over containing inflation between the 2-3% target. RBA increased their Australian CPI forecast for 2023 from 2.75% to 4.75% over the past 4 quarters. In contrast, the Fed is resolute on driving down inflation to 2% despite the probability of a US recession increasing for 2023.

Central bank forecasts for inflation and GDP growth in 2023



Source: RBA, Federal Reserve

Major commodities exporter

Australia is a major commodities exporter with abundant natural resources relative to its own needs. Liquid natural gas (LNG) for example is in short supply in Europe due to the low supply from Russia, contributing to high energy costs in the region. Australia is one of the largest exporters of LNG, putting downward pressure on energy costs domestically. The federal government is implementing price caps on domestic coal and LNG supply, reducing energy inflationary pressures.

Governments also often turn to infrastructure spending as a fiscal measure to expand growth in an economic downturn. Chinese President Xi Jinping has cited infrastructure spending as the government's main lever to rescue economic growth. The Australian resources sector could be a major beneficiary of this investment, as it was during the GFC.

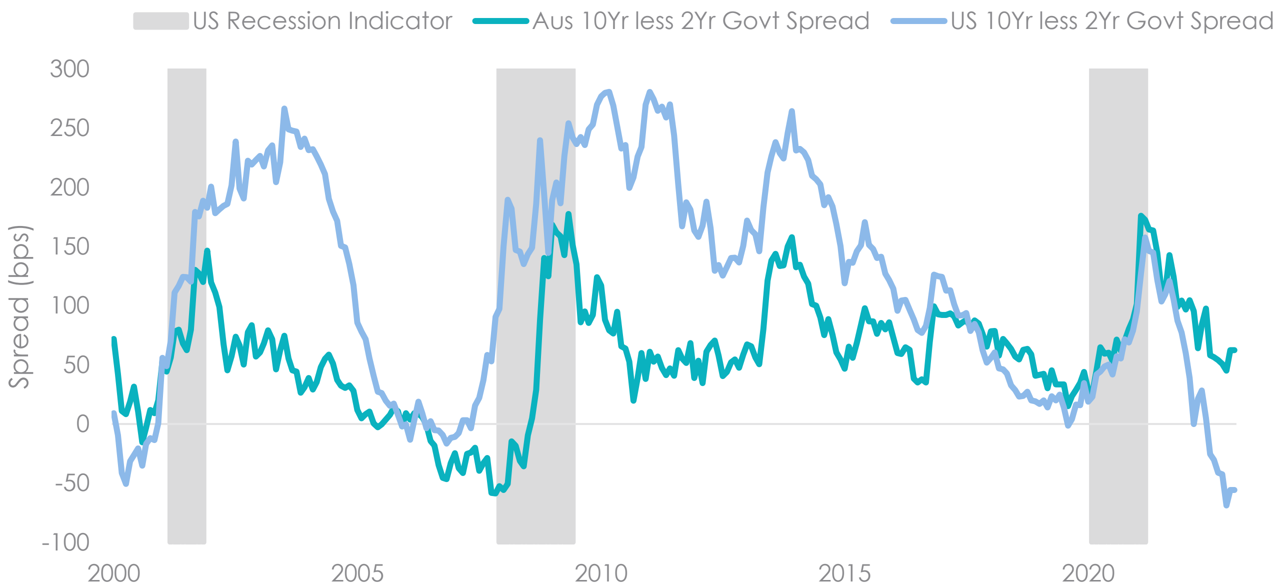
At the end of 2009, China's year on year infrastructure investment sky rocketed to 54 per cent, from 10 per cent the previous year. The spending helped resurrect economic growth during the lows of the GFC. As a result, Australian commodity export prices soared, and mining as a percentage contribution of Australian GDP jumped, boosting Australian resource companies.

China infrastructure investment growth YoY

Source: Bloomberg. Data to 30 November 2022.

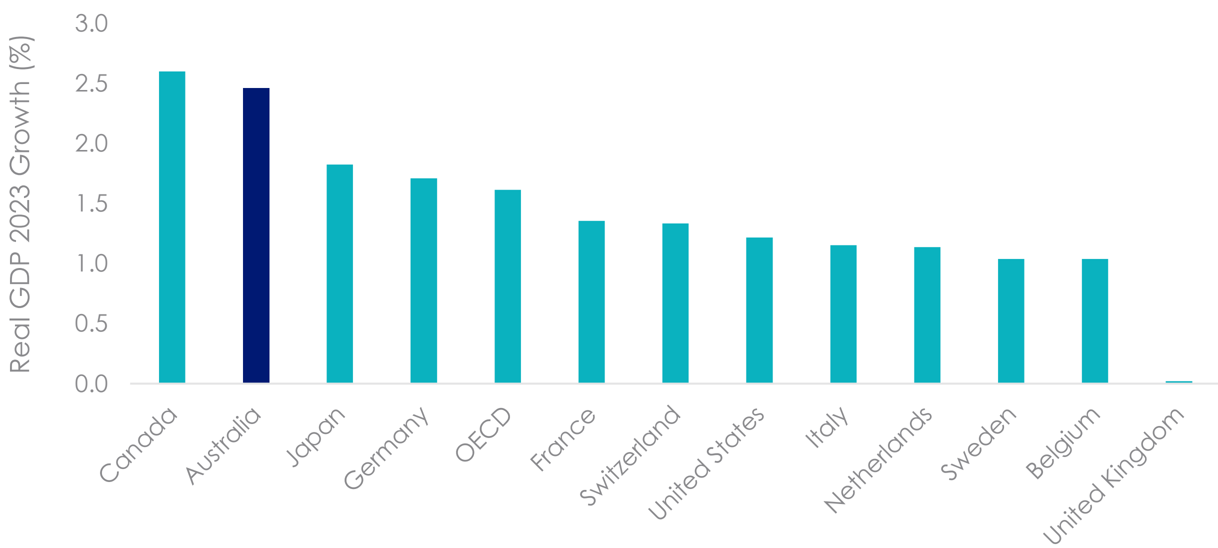
Bond markets and the Organisation for Economic Co-operation and Development (OECD) are optimistic on Australia's economic outlook relative to other G10 nations. The Australian government 10-year bond yield is higher than the 2-year whereas the US government bond yield curve is inverted. Yield inversion between the 2 and 10 year has historically been a leading indicator for an impending recession in the next 6 to 18 months. Australian projected real GDP growth for 2023 is expected to be one of the highest according to the OECD.

10 Year less 2-year government bond yields



Source: Bloomberg

OECD G10 2023 Real GDP Forecast YoY



Source: Bloomberg

Equity valuations

Asset deflation bear market has improved valuations. Price to earnings and enterprise value to EBITDA are below historical averages.

S&P/ASX 200 12m forward valuations – P/E

Source: Bloomberg

Price to Book

Source: Bloomberg

Price to Sales

Source: Bloomberg

Enterprise Value to EBITDA

Source: Bloomberg

Key Australian sector and key company outlook

Banks (neutral)

Australia's big 4 banks were some of the best performing stocks after reporting net interest margin (NIM) expansion. The rapid increase in mortgage rates and delayed marginal increase in deposit rates helped expand NIMs.

However, NIMs may have peaked for several reasons as we head into 2023.

1. Wages cost pressures. Wages account for more than 50% of bank expenses. The banks have come under significant pressure from bank unions to increase compensation rates to be in line with headline inflation. The days of annual wages expense growth of 1-3% are likely over, at least in the near terms with the RBA forecasting inflation to be 4.75% in 2023.

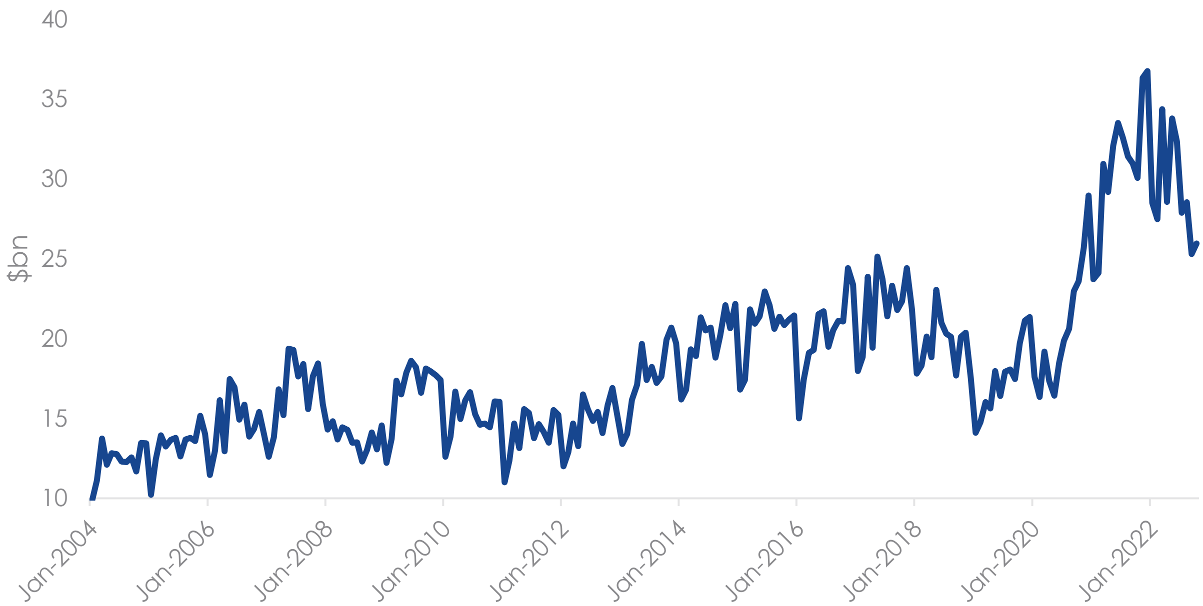
2. Higher funding costs. Australian corporate bond credit spreads for unsecured paper are above COVID-19 highs.

Australian financials average credit spread

Source: Bloomberg, Bloomberg Ausbond Credit Financials Index. You cannot invest in an index.

3. Slowing loan growth. Increase in mortgage rates has slowed loan growth which previously provided a major tailwind for banking revenue growth. Expect loan growth to slow further in 2023 as higher rates squeeze household and business balance sheets.

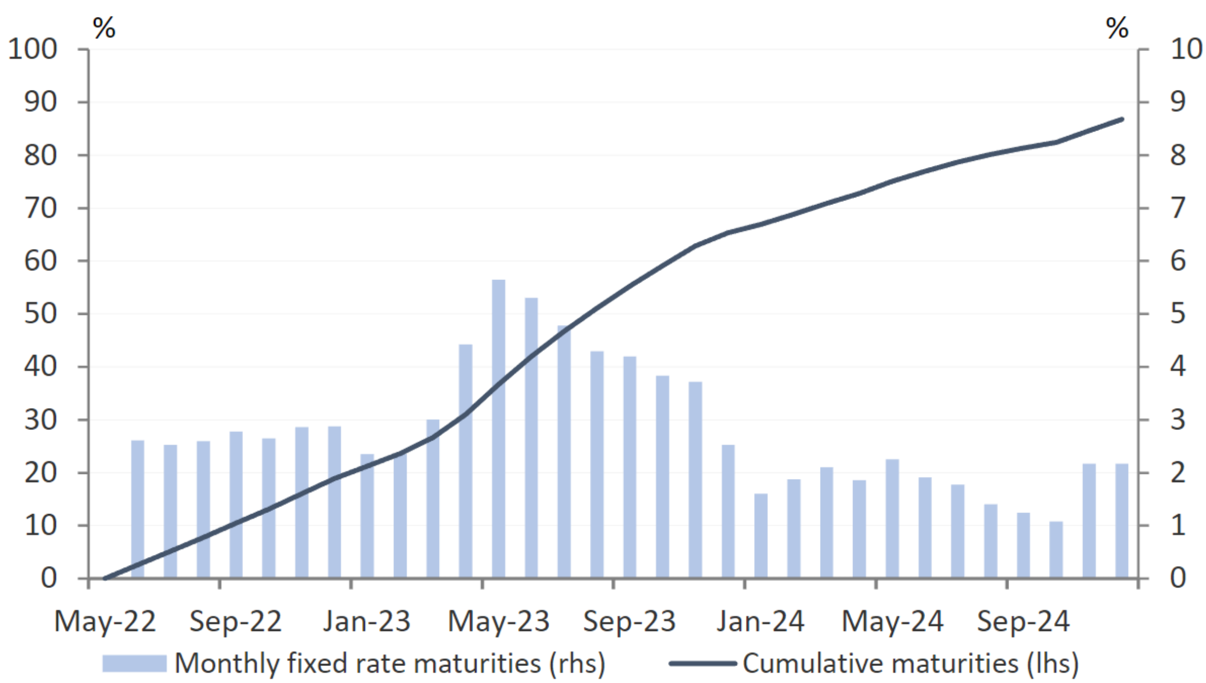
New loan commitments, total housing



Source: ABS

4. Higher delinquencies, rapid mortgage rate increases and roll-off of fixed rate mortgages this year is likely to put pressure on households and result in mortgage stress.

Fixed rate mortgages rolling off in 2023



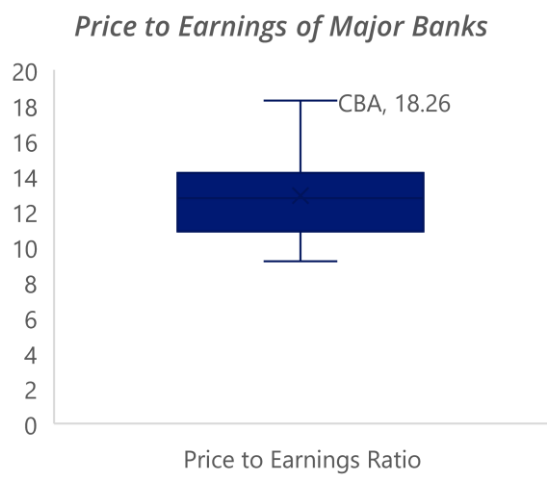
Source: RBA, Morgan Stanley Research

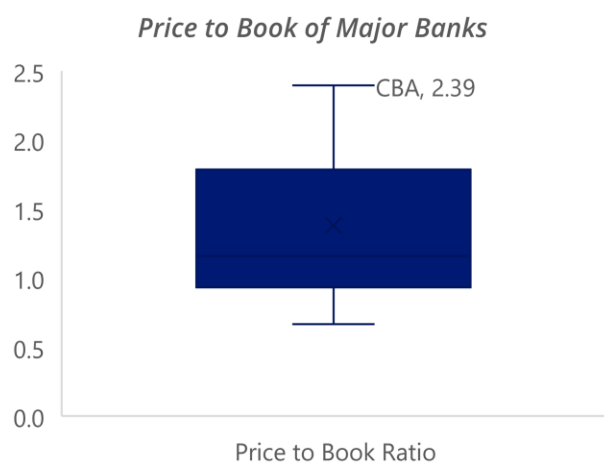
Commonwealth Bank of Australia (ASX: CBA)

The Australian Banks have held up during the calendar year with 1.31% return in an uncompromising year for equities[1]. CBA is a market darling of the ASX, its large market capitalization coupled with the Australian market's general positive view on the banking sector has allowed the stock to exhibit strong price support returning 5.58% for the year[2]. The bank is Australia's leading deposit franchise, is highly capitalised and has exhibited strong rate leverage which has contributed to revenue growth which was highlighted in the August reporting season followed by November AGM's were higher than expected deposits to loans have generally offset against the challenges this year.

The RBA has estimated that most Australian homeowners with variable mortgages are expected to roll within the next two years, with a significant portion of these occurring in the second half of 2023. Mortgage competition is influencing homeowner banking choices with favorable mortgage rates being paramount in a climbing rate environment. Greater competition will prove to be a headwind for the bank going into the new year.

From a valuation perspective, the bank is also more expensive than its peers on a relative to peer and historic basis, having the highest PE and price to book ratio in the sector.





Source: Bloomberg; ANZ, BEN, BOQ, CBA, MQG, NAB and WBC

Given the expensive valuation for CBA, rising operational cost, slowing loan growth and higher funding cost, the company faces significant obstacles in the year ahead. However, if the bank can continue to expand their net interest margins (NIMs) as rate hikes come to fruition in 2023, the stock price may be more resilient than expected.

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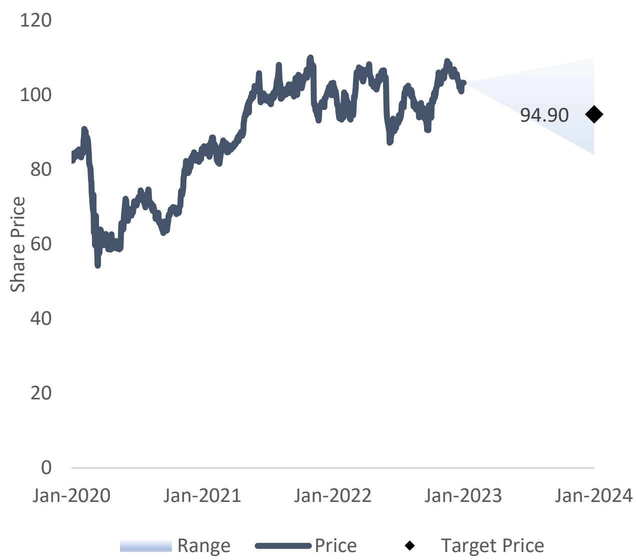
[1] As at 30 December 2022 using MVIS Australia Banks Index.

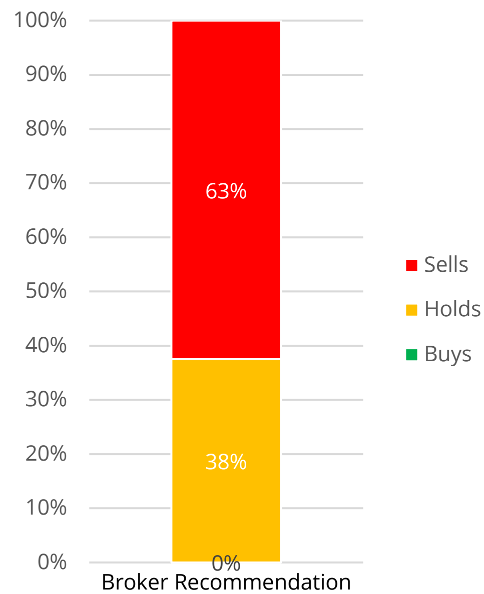
[2] As at 30 December 2022.

Median Share Price 12 month target (-7%)



Source: Bloomberg, as at 30 December 2022.

Broker buy/hold/sell split (16 analysts)



Source: Bloomberg, as at 30 December 2022.

From an income perspective, CBA looks unattractive when comparing to the past three years. CBA fully franked dividend yield is 5.35%, relative to the 6 Month Australian Bank Bill Rate at 3.77%[3]. It is evident the yield gap is closing in the current climate and with market conditions not boding well for overvalued equities, investors should consider the risk reward payoff in terms of capital risk for stocks with diminishing relative yield returns.

CBA Franked Dividend vs 6 Month BBSW

Source: Bloomberg. Past performance is not indicative of future performance

[3] As at 30 December 2022.

Resources (overweight)

During the global financial crisis, China's demand for Australia's natural resources was the saviour in helping the country avoid a technical recession defined as two consecutive quarters of negative gross domestic product (GDP) growth. Governments such as China often turn to infrastructure spending as a fiscal measure to expand economic growth in an economic downturn. This could be repeated.

Chinese President Xi Jinping has cited infrastructure spending as the government's main lever to rescue economic growth. China is finally transitioning to a 'living with COVID' environment. The Australian resources sector could once again be a major beneficiary of this investment, as it was during the GFC.

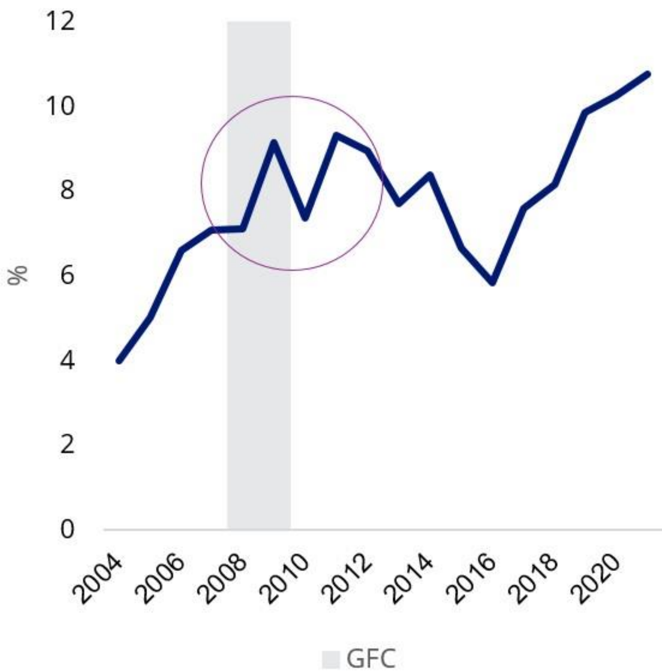
At the end of 2009, China's year on year infrastructure investment sky rocketed to 54 per cent, from 10 per cent the previous year as shown earlier. The spending helped resurrect economic growth during the lows of the GFC. As a result, Australian commodity export prices soared, and mining as a percentage contribution of Australian GDP jumped, boosting Australian resource companies.

The reopening of a country with 1.4 billion residents offers investment opportunities, particularly within Australian sectors that have high revenue exposure to China.

RBA Commodity Export Price Index

Source: Bloomberg. You cannot invest in an index.

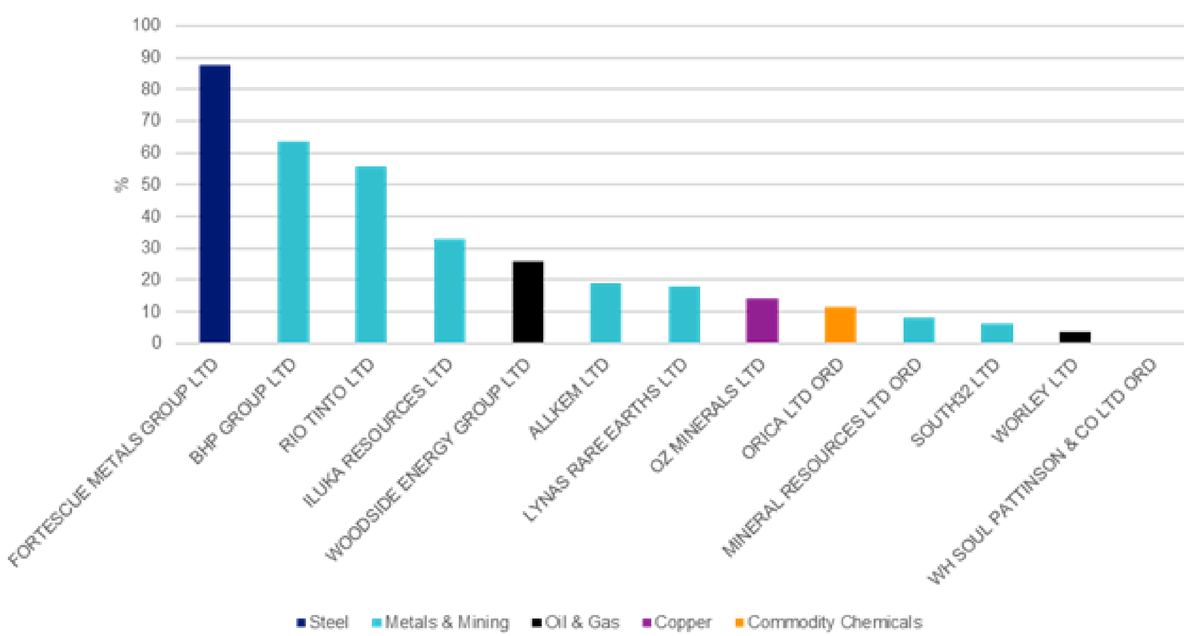
Mining as a share of Australian GDP



Source: ABS

Despite geopolitical tensions, and Chinese sanctions on some major Australian exports, China remains reliant on Australian mining resources. 19 per cent of Australian mining revenue is attributed to China, based on the constituent weighting of MVIS Australia Resources Index.

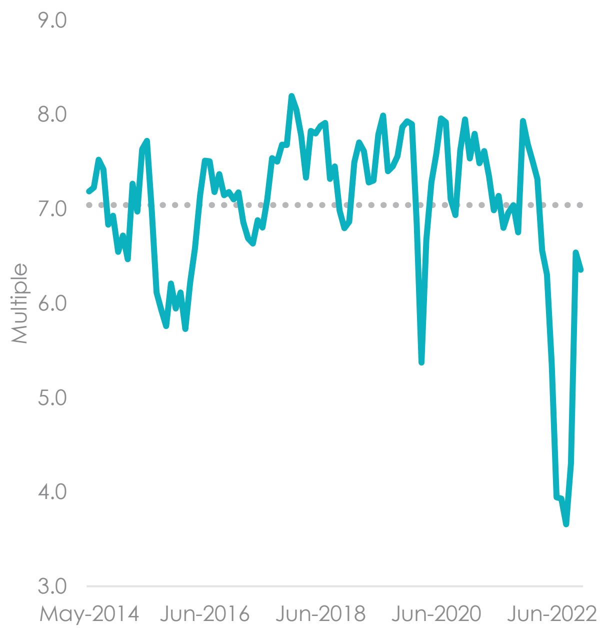
Australia resources revenue attributed to China



Source: Factset, as at 30 June 2022.

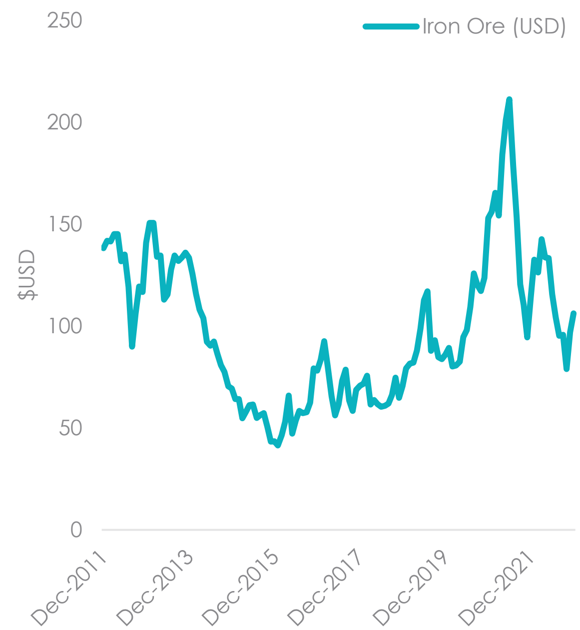
The recent downturn in global markets and economic weakness in China has improved the valuation profile of Australian resources. Price to 12-month forward cash flow is below its historic average and iron ore prices have dropped to 2018.

Australian Resources 12m forward price to cash flow



Source: Bloomberg, Australian resources as MVIS Australia Resources Index.

Iron ore price



Source: Bloomberg, Iron Ore Spot price Index 62% Import Fine Ore.

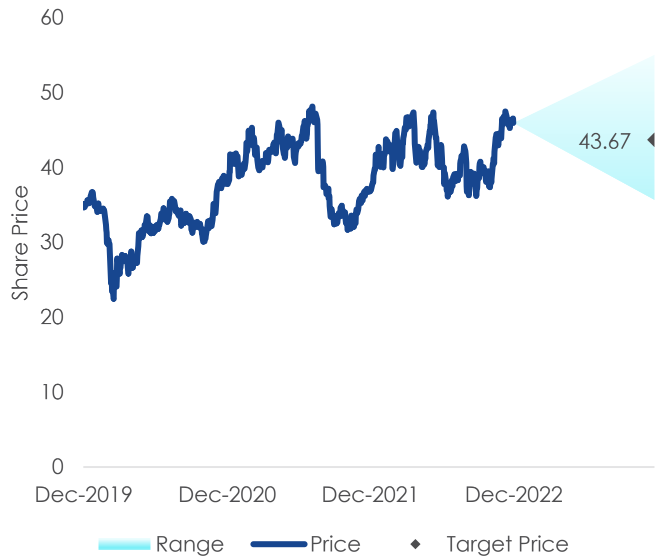
BHP Group (ASX: BHP)

The world macroeconomic climate weakened over 2022 on the back of COVID-19 related disruptions, the Russia / Ukraine war and inflationary headwinds. These headwinds have proved to be a boon for resource stocks, with limited supply and significant demand (primarily driven by China) leading Australian energy and materials stocks to deliver returns of 49% and 13% respectively[4]. This climate has bolstered BHP's return, with the world's largest mining company posting an eye-watering 48%[5] return through 2022.

Turning to 2023, BHP's ability to repeat this stellar performance remains subject to a variety of factors. One key concern remains the resilience of the global economy in the face of rapid monetary policy tightening. Indeed, a demand-sapping recession would drag upon global infrastructure investment and thus the performance of resource stocks. However, China – the world's largest importer of iron ore – has ended its zero-COVID policy. With this decision comes a return to Xi Jinping's policy of economic growth and substantial infrastructure investment. With over 60% of revenue derived from China[6], this is likely to prove a significant tailwind for BHP's stock price.

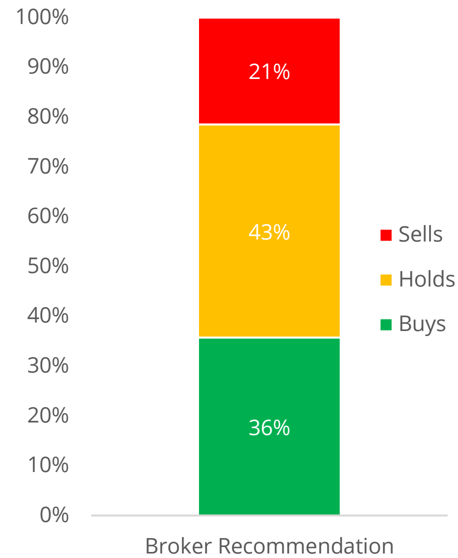
[4] S&P/ASX200 Energy Sector Index & S&P/ASX200 Materials Index. As at 31 December.
[5] As at 31 December.
[6] Factset, as at 30 June 2022.

Median Broker Consensus Share Price 12 month target (-6%)



Source: Bloomberg, as at 31 December 2022.

Broker buy/hold/sell split (10 analysts)



Source: Bloomberg, as at 31 December 2022.

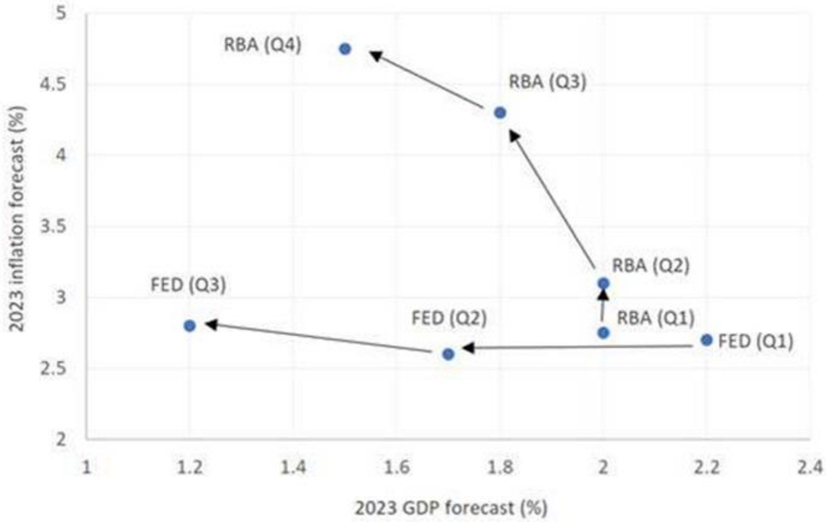
A-REITs (neutral to overweight)

A-REITs have had a 2022 they would rather forget, underperforming the market by over 18%. But, this year's worst performer could become next year's rising star. REITs' rough run in 2022 has mainly been driven by a sharp increase in the 10-year bond yield, which have more than doubled. However, we believe long dated government bond yields could be close to reaching their peak, and the RBA prioritising growth over inflation could provide tailwinds for REIT performance.

The RBA has started to temper the rate of cash rate increases over the past three months despite Australian inflation reaching a 40-year high in Q3 and expectations it will further increase in Q4 2022. The RBA increased the cash rate in October, November and December by 25 basis points, below market expectations of 50 basis point hikes during the first two months. This approach indicates to us that for 2023 the RBA is prioritising economic growth over containing inflation quickly. RBA increased their Australian CPI forecast for 2023 from 2.75% to 4.75% over the past 4 quarters. In contrast, the Fed is resolute on driving down inflation to 2% despite actions increasing the risk of a US recession 'hard landing'.

The RBA's focus is positive for potentially oversold A-REITs for three reasons.

Central bank forecasts for inflation and GDP growth in 2023



Source: RBA, Federal Reserve

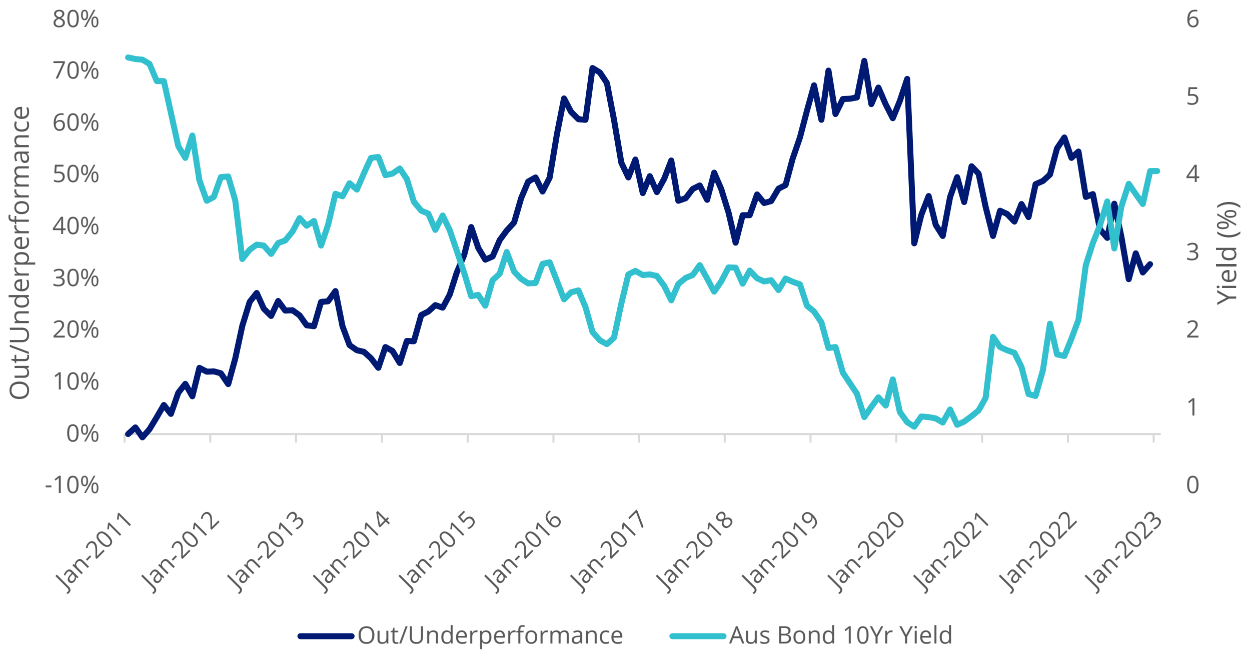
1. REIT income inflation linked

REITs historically outperform during persistent inflation periods. The RBA is forecasting inflation to be above its target in 2023. Commercial leases and contracts in office and logistics typically have inflation linked annual increases in rents written into the contract, providing inflation protection on income. An example was between the end of the dot-com bubble and GFC. During this period, Australian CPI year-on-year was 2.9 per cent on average and Australian 10-year government bond yields steadily increased over this time where A-REITs as represented by the S&P/ASX 200 A-REITs outperformed the S&P/ASX 200 by 3.99% between 1 January 2002 and 31 December 2006. Noting that as always, past performance is not indicative of future performance.

2. Government bond yields moderating

REIT performance is negatively correlated with bond yield movements due to the impact of change in borrowing costs on property valuations. The increase in government bond yields in 2022 due to rapid increases in the expected RBA cash terminal rate has been a major headwind for REIT performance.

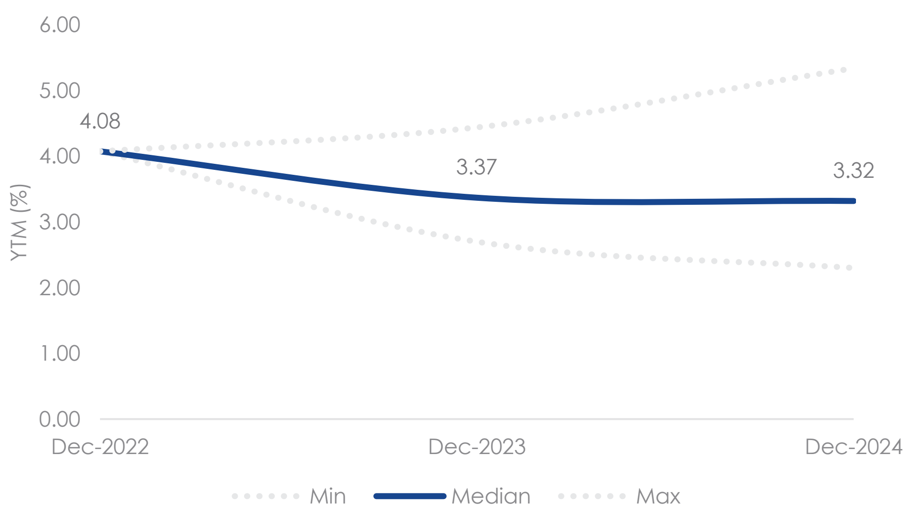
A-REITs performance relative to S&PASX 200 versus Australian government 10-year bond yield



Source: Bloomberg, Out/Underperformance as MVIS Australia A-REIT cumulative performance relative to S&P/ASX 200. Past performance is not indicative of future results. You cannot invest in an index.

However, long dated government bond yields could be close to reaching their peak. Broker consensus is that Australian Government bond 10-year yield will remain at similar levels over the next two years. Bond markets have priced in expected further RBA cash rate increases and there is a chance the RBA starts cutting the cash rate in late 2023 as the global economy slows, putting downward pressure on government yields. If yields fall, this would be a tailwind for REIT performance.

Australian government 10-year bond yield median broker forecast



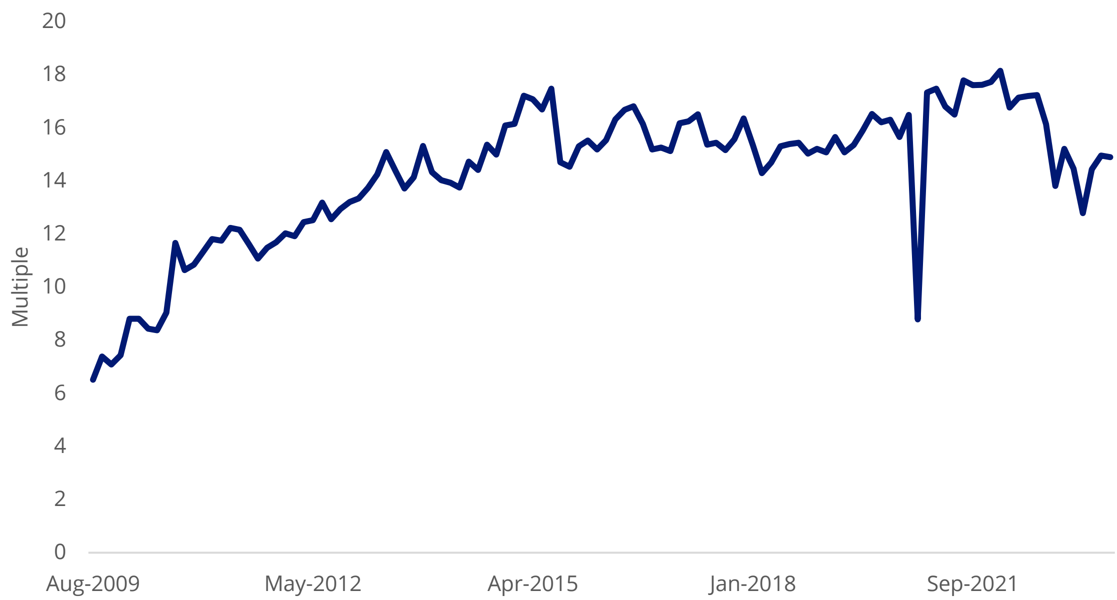
Source: Bloomberg, as at 28 December 2022.

3. Valuations attractive

The asset deflation bear market we have seen year to date has improved the valuation profile of REITs. Price to Adjusted Funds from Operations (AFFO multiple) is at a five-year low and price to Net Tangible Assets (NTA) is at a 9% discount. While not all NTA's may have been revised, prices are reflecting a discount to NTA. We are also seeing an increase in cap rates.

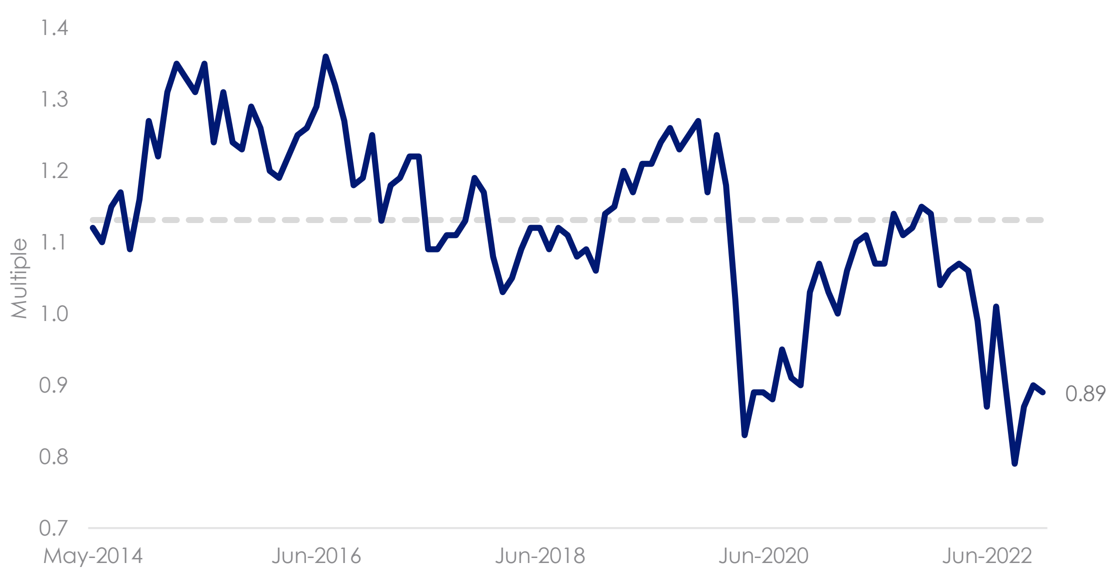
These measures are market convention for valuing REITs and are preferred to metrics such as price to earnings ratios.

A-REIT AFFO Multiple



Source: Bloomberg, A-REIT as MVIS Australia A-REIT Index. You cannot invest in an index.

A-REIT Price to NTA

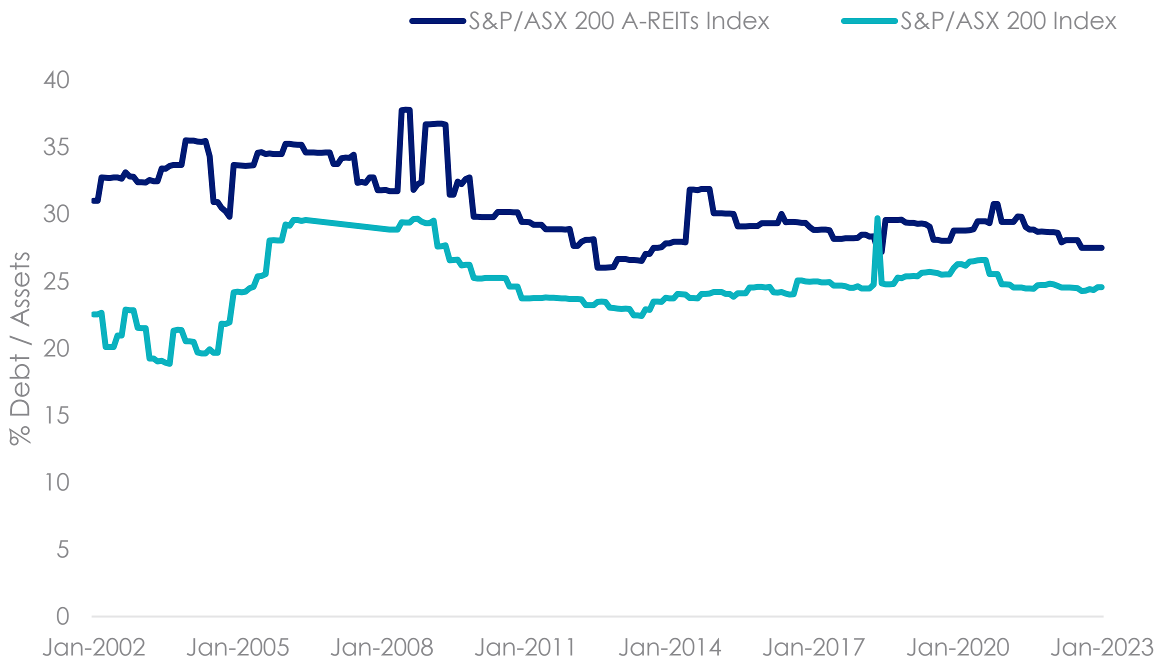


Source: Bloomberg, A-REIT as MVIS Australia A-REIT Index. You cannot invest in an index.

4. Reasonable and maintainable leverage

REIT leverage levels have been falling over the years. This should assist REITs in weathering an increase in their debt costs as a result of rising interest rates. There is also reasonable protection this year due to an average of 65% of interest rate hedging across the REIT universe. Those REITs with the lower interest rate hedging and tighter covenants will be affected the most.

Leverage – Debt/Assets



Source: Bloomberg. You cannot invest in an index.

The asset deflation bear market we have seen year to date has improved the valuation profile of REITs.

Goodman Group (ASX: GMG)

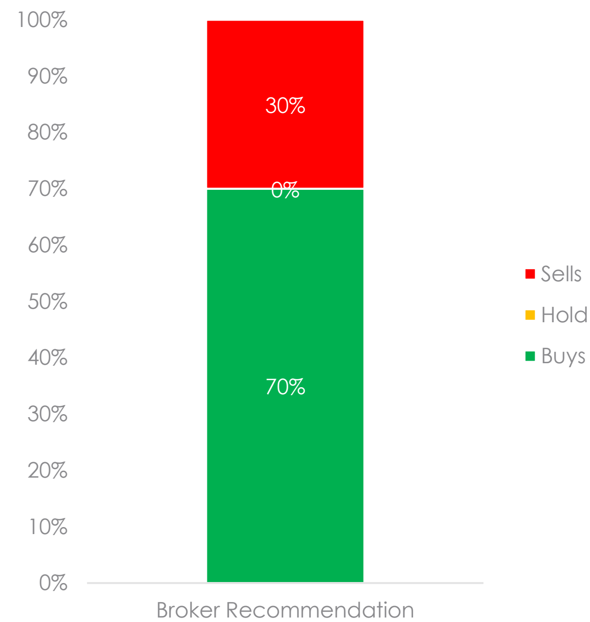
Industrial REIT Goodman Group was one of the worst performing REITs in 2022. The subsector saw an acceleration in warehousing and logistics demand following the emergence of COVID-19 and subsequent lockdowns. Strong sales and earnings growth resulted in Goodman Group becoming one of the most expensive ASX-listed REITs based on Adjusted Funds from Operations multiples, prior to the 2022 asset deflation bear market.

Looking forward, industrial REIT cap rates and net operating income are likely to remain sticky as tenants look to manage excess inventory levels and expand E-commerce channels amid low vacancy rates. Retailers will continue to invest in optimising delivery chains as they address demand for both in-store and online consumer spending. Warehousing provided by industrial REITs will potentially be key beneficiaries.

Median Broker Consensus Share Price 12 month target (+21%)

Source: Bloomberg, as at 31 December 2022.

Broker buy/hold/sell split (10 analysts)



Source: Bloomberg, as at 31 December 2022.

Energy (neutral)

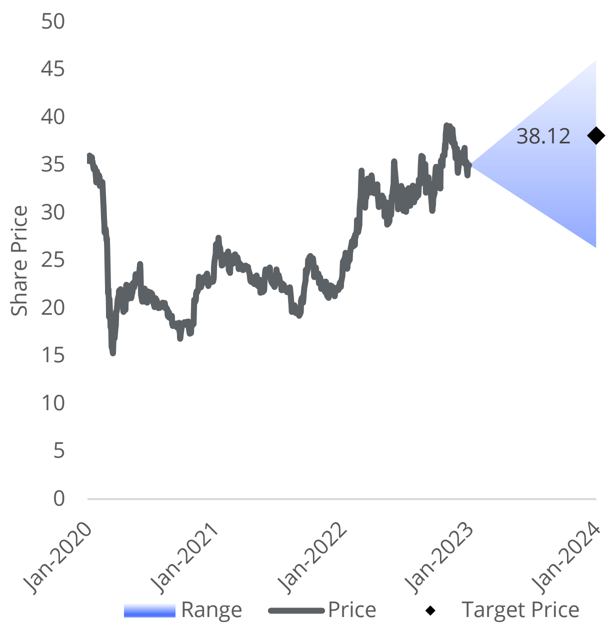
Australian energy was the best performing sector due to skyrocketing gas and oil prices triggered by Russia's invasion of Ukraine (and subsequent western sanctions). Energy prices are likely to remain elevated in 2023 despite expectations of a global recession. China in recent weeks has transitioned to a 'living with COVID' environment which will increase energy demand. China's LNG import volumes are 39% below their trend growth according to UBS. OPEC+ cut output by 1 million barrels per day in Q4 and US Strategic Petroleum releases of 1 million barrels per day have slowed.

Federal and State governments also recently announced 12m price caps on coal and gas provided to domestic markets. The consensus view is that these measures are manageable in the medium term but does increase policy uncertainty.

Woodside Energy Group (ASX: WDS)

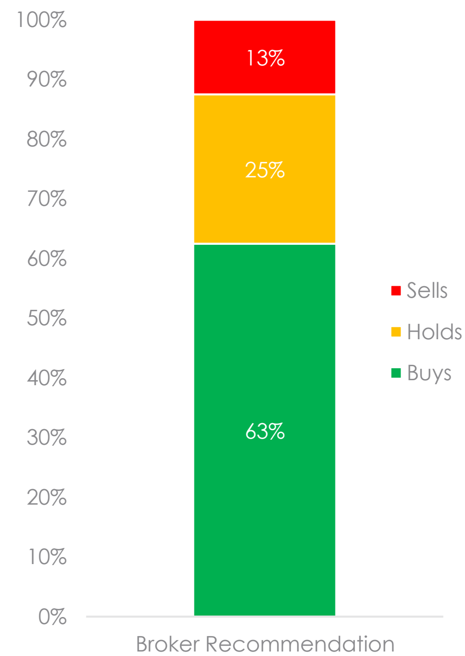
Lingering geopolitical tensions and underinvestment provide favourable risk skew to oil and gas prices. Elevated prices will also assist cashflow.

Median Broker Consensus Share Price 12 month target (+6%)



Source: Bloomberg, as at 31 December 2022.

Broker buy/hold/sell split (16 analysts)

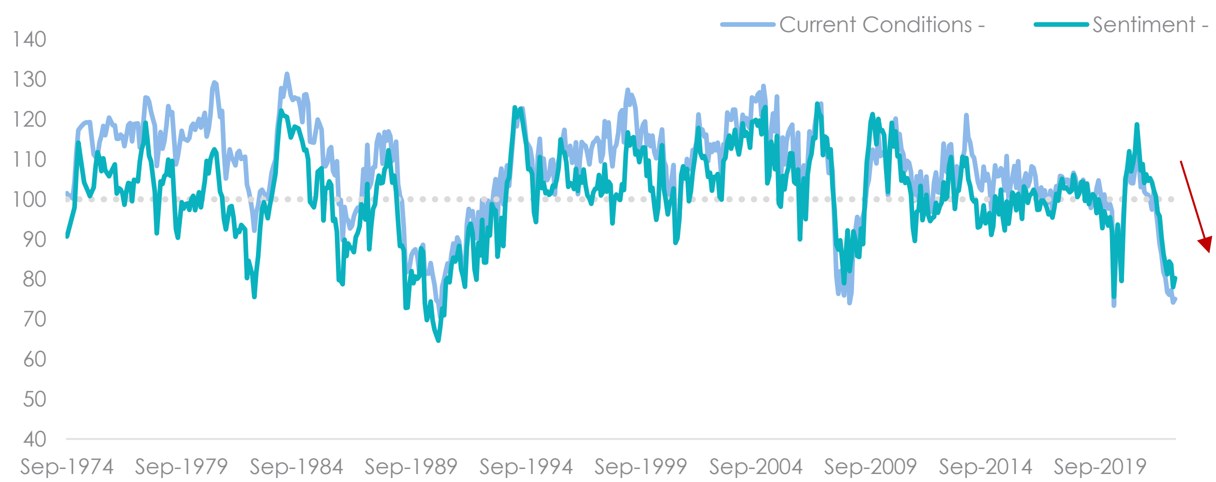


Source: Bloomberg, as at 31 December 2022.

Consumer discretionary (underweight)

Following IT, the Australian consumer discretionary sector has been the second worst performers in ASX in 2022, lagging the benchmark by over 20%[7]. The challenging landscape is likely to extend into 2023 for discretionary stocks. It is not surprising that the consumer sentiment decline has coincided with the RBA rate hikes since May last year. While we may see the peak of a hiking cycle soon, Westpac's December consumer survey results indicate that inflation concerns remain high and are not abating despite higher interest rates and a deteriorating economic outlook.

Westpac - Melbourne Institute Consumer Sentiment & Current Conditions



Source: Westpac-Melbourne Institute

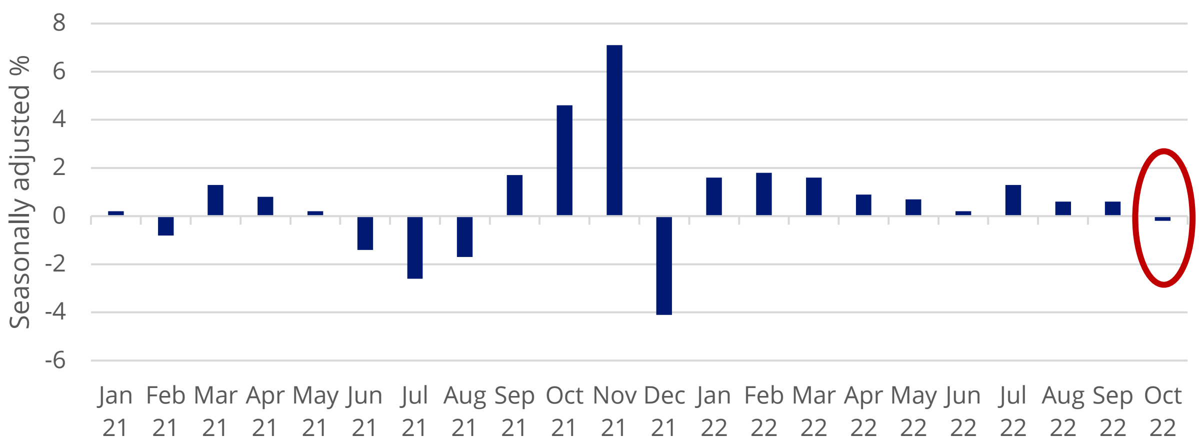
[7] S&P/ASX 200 Consumer Discretionary Sector GICS Level 1 Index vs S&P/ASX 200 for the calendar year

There are two factors we consider important for the sector's outlook.

1. Household savings

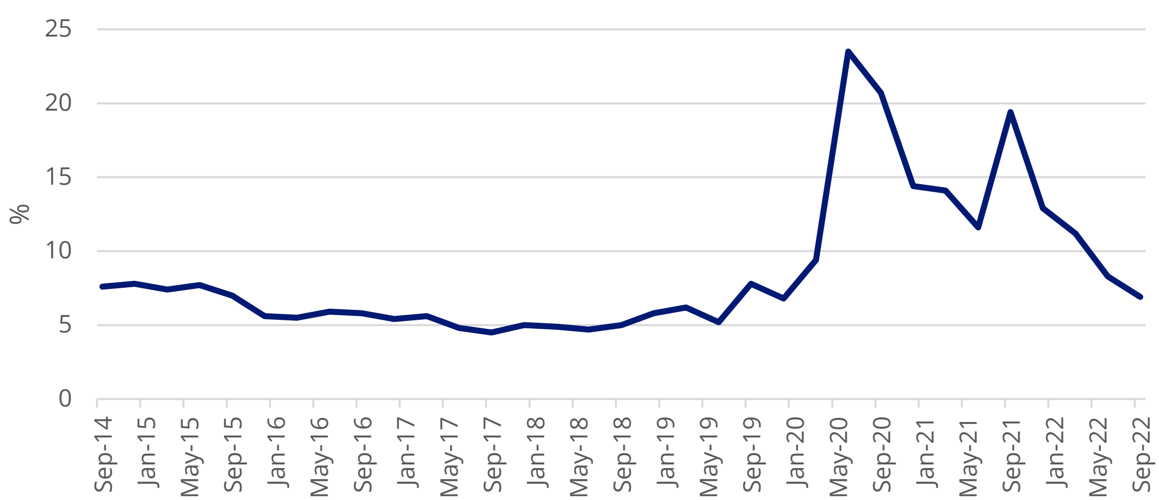
Since September 2021 the household savings ratio has continued to trend down, in other words the buffer built during lockdowns are now being depleted. While retail sales have held up well this year, we think there is time lag between the change of financial conditions and consumption behaviour. October saw the first MoM decline (-0.2%) in retail sales, which could be some early signs that rising costs of living are eating into household discretionary income. November and December data would draw a clearer picture of consumer pressure as spending is generally 25% higher than the remaining of the year, estimated by Morgan Stanley.

Australian Retail Sales MoM



Source: Bloomberg, As at 29 December 2022.

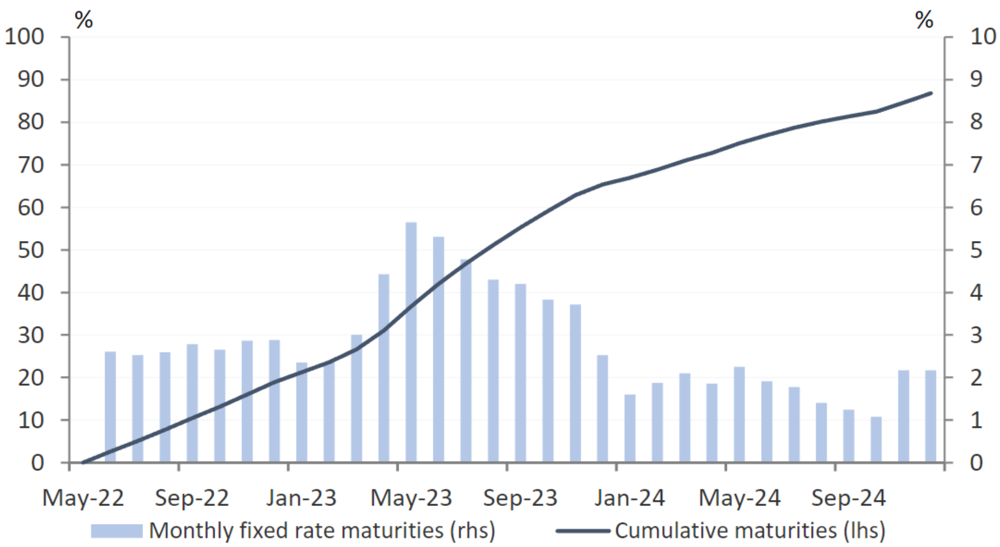
Household saving ratio



Source: ABS, As at September 2022.

2. Mortgage roll-off

It is estimated by RBA that the fixed rate mortgage roll-off will have a peak impact in 2Q23. Given the high interest rate environment this would adversely impact debt serviceability for households.



Source: RBA, Morgan Stanley Research

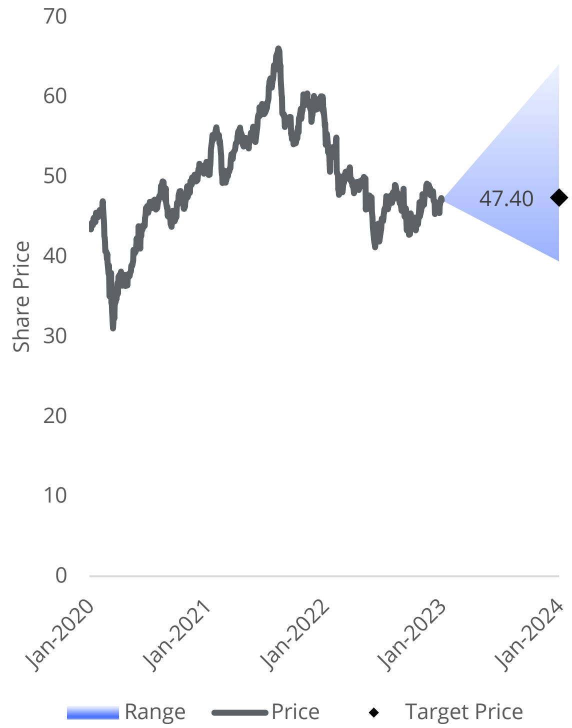
Wesfarmers (ASX: WES)

Wesfarmers hosts a wide range of businesses including general merchandise (Kmart, Target and Catch) and home-improvement (Bunnings). In 2022 Wesfarmers generated -18.34%, marginally outperformed the sector by 1.1%. The macroeconomic tightening and higher cost of energy prices results in a slowdown in consumer discretionary spending, consequently weaker equity performance for Wesfarmers.

As nearly all the company's revenue is generated domestically, we might see further headwinds in 2023. While Bunnings (the biggest business segment) sales remain resilient, EBIT margin has seen two consecutive drops as DIY spending slows. Based on Corelogic Data, the aggregate housing value in five capital cities have contracted 7.3% yoy[8], resulting in a negative wealth effect among households. In addition, Kmart inventory levels are building which may present risks this year. Consumers are likely to become more price sensitive amid a high interest rate and high inflation backdrop, as a result Kmart could also face more intense competition from online marketplaces.

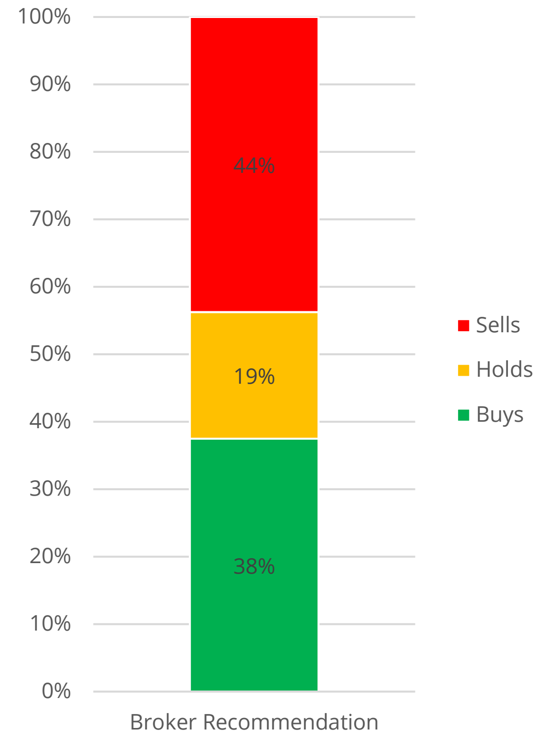
[8] https://www.corelogic.com.au/our-data/corelogic-indices

Median Share Price 12-month target (+0.8%)



Source: Bloomberg, as at 10 January 2023.

Broker buy/hold/sell split (15 analysts)



Source: Bloomberg, as at 10 January 2023.

Consumer Staples (overweight)

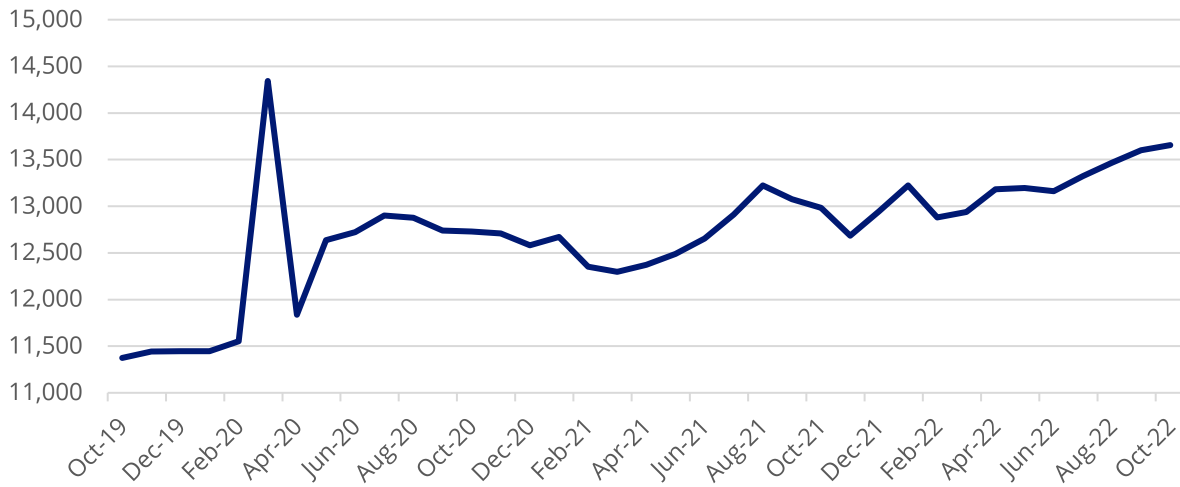
Consumer Staples stocks returned -3.6% in 2022, lagging the benchmark by over 4%. While the performance in the past year was underwhelming, we think the sector will offer some defensive benefits this year as inflation continues its upward trajectory. Generally the demand for staples are price inelastic – volume holds up well even with price increases.

Woolworths (ASX: WOW)

For the past year Woolworths generated -8.4%, significantly trailing the consumer staples sector by 4.8%.

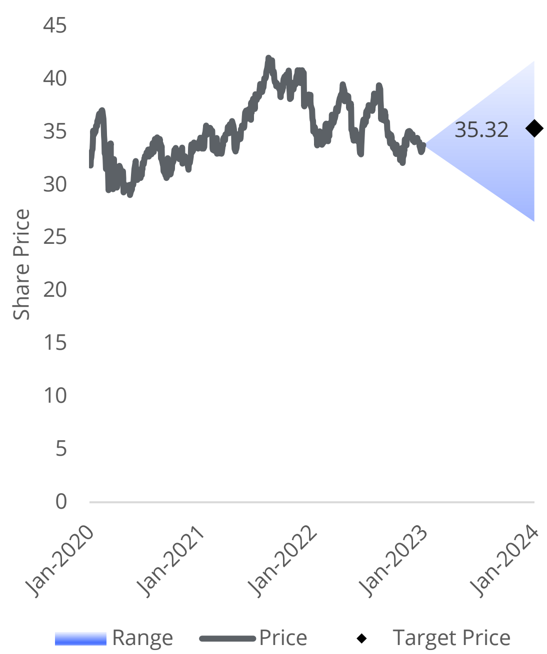
Woolworths as Australia’s largest supermarket chain possesses a sticky consumer base, and is well positioned to pass through any cost inflation to protect its margins. Additionally, the steady increase in food retailing bodes well for the company’s growth into 2023 and offers defensive characteristics. The company also continues to sharpen its e-commerce capabilities via personalized shopping trends and targeted discounts, which might prove to be a competitive advantage among its rivals.

Seasonally adjusted ($m)



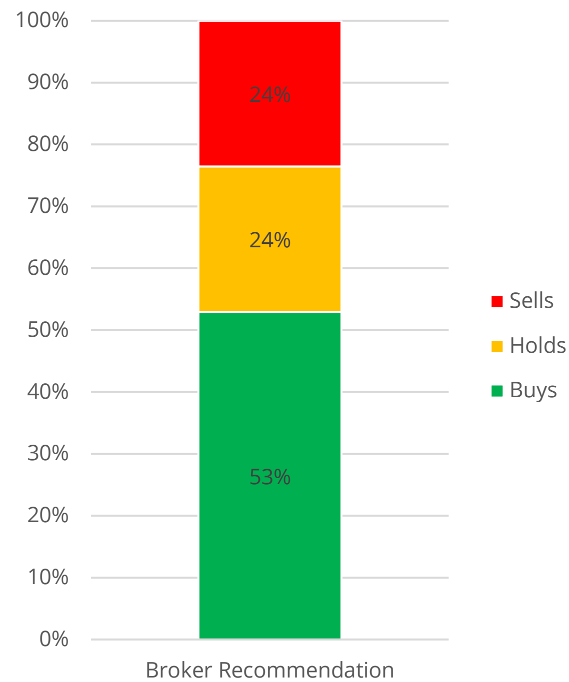
Source: ABS as at October 2022

Median Share Price 12-month target (+4%)



Source: Bloomberg, as at 10 January 2023.

Broker buy/hold/sell split (17 analysts)



Source: Bloomberg, as at 10 January 2023.

Conclusion

An Australian soft landing is likely. Australia on balance, is much better positioned than most countries to manage economic challenges in 2023. Wage growth has been relatively modest, and, the return of migration over the next 12 months will likely ease the labor market tightness. Australia also has abundant natural resources in short supply globally.

For 2023 we expect Australian equities to continue to outperform global equities. We favour Resources, REITs and Consumer Staples, are neutral on Banks and underweight Consumer Discretionary. During the year we expect to see improving relative performance from small cap and mid cap stocks.

We forecast the RBA cash rate to peak at 3.85% with the AUS 10yr yield to remain around the current 4% level, and we may see an inversion of the curve which could support bond proxies like REITs, infrastructure and utilities.

The caveat to the above is a) if the US experiences a recession b) Australian housing market and c) an exogenous shock.

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